Emerging East Asia—A Regional Economic Update

Economic Performance in the First Half of 2007

GDP Growth

Economic growth in emerging East Asia was likely stronger than expected in the first half of 2007, buoyed by strong consumption growth and external demand, and the rapid 11.5% growth in gross domestic product in the PRC.

Combined gross domestic product (GDP) in the nine largest economies grew by over 8.1% in the first quarter of 2007 (Q1), marginally lower than 8.2% in 2006, supported by strong consumption growth and external demand (Figure 1). In the first half of 2007, the People’s Republic of China’s (PRC) economy grew by 11.5%. In the year to March 2007, GDP growth was 5.6% in the four middle-income countries of the Association of Southeast Asian Nations (ASEAN-4), above 2006 levels. However, the four newly industrialized economies (NIEs)—Hong Kong, China; Republic of Korea (Korea); Singapore; and Taipei, China—moderated in Q1, with GDP growth slowing to 4.5%, from 5.4% in 2006.

Excluding the PRC, domestic demand in the region weakened slightly but remained solid in Q1 due to somewhat slower investment, while private consumption was stronger than in 2006, growing by 4.0% (Figure 2). The external sector continued to contribute strongly to the expansion as resilient consumption in the United States (US) and a strong recovery in Europe underpinned export demand.

Early data suggest the region continued robust growth in the second quarter of 2007 (Q2), with industrial production in several economies looking strong (Figure 3). PRC industrial production grew faster in Q2 than the Q1 average, while industry in Korea and Indonesia maintained last year’s strong momentum. Industrial growth in Thailand and Malaysia slowed, and the decline in the Philippines slowed in April. Second-quarter retail sales in the region also stayed healthy (Figure 4).

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1. The nine largest emerging economies are People’s Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.
2. Unless otherwise noted, all growth figures are year-on-year (y-o-y).
In the PRC, strong investment and solid consumption continued to support high growth as the investment boom regained force in 2007, having slowed in the second half of 2006. The Q2 growth rate of 11.9% was the highest in 12 years. Fixed-asset investment grew 26% (year-on-year) in the first 5 months of 2007, compared with 24% in 2006. Steady consumer spending saw retail sales trending upward through June, while externally, merchandise exports remained a key driver—the trade surplus in the first half of 2007 was $113 billion, almost double the amount in the first half of 2006.

Domestic demand in the ASEAN-4 economies also remained solid, due to strong private consumption, as public sector salary hikes and higher overseas remittances propped up household income (Figures 5–6). In Thailand, however, consumption growth was recently at its weakest in 6 years as political uncertainty continued to weigh down private spending. Government spending—election-related expenditures in the Philippines and infrastructure program disbursements in Indonesia, Malaysia, and Thailand—also boosted total consumption and investment. While investment picked up slightly in Malaysia during the first quarter, it was generally weak among the ASEAN-4 economies (Box 1), contributing only about 1% of total growth of 5.6% (Figure 7). In Thailand, investment contracted for two consecutive quarters as the political environment remained somewhat uncertain. Steady exports continued to contribute to solid growth in ASEAN-4 (Figure 8), although performance varied: external demand was steady for most ASEAN-4 economies, but exports slowed markedly in Malaysia. In the Philippines, continuing currency appreciation—mainly due to recent strong overseas worker remittances—has bolstered private consumption but hurt manufacturing. However, this effect on industry appears to be less severe than a similarly adverse exchange-rate effect associated with natural-resource earnings—popularly known as “Dutch disease”—because recipients of remittance inflows are more widely distributed.

Solid consumption has also fueled growth in some NIEs. In Hong Kong, China, rising income, strong employment, and buoyant equity markets underpinned an expansion in private consumption. In Korea, private consumption continued to recover steadily from the household debt-related contraction in 2003. In Singapore, however, private spending remained weak due to a slowdown in spending on motor vehicles, housing, and utilities. There was
weak private consumption in Taipei, China as well, due to high credit card debt. Investment performance was also mixed among the NIEs (Figure 9). Fixed investment, specifically in plants and facilities, has picked up in Korea, indicating a stronger corporate sector. Private investment remained strong in Singapore, supported by rapid growth in the services and construction sectors. However, investment slowed in Hong Kong, China and in Taipei, China. The NIEs external sector slowed somewhat in the first quarter, meanwhile, with net exports contributing 1.6% to aggregate growth of 4.5%.

Inflation

Inflation continued to fall in most ASEAN economies, but started to rise in PRC, Korea, and Singapore.

Headline inflation continued to fall in most ASEAN economies and remained low in Hong Kong, China and Taipei, China. However, it has started to rise in the PRC, Korea, and Singapore (Figure 10).

In the PRC, consumer price inflation hit a 2-year high of 4.4% in June from a low of 1% in July 2006, breaching the official target of 3% for 2007 and adding pressure on the central bank to further tighten monetary policy. Surging food prices—up more than 7.6% year-on-year in June—have driven the rise in recent months, although the main underlying factor remains the ample liquidity feeding the booming economy. The inflation rate is above the return on bank deposits, thus encouraging more flows to the already overheated stock markets, complicating government efforts to cool them down.

In ASEAN-4, inflation has stabilized. Headline inflation in Malaysia, the Philippines, and Thailand has been steady over the past 3 months, although as 2007 began it eased in the Philippines (helped by the strong currency) and in Thailand (on weaker domestic demand). In Indonesia, which dominates the ASEAN-4 trend, the one-off inflationary effects of the 2005 energy subsidy reductions have faded, with inflation dropping from more than 15% in June 2006 to 5.8% in June 2007 (Figure 11).

Inflation edged up in Korea and Singapore, but otherwise remained relatively contained in the NIEs, thanks partly to exchange rate appreciations. The most recent figures show that inflation remained low in Hong Kong, China and Taipei, China.
Headline inflation in Korea has been more or less unchanged in recent months, but core inflation rose to about 2.3% in the second quarter of 2007, from 2% in late 2006, as housing and utility costs increased (Figure 12). In Singapore, rising food and petrol prices drove inflation higher in the first five months of 2007.

**Balance of Payments**

*Throughout the region, current account surpluses were sustained in the first half of 2007, while capital inflows remained strong, contributing to healthy balance of payments positions.*

While regional export growth by value softened in the first half of 2007, import growth slowed even more, increasing the trade surplus. Slower export growth was due largely to the cyclical information technology (IT) industry, while sluggish domestic investment growth constrained import growth. Capital inflows continued their strong trend and, coupled with foreign exchange market interventions, international reserves continued to build across the region (see *Policy Options for Managing Capital Flows*, page 35).

In the PRC, the balance of payments (BOP) for the first half of 2007 likely continued the strong trend seen in 2006 (Table 1a). The huge trade surplus came from a strong export performance, due in part to a rush of orders before 1 July, when certain tax rebates on exports were either reduced or abolished. Accelerated or delayed export receipts and import (or foreign debt servicing) payments—possibly as the private sector became more adept at circumventing capital controls—may also have contributed to the bigger trade surplus.

