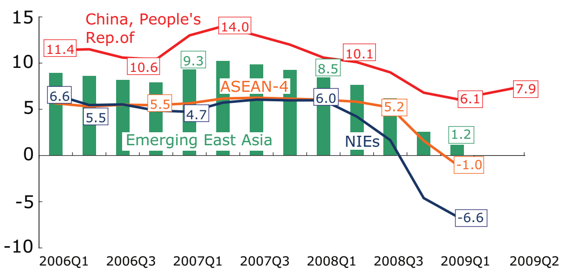
Emerging East Asia—
A Regional Economic Update

Recent Economic Performance

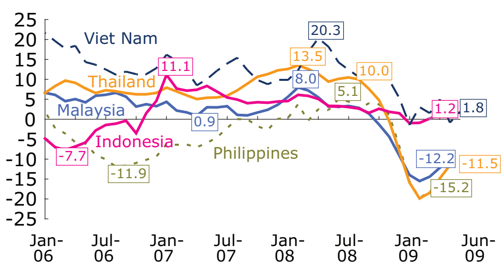
Growth and Inflation

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



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

Figure 2: Industrial Production Growth[1]—
ASEAN-4 and Viet Nam
(y-o-y, %)



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

Economic growth in emerging East Asia dropped sharply in the first quarter of 2009, but early indicators suggest the pace of decline slowed during the second quarter.

In the first quarter of 2009, aggregate growth in gross domestic product (GDP) of the 10 largest emerging East Asian economies[1] declined to 1.2% (year-on-year)[2], down from 2.6% in the last quarter of 2008 and in sharp contrast to the 8.5% growth in the first quarter of last year **(Figure 1)**. The region's four highly-open, newly industrialized economies (NIEs)[3]—the most sensitive to plummeting external demand and global recession—contracted by 6.6%. Also, four large Association of Southeast Asian Nations economies (ASEAN-4)[4] contracted—declining a combined 1.0%. Countering these slowdowns, however, was continued expansion in the People's Republic of China (PRC) , where GDP grew 6.1% in the first quarter. Still, despite the global recession, most of the region's economies have performed better during the current economic crisis than during the 1997/98 Asian financial crisis **(Table 1)**. Moreover, available data on second quarter performance and some leading indicators suggest that the slowdown may have bottomed out. In the second quarter, PRC's growth increased to 7.9% while early estimates show that Singapore's economic contraction moderated to -3.7%. Industrial production growth has moved away from recent lows in Indonesia, Malaysia, Philippines, Thailand, and Viet Nam **(Figure 2)**. In Indonesia, consumer confidence rose during the first 6 months of the year **(Figure 3)**. And purchasing managers' indexes (PMI) in the PRC and Singapore have been on the rise as well in recent months **(Figure 4)**.

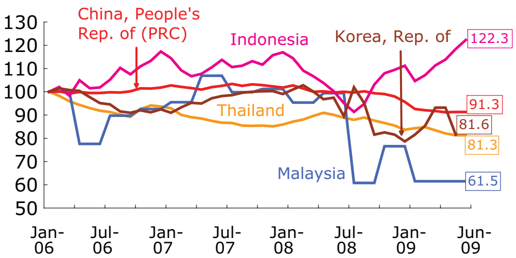
[1]The 10 largest emerging East Asian economies are China, People's Republic of; Hong Kong, China; Indonesia; Korea, Republic of; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

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

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

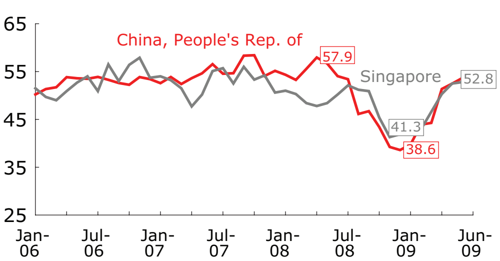
[4]Indonesia, Malaysia, Philippines, and Thailand.

Figure 3: Consumer Confidence Indexes—Selected Economies
(January 2006 = 100)



Notes: China Consumer Confidence Index for the PRC, Indonesia Consumer Confidence Index for Indonesia, South Korea Composite Consumer Sentiment Index (quarterly prior June 2008) for Republic of Korea, Malaysia Consumer Sentiments Index (quarterly) for Malaysia, and Thailand Consumer Confidence Index for Thailand.
Source: National Bureau of Statistics (People's Rep. of China), Bank Indonesia (Indonesia), Korea National Statistical Office and Bank of Korea (Republic of Korea), Malaysia Institute of Economic Research (Malaysia), and The University of the Thai Chamber of Commerce (Thailand).

Figure 4: Manufacturing Purchasing Managers' Indexes (PMI)[1]—China, People's Rep. of and Singapore



[1]Seasonally adjusted. Series for the People's Republic of China and Singapore refer to manufacturing output PMI.
Source: Datastream.

Table 1: Quarterly GDP Growth Rate—Selected Economies[1]

Country	Lowest		Latest[5]
	1997Q1—1998Q4		2009Q1
China, People's Rep. of[2]	7.20	(98Q2)	6.10
Hong Kong, China[3]	-8.06	(98Q3)	-7.79
Indonesia	-18.26	(98Q4)	4.37
Korea, Rep. of	-8.12	(98Q3)	-4.25
Malaysia[4]	-11.18	(98Q4)	-6.17
Philippines	-2.42	(98Q4)	0.45
Singapore	-4.20	(98Q3)	-9.6
Taipei,China	3.31	(98Q4)	-10.24
Thailand	-13.92	(98Q3)	-7.11

GDP = gross domestic product.
[1]Excludes Brunei Darussalam; Cambodia; Lao People's Democratic Republic; and Viet Nam for which quarterly data are not available for both crisis periods. [2]Year-on-year, year-to-date growth rate. [3]1998 growth rate based on 1993 prices. [4]1998 growth rate based on 1987 prices. [5]Based on 2000 prices.
Source: CEIC

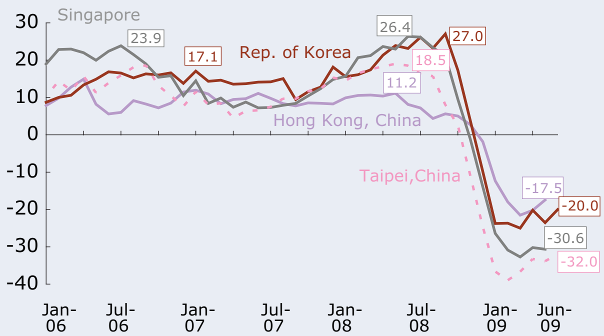
The collapse in external demand hurt economic growth across the region.

The synchronized recession in advanced economies led to a collapse in external demand across the region, with all economies suffering double-digit declines in exports **(Figures 5a, 5b)**. The worst-hit economies generally were those most reliant on international markets **(Figure 6)**.

Domestic investment and consumption declined in the NIEs and ASEAN-4, while they held up well in the PRC, in part, due to the sizable fiscal stimulus.

The poor global economic environment also caused investment to fall dramatically in the NIEs and ASEAN-4. The NIEs were particularly hard hit, with investment falling 15.3% in the first quarter of 2009. ASEAN-4 economies did not suffer as badly, with investment declining 5.3% over the same period. Domestic consumption was also weak—falling 2.3% in the NIEs—as consumers cut back on spending. In the PRC, however, while growth in domestic demand slowed somewhat, it remained relatively robust compared with the rest of the region **(Figures 7a, 7b)**.

Figure 5a: Export Growth[1]—NIEs
(USD value, y-o-y, %)



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

Figure 5b: Export Growth[1]—ASEAN-4
(USD value, y-o-y, %)

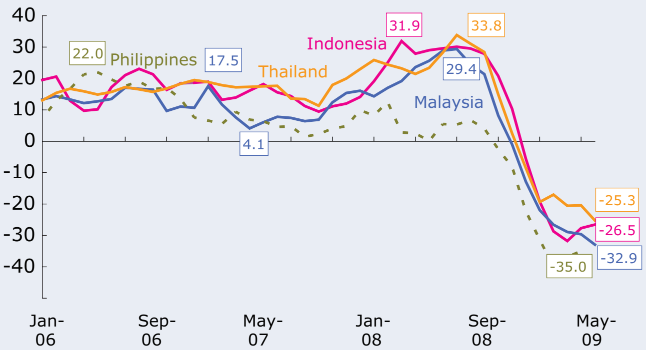
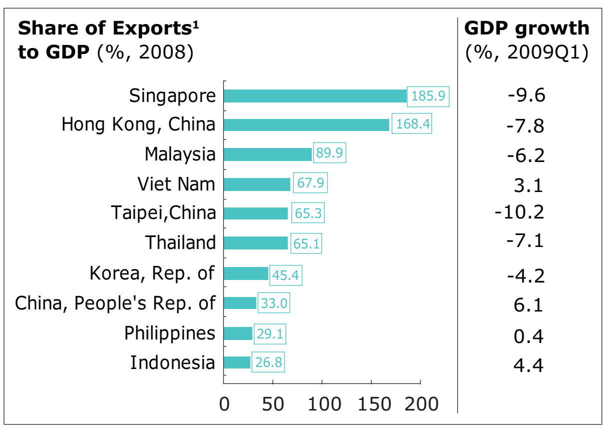


Figure 6: Exports Share and GDP Growth—Emerging East Asia



[1]Merchandise exports.
GDP = gross domestic product.
Source: CEIC; International Monetary Fund's *Direction of Trade Statistics, International Financial Statistics,* and *World Economic Outlook;* Datastream.

Economic contraction in the NIEs was the worst since the 1997/98 Asian financial crisis due to the precipitous drop in exports and weak domestic demand.

The collapse in global demand led to a dramatic slowdown in NIEs exports during the first 5 months of the year. Along with the precipitous drop in domestic demand, industrial production fell sharply **(Figure 8)**. However, the pace of the decline has begun to moderate. The worst-hit economies were Taipei,China and Singapore, where GDP in the first quarter fell by 10.2% and 9.6%, respectively. Double-digit declines in fixed investments and exports contributed to the steep fall in Taipei,China's GDP. Hong Kong, China's economy also continued to shrink in the first quarter of 2009, declining 7.8%, with both external and domestic demand contracting. Meanwhile, the Republic of Korea's (Korea) economy contracted 4.2% in the first quarter of 2009—however, the decline may have stopped as the economy grew 0.5% (seasonally adjusted annualized rate) compared with the last quarter of 2008. Collectively, economic growth in the NIEs has declined more than during the 1997/98 Asian financial crisis, although the pace of decline has been less steep **(Figure 9a)**.

Figure 7a: Domestic Demand Growth—NIEs
(y-o-y, %)

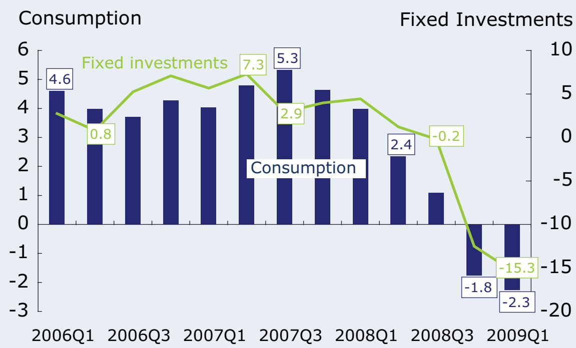
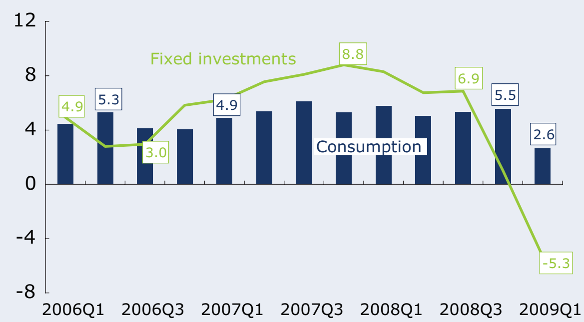
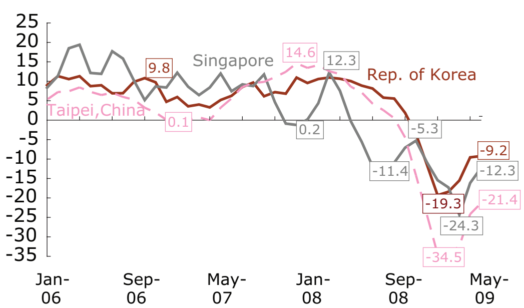


Figure 7b: Domestic Demand Growth—ASEAN-4
(y-o-y, %)



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

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



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

Growth in ASEAN-4 economies also slowed due to falling exports and weakness in domestic demand, though the extent of the slowdown was less than among the NIEs.

The four middle-income ASEAN economies (Indonesia, Malaysia, Philippines, and Thailand) contracted 1.0% in the first quarter. Malaysia and Thailand had the largest declines, with GDP contracting by 6.2% and 7.1%, respectively. Both countries suffered from a double-digit fall in exports (see Figure 5b). Also, the Thai economy reacted to political unrest that hurt tourism, investment, and consumer confidence. Private consumption in Malaysia declined by 0.7% as the economic retrenchment sapped consumer confidence. The global downturn also affected growth in Indonesia and the Philippines. However, with both countries less reliant on exports than many of their emerging East Asian neighbors, their respective slowdowns were not as dramatic. Indonesia's economy was helped by strong growth in private consumption—up 5.8% from the previous quarter's 4.8% increase—due, in part, to election-related spending. In line with the slowdown in economic activity, industrial production declined for all ASEAN-4 economies except Indonesia (see Figure 2). To date, ASEAN-4 economies have been affected much less by the current crisis than during 1997/98 **(Figure 9b)**.

Figure 9a: GDP Growth during Crisis Periods—NIEs[1] (quarterly, % change)

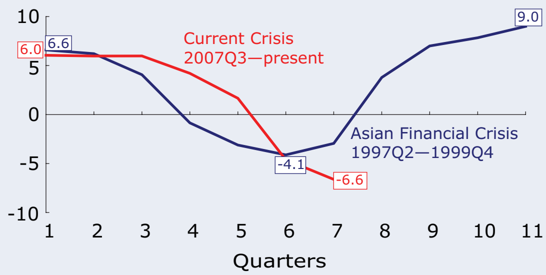
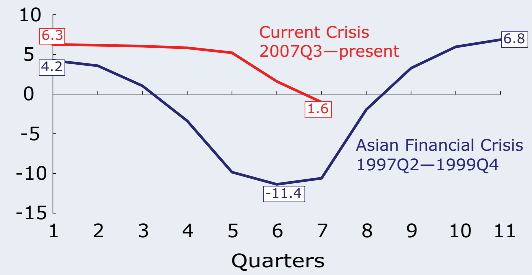


Figure 9b: GDP Growth during Crisis Periods—ASEAN-4[2] (quarterly, % change)



[1]Newly industrialized economies (NIEs) refers to Hong Kong, China; Korea, Republic of; Singapore; and Taipei,China. [2]Refers to Indonesia, Malaysia, Philippines, and Thailand. GDP growth rates for Indonesia and Malaysia during the Asian Financial Crisis are based on 1993 and 1987 prices, respectively. Growth rates for the current crisis are based on 2000 prices.
Source: OREI staff calculations based on data from national sources.

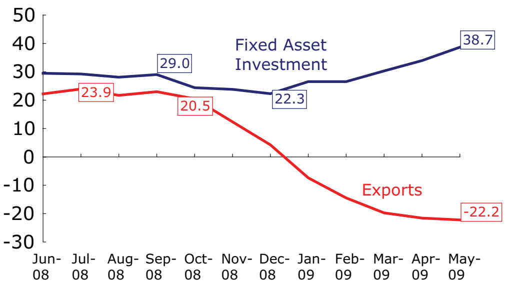
The smaller ASEAN economies performed better than their larger ASEAN partners as they are less dependent on external demand.

Viet Nam's economic growth continued to slow to 3.1% in the first quarter of 2009—the lowest level of growth in a decade. However, growth picked up in the second quarter to 4.4%. Cambodia's GDP grew 6.5% in 2008, lower than the 10.2% growth rate in 2007. In the Lao People's Democratic Republic (Lao PDR), GDP growth was 7.2% in 2008 on the back of continued growth in the mining and hydropower sectors. GDP in Brunei Darussalam is estimated to have contracted by 2.7% in 2008 as a result of lower oil and gas output. Estimates suggest that Myanmar's GDP growth slowed to between 0.9% and 4.5% in fiscal year (FY) 2008 from the official growth figure of 11.9% for FY 2007.

Growth slowed in the PRC as well, yet the huge fiscal stimulus helped cushion a massive decline in exports and enabled the country to maintain robust growth.

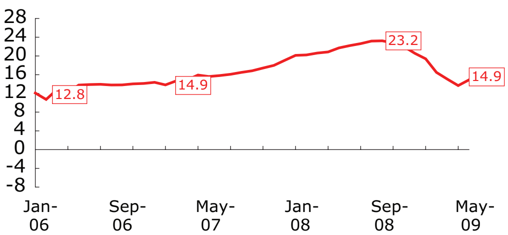
Amid the slowdown across most of emerging East Asia, the PRC remains a major bright spot as it continued to grow at a healthy rate during the first half of the year. GDP growth continued its 2-year moderation from its 14% peak in the second quarter of 2007. The 6.1% GDP growth in the first quarter of 2009 was the lowest since the introduction of quarterly GDP figures in the

Figure 10: Fixed Asset Investment and Exports[1]—PRC (y-o-y growth, %)



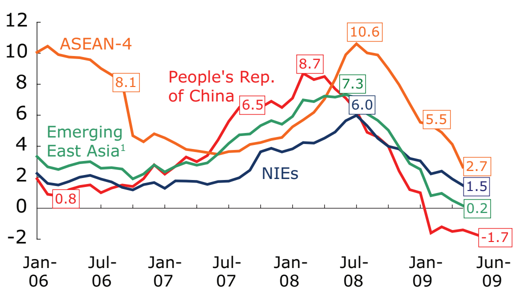
PRC = People's Republic of China, y-o-y = year-on-year.
[1]3-month moving average of merchandise exports.
Source: OREI staff calculations based on CEIC data.

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



PRC = People's Republic of China
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

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



ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; NIEs = Hong Kong, China; Korea, Rep. of; Singapore; and Taipei,China; y-o-y = year-on-year.
[1]Refers to ASEAN-4, NIES, People's Republic of China, and Viet Nam.
Source: OREI staff calculations based on CEIC data.

fourth quarter of 1999. But growth performance improved in the second quarter, increasing by 7.9%. Like other emerging East Asian economies, however, PRC exports were badly affected by the plunge in external demand, falling 22.2% in May. However, continued strong growth in fixed-asset investment, which was given added impetus by the government's massive stimulus package, managed to offset the effects of declining exports. Fixed-asset investment growth accelerated to 38.7% in May this year, compared with 25.4% in May 2008 **(Figure 10)**. However, consumer demand, as reflected by retail sales growth, weakened to 13.7% in April before rising again to 14.9% in May **(Figure 11)**.

The slowdown in growth, coupled with lower oil and food prices, contributed to a continued decline in inflation across the region.

In line with the slowdown in demand, headline inflation continued to decline in all of the region's economies. From February to June 2009, in fact, PRC prices deflated by a monthly average of about 1.5%, continuing their decline from the 8.7% inflation reached in early 2008 **(Figure 12)**. Headline inflation also declined in the NIEs, with Taipei,China and Singapore, whose economies contracted the most among the NIEs, experiencing deflation over the past few months **(Figure 13a)**. Weaker demand also led to lower inflation throughout ASEAN **(Figure 13b)**. Thai prices deflated for the sixth straight month in June. After reaching a peak of 28.3% in August 2008, inflation in Viet Nam fell to 3.9% in June. Lower oil and commodity prices compared with last year's record levels helped contribute to the slowdown. Core inflation continued to fall in emerging East Asia during the first 6 months of 2009. The drop was most significant in Malaysia, with core inflation at 0.4% in May, compared with the third quarter 2008 peak of 9.6%. Core inflation turned negative in May in Thailand due to weak demand **(Figures 14a, 14b)**.

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

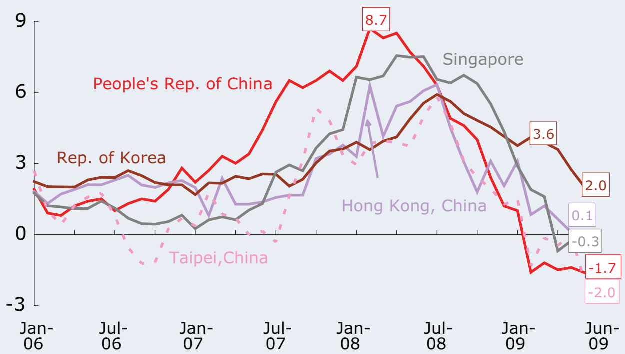
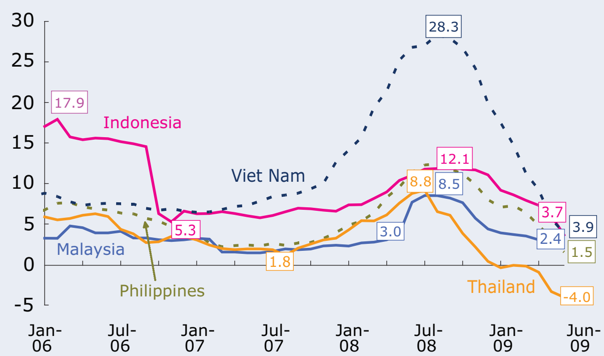


Figure 13b: Inflation in Selected ASEAN Economies—Headline Rates (y-o-y, %)



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

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

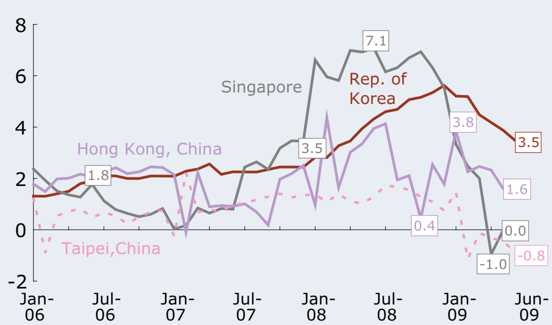
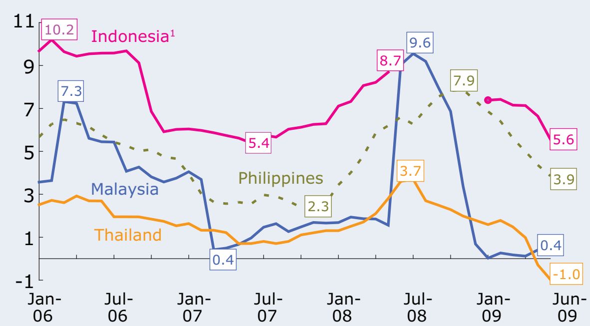


Figure 14b: Core Inflation Rates—ASEAN-4 (y-o-y, %)



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

Balance of Payments

The balance of payments turned positive again across much of the region in the first quarter of 2009, as current account surpluses increased and capital outflows moderated.

Overall balance of payments as a percentage of GDP grew substantially across the region in the first quarter of the year **(Tables 2a, 2b, 2c)**. While the global economic slowdown led to a collapse in exports for most emerging East Asian economies, imports fell much faster—due to weaker domestic demand and reduced trade in intermediate inputs. As a result, the current account surpluses widened in the first quarter of 2009. With the financial sector showing signs of stabilizing and investors once again confident about investing in the region, capital that had been repatriated in the second half of 2008 began to return. Some countries saw net inflows of portfolio investment, while in others the rate of portfolio outflows moderated. Foreign exchange reserves increased in most emerging East Asian economies as authorities sterilized excess inflows to manage currency appreciation pressures **(Table 3)**.

Table 2a: Balance of Payments—ASEAN-4 (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008	2008-Q1	2008-Q2	2008-Q3	2008-Q4	2009-Q1
Current Account	**4.2**	**3.3**	**2.2**	**5.3**	**6.2**	**3.7**	**5.0**	**3.8**	**2.9**	**3.1**	**8.6**
Net goods balance	9.7	8.4	6.8	8.8	8.6	5.9	6.8	7.1	5.2	4.4	8.7
Net services	-3.3	-2.7	-2.8	-2.4	-1.7	-1.3	-1.4	-2.1	-0.9	-0.8	0.3
Net income	-3.6	-3.7	-3.8	-3.1	-2.6	-2.6	-2.0	-3.0	-3.1	-2.4	-2.4
Net transfers	1.4	1.4	2.1	2.0	1.8	1.7	1.7	1.8	1.6	1.9	1.9
Capital and Financial Account	**-1.8**	**1.0**	**0.2**	**-0.3**	**-0.7**	**-2.0**	**7.1**	**-0.9**	**-5.3**	**-9.2**	**-3.7**
Capital account[1]	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Net direct investment	0.9	1.1	2.2	1.5	0.6	0.2	0.1	0.4	-0.9	1.3	2.1
Net portfolio investment	0.2	2.3	1.4	1.7	0.9	-2.6	5.1	-2.5	-6.8	-5.9	-0.7
Net other investment	-2.9	-2.4	-3.4	-3.6	-2.2	0.3	1.8	1.2	2.3	-4.6	-5.1
Net errors & omissions	-0.4	-0.3	-1.0	-0.4	-0.4	0.0	0.6	-0.6	-0.6	0.7	0.7
Overall Balance	**2.0**	**4.0**	**1.3**	**4.5**	**5.1**	**1.6**	**12.7**	**2.3**	**-3.0**	**-5.4**	**5.5**

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

Table 2b: Balance of Payments—NIEs (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008	2008-Q1	2008-Q2	2008-Q3	2008-Q4	2009-Q1
Current Account	**5.3**	**6.4**	**5.2**	**5.1**	**5.7**	**4.3**	**3.8**	**3.8**	**2.4**	**7.9**	**9.0**
Net goods balance	4.9	5.9	5.6	4.9	4.9	2.0	1.4	2.8	0.7	3.2	5.2
Net services	0.4	0.6	0.5	0.6	0.8	1.5	1.0	1.0	1.2	3.2	2.5
Net income	0.6	0.5	-0.2	0.2	0.6	1.4	2.0	0.7	1.1	1.6	1.5
Net transfers	-0.7	-0.7	-0.7	-0.7	-0.6	-0.5	-0.6	-0.7	-0.6	-0.1	-0.2
Capital and Financial Account	**-1.2**	**-1.1**	**-2.5**	**-2.8**	**-6.9**	**-3.6**	**0.9**	**-2.3**	**-5.7**	**-7.9**	**-1.2**
Capital account[1]	-0.2	-0.2	-0.2	-0.2	-0.1	0.1	-0.1	0.0	0.2	0.3	0.5
Net direct investment	0.5	-0.3	0.8	0.5	-0.7	-0.3	0.4	-2.9	-0.2	1.9	2.0
Net portfolio investment	-2.7	-3.2	-2.6	-4.5	-4.7	-5.2	-8.2	-1.7	-4.1	-7.1	0.9
Net other investment	1.3	2.5	-0.4	1.4	-1.4	1.9	8.8	2.4	-1.6	-2.9	-4.6
Net errors & omissions	0.6	1.0	1.0	0.7	3.6	0.2	0.4	-0.8	1.0	0.2	0.5
Overall Balance	**4.7**	**6.3**	**3.7**	**3.1**	**2.5**	**1.0**	**5.1**	**0.7**	**-2.3**	**0.2**	**8.2**

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

Table 2c: Balance of Payments—People's Rep. of China (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008	2008H1	2008H2
Current Account	**2.6**	**3.6**	**7.2**	**9.5**	**11.3**	**9.8**	**10.0**	**9.7**
Net goods balance	3.2	3.1	6.0	8.2	9.6	8.3	6.9	9.4
Net services	-0.5	-0.5	-0.4	-0.3	-0.2	-0.3	-0.2	-0.4
Net income	-1.0	-0.2	0.5	0.6	0.8	0.7	2.0	-0.3
Net transfers	1.0	1.2	1.1	1.1	1.2	1.1	1.3	0.9
Capital and Financial Account	**3.0**	**5.7**	**2.8**	**0.3**	**2.2**	**0.4**	**3.8**	**-2.2**
Capital account[1]	0.0	0.0	0.2	0.2	0.1	0.1	0.1	0.1
Net direct investment	3.3	2.8	3.0	2.1	3.7	2.2	2.1	2.2
Net portfolio investment	-0.2	1.0	-0.2	-2.5	0.6	1.0	1.0	0.9
Net other investment	0.0	2.0	-0.2	0.5	-2.1	-2.8	0.5	-5.4
Net errors & omissions	0.4	1.4	-0.7	-0.5	0.5	-0.6	0.9	-1.8
Overall Balance	**6.0**	**10.7**	**9.2**	**9.3**	**14.0**	**9.7**	**14.7**	**5.7**

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

Table 3: Foreign Exchange Reserves (excluding gold)