Despite a slowdown in ASEAN-4 exports in the first half of 2007, the aggregate trade surplus remained high (Table 1b). The current account balance improved dramatically by 58% year-on-year in Q1, maintaining a healthy overall BOP position despite a small deficit on the financial account. Thailand led the region with its strong export growth fueled by electronics and vehicles. Export growth has eased somewhat in Malaysia, but remained robust in Indonesia in recent months. The Philippines has run trade deficits, but posted current account surpluses due to stronger remittance inflows—reaching the equivalent of about 11% of GDP in recent quarters. Similar to 2006, the ASEAN-4 aggregate financial

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**Figure 9: Fixed Assets Growth (y-o-y, %)**

Note: PRC figures are based on nominal fixed-asset investment growth (year-to-date).
Source: OREI staff calculations based on CEIC data, Hong Kong Monetary Authority, and Central Bank of China. (Taipei, China).

**Figure 10: Regional Inflation—Headline Rates (y-o-y, %)**

Sources: OREI staff calculations based on CEIC data, Hong Kong Monetary Authority, and Central Bank of China. (Taipei, China).

**Figure 11: Inflation in Selected ASEAN Economies—Headline Rates (y-o-y, %)**

Sources: OREI staff calculations based on data from CEIC and *International Financial Statistics* (IMF).
Table 1a: **Balance of Payments—PRC** (% of GDP)

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Sources: International Financial Statistics Online (IMF) and CEIC.

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

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Sources: International Financial Statistics Online (IMF) and CEIC.

Table 1c: **Balance of Payments—NIES** (% of GDP)

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Sources: International Financial Statistics Online (IMF) and CEIC.
account was roughly balanced in Q1. While the direct investment and portfolio investment accounts enjoyed a comfortable surplus at the end of the first quarter, the “other investment” account has been persistently in deficit, partly due to debt repayments.

The NIEs had strong current account surpluses in Q1—except for Korea, which was running a small deficit (Table 1c). The reversal in Korea was due largely to a huge deficit in services trade caused by persistent growth in outbound tourism. Hong Kong, China’s strong services trade and income surpluses led to a healthy current account surplus, despite a deficit in the trade of goods. The NIEs financial account performance has been quite diverse—capital flowed into Korea, out of Taipei, China and Singapore, and was in balance in Hong Kong, China. First-quarter capital outflows were mainly bank-related in Singapore and portfolio-related in Taipei, China. In Korea, net inflows in “other investments” were 70% above net outflows in portfolio investments—a trend over the past year or so indicating that borrowing from foreign banks might be increasing. The NIEs aggregate trade surplus decreased in recent months as export growth fell, despite easing import growth.

Financial Markets and Exchange Rates

Financial markets gained across the region in the first half of the year despite some volatility, with policymakers in several economies increasingly anxious about the risk of a possible equity market bubble developing.

After a bout of nervousness in late February and early March—following a temporary plunge in PRC markets—stock markets showed volatility again in May and June, unsettled by rising long-term interest rates. Gains in equity prices through early July ranged from 10% in Taipei, China to 26% in the Philippines (Figures 13–14). In the PRC, the combined stock price index for Shanghai and Shenzhen markets gained 43% in the first 6 months of 2007, on top of a 148% rise in 2006.

In late May, the PRC stock markets tumbled as the government tripled the stamp duty on stock trading and tightened monetary policy in a bid to dampen the strong rise in asset prices; although the markets recovered somewhat since. The possibility of a sudden unwinding of yen-carry trades exacerbates any volatility.
in emerging East Asia’s financial markets. This could happen if Japan raises interest rates and investors who had previously borrowed yen to invest in high-yielding emerging market assets and currencies decide to close their positions.

Despite market interventions, regional currencies appreciated 3% on average against the US dollar due to strong balance of payments positions.

Regional authorities continued to intervene in foreign exchange markets to curb appreciation, evident in rising foreign exchange reserves. In the year to date, the Philippine peso (up 7.4%) and “offshore” Thai baht (up 19.5%) continued to outperform other currencies (Figures 15–16). In both economies, growing current account surpluses have supported the rise, and the Bank of Thailand’s scaling back of controls on capital flows may also have encouraged capital inflows in the first half. The PRC renminbi appreciated by about 3% in the first half. Other regional currencies were fairly stable.

As inflation eased, yield curves in the ASEAN-4 economies, particularly Indonesia and Thailand, continued to shift down in the first 6 months of the year (Figures 17a–17b). By contrast, yield curves in some NIEs shifted upward from December through June 2007 as the central banks took on a tightening bias in Q2 and world interest rates rose overall. PRC interest rates are also climbing as authorities struggle to cool the overheating economy (Figure 17c). Yield curves also steepened in some economies in the first half, mirroring the world trend. In Thailand, long yields fell as demand for bonds with longer maturities increased while lower policy interest rates pushed yields on shorter maturities down even further.
Monetary and Fiscal Policy

Monetary policy responses varied across the region—with PRC; Korea; and Taipei, China tightening policy, Malaysia keeping policy rates unchanged, while policy rates in Indonesia, Philippines, and Thailand were lowered.

Several emerging East Asian economies tightened conditions in an attempt to rein in inflation or excessive growth, while others remained neutral or eased conditions in response to falling inflation (Figure 18).

In the PRC, the central bank has raised its benchmark rate three times thus far in 2007 (0.81 percentage point total) and the reserve requirement ratio five times (2.5 percentage points in total) as it tries to rein in powerful growth and surging stock markets. The government also cut the interest income tax from 20% to 5% on 20 July. Interest rates remain very low, however, and there is growing concern that this is feeding resurgent investment and asset price inflation. The authorities have also placed restrictions on loans for stock purchases and raised the stamp duty on share trading, while the central bank in May widened the renminbi trading band against the US dollar from 0.3% to 0.5%. M2 money supply in recent months was growing more than 17%, slightly higher than the 16% central bank target (Figure 19). Monetary tightening is widely expected to continue.

In July, Bank Indonesia (BI), the central bank, cut its policy rate by 25 basis points to 8.25%, the first time it dipped below the level set when the target was introduced in July 2005—just before the central bank was forced to raise rates steeply as the rupiah weakened. Malaysia has kept policy rates steady for over a year. The Bank of Thailand cut its policy rate on 18 July to 3.25%, for a total of 150 basis points since early January. The Philippine central bank, Bangko Sentral ng Pilipinas (BSP), cut its policy rate from 7.5% to 6% on 12 July—at least partially offset by removing its tiered interest-rate system for bank placements with the BSP—and increasing the overbought foreign exchange limit of commercial banks. The rate cut aims to alleviate the continuing appreciation of the Philippine peso and to stimulate sluggish investment.
Among the NIEs, monetary policies converged. Amid robust growth and increasing inflationary pressures, the Bank of Korea tightened its key policy rate to a 6-year high of 4.75% in July 2007, the first hike since August 2006. Taipei, China has adjusted its monetary policy cautiously since 2006, bringing it to a more neutral level—its comparatively lower interest rates have encouraged capital outflows and put downward pressure on its currency. As the Singapore dollar appreciated, monetary conditions in Singapore continued to tighten, though the 3-month interbank rate has fallen by about 100 basis points thus far in 2007.