	Value (USD billion)				**% Change** (y-o-y)			**% Change** (m-o-m)		
	Jun-08	Sep-08	Dec-08	Mar-09	Sep-08	Dec-08	Mar-09	Jan-09	Feb-09	Mar-09
Brunei Darussalam	0.7	0.7	0.7[3]	—	15.3	4.5[3]	—	—	—	—
Cambodia	2.3	2.4	2.3	2.4	53.3	26.8	14.4	-0.1	0.3	2.4
China, People's Rep. of	1,811.1	1,907.7	1949.3	1956.8	32.9	27.4	16.2	-1.7	-0.1	2.2
Hong Kong, China	157.5	160.5	182.5	186.2	14.0	19.6	15.9	-0.5	-2.5	5.2
Indonesia	57.3	55.0	49.6	52.7	7.5	-9.8	-7.3	-1.7	-0.8	8.9
Korea, Republic of	258.0	239.6	201.1	206.3	-6.9	-23.3	-21.9	0.3	-0.1	2.4
Lao PDR	0.7[3]	—	—	—	—	—	—	—	—	—
Malaysia	125.5	109.4	91.1	87.4	11.8	-9.9	-27.1	-0.1	-0.3	-3.6
Myanmar	—	—	—	—	—	—	—	—	—	—
Philippines	32.7	32.9	33.2	34.5	17.9	9.9	5.2	4.5	-1.3	0.8
Singapore	176.7	168.8	174.2	166.1	10.7	6.9	-6.4	-4.1	-2.1	1.6
Taipei,China	291.4	281.1	291.7	300.1	6.9	7.9	4.6	0.3	0.5	2.0
Thailand	103.2	100.0	108.7	113.7	27.1	27.5	5.8	-0.4	2.3	2.7
Viet Nam	22.3	23.8	23.9	22.7[3]	5.6	1.8	-12.3[3]	-4.4	-0.8	—
Emerging East Asia	**3,039.3**[1]	**3,082.0**[2]	**3,108.1**[2]	**3,128.9**[4]	**21.8**[2]	**16.2**[2]	**7.2**[4]	**-1.3**[4]	**-0.2**[4]	**1.5**[5]
Japan	978.7	974.1	1,009.4	996.0	5.0	5.9	0.3	-2.1	-0.2	1.0
East Asia	**4,018.0**[1]	**4,056.2**[2]	**4,117.5**[2]	**4,124.9**[4]	**17.3**[2]	**13.5**[2]	**5.5**[4]	**-1.5**[4]	**-0.2**[4]	**1.4**[5]

m-o-m = month-on-month, y-o-y = year-on-year, — = data not available
[1]Excludes Myanmar as data are unavailable. [2]Excludes Lao People's Democractic Republic (PDR) and Myanmar as data are unavailable. [3]If data is unavailable for reference month, data is for most recent month in which data is available. [4]Excludes Brunei Darussalam, Lao PDR, and Myanmar as data are unavailable. [5]Excludes Brunei Darussalam, Lao PDR, Myanmar, and Viet Nam as data are unavailable.
Source: *International Financial Statistics Online,* International Monetary Fund; and CEIC.

Current account surpluses increased across much of the region as imports declined faster than exports.

The PRC's overall trade surplus increased to $88.8 billion in the first 5 months of 2009 from $76.7 billion in the first 5 months of 2008, as imports fell more dramatically than exports. However, in June, imports picked up, resulting in a trade surplus for the first half of 2009 of $97 billion, down slightly from $97.5 billion in the first half of 2008.The NIEs also experienced large drops in exports. However, with the exception of Hong Kong, China and Singapore, the pace of the decline of imports was faster than that of exports, resulting in larger trade surpluses. The situation was similar among ASEAN-4 economies, except for the Philippines, as they experienced faster declines in imports and thus higher trade surpluses. As a result, the current account balance for both the ASEAN-4 and NIEs widened in the first quarter of 2009.

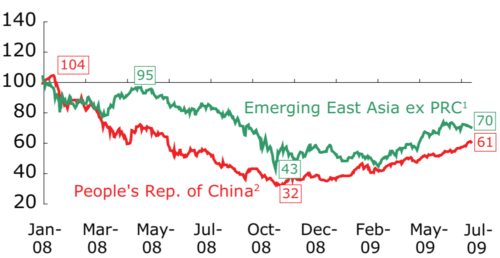
In the first quarter of 2009, the capital account and financial account showed a smaller deficit in much of emerging East Asia as capital outflows moderated significantly.

Capital inflows to the PRC continued in 2009, as foreign reserves increased by $185.6 billion in the first half of the year compared with an increase of $137.2 billion in the second half of 2008. The bulk of the increase, $177.9 billion, came in the second quarter. The NIEs capital and financial account showed a much smaller deficit in the first quarter of 2009 as portfolio investment flowed in again after a huge outflow in the fourth quarter of 2008. Similarly, the ASEAN-4 economies also recorded a smaller deficit in their capital accounts as portfolio investment outflows moderated significantly. Despite the economic turmoil, foreign direct investment has continued to flow into the NIEs and ASEAN-4 economies in the first quarter of 2009.

Financial Markets and Exchange Rates

Stock markets rebounded strongly in the first half of 2009, with the MSCI AC (All Country) Asia ex Japan Index rising 68% over its November 2008 trough.

Figure 15: Composite Stock Price Indexes
(last daily price, 2 January 2008 = 100, local index)

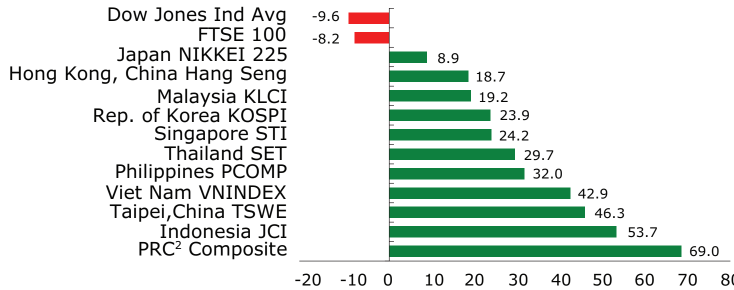


[1]Daily stock price indexes of Hang Seng (Hong Kong, China); JCI (Indonesia); KOSPI (Korea); KLCI (Malaysia); PCOMP (Philippines); STI (Singapore); TWSE (Taipei,China); and SET (Thailand); weighted by market captialization.
[2]Daily stock price indexes of combined Shanghai and Shenzhen Composite, weighted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

Financial markets appear to have stabilized in emerging East Asia as stock markets in the region rebounded strongly showing some return of risk appetite. The MSCI AC (All Country) Asia ex Japan Index[5] was up 68.0% compared with last November. Through 7 July, the PRC's composite stock market index increased 69.0% for the year **(Figures 15, 16)**. The gain likely reflects the effects of the PRC's huge fiscal stimulus package. In contrast to the strong performance in emerging East Asia, the Dow Jones Industrial Average and the FTSE 100 both declined over the same period. Despite the rebound across emerging East Asian equity markets, they remain below their levels at the beginning of 2008 **(Figures 17a, 17b)**.

[5]Includes China, People's Republic of; Hong Kong, China; India; Indonesia; Korea, Republic of; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

Figure 16: Stock Price Indexes[1]
(2 January 2009 to 7 July 2009, % change)



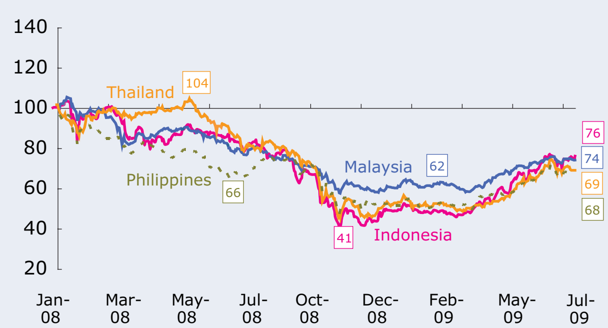
[1]Latest closing as of 7 July 2009. [2]People's Republic of China (PRC)
Source: OREI staff calculations based on data from Reuters and Bloomberg.

Several currencies in the region appreciated against the US dollar as investors' risk appetite has gradually returned.

Another sign that financial markets have stabilized in the region is that most regional currencies strengthened against the US dollar during the first half of the year. The Korean won reversed its decline and appreciated by 3.7% against the dollar on the back of a current account surplus and stronger-than-expected economic growth **(Figure 18)**. The Indonesian rupiah also appreciated in 2009 (6.9%), while the Vietnamese dong depreciated 1.8% as the State Bank of Viet Nam allowed it to weaken to make exports more competitive **(Figures 19a, 19b)**. Meanwhile, the Philippine peso and Malaysian ringgit depreciated against the

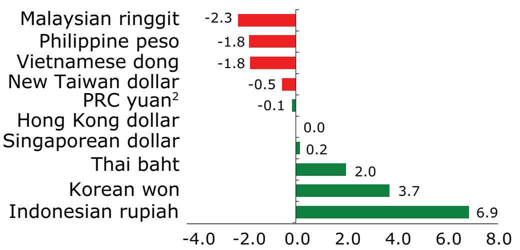
Figure 17a: Composite Stock Price Indexes—NIEs[1]
(last daily price, 2 January 2008 = 100, local index)

Figure 17b: Composite Stock Price Indexes—ASEAN-4[1] (last daily price , 2 January 2008 = 100, local index)



[1]Daily stock price indexes of Hang Seng (Hong Kong, China); KOSPI (Korea); STI (Singapore); and TWSE (Taipei,China); JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines); and SET (Thailand).
Source: OREI staff calculations based on Reuters data.

Figure 18: Regional Currencies[1]
(2 January 2009 to 7 July 2009, % change)



[1]Latest closing as of 7 July 2009, based on the USD value of local currency. Negative values indicate depreciation of local currency.
[2]PRC = People's Republic of China
Source: OREI staff calculations based on Reuters data.

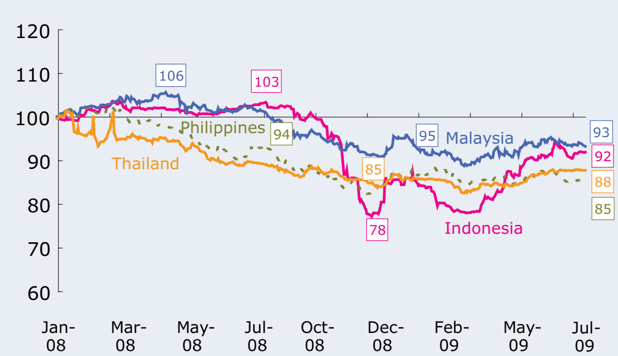
dollar in the first half of the year, as the Malaysian and Philippine economies are weaker than other economies in the region.

Bond yield curves for most emerging East Asian markets shifted upward and steepened in recent months, a reaction to several factors, including a possible sign of investors' confidence that recovery is in the offing.

Bond yield curves have shifted upward in most emerging East Asian markets in the year through 7 July. However, they remain below their 15 September 2008 levels (the day Lehman Brothers collapsed). Yield curves have also steepened for most economies in the region. The upward movement and steepening of the yield curves this year could be due to several factors, including (i) additional market liquidity as governments issue new debt to finance fiscal stimulus; (ii) expectations that the new liquidity could add to future inflationary pressures; and (iii) improved investor expectations about economic recovery. In the PRC and Korea, where economic growth has been strong, there has been a significant upward shift and a slight steepening in the bond yield curves. In Malaysia and Thailand, concerns about the size of fiscal deficits may have caused the yield curves to steepen significantly as well as pushing them upward. **(Figures 20a, 20b, 20c, 20d)**.

Figure 19a: Exchange Rate Indexes—NIEs and PRC
(local currency vis-à-vis USD, 2 January 2008 = 100)

Figure 19b: Exchange Rate Indexes—ASEAN-4
(local currency vis-à-vis USD, 2 January 2008 = 100)



Source: OREI staff calculations based on Reuters data.

Figure 20a: Benchmark Yields—China, People's Republic of (% per annum)

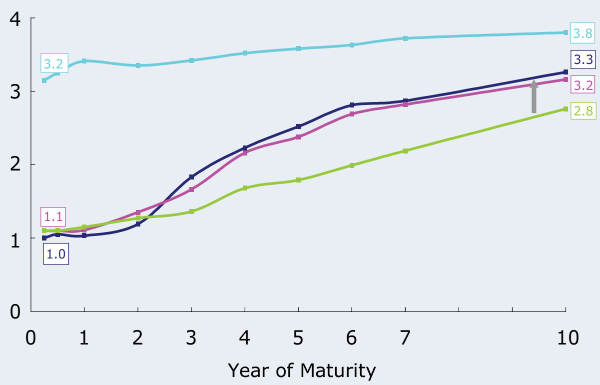


Figure 20b: Benchmark Yields—Korea, Rep. of (% per annum)

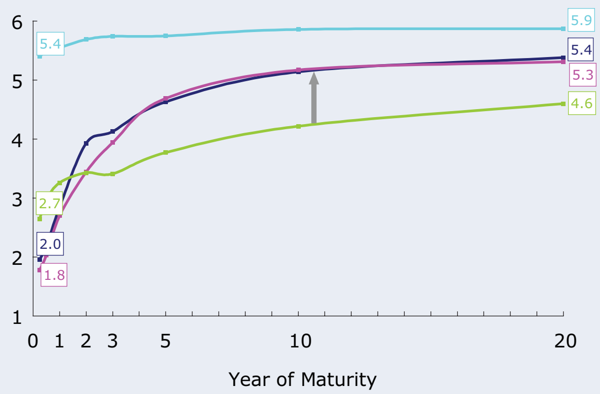


Figure 20c: Benchmark Yields—Malaysia (% per annum)

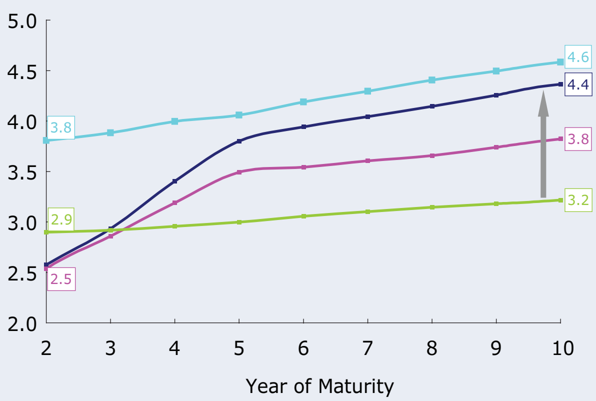
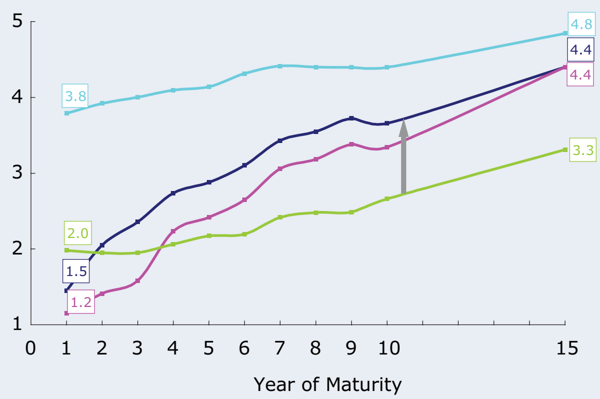


Figure 20d: Benchmark Yields—Thailand (% per annum)



7-Jul-2009 31-Mar-2009 31-Dec-2008 30-Sep-2008

Source: Bloomberg.