The trend toward withdrawing fiscal stimulus and strengthening public finances—begun in 2002—continued into 2007.

Fiscal prudence continues to be the dominant trend in emerging East Asia (Table 2). In the PRC, the fiscal position has improved steadily, as strong economic growth and improved revenue collection led to much higher revenues and a lower deficit than was planned in the 2006 budget. The budget for this year calls for a slight increase in the deficit, however.

In ASEAN-4 economies, following successful fiscal consolidation in recent years, the Indonesian government is poised to increase investments to improve growth prospects. The challenge is to keep the budget deficit around 1.0% of GDP in 2007 and to reduce government debt to 30% of GDP by 2009 while promoting a better investment climate and infrastructure development.
Despite stronger-than-expected oil-related revenues, Malaysia’s fiscal position is expected to deteriorate slightly this year because of new investment projects and development programs planned under the Ninth Malaysian Plan. Thailand has seen its small surplus gradually decline, and this year expects to run a slight deficit even as it limits efforts to accelerate infrastructure spending in key utilities and services. In the Philippines, after slicing its deficit sharply over the past several years, the government missed its revenue target as well as the budget deficit ceiling set for the first quarter of 2007.

Among the NIEs, Singapore generally runs a healthy surplus. The Hong Kong, China budget moved into surplus in 2004–05. Taipei, China has seen its fiscal deficit gradually improve, though its deficit for this year is planned to increase slightly. And Korea’s deficit has increased over the past several years, though in marginal increments.

**Assessment of Financial Vulnerability**

*Against a background of favorable economic conditions, financial sectors in the region have generally remained strong, although there are several signs of stress related to sharply higher asset prices in several markets.*

While financial systems in the region are now less exposed to changes in debt-related capital flows than a few years ago, new risks related to the movement of banks into activities such as household lending, securities, and property have emerged (see *Emerging East Asian Banking Systems: Ten Years after the Crisis*, page 54). National authorities will need to remain vigilant to curtail excesses in particular markets to ensure that lending standards are not compromised and that banks contain their exposure to market risk—among other risks that require monitoring.
Table 3: **Public and External Debt** (% of GDP)

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<td>70.5</td>
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<td>51.5(^p)</td>
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<td>31.7</td>
<td>29.5</td>
<td>27.5(^p)</td>
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<td>33.9</td>
<td>32.5(^e)</td>
<td>32.6(^p)</td>
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</tbody>
</table>

\(^p\) = projection, \(^e\) = estimate

\(^1\) Central government debt.

\(^2\) Nonfinancial public sector debt.

Sources: Article IV Consultations, various issues (IMF); and national sources.

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**Prudential Indicators**

**Prudential indicators for regional banking systems remain strong and sizable capital cushions have been created.**

Generally favorable economic conditions in recent years—relatively rapid GDP growth and generally low inflation—have played a key role in helping banking sectors in the region return to strong profitability and build up sizable capital cushions, following the insolvencies arising from the 1997/98 Asian financial crisis. Declining public and external debt burdens (Table 3) and improved sovereign risk ratings (Figure 20) have also been important contributions to this trend.

Progress in improving asset quality and sustaining high regulatory capital ratios in regional banking systems continued in the first half of 2007 (Table 4a). Nonperforming loan (NPL) ratios have remained low or have fallen further in most banking systems in the region, even as significant differences persist across economies (Table 4b). At the same time, after increasing sharply in many economies, regulatory capital ratios have been sustained at generally high levels across the region.
Regional banking system improvements have been reflected in relatively high rates of return on bank assets (ROA) and equity (ROE) (Tables 4c–4d) although these data should be interpreted cautiously. Recent returns may be only temporarily boosted by the current benign conditions in financial markets—to the extent to which bank income is increasingly derived from...

Table 4a: **Risk-Weighted Capital Adequacy Ratios**

<table>
<thead>
<tr>
<th>Country</th>
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<th>2004</th>
<th>2005</th>
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... = not available.

Note: Based on officially reported risk-adjusted capital adequacy ratios under Basel I and applied to commercial banks (except Korea, where data includes nationwide commercial banks, regional banks, and specialized banks). Data for the Philippines is on a consolidated, not solo, basis. Data for Japan is for major commercial banks only.

1 Data for Indonesia as of January 2007.
2 Based on Basel II calculation.
3 Data for Singapore as of September 2006.

Source: National sources.

Table 4b: **Nonperforming Loans**

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Memo items: compromised assets ratio (Indonesia) and nonperforming assets ratio (Philippines)

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</table>

... = not available

1 Reported nonperforming loans are gross classified loan ratio of retail banks.
2 As of September 2006.
3 As of June 2006.

Notes:
1. The table excludes NPLs transferred from bank balance sheets to asset management companies.
2. The measurement of NPLs follows official definitions and differs across economies depending on loan classification (for example, whether a 3-month or 6-month rule is used), the treatment of accrued interest, and whether specific provisioning is deducted from the NPL measure.
3. For Malaysia and the Philippines, reported NPLs are net of specific provisioning.
4. Compromised assets ratio includes reported NPLs, restructured loans, and foreclosed assets for the 16 largest banks in Indonesia; distressed asset ratio refers to the ratio of NPL + real and other properties owned and acquired (ROPOA) + restructured loans, current to total loan portfolio (TLP), gross + ROPOA.

Sources: National sources; CEIC; and Financial Stability Report (IMF).
### Table 4c: Rate of Return on Commercial Bank Assets (% per annum)

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... = not available.  
1As of September 2006.  
Sources: CEIC and national sources.

### Table 4d: Rate of Return on Commercial Bank Equity (% per annum)

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...= not available.  
Note: Last quarter or month of period.  
1As of November 2006.  
2As of September 2006.  

securities investments and fees, and not from the core business of lending. Also, generally high reported returns are premised on an appropriate accounting for asset quality and provisioning. Any shortcoming in these areas can lead to an overstatement of the ROA and ROE.

### Activity Indicators

*Against generally subdued lending to the business sector, banking systems in the region have been moving into investment banking and other new activities.*

In much of the region, securities investments now represent a significant share of bank assets, while lending has been relatively strong in sub-markets such as consumer finance and real estate. Although this shift has helped to strengthen income, it has also changed the risk profile of banking systems and exposed them to
new risks related to interest rates, equity prices, the household sector, and conditions in property markets.

Securities investments (including sovereign bonds) now represent a significant share of bank assets in the region, exposing banks to new kinds of risks (Table 5). While holdings of sovereign and highly-rated private bonds tend to reduce the credit risk banks assume—compared with general business lending—they tend also to increase the exposure to market risk. In response, authorities in the region have been enforcing capital requirements for market risk under Basel I—and with effect on 1 January 2007 under Basel II in Hong Kong, China—and have been stress testing their banking systems to increases in interest rates and market volatility. While the results of these tests generally imply enhanced robustness, new important sources of risk are apparent (see Box 5).

Secured and unsecured household lending are also becoming more important in the region (Table 6a–c), making banks vulnerable to a sharp correction in real estate prices. Given that growth has generally come off a low base, total household indebtedness in relation to GDP still remains low in most economies in the region, but has risen to over 40% of GDP in Hong Kong, China; Korea; Malaysia; Singapore; and Taipei, China. Of this, a significant share is mortgage-related, rather than unsecured credit. As a result, real estate-related loans (as classified by national authorities) have accounted for an increasing share of total financial sector lending in many economies (Figure 21). While helping to sustain

---

**Table 5: Securities Investment to Total Assets of Commercial Banks (%)**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
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<th>2005</th>
<th>2006</th>
<th>2007Q1</th>
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</tbody>
</table>

... = not available.

Note: For Indonesia, claims rather than securities data are used.
As of February 2007.
Sources: CEIC, Hong Kong Monetary Authority, Bank Indonesia, and Bangko Sentral ng Pilipinas.

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3 A large part of Hong Kong, China’s household indebtedness is mortgage loans, which as a ratio of GDP tend to be high because of the high price of residential property.
### Table 6a: Household Indebtedness (% of GDP)

<table>
<thead>
<tr>
<th></th>
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### Table 6b: Household Non-mortgage Indebtedness (% of GDP)

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### Table 6c: Household Mortgage Indebtedness (% of GDP)

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</table>

... = not available.

1 Sum of loans for personal use, credit cards, purchase of consumer durable goods, and purchase of passenger cars for commercial banks, merchant banks, and finance companies. 2006 and 2007 data from commercial banks and merchant banks only.

2 Refers to consumer loans from commercial banks and finance companies.

Sources: CEIC; Monthly Statistical Bulletin, Bank Negara Malaysia; Monthly Statistical Bulletin, Monetary Authority of Singapore; and Hong Kong Monetary Authority.

profitability, this has increased banking systems’ exposure to sharp declines in real estate prices. In response, national authorities have been seeking to enforce increasingly conservative loan-to-valuation ratios in real estate lending—limiting a property loan to, say, a maximum of 70–80% of property value. The aim is to ensure adequate cushions for financial institutions in the event of property price corrections. In addition, measures have been implemented in several economies to cool real estate and other markets that have been excessively frothy. In the PRC, a series of measures over the past 3 years has been implemented to limit run-ups in real estate markets and, most recently, to
cool down the richly valued stock market. In Korea, as property prices continued to rise in the Seoul region, the government has implemented new measures to alleviate apartment shortages and curb speculation. In Viet Nam, commercial banks have boosted lending to local investors, leading to a sharp increase in equity prices.

**Market Indicators**

*Given the extensive restructuring of the banking sector in many economies—and the high levels of official support provided—a relatively stronger bank performance might have been expected.*

Assessments by credit rating agencies, as well as the performance of bank shares generally, paint a somewhat less encouraging picture of banking systems than the officially-reported indicators (see Table 18). Based on historical experience, however, credit ratings have tended to lag rather than lead changes in performance and it may be that ratings will eventually be upgraded, provided recent improvements in banking performance are sustained. In terms of bank share prices, the picture is not uniformly favorable. On a positive note, weakness in bank share prices relative to overall indices has been partially reversed in Korea and Malaysia, and bank share prices recently have been slightly outperforming the market in Malaysia (Figures 22a–b). Elsewhere, however, with the exceptions of Singapore and Hong Kong, China, banks have been underperforming the market, in some cases by growing amounts. In view of the sharp rise in many regional equity markets in recent years, comparing bank performance relative to the overall market might be an exceedingly demanding benchmark.

External Economic Environment

In 2007, the world’s major industrial economies should continue to make the transition to lower yet more sustainable growth rates.

Economic growth in the Organisation for Economic Co-operation and Development (OECD) is projected to slow from 3.2% in 2006 to 2.7% in 2007. Large output gaps in the OECD economies—resulting from the 2001 global downturn—closed substantially in 2006, and capacity utilization rates are expected to tighten further in 2007 (Figure 23). Thus, persistently tight global and national resource markets in key economies will keep monetary authorities vigilant against inflation.

The US economy is likely heading toward a soft landing in 2007, with inflation contained and the current account deficit likely to narrow somewhat.

After slowing to about 2.2% in the second half of 2006, GDP growth dipped further to 0.7% (annualized quarterly growth) in the first quarter (Q1) of 2007. The effects on construction from the housing market correction and on manufacturing from an inventory drawdown are likely to continue to constrain growth in 2007 (Figure 24). Housing starts have stabilized in the past few months, but were still down 29% from a year ago. New manufactured goods orders barely increased in the first 5 months of 2007, compared with the same period of 2006. However, unemployment remains at a 6-year low and personal income is growing, which should help limit the depth and breadth of the slowdown. While headline inflation climbed to 5.0% during Q1, from 2.5% in 2006, due to large rises in energy and food prices, core inflation declined to 2.3% in the first half, from 2.6% in 2006. Inflation in general is expected to remain under control. After growing by nearly 10% in 2006, real exports stalled in Q1, while real import growth surged to 5.5%. The US current account imbalance remains substantial. While the US Federal Reserve kept its official rate steady on 28 June, and has done for 12 months, the US yield curve steepened in recent months as long-term rates rose sharply.
In the euro area, after hitting a 6-year high of 2.7% in 2006, GDP growth is expected to remain strong, while inflation could drift higher, with the current account remaining more or less balanced.

In Q1, the euro-area economy held firm on the back of robust investment and German industrial strength, expanding 3.0% over the previous year (Figure 25). However, that pace is likely to moderate somewhat as a slowing US economy and a stronger euro dampen export growth, and further monetary tightening cools domestic demand. Nonetheless, improved economic sentiment, bolstered by stronger fundamentals such as faster productivity growth, should sustain GDP growth in 2007 (Figure 26). Euro-area inflation rose above 2.0% for most of 2006, peaking at 2.5% in Q2, before easing slightly below 2% in the first 5 months of 2007. However, as resource markets tighten and the recovery appears set to be stronger, inflation may rise in the short term. After raising the official rate to 4% in June, the European Central Bank maintained its key rate at its July meeting, but said that “the medium-term outlook for price stability remains subject to upside risks.”