Monetary and Fiscal Policy

With growth slowing and inflation falling, authorities continued to ease monetary and fiscal policies.

The main concern facing monetary authorities in emerging East Asia is how to reverse the economic slowdown. Central banks have continued to aggressively reduce policy rates in response **(Figures 21a, 21b)**. They have also introduced a variety of other measures to increase liquidity in the banking system and to encourage banks to expand lending.

Figure 21a: Policy Rates[1]—PRC; Hong Kong, China; Korea, Rep. of; Taipei,China
(% per annum)

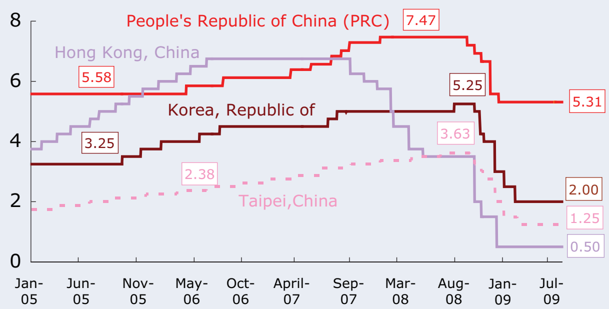
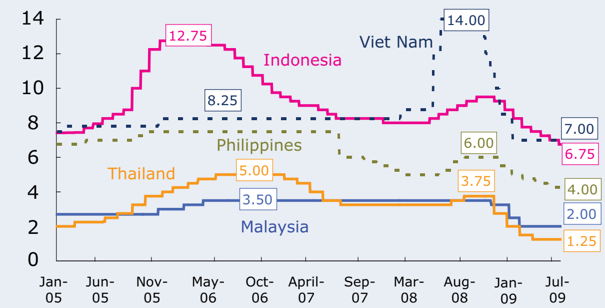


Figure 21b: Policy Rates[1]—ASEAN-4 and Viet Nam
(% per annum)

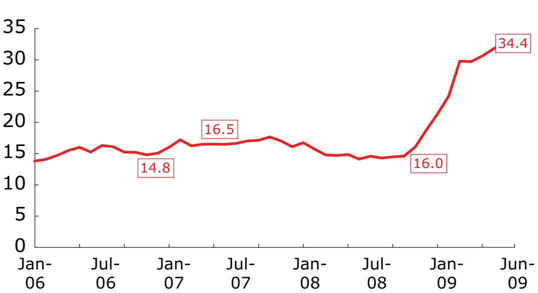


Note: [1]1-year lending rate (People's Republic of China); Hong Kong base rate (Hong Kong, China); Korea base rate (Republic of Korea); discount rate (Taipei,China); State Bank of Indonesia (SBI) rate before July 2005 and Bank Indonesia (BI) rate from July 2005 onwards (Indonesia); overnight policy rate (Malaysia); reverse repurchase (repo) rate (Philippines); 14-day repo rate before 17 Jan 2007 and 1-day repo rate from 17 Jan 2007 onwards (Thailand); prime rate (Viet Nam).
Source: Bloomberg and Datastream.

Favorable monetary conditions in the PRC have seen bank lending surge in the first half of 2009, while the NIEs have also continued to ease monetary policies to jump-start economic growth.

The PRC's monetary policy remains accommodative as the export decline and deflation led monetary authorities to stimulate growth. While policy rates were not reduced in the first half of the year, the lifting of credit quotas in 2008 resulted in a surge of bank lending (34.4% year-on-year in June 2009) **(Figure 22)**. Among the NIEs, Taipei,China aggressively cut its policy rate twice since the start of 2009, bringing it to a record low of 1.25%. Korea has also cut its policy rate twice this year, bringing it to 2.0%. Hong Kong, China has introduced a variety of measures to provide liquidity support, including a HK$227 billion currency swap agreement with the People's Bank of China. Since its policy shift in October 2008, the Monetary Authority of Singapore has maintained its 0% appreciation target, while keeping its trading band unchanged.

Figure 22: Bank Lending Growth—China, People's Rep. of (%, y-o-y)



y-o-y = year-on-year.
Data refers to financial institution loans
Source: CEIC and People's Bank of China.

ASEAN economies have also reduced policy rates to stimulate economic growth.

As inflationary pressures moderate, ASEAN countries had plenty of room to reduce interest rates. Bank Indonesia reduced its policy rate seven times since the beginning of 2009—from

9.25% to a record low of 6.75%—to stimulate economic growth. Bangko Sentral ng Pilipinas (BSP) also took a gradual approach to cutting its policy rate—reducing it five times so far this year—from 5.5% to 4.0%. In contrast to the gradual approach taken by Indonesian and Philippines authorities, the State Bank of Viet Nam slashed its interest rate by 150 basis points at the end of January 2009. The Bank of Thailand cut its 1-day repo rate thrice during the first half of the year to a 5-year low of 1.25%, while the overnight policy rate was cut twice in Malaysia—from 3.25% to 2.0%.

The PRC is implementing a sizable fiscal stimulus package, which was first announced in November 2008, while the NIEs have also introduced a variety of fiscal measures to cushion the external demand shock.

As a result of the 2-year stimulus package worth CNY4 trillion, the PRC's fiscal deficit is expected to rise from 0.4% of GDP in 2008 to 3.0% in 2009. While the government has not announced additional policy measures, it remains committed to spending more on stimulus if necessary. The fiscal stimulus is credited with helping the PRC's economy maintain growth amid a collapse in exports. However, there are concerns that local authorities in the PRC may not be able to spend the stimulus money effectively. Meanwhile, Hong Kong, China announced plans in February to spend HK$1.6 billion to generate 62,000 jobs and internships over 3 years. In May, authorities unveiled tax cuts and fee waivers totaling HK$16.8 billion. In Korea, the Ministry of Strategy and Finance announced a supplementary budget in April worth $13 billion to support job and welfare programs, credits and grants for exporters and small- and medium-sized businesses (SMEs), and subsidies to local governments. Singapore has also aggressively used fiscal measures, announcing in January that it would spend S$20.5 billion, which is equivalent to 8.0% of GDP, to stimulate the economy. Taipei,China targeted consumers by distributing NT$85.7 billion worth of consumer vouchers in January to encourage consumption.

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

	2000–2004 Average	2004	2005	2006	2007	2008	2009[6]
Cambodia[1]	-5.3	-4.5	-2.5	-2.7	-2.9	-1.7	-3.2
China, People's Rep. of[1]	-2.2	-1.3	-1.2	-0.8	0.6	-0.4	-3.0
Hong Kong, China[4]	-2.4	1.6	1.0	3.9	7.5	0.1	-3.9
Indonesia	-1.2	-1.1	-0.2	-0.9	-1.2	0.0	-2.5
Korea, Rep. of[5]	1.5	0.7	0.4	0.4	3.8	1.2	-2.2
Malaysia[2]	-5.0	-4.1	-3.6	-3.3	-3.2	-4.8	-7.6
Philippines	-4.4	-3.8	-2.7	-1.1	-0.2	-0.9	-3.2
Singapore[1,4]	7.0	6.9	9.0	8.3	13.9	6.5	-3.5
Taipei,China[1]	-3.3	-2.4	-1.6	-0.7	-0.4	-1.4	-3.6
Thailand[4]	-0.4	0.3	0.2	0.1	-1.1	-0.3	-3.5
Viet Nam[3]	-4.5	-4.9	-4.9	-5.0	-4.9	-4.5	-4.8

[1]Refers to general government balance. [2]Refers to federal government balance. [3]Refers to state budget balance. [4]Fiscal year. [5]Balance including social security funds. [6]Budget deficit estimates in 2009 budgets of respective countries, except for Cambodia (International Monetary Fund projection); China, People's Rep. of (maximum government estimate); Philippines (revised government target), and Thailand (government estimate).
Source: National sources; *Asian Development Outlook* (various issues), Asian Development Bank; *Article IV consultation reports,* International Monetary Fund; and CEIC.

Authorities across ASEAN have also introduced a variety of fiscal measures to stimulate their economies.

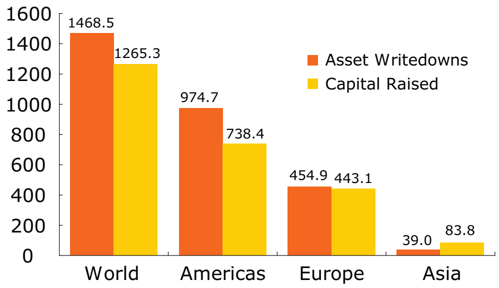
In an attempt to fend off recessionary pressures, ASEAN economies have introduced fiscal stimulus measures as well. In Indonesia, the government raised its budget deficit target to 2.5% of GDP from 1.0% to accommodate an Rp73.3 trillion stimulus package comprising tax incentives, pay increases, export guarantees, cash transfers, and increased government spending. Meanwhile, Thailand introduced its first supplemental stimulus package in mid-January worth B116 billion, which included cash handouts of B2,000 to low-income earners. This package was later supplemented by a B40 billion tax relief package. Finally, Malaysia unveiled a second stimulus package worth RM60 billion in March 2009 and raised its deficit target upward to 7.6% of GDP **(Table 4)**.

Assessment of Financial Vulnerability

The region's banking systems appear capable of weathering the economic storm, being further supported by recent stability in global financial markets.

As the near-term outlook shows lessening signs of weakness, a repeat of the 1997/98 Asian financial crisis is unlikely, given the relatively sound macroeconomic fundamentals that have been built up across the region since then. Many emerging East Asian economies are expected to continue to have manageable fiscal and external positions despite the impact of the global economic crisis **(Table 5)**. The region's banks have largely escaped massive writedowns related to holdings of toxic credit investments and the complete seizure of the interbank markets after the collapse of Lehman Brothers in September 2008. Of the $1.5 trillion in writedowns reported globally since the subprime debacle began, only 2.7% ($39 billion) have originated in Asia **(Figure 23)**. Meanwhile, Asian banks have raised nearly twice that amount ($83.8 billion) to bolster their capital positions. The new capital is not only replenishing depleted amounts, but also cushioning against potential losses arising from problematic loans during the current and any subsequent economic slowdowns. This is important as the market now demands a higher level of capital as a sign of bank strength and resilience.

Figure 23: Writedowns and Capital Raised by Major Banks since 2007Q3
(USD billion, as of 7 July 2009)



Source: Bloomberg.

With authorities' support, domestic interbank markets have returned to normal.

In addition, domestic interbank markets in Asia did not seize up as severely as their counterparts in developed countries. But there were some signs of stress in the money markets for local currencies in Hong Kong, China and Singapore; while in Korea, US dollar funding became even scarcer. However, interbank markets in all three of these economies saw a return to normality after additional liquidity injections, an expansion of liquidity facilities, a temporary blanket deposit guarantee, and liquidity swap operations with the US Federal Reserve. The gradual return of liquidity in global credit markets has also been helpful.

Table 5: Assessment of Vulnerability (%)

	Inflation (latest available)		Fiscal Balance/ GDP (2008)[1]	Current Acct./GDP (latest available)		External Debt/ GDP[2] (4Q08)	Short-Term External Debt/ Reserves (4Q08)[3]	Govt. Debt/ GDP (2008)[4]	Foreign Reserves (number of months of imports)[5]		Foreign Liabilities/ Foreign Assets[6] (latest available)		Loans/ Deposits of Banks[7] (latest available)	
Brunei Darussalam	2.3	(Apr 09)	29.1	45.6	(2006)	7.9	62.4	—	3.4	(Dec 08)	3.6	(Jan 09)	0.73	(Jan 09)
Cambodia	−3.9	(Apr 09)	−1.7	−6.6	(4Q07)	16.1	5.8	26.8	8.8	(Feb 09)	98.8	(Mar 09)	0.97	(Mar 09)
China, People's Rep. of	−1.4	(May 09)	−0.4	9.7	(2H08)	4.0	5.4	—	22.4	(Mar 09)	22.5	(Apr 09)	0.71	(Apr 09)
Hong Kong, China	0.1	(May 09)	0.1	10.7	(1Q09)	173.9	57.7	1.3	6.4	(Apr 09)	63.0	(Mar 09)	0.44	(Mar 09)
Indonesia	3.7	(Jun 09)	0.0	1.6	(1Q09)	20.7	57.5	31.2	7.1	(Apr 09)	53.3	(Apr 09)	0.77	(Apr 09)
Korea, Republic of	2.0	(Jun 09)	1.2	5.1	(1Q09)	26.4	59.6	29.1	6.6	(Apr 09)	185.2	(Feb 09)	1.35	(Feb 09)
Lao PDR	3.2	(Dec 08)	−1.7	2.6	(2007)	46.5	30.3	53.3	3.4	(May 08)	31.6	(Apr 08)	0.35	(Apr 08)
Malaysia	2.4	(May 09)	−4.8	20.2	(1Q09)	27.0	29.1	41.4	7.6	(Apr 09)	124.2	(Apr 09)	0.92	(Apr 09)
Myanmar	12.7	(Feb 09)	—	5.5	(2006)	9.3	55.0	—	4.6	(Jun 07)	—		0.43	(Dec 08)
Philippines	1.5	(Jun 09)	−0.9	5.9	(1Q09)	36.0	28.1	63.6	8.4	(Apr 09)	54.6	(Apr 09)	0.81	(May 09)
Singapore	−0.3	(May 09)	6.5	10.2	(1Q09)	276.2	68.8	99.2	6.8	(Mar 09)	86.7	(Apr 09)	0.81	(Mar 09)
Taipei,China	−2.0	(Jun 09)	−1.4	14.6	(1Q09)	16.2	9.5	31.6	20.4	(Jun 09)	54.4	(Apr 09)	0.69	(May 09)
Thailand	−4.0	(Jun 09)	−0.3	14.8	(1Q09)	11.9	10.3	38.1	9.3	(May 09)	51.3	(Apr 09)	0.94	(Apr 09)
Viet Nam	3.9	(Jun 09)	−4.5	−19.2	(4Q07)	31.4	20.2	44.4	3.8	(Feb 09)	75.6	(Feb 09)	0.98	(Feb 09)

GDP = gross domestic product, — = not available

[1]Data for Brunei Darussalam is primary budget balance estimate; for the Lao People's Democratic Republic (PDR), it is the overall balance (including grants) projection from IMF Article IV Consultation reports. Data for Cambodia; China, People's Republic of; Singapore; and Taipei,China refer to general government balance; for Malaysia, it covers federal government balance; for Republic of Korea, the balance includes social security funds; and for Viet Nam, it refers to state budget balance. Data for Hong Kong, China; Lao PDR; Singapore; and Thailand are on a fiscal year basis. [2]Total external debt includes cross-border loans from the Bank for International Settlements (BIS) reporting banks and BIS reporting banks to nonbanks, total official bilateral loans, total multilateral loans, total official trade credits, and international debt securities as defined in the Joint External Debt Hub. Full year 2008 nominal GDP (US$) was sourced from the International Monetary Fund's *World Economic Outlook,* April 2009. [3]Short-term external debt includes loans and credits, and debt securities due within a year as defined in the Joint External Debt Hub. Total reserves data for Lao PDR as of 1Q08 and for Myanmar, as of 2Q07. [4]Data for Cambodia is a projection, while data for Indonesia, Lao PDR, and Viet Nam are estimates from IMF Article IV Consultation reports. Data for Indonesia; Korea, Republic of; and Taipei,China cover central government debt; for Malaysia it covers federal government debt; and for the Philippines, it covers central government debt. [5]Refers to reserves minus gold over a 12-month moving average of imports (cif). [6]Indicator covers foreign liabilities and assets of banking institutions, deposit money banks, and other depository corporations of each country. [7]Covers loans to the private sector and non-financial institutions; and deposits (demand, time, savings, foreign currency, bond, and money market instruments) of banking institutions, deposit money banks, and other depository corporations of each country.