GDP growth in Japan is projected to reach about 2.5% in 2007, slightly above the 2.2% rate in 2006.

Supported by a rebound in consumer spending, Q1 GDP growth rose to 3.3% (annualized), from 2.2% in 2006 (Figure 27). While external demand eases, Japan’s private demand growth will likely stay robust in 2007, bolstered by a still-accommodative monetary stance and by resilient consumer and business sentiment (Figure 28). Headline inflation will remain close to zero in 2007, reflecting moderate wage growth and the base effect of a re-weighting of the consumer prices index basket. The weak yen has been a major support for Japanese corporations and, together with strengthening domestic demand, underpins Japan’s economic expansion. The Bank of Japan raised its policy rate in February 2007 and kept the rate unchanged at recent meetings, but has stressed that inflation is likely to follow a positive trend in the longer term.
World trade volume growth will likely moderate slightly in 2007 from the above-trend growth of nearly 10% in 2006, as growth slows in several key economies and adjustments to inventory levels affect global industrial production.

Overall, the projected slowdown in world trade growth is expected to be relatively modest, as OECD leading indicators suggest industrial production is poised for a rebound. Meanwhile, a sustained rise in demand for information technology—boosted by the rapid growth of Internet use for increasingly sophisticated activities—bolsters medium-term prospects for high-tech manufacturing. After falling in mid-2006, the semiconductor book-to-bill ratio rose in recent months from 0.94 in October 2006 to 1.0 in May 2007.

Energy and commodity prices are expected to remain elevated, given tight supply conditions.

Crude oil flirted with record highs (just under $80) in July on expectations that demand will pick up in the summer travel season in the northern hemisphere. At the same time, limited spare capacity and continued geopolitical uncertainties will leave prices subject to volatility. Other commodity prices, including metals, grains, and fats and oils, made significant gains through to June 2007 (Figure 29). They have yet to clearly show the moderating trend widely expected in 2006.

While the current monetary tightening cycle may have reached its peak in the US, official interest rates may continue to rise in other parts of the world in 2007.

The US Federal Reserve paused in its step-by-step tightening of policy in June 2006, but other major economies continued to tighten over the second half of the year, and into 2007. In early June 2007, a sharp sell-off in bond markets pushed up the yield on the 10-year US Treasury bond to its highest level since 2002 (Figure 30). Yield curves in the euro area, where markets appear to anticipate further rate hikes, shifted upward and steepened.

While interest rates are rising in industrial countries, emerging market sovereign spreads on US dollar debt remain relatively compressed, although they have widened a little from late 2006 lows (Figure 31). Corporate spreads are also rising and there is
A period of stable gains in global financial markets is giving way to a return of volatility amid reemerging investor sensitivity to risk.

After corrections in February and March 2007, equity markets continued to rise. Posting an 18.8% increase in 2006, the world Morgan Stanley Capital International Inc. (MSCI) Index was up by 8% for the first half of 2007 (Figure 32). The sharp rise in long-term bond yields may signal that ample global liquidity is evaporating, which could lead to a rise in volatility as financial markets re-price risk. Despite recent developments, global financial volatility is expected to remain manageable and its impact on global economic activity limited. In the US, for example, deterioration in asset quality is thus far primarily confined to sub-prime mortgage markets.

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.

Leading indicators released in recent months are showing signs that industrial production may soon pick up, pointing to prospects for solid if somewhat softer growth of external demand for regional products (Figure 33). Inflation risks, however, tend to the upside because global spare capacity is shrinking and commodity prices have remained elevated in recent months. If the recent rise in long-term interest rates in industrial economies is sustained and extended, this may encourage stronger capital inflows back to those markets and help alleviate currency pressures in emerging markets. With resource markets relatively tight, global monetary policy rates should remain near cyclical peaks or climb higher. As risk spreads come off recent lows amid a return to volatility, financial conditions will warrant close monitoring.
Regional Economic Outlook for 2007–2008

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.

In general, emerging East Asia economies appear poised to continue to enjoy strong economic expansions in 2007 and 2008, but below the high 8.4% GDP aggregate growth rate of 2006 (Table 7). Mirroring external trends, aggregate emerging East Asia exports should moderate in 2007 from very high growth in 2006. The region's export growth was rapid in 2003–06 because of increasing export volumes and rising export prices, especially for commodities. As expansions mature in major industrial economies, export volume growth is likely to taper off while, in some cases, export prices are expected to fall as well. This latter effect will have a greater impact on the commodity-exporting ASEAN economies, which are forecast to see a drop in export growth in 2007. PRC export growth is forecast to slow as some policy measures (such as reductions in tax rebates for exports) start to take effect.

The PRC economy is forecast to maintain its strong growth momentum in 2007, but is expected to moderate somewhat in 2008, primarily due to tightening policy actions—introduced in late 2006 and this year—to curb strong investment and asset price inflation.

GDP growth in the PRC is projected to ease marginally to 11.0% in 2007 from 11.1% in 2006, due to falling growth in fixed-asset investment, a gradually appreciating renminbi, continued monetary tightening, and an expected slight deceleration in the growth of external demand. However, the offsetting stimulus of increased public spending, especially related to the 2008 Olympic Games and efforts to encourage the rural economy, should sustain rapid growth in 2007.
Table 7: Annual GDP Growth Rates (%)

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... = not available

1 Aggregates are weighted according to gross national income levels (atlas method, current $) from World Development Indicators (World Bank).
2 Excludes Brunei Darussalam and Myanmar for all years as weights are unavailable.
3 For Indonesia, GDP growth rates from 1996–2000 are based on 1993 prices, while growth rates from 2001 onward are based on 2000 prices.
4 For FY April–March.
5 Figures for FY April–March are not linked to the GDP figures 2003 backwards due to NSO revisions of sectoral estimates.
6 Forecasts for People’s Republic of China, euro area, Japan, Philippines, and United States have been updated from the March 2007 issue of the Asian Development Outlook (ADO) based on revisions supplied by the ADO team.

In the NIEs, moderating external demand combined with country-specific domestic demand factors will likely slow GDP growth to 4.7% in 2007 and 4.8% in 2008.

Consumption and investment growth are likely to slow in Korea, as consumer and business sentiment sag under the weight of concerns about a strong won and the sustainability of high real estate prices. In Singapore, in contrast, rising consumer demand and a fading inventory correction are partly offsetting the effects of a moderation of fixed-investment growth, which expanded rapidly in 2006. And in Hong Kong, China, GDP growth will likely
continue to ease after peaking in 2004 at 8.6% and moderating through 2005–06. For Taipei, China, weaker consumption and investment, held back by high credit-card debt and sluggish industrial production, will lead to lower GDP growth in 2007 than in 2006.

**GDP in the four large economies in ASEAN is forecast to grow 5.3% in 2007 and 5.8% in 2008.**

Despite slowing export growth, the possible harmful effects of El Niño, and lagging structural reforms, Indonesia’s GDP growth is forecast to pick up in 2007, stimulated by moderately supportive fiscal policy, falling inflation, and monetary easing. In Malaysia, growth in domestic demand should remain relatively robust, supported by strong public spending. In the Philippines, the outlook is favorable for 2007; GDP growth accelerated in Q1 and, given capacity constraints, is likely to be higher in 2007. Thailand’s GDP growth is forecast to ease in 2007 because of the lingering effects of the political turbulence and policy uncertainty in 2006. However, an expansionary fiscal policy and an easier monetary stance will help mitigate slower export growth.

Of the smaller ASEAN economies—Cambodia, Lao People’s Democratic Republic (Lao PDR), and Viet Nam—are expected to sustain very robust growth rates in 2007. Viet Nam’s booming economy is forecast to maintain its pace in 2007, after growing 8.2% in 2006, in part because its January 2007 accession to the World Trade Organization (WTO) is expected to spur fixed-investment growth. Cambodia and Lao PDR should see economic growth slowing somewhat in 2007 from recent high rates, which were stimulated in part by liberalization of the global textile market. For Cambodia, GDP growth is forecast to slow from 10.4% in 2006 to 9.5% in 2007, ending 3 straight years above 10%. Similarly, GDP growth in Lao PDR should slip from 7.3% in 2006 to 6.8% in 2007.

With economic expansion remaining strong and oil prices elevated, any further reductions in inflation in the NIEs and ASEAN-4 economies are expected to be limited in 2007. As food prices stabilize, inflation in the PRC should not rise further in the coming quarters. Overall, robust growth, relatively tight labor markets across the region, and higher energy prices are expected to generally increase inflationary pressures throughout the region in 2007.
Current account surpluses are expected to remain very large in 2007 in PRC; Hong Kong, China; Malaysia; and Singapore. However, they are likely to be closer to balance in Indonesia, Korea, Thailand, and Viet Nam. Reflecting trends in global financial markets—world long-term interest rates are on the rise—net capital inflows to the region may remain somewhat volatile during the remainder of 2007. Persistent current account surpluses and net capital inflows will continue to put appreciation pressure on several regional currencies, though to a varying degree. As authorities intervene in the foreign exchange markets to curb appreciation, foreign exchange reserves will continue to rise across the region. Currencies in the region will also appreciate in real terms as inflation potentially heads higher.

Risks to the Outlook

*Despite declining headline and core inflation rates in key industrial economies, inflation remains elevated and—with shrinking output gaps and tight resource markets—could stay that way.*

Recent trends and projections suggest OECD labor markets are becoming relatively tight and wages are beginning to rise faster, even as productivity growth levels or slows (Table 8). While labor income growth lagged both productivity growth and growth of the return on capital during much of the current expansion, there is a risk of faster wage growth that would feed into inflation. In its 28 June policy meeting, the US Federal Reserve noted that the high level of resource use could potentially sustain inflationary pressures. Also, inflationary pressures are showing up in emerging East Asia—in the PRC, for example, inflation increased rapidly in the first half of 2007 as the economy steamed ahead. Sustained government efforts to rein in excessive investment growth have had some success, but there remains a risk of reacceleration, which could add to regional and global inflationary pressures. Labor markets have tightened in several economies in the region (Table 9). If inflation—especially core inflation—remains elevated, monetary authorities in the region would have less flexibility in dealing with possible weakness in economic activity.
The potential for more severe financial market volatility—arising from uncertainty about key economic trends and from heightened market sensitivity to risk—is significant.

The global financial market recovered quickly from the jitters in February and March. The sell-off in the bond markets in early June, however, may be signaling that ample global liquidity is beginning to evaporate. The volatility followed a sustained run-up in global and regional asset prices, and these gains appeared increasingly unrelated to economic fundamentals, leaving markets vulnerable. Investors are skittish partly because of feared losses arising from policy uncertainty. With additional uncertainty arising from conflicting signals about future global economic trends, there is a real risk of further, possibly more severe volatility, which could be accentuated by any unwinding of yen-carry trades. As markets swing between fears of upside and downside risk, the adjustment to reduced global liquidity, until now relatively smooth, could become disruptive, with a sharp re-pricing of risk that would raise regional financing costs. As of the end of June, there was little sign of a re-pricing of risk with sovereign

Table 8: OECD Unemployment (% of labor force)

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<th>2006</th>
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Table 9: Unemployment Rate in Selected Emerging East Asian Economies (%; end of period)

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... = not available
Sources: Official statistics bureaus and Bloomberg.
spreads remaining low. To the extent that lower spreads reflect clear improvement in fundamentals, any deterioration should be limited. However, those economies that previously saw the most rapid spread compression (such as Indonesia and the Philippines) now face a greater likelihood of increasing risk premiums.

**Although it is widely expected that the US economy will pick up in the second half of 2007, uncertainties about its economic trends persist, given market jitters about the possibility that weakness in the sub-prime mortgage market will spread to the wider economy.**

With global liquidity falling amid multi-year bull runs in many asset markets, investors are increasingly sensitive to any evidence of weakness in the 5-year global—and US—expansion. This is especially true of any evidence pointing to a deepening of the industrial production correction or of a wider and deeper impact of the US housing market correction. Emerging East Asian economies are vulnerable to further slowing of growth if external demand turns out weaker than expected.

The impact of recent swings in global financial flows—with investors searching for yield while oscillating between fears of recession and inflation—are exacerbated by vulnerabilities within the underlying global payments imbalances. Large and persistent structural payments imbalances and the associated policies have impact on market outcomes. Perceived exchange rate misalignments in emerging economies encourage local and global investors to take risks. This is especially true given prevalent views that these imbalances will eventually be unwound by a weakening US dollar. At the same time, however, sudden changes in risk perceptions on emerging markets can send investors fleeing for the security of deeper markets and safer assets. Recent research suggests that persistent global payments imbalances may arise partly due to sharply differing levels of financial depth between developed and emerging markets. These imbalances are unlikely to be corrected solely by a rebalancing of global sources of growth away from the US, and will likely require significant exchange rate movements. A disorderly adjustment in the global payments imbalance could lead to a sharp contraction of US aggregate demand and could be accompanied by a rapid fall in investor confidence, which would have a serious impact on the region.
Severe noneconomic disruptions, such as a geopolitical shock or an avian flu pandemic, may have a relatively low probability, but potentially could still impose large costs on global and regional economies.

Given present inflation and recession risks, a large oil price shock could ignite an episode of stagflation. This would be particularly true if the source of the shock were geopolitical—such as an increase in instability in the Middle East. The potential for a global health pandemic also remains a risk. Avian flu, for example, again made international headlines when infected poultry appeared in the United Kingdom in January 2007 (Table 10). In the region, Indonesia continues to see significant numbers of human cases and casualties. Finally, there is a risk of damage from natural disasters arising, for example, from an El Niño pattern, or even anomalous weather patterns associated with possible global warming.