Source: CEIC; national sources; Joint External Debt Hub, BIS-IMF-OECD-WB; *International Financial Statistics, Direction of Trade Statistics, World Economic Outlook* April 2009, and *Article IV Consultations;* International Monetary Fund.

Table 6: Risk-Weighted Capital Adequacy Ratios (% of risk-weighted assets)

Economy	2000–2004 Average	2004	2005	2006	2007	2008[1]	2009[2]
China, People's Rep. of	-2.3[3]	-4.7	2.5	4.9	8.4	8.2	—
Hong Kong, China	16.1	15.4	14.8	14.9	13.4	14.7	15.6
Indonesia	18.7	19.4	19.3	21.3	19.3	16.8	17.8
Korea, Republic of	10.7	11.3	12.4	12.3	12.0	12.7	13.4
Malaysia	13.4	14.3	13.6	13.1	12.8	12.2	13.7
Philippines	17.0	18.7	17.7	18.5	15.9	15.7	—
Singapore	17.7	16.2	15.8	15.4	13.5	14.3	—
Taipei,China	10.5	10.7	10.3	10.1	10.6	10.8	—
Thailand	13.2	13.0	14.2	14.5	15.4	14.1	15.2

— = not available.
[1]Data for Singapore as of Sep 2008 and for People's Republic of China as of Mar 2008. [2]Data for Malaysia as of May 2009; for Thailand as of Apr 2009; for Hong Kong, China and Republic of Korea as of Mar 2009; and for Indonesia as of Jan 2009. [3]Average of 2000 and 2002-2004 figures. Figure for 2000 is ratio for state commercial banks.
Source: National sources and *Global Financial Stability Report* April 2009, International Monetary Fund.

a. Prudential Indicators

Banks continue to maintain ample capital cushions.

In the region's economies, risk-weighted capital adequacy ratios at above 10% continue to provide a strong capital cushion **(Table 6)**. This is even true in Korea, where the banking system is relatively more vulnerable given the greater reliance on external borrowing and a currency that is still sharply depreciated despite its recent rise. In addition, numerous banks have already raised capital or plan to do so in the near future. This should bode well, along with pressure from governments, for lending to stimulate economies. In some countries, governments have set up special capital funds, which banks can tap if needed, and re-activated the asset management company's role in cleansing and restructuring banks' bad debt.

Despite generally good profits and low non-performing loan ratios, concerns remain.

Banks' profitability had held up well **(Tables 7, 8)**, but more recent data present a mixed picture, largely due to falling income from fees and commissions amid the economic deceleration. Loan loss provisions have also increased in line with rising bad debts, even as available nonperforming loan ratios remained at low

Table 7: Rate of Return on Commercial Bank Assets (% per annum)

Economy	2000–2004 Average	2004	2005	2006	2007[1]	2008[2]	2009[3]
China, People's Rep. of	0.2	0.5	0.6	0.7	1.0	—	—
Hong Kong, China[4]	1.2	1.7	1.7	1.7	1.9	1.8	1.6
Indonesia	2.2	3.5	2.6	2.6	2.8	2.3	2.7
Korea, Republic of	0.4	0.9	1.2	1.1	1.1	0.5	—
Malaysia	1.3	1.4	1.4	1.3	1.5	1.6	—
Philippines	0.8	1.0	1.1	1.3	1.4	0.8	0.8
Singapore	1.1	1.2	1.2	1.4	1.3	1.1	—
Taipei,China	0.3	0.6	0.3	-0.4	0.1	-0.1	—
Thailand	0.7	1.3	1.3	0.8	0.2	1.0	0.9

— = not available.
[1]Data for People's Republic of China as of Jun 2007. [2]Data for Singapore as of Sep 2008 and for Malaysia as of Jul 2008. [3]Data for Hong Kong, China; Philippines; and Thailand as of Mar 2009; and for Indonesia as of Jan 2009. [4]Net interest margin of retail banks.
Source: National sources and *Global Financial Stability Report* April 2009, International Monetary Fund.

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

Economy	2000–2004 Average	2004	2005	2006	2007[1]	2008[2]	2009[3]
China, People's Rep. of	—	13.7	15.1	14.8	19.9	—	—
Hong Kong, China[4]	14.9	17.2	16.7	16.7	21.3	12.6	—
Indonesia	18.5	34.5	26.4	30.2	25.7	26.0	—
Korea, Republic of	6.1	15.2	18.4	14.6	14.6	—	—
Malaysia	16.3	16.7	16.7	16.2	19.7	—	—
Philippines	5.9	7.6	9.5	11.5	11.8	7.2	7.3
Singapore	9.6	11.6	11.2	13.7	12.9	11.9	—
Taipei,China	4.1	8.8	4.4	-7.3	2.6	-0.7	—
Thailand	13.3	19.4	16.5	10.2	2.8	12.2	11.0

— = not available.
[1]Data for People's Republic of China as of Jun 2007. [2]Data for Indonesia as of Aug 2008. [3]Data for the Philippines and Thailand as of Mar 2009. [4]Covers only locally-incorporated banks.
Source: National sources and *Global Financial Stability Report* April 2009, International Monetary Fund.

levels **(Table 9)**. The coverage of provisions for nonperforming loans in the PRC, Korea, and Singapore was above 100% in 2008, while for other economies coverage was above 80% **(Table 10)**. Meanwhile, the region's sovereign credit ratings remain generally stable, although the outlook has been revised to negative with the possibility of a future downgrade for Korea and Taipei,China (2Q2009) **(Figures 24a, 24b, 24c, 24d)**. Fitch Ratings downgraded Thailand on 16 April. Rating agencies have similarly revised downward the outlook for numerous financial institutions.

Table 9: Nonperforming Loans (% of commercial bank loans)

Economy	2000–2004 Average	2004	2005	2006	2007	2008[1]	2009[2]
China, People's Rep. of	21.0	13.2	8.6	7.1	6.2	2.5	2.0
Hong Kong, China[3]	4.0	1.6	1.4	1.1	0.9	1.2	1.5
Indonesia	10.2	4.5	7.6	6.1	4.1	3.2	3.6
Korea, Republic of	3.1	2.0	1.3	0.9	0.7	1.2	1.5
Malaysia[3]	8.9	6.8	5.6	4.8	3.2	2.2	2.2
Philippines[3]	14.8	12.7	8.5	5.7	4.4	3.5	3.7
Singapore	5.3	5.0	3.8	2.8	1.5	1.4	—
Taipei,China	5.2	2.8	2.2	2.1	1.8	1.5	—
Thailand[3]	13.5	10.9	8.3	7.5	7.3	5.3	5.5

— = not available.
[1]Data for Singapore as of Sep 2008. [2]Data for Malaysia as of May 2009; for the Philippines as of Apr 09; for China, People's Republic of; Hong Kong, China; Korea, Republic of; and Thailand as of Mar 2009; and for Indonesia as of Jan 2009. [3]Reported nonperforming loans are gross classified loans of retail banks.
Source: National sources and *Global Financial Stability Report* April 2009, International Monetary Fund.

Table 10: Bank Provisions to Nonperforming Loans[1] (%)

Economy	2000	2008[2]
China, People's Rep. of	4.7	115.3
Hong Kong, China	—	—
Indonesia	36.1	98.5
Korea, Republic of	81.8	155.4
Malaysia	57.2	88.9
Philippines	43.7	86.0
Singapore	87.2	119.9
Taipei,China	24.1	76.6
Thailand	47.2	97.9

— = not available.
[1]Values for Indonesia are write-off reserve on earning assets to classified earning assets ratio; while those for Malaysia refer to general, specific, and interest-in-suspense provisions. Data for People's Republic of China in 2000 cover state commercial banks only. [2]Data for Korea, Republic of and Singapore as of Sep 2008, and Indonesia as of Aug 2008.
Source: *Global Financial Stability Report,* and *International Financial Statistics,* International Monetary Fund; and national sources.

b. Activity Indicators

Loan growth in the region generally rose throughout 2008 before weakening somewhat in 2009, with the exception of the PRC, where loans grew much faster in the first half of 2009.

Among the ASEAN-4, loan growth was particularly strong; while in the NIEs, it has eased significantly since the last quarter of 2008. Banks across the region are now operating in a tougher lending environment and are inclined to reduce lending to protect their balance sheets as economic activities slow. At the same time, potential borrowers are less inclined to take on loans given uncertain employment and business prospects. Appropriate financial and fiscal measures should, therefore, be implemented to ameliorate such concerns and get credit to where it is needed to stimulate economic activity. In the PRC, the amount of new loans through June of this year has surpassed the total amount of new loans made in all of 2008 **(Figure 25)**. Such aggressive moves, while laudable, should not be made at the expense of laxer lending standards, which could simply lead to a rebound in bad loans a few years on. On the other hand, securities investments as a share of total bank assets have increased in some economies—buoyed by a moderation in lending activities

Figure 24a: S&P Sovereign Ratings—ASEAN-4 and Viet Nam (long-term foreign currency)

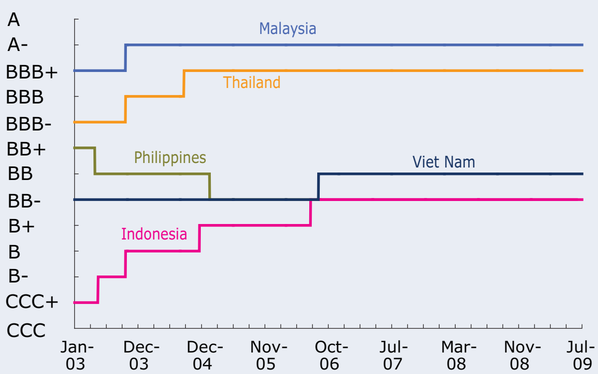


Figure 24b: S&P Sovereign Ratings—NIEs and PRC (long-term foreign currency)

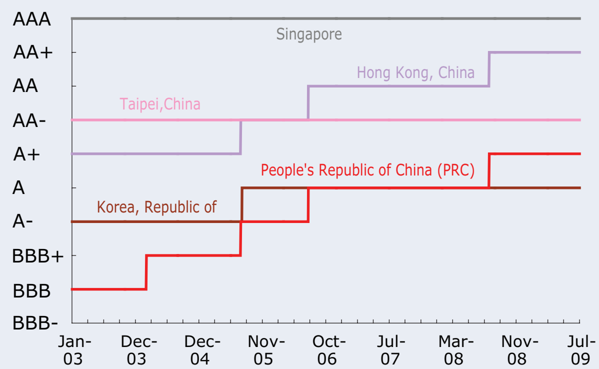


Figure 24c: Moody's Sovereign Ratings—ASEAN-4 and Viet Nam (long-term foreign currency)

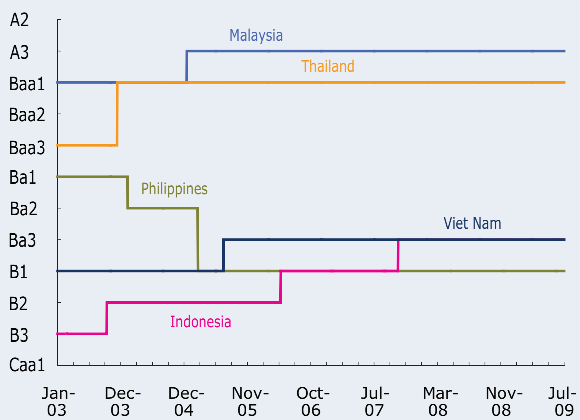
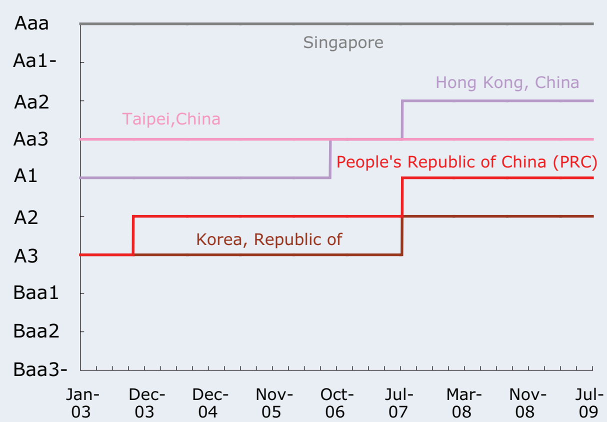
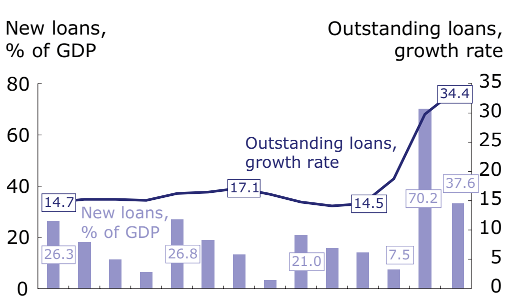


Figure 24d: Moody's Sovereign Ratings—NIEs and PRC (long-term foreign currency)



NIE = newly industrialized economy.
Source: Bloomberg.