Table 10: **Confirmed Cases of Avian Influenza A/(H5N1)—as of 29 June 2007**

<table>
<thead>
<tr>
<th>Date of Onset</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<td></td>
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<tr>
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<td>70</td>
<td>44</td>
<td>69</td>
<td>61</td>
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Notes:
1. Total number of cases includes number of casualties.
2. The World Health Organization reports only laboratory-confirmed cases.
Policy Issues

*Given the outlook for robust and sustained economic growth in the region, and the risks outlined above, monetary authorities in emerging East Asia should be vigilant, attuning policy responses to their individual economic circumstances.*

In economies with rising inflation and surging domestic liquidity, such as the PRC and possibly Korea, there is a clear case for more monetary tightening. In those with benign inflation, however, authorities may have more room to support growth. In other cases, such as Indonesia and Thailand, continued easing of relatively tight monetary conditions might be warranted if inflation continues to fall. Inflation needs to be managed within the context of expectations that global interest rates will rise further. This in turn has consequences for both the conduct of monetary policies and the management of external balances.

Surging capital inflows have contributed to excess liquidity growth and are associated with significant increases in asset prices. Gross capital inflows to the region have reached record levels, in both absolute terms and ratios relative to GDP, and have direct effects on asset prices in the region. A package of policies is needed to address basic macroeconomic problems complicated by capital flows and specific market problems that capital inflows contribute to. These options include enhancing exchange rate flexibility, carefully crafting any monetary policy response, being cautious on fiscal policy responses, refining or liberalizing capital outflows, and strengthening financial market regulation and supervision.

Administrative restrictions to reduce asset price or exchange rate appreciation should be used with caution. Recent financial market nervousness about the actual or potential imposition of administrative measures to reduce speculation in currency and asset markets indicates the need for a cautious approach. Certainly, as investor euphoria grew, explosive price appreciation in recent months in several regional asset markets became increasingly divorced from underlying economic fundamentals, complicating macroeconomic management. Yet, hurried administrative measures are potentially disruptive and may only temporarily alleviate the symptoms of underlying structural problems. Policy makers should especially strive for effective communication of policy intentions to avoid skittish, rumor-
driven markets. In addition, regulators should be vigilant against imprudent financial sector practices that foster speculation—such as excessive bank lending to stock investors.

Authorities in the PRC have been taking various policy measures to restrain excessive investment in recent years, while investment remains stubbornly low in the ASEAN economies most affected by the crisis.

While the PRC is trying to control the excessive investment of recent years, in ASEAN-4 economies, improvements in the investment climate are needed to help stimulate investment and reduce the potential for speculative bubbles by channeling funds to productive investments and rebalancing sources of growth. The need for action is clear: in some cases, aspects of the investment climate have actually deteriorated over the past decade (Box 1). Governance issues such as policy uncertainty, a weak rule of law, and poor regulatory quality are key areas of weakness. Regional forums such as the ASEAN+3 Economic Review and Policy Dialogue can encourage progress by forging views on “best practice” policies conducive to regional and national economic development, and can provide a collective voice for promoting them.

Measures to develop deeper financial markets in the region can also help reduce the risk of asset bubbles forming in shallow real estate and equity markets, as well as vulnerability to a potentially disorderly correction of the global payments imbalance.

Regional policy makers are well aware of the problem posed by the shallowness of financial markets in the region relative to deeper markets in the US, Europe, and the developed Asian economies. Indeed, the Asian Bond Markets Initiative represents a clear desire to develop efficient and liquid bond markets in the region. Recent global turbulence reinforces the importance of such development. Local investor interest in domestic financial instruments is soaring in the region and financial markets and regulators must keep up. It is not just that financial markets in the region lag global markets in sophistication and depth; financial markets lag behind as compared with development in other sectors—especially the region’s export-related sectors. In some areas, such as electronics, telecommunications, commerce,
and transportation, rapid technological gains are turning into large profit and income gains, in turn boosting savings and the demand for financial assets.

Allowing market signals to encourage energy conservation policies could also make macroeconomic management easier.

Global oil prices have started to rise again in 2007, and most experts foresee continued tightness in energy markets, especially if demand growth from emerging markets is left unchecked. With a return to cheap energy unlikely, budget-constrained regional policy makers—many of them overseeing energy-intensive yet resource-scarce economies—face some tough choices (Box 2). Moreover, promoting efficient regional energy markets remains imperative, with efforts focused on (i) reducing subsidies and bringing local prices in line with global prices to eliminate wasteful, low-value uses; (ii) introducing measures to promote energy efficiency; (iii) avoiding distorting and possibly ineffective administrative price controls; and (iv) fostering competitive energy markets which reward private sector innovation.

Box 1: Investment Climate in ASEAN-4—Ten Years after the Crisis

Ten years after the Asian financial crisis, investment rates in the crisis-affected ASEAN economies of Indonesia, Malaysia, Philippines, and Thailand have settled at much lower levels (Figure B1.1). This is despite the return to normal levels and the general stability of macroeconomic conditions, including more prudent fiscal and monetary policies, more flexible exchange rates, substantial foreign exchange reserves, and sustainable external debt.

In general, the investment slowdown is attributed to two sets of factors. The first includes underused capacity, the presence of financing constraints, falling public sector investment, increased competition for investment capital from the PRC and Viet Nam, and an increased perception of risk and uncertainty. The second set refers to various, location-specific factors which shape the opportunities and incentives for firms to invest, and define a country’s investment climate. These include inadequate infrastructure, a shortage of skilled labor, weak institutions, excessive regulation, and the low quality of institutions.

While the first set of factors underpinned the investment slowdown during the early part of the crisis, they are less important 10 years later. In particular, underused capacity has slowly declined with the recovery in manufacturing and strong output growth. Financing constraints have also eased given high savings, stronger bank balance sheets, and a sizeable restructuring of nonperforming loans. Consolidation efforts have also dramatically improved fiscal conditions, while foreign direct investment has recovered in some crisis-affected economies (Figure B1.2).

Notwithstanding these reforms, a weak investment climate continues to restrain capital spending, with concern in the following areas: (i) a somewhat uncertain macroeconomic environment; (ii) inadequate infrastructure; (iii) a shortage of skilled labor; and (iv) a heavy regulatory
burden arising from poor governance and weak institutions.

While the macroeconomic environment has remained sound in recent years, the overall outlook has ebbed in the crisis-affected ASEAN economies. This is evident from slowing trend growth, increased growth volatility, and lower mean expectations for future growth. In combination with lower capital and labor productivity growth, these suggest that expected returns from investment have eased.