Figure 25: Bank Lending—People's Republic of China



GDP = gross domestic product.
Source: OREI staff calculations based on data from CEIC.

and the larger issuance of government bonds to fund greater fiscal spending **(Table 11)**.

c. Market Indicators

Despite recent stock market recoveries, financial share prices have performed less favorably than overall market indexes.

In all economies, except the PRC, the financial stock price index had dropped much more precipitously than the overall stock market index **(Figures 26a, 26b)**. When the crisis unfolded, investor confidence was shaken by the health of banks because

Table 11: Securities Investment to Total Bank Assets of Commercial Banks (%)

Economy	2000–2004 Average	2004	2005	2006	2007	2008	2009[1]
Hong Kong, China	16.9	19.2	19.6	20.2	17.7	17.8	18.4
Indonesia	18.3[2]	20.2	18.0	24.8	27.8	20.1	21.3
Korea, Republic of	23.2	20.8	22.1	20.2	18.6	16.5	16.8
Malaysia	12.7	10.6	9.6	9.3	11.9	14.6	14.6
Philippines[3]	23.8	32.6	30.1	23.7	21.2	23.9	25.6
Singapore	16.9	17.1	16.5	15.9	15.8	14.8	14.4
Taipei,China	13.6	14.2	12.1	12.0	11.9	11.7	12.5
Thailand	15.2	16.0	16.0	15.8	15.9	13.7	15.4

— = not available.
[1]Data for Malaysia; Singapore; and Taipei,China as of May 2009; for Hong Kong, China; Philippines; and Thailand as of Apr 2009; for Republic of Korea as of Mar 2009; and for Indonesia as of Jan 2009. [2]Refers to 2001—2004 average. [3]Financial assets (net of allowance for credit losses) as a ratio of total assets of commercial banks.
Source: National sources and CEIC.

Figure 26a: Ratio of Financial Stock Price Index to Overall Stock Market Index—NIEs-4 and PRC
(January 2006 = 100)

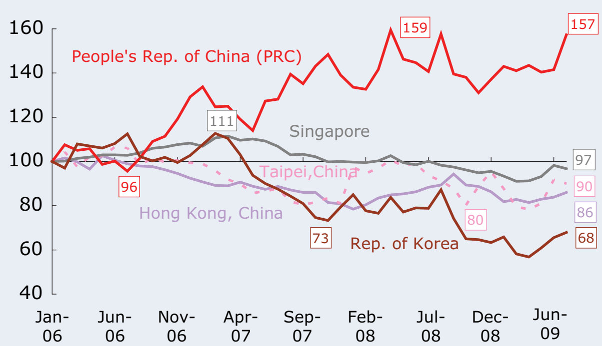
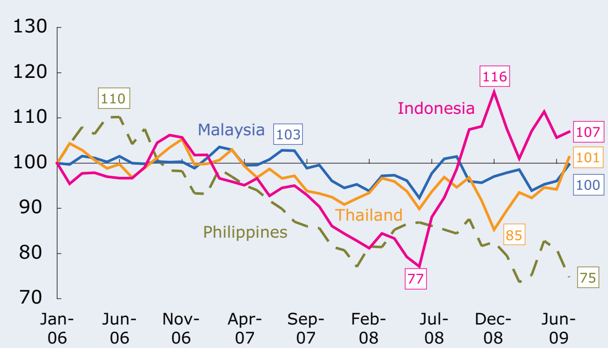


Figure 26b: Ratio of Financial Stock Price Index to Overall Stock Market Index—ASEAN-4
(January 2006 = 100)

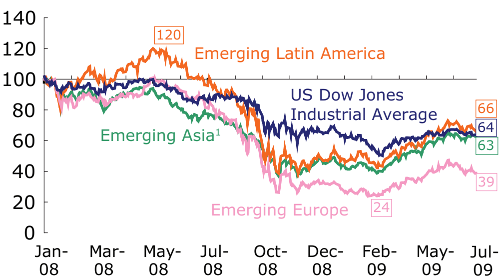


NIE = newly industrialized economy.
Source: OREI staff calculations using Reuters data.

of the uncertainty over the extent of toxic asset holdings. Right after the collapse of Lehman Brothers, confidence plummeted when it became clear that Asia would not escape the effects of a sharp contraction in demand from developed countries. As the heart of Asian businesses, banks remain the weakest link in regional economies, which is reflected in their performance vis-à-vis the overall market. That said, the region's banking systems have made significant progress since the 1997/98 Asian financial crisis and remain in a better position than banks in other regions. Along with measures implemented to protect depositors and stabilize financial systems, the post-crisis reforms have largely helped emerging East Asian banks escape the same fate as their western counterparts.

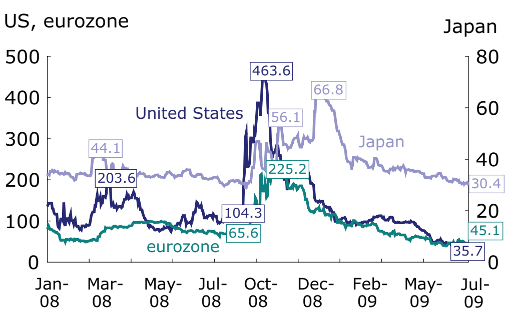
Economic Outlook, Risks, and Policy Issues

Figure 27: MSCI Indexes
(2 Jan 2008 = 100)



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

Figure 28: TED Spreads[1]–G3



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

External Economic Environment

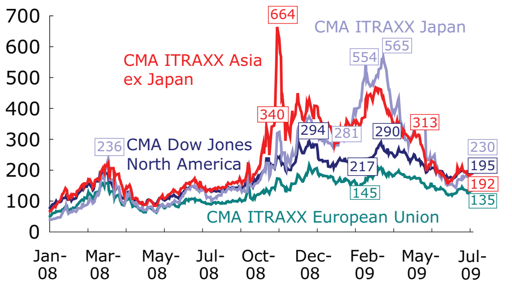
In recent months, the world economy has shown tentative signs of stabilizing, with financial stress and the pace of economic decline easing.

Measures taken by major economies to shore up financial stability boosted global stock markets recently, following several months of plunging prices **(Figure 27)**. Credit spreads have narrowed since March **(Figure 28)**; indicating that liquidity in international financial markets has improved significantly. Corporate default risk has decreased over the past 2 months—though the global recession and worsening corporate earnings outlook have kept default risk elevated **(Figure 29)**. Emerging market sovereign bond spreads have fallen, yet remain wide with credit quality deteriorating **(Figure 30)**. Despite major central bank intervention and the slowdown in economic decline, growing concerns over future inflation from the increased government debt associated with financial stimulus has driven long-term treasury yields up sharply from their very low levels following the September 2008 Lehman Brothers' collapse **(Figure 31a)**. As the short end remains low due to aggressive monetary easing among G3 economies—US, eurozone, and Japan—yield curves have steepened, which may indicate an economic upturn is approaching **(Figure 31b)**. Early indicators from major industrial economies—business and consumer confidence, purchasing managers' indexes, and consumer spending—show the pace of economic contraction has slowed and the worst of the decline may be over.

Despite these early indicators, the global economy is expected to contract in 2009 for the first time since World War II.

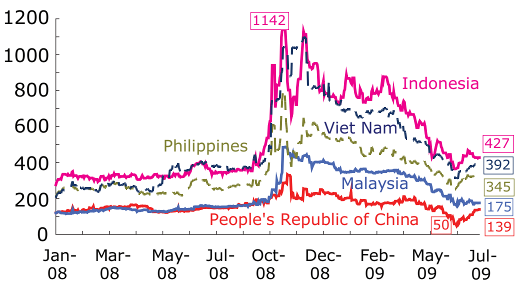
A global, synchronized economic downturn is underway with the G3 economies all in recession. The International Monetary Fund (IMF) now projects GDP in advanced economies to decline by 3.8% in 2009—after growing 0.8% in 2008. The world economy is expected to remain sluggish in 2010. The process of financial deleveraging as a result of the crisis exacted a heavy toll on

Figure 29: Credit Default Swap Indexes
(investment grade, senior 5-year)



Source: Datastream.

Figure 30: JPMorgan EMBI Sovereign Stripped Spreads (basis points)



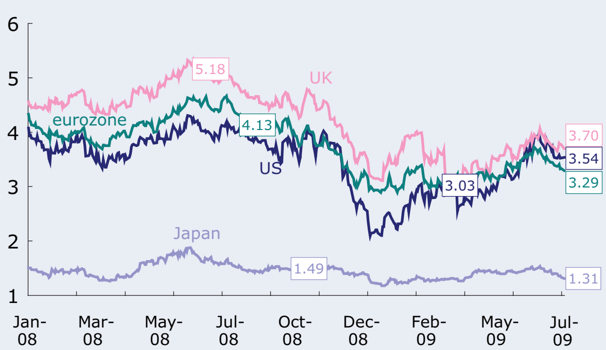
Source: Bloomberg.

asset prices and credit conditions. The value of financial assets worldwide may have fallen by well over $50 trillion.[6] With cash-strapped households and firms suffering from the credit squeeze, demand weakened and economic activity slowed. As demand dropped, world trade and industrial production also plummeted in the last few months of 2008 and into early 2009. The negative feedback loop between the real and financial sectors could further cloud the outlook, unless more comprehensive and coordinated policy actions break the vicious cycle.

While the pace of economic decline in the US has slowed, GDP is nonetheless expected to record its worst contraction in 60 years.

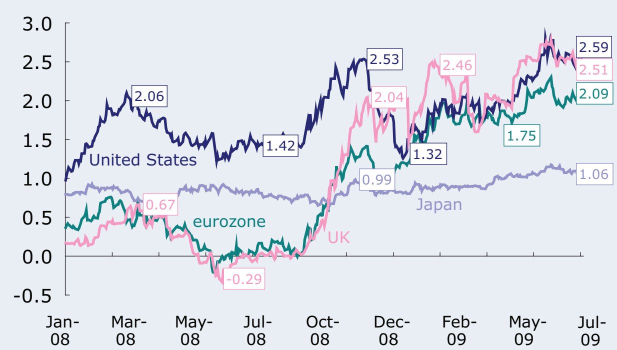
After shrinking 6.3% (quarter-on-quarter, seasonally adjusted annualized rate) in the fourth quarter last year—its biggest quarterly slowdown since 1982—the US economy contracted a further 5.5% in the first quarter of 2009. Strong second quarter growth in 2008 skewed the recessionary pattern, leaving the US economy showing overall growth of 1.1% in 2008 **(Figure 32)**. The labor market remains weak with the unemployment rate climbing toward 10% **(Figure 33)**. However, the US housing market is showing tentative signs of stabilization, with new and existing home sales growing, albeit at low levels. Deep price

Figure 31a: 10-Year Government Bond Yields (% per annum)



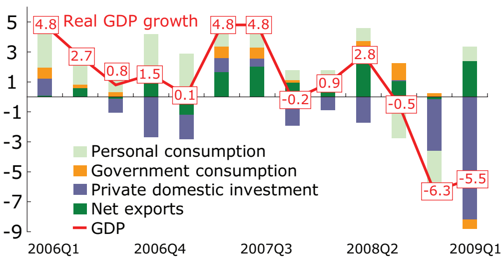
UK = United Kingdom, US = United States.
Source: Datastream.

Figure 31b: 2-year and 10-year Government Bond Yield Spreads (% per annum)



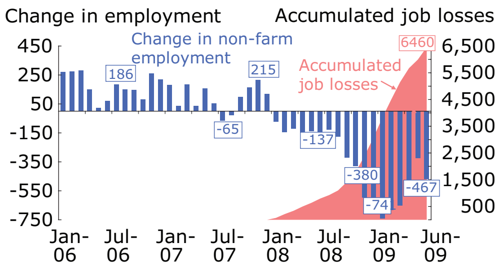
[6]See Loser, Claudio M. 2009. *Global Financial Turmoil and Emerging Market Economies: Major Contagion and a Shocking Loss of Wealth?* Available: http://www.adb.org/Media/Articles/2009/12818-global-financial-crisis/Major-Contagion-and-a-shocking-loss-of-wealth.pdf. ADB. March.

Figure 32: Contributions to Growth—US (seasonally adjusted, annualized, q-o-q, % change)



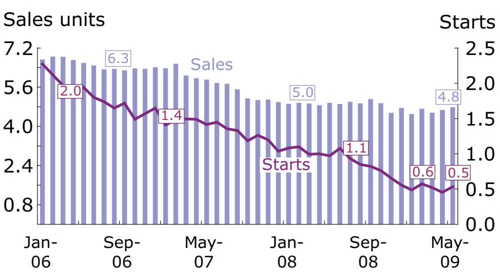
GDP = gross domestic product, q-o-q = quarter-on-quarter.
Source: US Bureau of Economic Analysis.

Figure 33: Change in Non-Farm Employment and Accumulated Job Losses[1] (in thousands)



[1]Accumulated job losses since December 2007. Figures for April and May 2009 are preliminary.
Source: OREI staff calculations based on data from the US Department of Labor, Bureau of Labor Statistics.

Figure 34: Private Housing Starts[1] **and Existing Home Sales**[2]**—US** (million units)



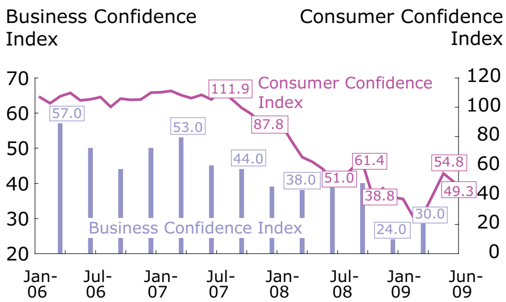
US = United States.
[1]Seasonally adjusted levels. [2]Seasonally adjusted and annualized.
Source: CEIC.

discounts from foreclosures and favorable mortgage rates are attracting new buys and mortgage refinancing **(Figure 34)**. In addition, US consumers are feeling less pessimistic about the economy as confidence rises, a possible boost to future consumer spending **(Figure 35)**. The US Federal Reserve's (Fed) largely positive stress test results for major US banks boosted investor confidence. Also, the Fed recently outlined a series of specific requirements for banks to exit the Troubled Asset Relief Program (TARP), including a requirement that the bank sell equity to the public. Headline inflation is near zero and likely to remain very low, at least in the short term. Core inflation, which excludes food and energy, is at about 2%. Following the trauma of deleveraging and lost wealth, US households have now started to save, with the personal savings rate reaching 6.9% in May, the highest in 15 years. The massive shift in consumer behavior will produce great benefits in the long run, but is slowing recovery in the near term. The US economy is now expected to contract 3.0% this year, before returning to a forecasted 1.6% growth rate in 2010. There remain, however, significant downside risks and uncertainties, leaving any forecast tentative.

The eurozone is expected to experience a severe recession this year as its financial markets remain stressed, industrial production plunges, and unemployment surges.

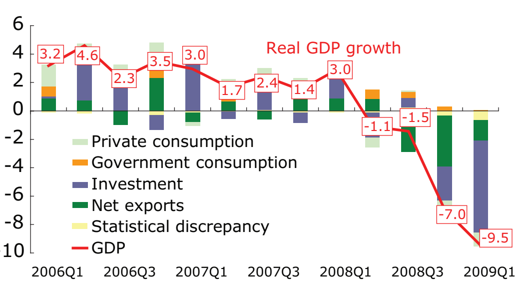
The eurozone economy contracted 9.5% (q-o-q, seasonally adjusted annualized rate) during the first quarter of 2009, after shrinking 7.0% in the last quarter of 2008 **(Figure 36)**. Exports fell sharply on slumping global demand **(Figure 37)**. As the credit crunch broadened, banks held back lending and corporate spending dropped. Consumers remain cautious, given the heightened uncertainty about job prospects and credit conditions. Germany is among the hardest hit. As its key export markets fell victim to the deepening financial crisis, exports and industrial production declined sharply. Financial conditions remain tenuous, particularly with large bank exposure to Central and Eastern Europe, where rising loan losses hint at credit downgrades. Business and consumer confidence in the eurozone remains low, despite some move upward in the past month or so, suggesting that a longer and more protracted recession is on the horizon **(Figure 38)**. There are some signs of improvement, such as slower declines in retail sales and industrial production **(Figure 39)**. Eurozone headline inflation dipped below zero to

Figure 35: US Business and Consumer Confidence Indexes



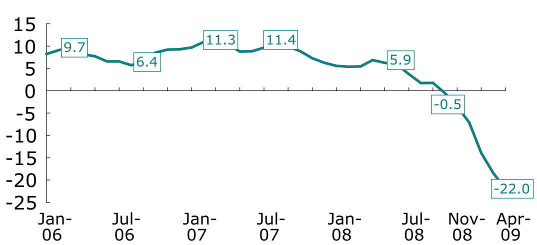
US = United States.
Notes: Consumer Confidence (1985 = 100). A business confidence index above 50 means there are more positive than negative responses. Consumer confidence index is monthly; business confidence index is quarterly.
Source: Datastream.

Figure 36: Contributions to Growth[1]—eurozone (seasonally adjusted, annualized, q-o-q, % change)



GDP = gross domestic product, q-o-q = quarter-on-quarter.
[1]2009Q1 figures are second estimates.
Source: Eurostat website.

Figure 37: Export Growth[1]—eurozone[2]
(y-o-y, % change)



[1]3-month moving average of seasonally adjusted, year-on-year growth. [2]Refers to Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.
Source: OREI Staff calculations based on Datastream data.

−0.1% in June 2009, the lowest since the start of the series, suggesting substantial economic slack. The European Central Bank (ECB) cut its benchmark interest rate to 1.0% in May 2009, a total of 150 basis points so far this year, and has maintained its emergency lending window open to banking systems. European governments ploughed hundreds of billions of euros into ailing banks to prop up market confidence. The eurozone economy is expected to contract 4.3% in 2009 and may stagnate in 2010.

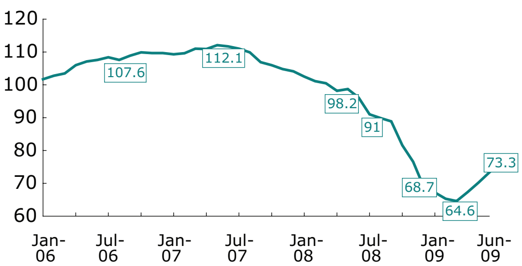
Japan's GDP is forecast to contract by 5.8% this year, the largest contraction since 1955, as export demand continues to collapse and domestic consumption remains sluggish.

In the first quarter of 2009, Japan's economy contracted a whopping 8.8%, with the annualized quarterly contraction of 14.2% being the largest drop since records began in 1955 and the fourth straight quarter of negative growth **(Figure 40)**. With its reliance on trade, Japan suffered the worst contraction among major industrialized nations. Exports in real terms fell at an annualized 70% (q-o-q, seasonally adjusted) in the first quarter. Domestic demand also declined for the fourth quarter in a row. Declining corporate profits continue to drive business sentiment down. But consumer sentiment improved slightly—though remained low—in recent months, suggesting domestic demand will remain weak **(Figure 41).** Japan's stock prices have rebounded about 10% since the beginning of 2009, though at one point plunged to a 26-year low. Industrial production has been growing in recent months, after a precipitous fall early in the year, and Japan's purchasing managers' index—an important sentiment indicator—has picked up in recent months **(Figure 42)**. The Bank of Japan has kept its policy rate low after slashing it from 0.3% to 0.1% on 19 December. The central bank has also announced it will buy commercial paper and shares to boost asset prices.

World trade volume is forecast to decline for the first time in nearly 3 decades, as economic activity in advanced economies collapses.

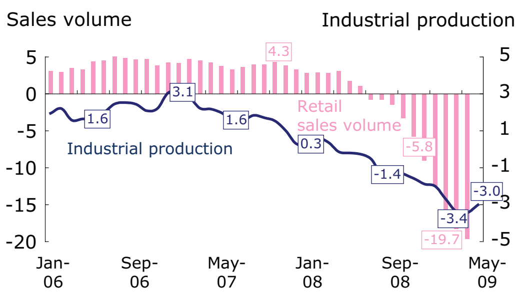
Trade is again proving to be a potent channel for transmitting shocks—developing a downward spiral through declines in world demand and industrial production **(Figure 43)**. A sharp falloff in G3 import demand has been battering developing economies

Figure 38: Economic Sentiment Indicator[1]—eurozone[2]



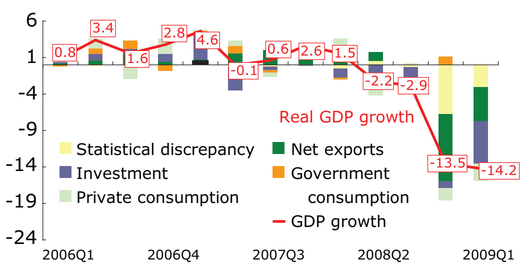
[1]The economic sentiment indicator is a composite index of business and consumer confidence indicators based on surveys of economic assessments and expectations in the eurozone. [2]eurozone in this figure refers to Euro Area 16, composed of the following countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.
Source: Datastream.

Figure 39: Retail Sales and Industrial Production[1]—eurozone



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

Figure 40: Contributions to Growth[1]—Japan (seasonally adjusted, annualized, q-o-q, % change)



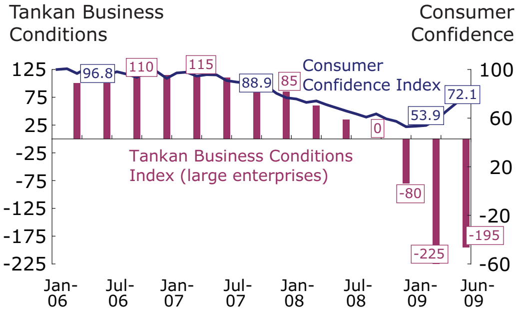
GDP = gross domestic product, q-o-q= quarter-on-quarter.
[1]2009Q1 figures are 2nd preliminary estimates.
Source: Cabinet Office, Government of Japan.

that rely on exports for a large portion of GDP, while hurting industrial activity as well. With emerging East Asia vulnerable to changing demand conditions in major industrial countries, the downturn in exports has directly translated into slowing GDP growth. Trade within the region is imploding, particularly as the PRC remains an assembly hub for final products destined for major industrial countries—with a large proportion of the intermediate goods sourced from the Association of Southeast Asian Nations (ASEAN) and the newly industrialized economies (NIEs). It now appears likely that sagging global demand and the continuing financial crisis will seriously affect industrial production in the region. World trade volume is expected to contract 12.4% in 2009, sharply down from the estimated 6.2% growth last year.

The high-tech and auto industries have been particularly hurt by the global recession, as tight finance, slowing demand, and uncertainty over the short-term choke demand and investment.

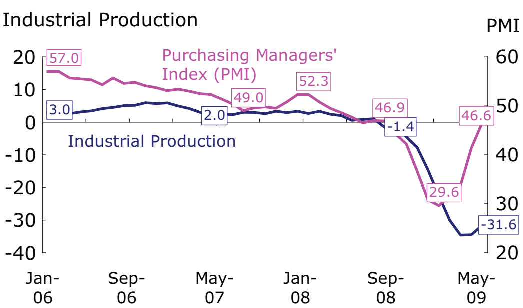
Sales of computer equipment and software continue to decline in major industrial countries **(Figure 44)**. In the first quarter of 2009, US corporate spending on equipment and software fell 33.7% q-o-q, following a contraction of 28.1% the previous quarter. Weak demand for consumer electronics, wireless communication devices, and personal computers is also putting a damper on high-tech production worldwide. Slumping global demand for automobiles in general and a shift in demand toward more fuel-efficient cars have been the bane of the auto industry in recent years, particularly in the US (leading to the bankruptcies of General Motors and Chrysler). However, there are signs that both the high-tech and auto industries are stabilizing. After declining for two quarters, final sales of computers in the United States (US) rose 16.2% (q-o-q, seasonally adjusted and annualized). The pace of decline in new orders in major industrial countries has slowed over the past few months, as business and consumer confidence recovers **(Figure 45)**. Global auto sales improved in the second quarter, led by emerging markets. In the PRC, auto sales were up 18% in the first half of 2009—supported by government incentives including a sales tax cut for small cars and one-off cash subsidies to owners who trade in high-emission vehicles.

Figure 41: Business and Consumer Sentiment Indexes—Japan (Jan 2006 = 100)



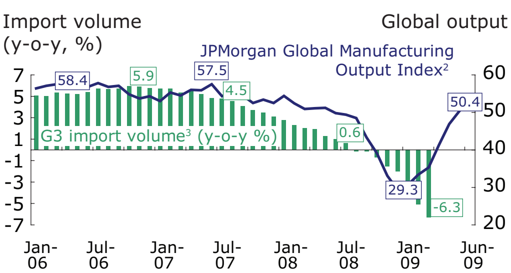
Source: OREI staff calculations based on Datastream data.

Figure 42: Industrial Production[1] and Purchasing Managers' Index[2]—Japan



[1]Year-on-year growth of 3-month moving averages. [2]Refers to Manufacturing PMI; seasonally-adjusted series.
Source: Bloomberg and OREI staff calculations based on data from CEIC.

Figure 43: Global Manufacturing Output and G3 Import Volume[1]



y-o-y = year-on-year.
[1]Annual growth rate. [2]A component of the JPMorgan Global Manufacturing Purchasing Managers' Index (PMI), which serves as an indicator of global manufacturing business conditions, based on data collected from surveys around the world. A reading above 50 indicates an increase in the variable from the previous month and a reading below 50 indicates a decrease. [3]G3 (eurozone, Japan, US) 12-month moving average growth rates were aggregated using import values in USD.
Source: OREI staff calculations based on data from *International Financial Statistics*, International Monetary Fund; Bloomberg; JPMorgan; and Datastream.

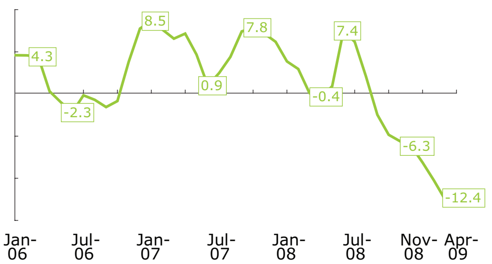
The increase in commodity prices since the beginning of the year will likely stabilize over the remainder of 2009.

Commodity prices, as measured by the International Monetary Fund (IMF) Primary Commodity Prices, have risen 17% from their lows in February this year. Yet, they remain far below their peaks of mid-2008 **(Figure 46)**. The commodity price boom, which lasted from 2003 through mid-2008, abruptly ended when global demand sunk in response to the financial and broader economic crisis. The sharp rise and subsequent decline in commodity prices illustrates the classic boom and bust cycle of commodities in response to global growth. Having tumbled from close to $150 per barrel (bbl) last July to below $40/bbl at the end of 2008 as global energy demand collapsed amid the deepening economic crisis, oil prices doubled in the first half of 2009 to about $70/bbl **(Figure 47)**. While the Organization of the Petroleum Exporting Countries (OPEC) has reduced target production levels, weaker global demand and increased capacity among several OPEC producers also imply that surplus production capacity should rise significantly over the next several years, limiting the possibility of oil prices from rising further **(Figure 48)**. Oil futures suggest that oil prices will remain at about $70/bbl for 2009 and early 2010. Slower growth, increased production capacity, and a build-up in stocks for many commodities are expected to keep prices of non-oil commodities at bay throughout 2009.

The overall external environment for emerging East Asia remains difficult and uncertain, with the recession in advanced economies continuing and global financial conditions improving yet tight.

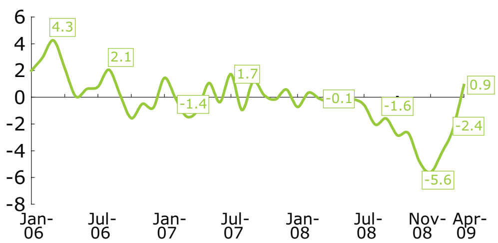
The weakest link undoubtedly remains the global banking system. Large writedowns on mortgage-backed securities and other assets continue to erode the capital base in major global banks. Banks worldwide have thus far reported more than $1.47 trillion in writedowns and more losses are expected in the coming months (see Figure 23). While having eased in the past few months, financial conditions remain tight compared with the period before September 2008, thereby, slowing economic activity in developed countries. Limited credit also constrained growth and trade in emerging market economies—including emerging East Asia. Strong policy responses are supporting the

Figure 44: Computer and Software Sales—G3[1] (y-o-y, % change)



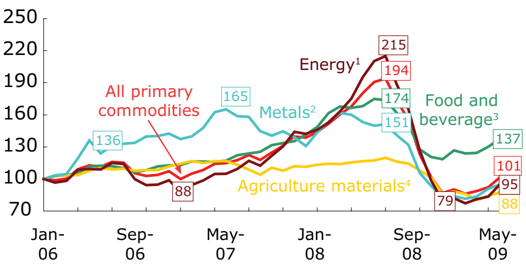
[1]3-month moving average of growth in sales values. G3 refers to United States, eurozone, and Japan.
Source: Datastream and Eurostat.

Figure 45: New IT Orders[1]**—G3**[2]
(% change)



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

Figure 46: Primary Commodity Price Indexes (Jan 2006 = 100)



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

global economy, yet the immediate outlook remains both weak and uncertain.