Private infrastructure investment has fallen since the 1997 economic crisis, particularly in countries such as Indonesia and the Philippines, contributing to a huge gap between the need for investment and actual spending. Emerging East Asian economies now need more than $200 billion annually to close this infrastructure gap, and to finance new investment and maintenance in the power, transport, information and communications technology, and water sectors. Infrastructure is clearly a key business concern, with about 20% of firms in the region reporting that poor access to power, telecommunications, or transportation has been a major or severe obstacle. In the crisis-affected ASEAN economies, the factors hurting business include (i) poor access to power and frequent power interruptions; (ii) inadequate shipping facilities and the high cost of transporting goods; (iii) traffic congestion; and (iv) poor communication facilities.

A skilled workforce is also essential for firms to adopt new technologies and absorb new ideas and innovations. Yet surveys show that 20% of firms in many developing countries rate inadequate skills and education of workers as a major obstacle. In general, skills shortages stem from poor education systems. In Thailand, for example, a shortage of skills cost firms on average the equivalent of 15% of output; the country’s secondary school completion rate, at 4.2% in 2000, is among the lowest in the region. In Malaysia, the education completion rate, at 6.3% in 2000, is lower than the middle-income norm. In the Philippines, the low quality of education is an issue, as seen in its low ranking in the 2003 Trends in International Mathematics and Science Study. To improve education outcomes and create a skilled workforce a number of complementary reforms are needed. These include (i) greater public funding to expand access to education; (ii) better quality of education and an improved certification and accreditation system; (iii) facilitation of private sector provisions; and (iv) support to life-long learning.

In terms of the business operating climate, it takes longer to open a business in Indonesia, to close one or resolve bankruptcy in Indonesia and the Philippines, and to obtain a license in Malaysia and Indonesia, than in the baseline economies. It is also more difficult to hire and fire workers in Indonesia, while investor protection is weak in the Philippines. In most of the crisis-affected economies, it takes a long time to enforce contracts. In the near term, it is important that these countries streamline business procedures, promote competition by speeding up privatization and facilitating trade and customs reform, enhance regulatory capacity through improved transparency and accountability, liberalize labor markets, and strengthen courts and the judiciary.

Reducing barriers to investment across ASEAN-4 would generate growth and reduce poverty. However, the magnitude of the gains and how best to achieve them are not currently well understood. In the post-crisis years, although Indonesia, Malaysia, Philippines, and Thailand have taken several initiatives to streamline their investment climates, macroeconomic volatility, inadequate infrastructure, and burdensome regulations relating to business operations likely impeded investment to varying degrees. There is clearly scope for improving the various elements of the investment climate. Putting in place appropriate policy reforms to improve the investment climate could help revive investment and improve productivity.

Box 2: Coping with an Oil Price Shock

Oil prices are on the rise again. The price of Brent Crude flirted again with nearly $80 per barrel (bbl) in July, after troughing at $51.3/bbl in January, well down from its former peak in August 2006 at $78.6/bbl (Figure B2.1). Global oil demand is strong, driven in particular by continued robust demand from the United States (US) and the People’s Republic of China (PRC), and partly reflecting a stronger-than-expected global economy. On the supply side, the Organization of the Petroleum Exporting Countries continues to curb production to meet lower targets. And tight market conditions have been further aggravated by recent supply disruptions in Nigeria and Iraq, and

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4 See World Bank Governance Indicators Database.
as geopolitical uncertainties weigh on many major production facilities.

Nonetheless, the economic impact on emerging East Asia of sustained high oil prices has been much more modest this time around than in previous episodes: GDP growth averaged 7.6% over the past 5 years and is expected to reach 8.1% in 2007. Several factors may have contributed. Importantly, sound macroeconomic environments with stable inflation, healthy fiscal balances, and low levels of external debt in the region have allowed greater policy flexibility for coping with the oil shock. Second, the current oil shock is driven largely by rapid demand growth from a strong global economy, providing a favorable external environment for emerging East Asia. Third, unlike previous oil spikes caused by severe supply disruptions, the current rise has been gradual, allowing affected economies more time to adjust. And finally, the current rise has been less inflationary in emerging East Asia, where annual inflation averaged only 2.6% in 2003–2006, edging up to only 2.8% by May 2007 (see Figure 10). Sluggish investment and improved monetary policy may have also contributed to low inflation.

Still, the impact of higher oil prices has not been evenly spread, as different policy frameworks and responses contributed to diverse outcomes. In countries such as the Republic of Korea (Korea), Philippines, and Thailand, monetary policy has been more active, and effectively used inflation targeting to curb the effects of higher oil prices. And greater exchange rate flexibility in some economies—Korea, Philippines, Thailand and, to a lesser extent, Malaysia—has mitigated the immediate pass-through of higher oil prices to local prices.

The degree of direct pass-through from global to local energy prices has also been controlled through national energy policies and pricing structures. To varying degrees, retail gasoline and diesel prices in the PRC, Indonesia, Malaysia, and Thailand have held below prevailing prices in the low-tax, but competitive US market.

Figure B2.1: Brent Crude Oil Prices, January 1971–July 2007: ($/barrel)

![Brent Crude Oil Prices Chart]

Refers to the period 1–19 July 2007.
Note: Real Brent price was deflated using producer’s price index of all commodities with December 2001 as base year.

However, subsidies or administered prices, while temporarily mitigating the inflationary effects of rising crude prices, have delayed necessary economic adjustments and produced fiscal strains. In Thailand, fuel subsidies introduced in 2004 were abandoned after little more than a year, having incurred an estimated fiscal cost of about $2.2 billion. In Malaysia, price subsidies have been also gradually reduced, lifting gasoline and diesel prices in 2005–06. In Indonesia, the high cost of fuel subsidies compromised fiscal sustainability and contributed to a sharp depreciation of the rupiah in August 2005, after which subsidies were significantly reduced.

Important lessons arise from the Asian experience. It is essential to maintain a stable macroeconomic environment of low inflation and prudent fiscal balances with modest levels of debt at any time. Sound initial conditions not only provide a buffer against any unexpected external shocks, but also allow room for policymakers to take economic stabilization measures when necessary.

It is also important to understand that there will be trade-offs in macroeconomic stabilization policies, though discretion may be warranted to help the necessary adjustments and minimize costs. For example, when the shock is temporary and inflationary expectations are low, monetary authorities can afford to care more about growth and unemployment. However, in the absence of timely monetary responses, inflationary expectations could rise and trigger spiral increases in domestic prices and wages. Likewise, the use of subsidies or price controls cause significant economic distortions and fiscal costs.

Finally, policies that reduce the intensity of oil use over time will mitigate the risk of higher oil prices in the future. Long-term measures to promote energy efficiency are also crucial for environmentally sustainable development. Emerging East Asia’s energy policies need to ensure coherent policy management within broader policy frameworks to achieve sustainable energy and development. A priority for national energy policies has to be setting out clear strategies for ensuring efficiency in energy use, development of alternative energy sources, adequacy and reliability of supply, and measures to mitigate environmental impact.