Regional Economic Outlook for 2009–2010

Economic forecasts for major industrial economies in 2009 continue to be revised downward, with a drag effect on emerging East Asia's growth outlook likely.

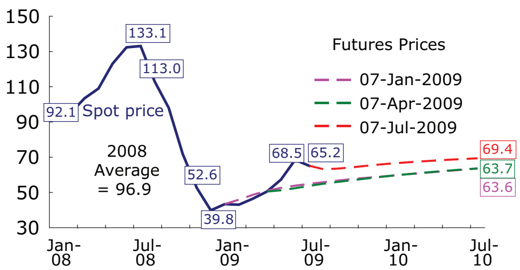
While there are signs of improvement in G3 economies in the second quarter, weak and uncertain global economic conditions have led to a lowering of growth forecasts for 2009. ADB's March *Asian Development Outlook* (ADO) forecasts a 3.0% growth rate for emerging East Asia for 2009.[7] Since then, downside risks to the outlook have increased in a number of economies, including Hong Kong, China; Malaysia; Philippines; Taipei,China; and Thailand. On the other hand, there are upside risks to the 2009 outlook for the PRC, and possibly Indonesia.

The weak external environment implies that external demand for the region's products will remain sluggish.

Before emerging East Asia can return to the levels of growth seen in recent years, industrialized economies must recover sufficiently to rekindle demand for the region's exports. The US, Japan, and Europe remain major markets for Asian exporters (see Figure 1.2). Trade within emerging East Asia has grown rapidly in recent years, but it remains largely based on parts and components rather than final goods. The region has yet to provide final demand for its own exports. As a result of only a modest recovery projected in 2010, the region's external demand will not pick up soon, and the region's export recovery will largely hinge on how quickly major industrial countries recover. Until stimulus in advanced economies begins to gain traction and households realign their debt and savings profiles, it is unlikely that external demand will drive the region's export production back to full throttle any time soon.

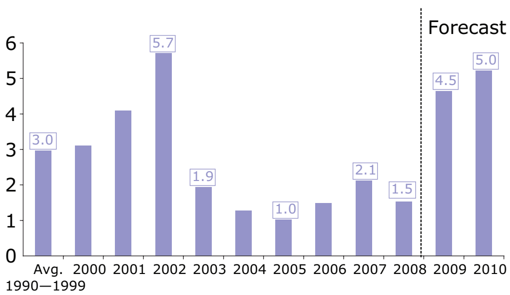
[7]*Asian Development Outlook 2009 i*s available at http://www.adb.org/Documents/Books/ADO/2009/default.asp .

Figure 47: Brent Spot[1] and Futures Prices
(USD per barrel)



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

Figure 48: OPEC Spare Capacity
(barrels per day, million)



OPEC = Organization of the Petroleum Exporting Countries.
Source: *Short-Term Energy and Summer Fuels Outlook* (July 2009), US Energy Information Administration.

Domestic demand in emerging East Asia is expected to pick up gradually from the second half of 2009 as policy measures in the region gain traction and business and consumer confidence improves.

The stimulus measures adopted by governments across emerging East Asia since September 2008 have started to take effect. Monetary and fiscal easing—and a significant depreciation of many of the region's currencies—have helped reinvigorate some domestic demand. Early indicators such as industrial production, retail sales, fixed-asset investment, and business and consumer confidence, all show that economic activity slowed less or began to grow in the second quarter. GDP growth in the second quarter of 2009 for the PRC and Singapore, for example, improved significantly from the first quarter of 2009. Domestic demand is strengthening, which should support a recovery in emerging East Asia beginning in late 2009.

Emerging East Asia has entered the transition from recession to recovery—possibly V-shaped—with GDP growth sourced more from domestic stimulus than a resurgence in external demand.

The regional outlook has improved from just a few months ago. The deceleration of emerging East Asia's growth from 6.1% in 2008 to 3.0% in 2009 remains the worst since the 1997/98 Asian financial crisis. This resiliency, supported by expansionary policies, will allow the region's largest economies to sustain positive, if much slower, growth. Those economies with strong global trade and financial links, however, are expected to continue to contract, though less dramatically **(Table 12)**. As external demand will remain sluggish in the near future, emerging East Asia's recovery is expected to be gradual, with 2010 growth rising to about 6.0%. It will undoubtedly take time before the region's economies return to their full potential.

Mainly due to the sharp drop in exports, economic growth in the PRC is expected to slow this year to its lowest annual rate in nearly 2 decades, while reaching 8.0% in 2010.

The PRC economy grew 6.1% in the first quarter of the year, rising to 7.9% in the second quarter, which is already painting a better picture for the rest of the year. The government's stimulus

Table 12: Annual GDP Growth Rates (%, y-o-y)

	2000–2007 Average	2004	2005	2006	2007	2008	2009Q1	2009Q2	March 2009 ADB Forecasts[8] 2009	2010	Expected revision to 2009 forecast
Emerging East Asia[1,2]	**7.6**	**8.0**	**7.7**	**8.7**	**9.7**	**6.1**	**1.2**	**—**	**3.0**	**6.0**	▲
ASEAN[1,2]	**5.4**	**6.5**	**5.7**	**6.0**	**6.4**	**4.2**	**-1.9**	**—**	**0.7**	**4.2**	▼
Brunei Darussalam	2.3	0.5	0.4	4.4	0.6	-2.7	—	—	-0.4	2.3	■
Cambodia	9.5	10.3	13.3	10.8	10.2	6.5	—	—	2.5	4.0	■
Indonesia[3]	5.0	5.0	5.7	5.5	6.3	6.1	4.4	—	3.6	5.0	▲
Lao PDR	6.7	7.0	6.8	8.7	7.8	7.2	—	—	5.5	5.7	■
Malaysia[4]	5.6	6.8	5.3	5.8	6.2	4.6	-6.2	—	-0.2	4.4	▼
Myanmar[5]	12.9	13.6	13.6	13.1	11.9	—	—	—	—	—	—
Philippines[6]	5.1	6.4	5.0	5.3	7.1	3.8	0.4	—	2.5	3.5	▼
Thailand	5.1	6.3	4.6	5.2	4.9	2.6	-7.1	—	-2.0	3.0	▼
Viet Nam	7.6	7.8	8.5	8.2	8.4	6.2	3.1	4.4	4.5	6.5	■
Newly Industrialized Economies[1]	**4.9**	**5.9**	**4.7**	**5.6**	**5.6**	**1.6**	**-6.6**	**—**	**-3.3**	**3.5**	▼
Hong Kong, China	5.3	8.5	7.1	7.0	6.4	2.4	-7.8	—	-2.0	3.0	▼
Korea, Rep. of	5.2	4.6	4.0	5.2	5.1	2.2	-4.2	—	-3.0	4.0	■
Singapore	6.0	9.3	7.3	8.4	7.8	1.1	-9.6	-3.7[7]	-5.0	3.5	▼
Taipei,China	4.1	6.2	4.2	4.8	5.7	0.1	-10.2	—	-4.0	2.4	▼
China, People's Rep. of	10.1	10.1	10.4	11.6	13.0	9.0	6.1	7.9	7.0	8.0	▲
Japan	1.7	2.7	1.9	2.0	2.4	-0.8	-8.8	—	-5.8	1.1	
US	2.5	3.6	2.9	2.8	2.0	1.1	-2.5	—	-3.0	1.6	
eurozone	2.1	2.1	1.7	2.9	2.7	0.7	-5.2	—	-4.3	0.5	

▲ = most likely to be revised upward, ▼ = most likely to be revised downward, ■ = most likely to remain unchanged.
FY = fiscal year, GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic, US = United States, and y-o-y= year-on-year.
— = not available
[1]Aggregates are weighted according to gross national income levels (atlas method, current $) from the World Bank's *World Development Indicators*. [2]Excludes Myanmar for all years as weights are unavailable. Quarterly figures exclude Brunei Darussalam; Cambodia; Lao PDR; and Myanmar for which quarterly data is not available. [3]GDP growth rates from 1999–2000 are based on 1993 prices, while growth rates from 2001 onward are based on 2000 prices. [4]Growth rates from 1999–2000 are based on 1987 prices, while growth rates from 2001 onward are based on 2000 prices. [5]For FY April–March. [6]Figures for 2004–2006 are not linked to the GDP figures 2003 backwards due to National Statistics Office revisions of sectoral estimates. [7]Advance estimate released by Singapore's Ministry of Trade and Industry. [8]2009 figures for Japan, US, and eurozone are revised forecasts from the March 2009 *Asian Development Outlook* (ADO).
Source: ADB, Eurostat website (eurozone), Economic and Social Research Institute (Japan), Bureau of Economic Analysis (US), and International Monetary Fund's *World Economic Outlook* (April 2009).

package has boosted demand, as fixed-asset investment growth was strong in recent months. Expansionary monetary policy drove broad money (M2) up 28.5% in the year to June 2009, significantly higher than the 15.0% in the second half of 2008. While fine-tuning the fiscal stimulus package—with more on social spending and affordable housing and less on infrastructure—the government has budgeted a deficit of 3.0% of GDP in 2009, well above the 0.4% of GDP in 2008. The increase is the largest since the late 1970s and will help cushion the impact of the global crisis. GDP growth is forecast to slow this year from the 9.0% rate in 2008, before recovering to 8.0% in 2010, with risks on the upside. Because the PRC's imports from the region have increased significantly in recent years, continued robust growth in the PRC will likely benefit other economies in the region as well **(Box 1)**.

Highly dependent on external demand and tightly integrated with global financial markets, the NIEs will likely contract this year before experiencing moderate growth in 2010.

From meager growth in 2008 of 1.6%, the aggregate GDP of the NIEs is forecast to contract 3.3% in 2009, before returning to a 3.5% growth rate in 2010. Economic activity remains well below the levels prior to September 2008, when the Lehman Brothers bankruptcy set the dominoes falling toward world recession. In general, the NIEs should pick-up gradually from the second half of 2009 and into 2010. Korea's economy may have bottomed out in the first quarter, when it grew 0.5% (q-o-q, seasonally adjusted annualized rate) as government and central bank stimulus appears to have begun to take hold. A weak won also helped. With sharply falling external demand and persistent financial stress, Korea's economy is expected to contract 3.0% for 2009 before recovering to a 4.0% growth rate in 2010. Due to its strong global trade and financial links, GDP in Hong Kong, China is projected to contract 2.0% in 2009, despite the expansionary spending and continuing robust growth in the PRC. Similarly, in Singapore, in spite of a massive fiscal stimulus package—leading to a fiscal deficit of 3.5% of GDP—the economy is expected to contract 5.0% in 2009. Suffering a 10.2% first quarter GDP contraction, the economy of Taipei,China is expected to shrink 4.0% in 2009, with a forecast return to growth of 2.4% in 2010. The 2009 growth forecast has some upside risks for Korea, but those for Hong Kong, China; and Taipei,China have risks on the downside.

Box 1: Will the People's Republic of China Lead the Recovery in Emerging East Asia?

The People's Republic of China (PRC) is the largest economy in emerging East Asia. It has avoided the worst effects of the global downturn, growing a robust 7.1% in the first half of the year. This has led many to believe that the PRC will help ignite economic recovery across the region.

To achieve this, the PRC's economy must continue its strong growth. There are good reasons to believe it will. Like other emerging East Asian economies, PRC exports have fallen drastically. But the PRC's massive fiscal stimulus package appears to have countered this external demand shock. Along with fiscal stimulus, there has also been substantial monetary easing leading to a surge in new lending. Together, these measures suggest that robust economic growth in the PRC will continue, at least in the short term.

The huge stimulus package boosted the government's fiscal deficit this year to a projected 3.0% of GDP from 0.4% in 2008. This may be the highest since 1979, but remains low compared with deficits in much of the rest of emerging East Asia. Unlike most developed countries, the PRC has also been able to get its banks to ramp up lending. In the first quarter alone, new bank lending exceeded last year's total. This is good for the economy and economic activity, so long as it stays manageable.

The share of private consumption in the PRC has been declining since 1995—accounting for only 35% of GDP in 2008—while the importance of net exports and investment has been rising. To ensure sustainable growth, rebalancing growth toward greater consumption from an over-reliance on exports is likely. But PRC consumers so far have remained cautious—while still strong, growth in retail sales slowed to 15.0% in June 2009 year-on-year (y-o-y) from 23.2% in September 2008. However, as the global financial system begins to regain stability and economic recovery begins to take hold, consumer confidence may strengthen further. Thus, it is likely that the PRC will recover ahead of other emerging East Asian economies, reaching its targeted growth rate of 8.0%.

Should the PRC recover quickly, will it help recovery in other emerging East Asian economies?

The PRC can serve as a huge market for emerging East Asian exports. The share of emerging East Asia's exports to the PRC and to Hong Kong, China has been rising over the years[1] **(Table 1.1)**. For example, the share of Taipei,China's exports to the PRC and Hong Kong, China rose from below 25% in 2000 to almost 40% in 2008. With most advanced economies in recession, the PRC is one of the few large economies still growing. Recent trends show that while exports from ASEAN-4 and the NIEs to the United States (US) have continued falling, exports to the PRC and Hong Kong, China have started increasing **(Figures 1.1a, 1.1b)**.

[1]Exports to Hong Kong, China are frequently bound for factories in the PRC.

Table 1.1: Exports of Emerging East Asia to the People's Republic of China and Hong Kong, China
(% of total exports)

Year	Indonesia	Rep. of Korea	Malaysia	Philippines	Singapore	Taipei,China	Thailand	Viet Nam	EEA
2000	6.6	16.0	7.2	6.1	11.3	24.4	8.8	12.4	13.6
2001	5.9	17.5	8.5	6.7	12.9	26.6	9.2	11.2	14.6
2002	6.9	19.8	10.8	9.6	14.2	32.1	10.2	10.8	17.1
2003	7.8	23.6	12.4	13.3	15.0	35.7	12.1	10.9	19.5
2004	7.9	25.5	12.1	13.6	16.3	38.0	12.1	12.1	20.7
2005	9.0	25.9	12.0	16.8	17.6	39.1	13.5	10.8	21.4
2006	9.5	25.9	11.8	16.7	19.5	39.8	14.2	9.1	21.8
2007	9.5	25.9	12.9	21.9	19.8	40.7	15.1	7.9	22.3
2008	9.9	28.4	15.9	33.8	19.2	39.0	14.6	8.2	22.8

Note: Emerging East Asia (EEA) includes Indonesia; Korea, Republic of; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: OREI staff calculations based on *Direction of Trade Statistics,* International Monetary Fund.

Figure 1.1a: Destination of ASEAN-4 Exports
(USD million)

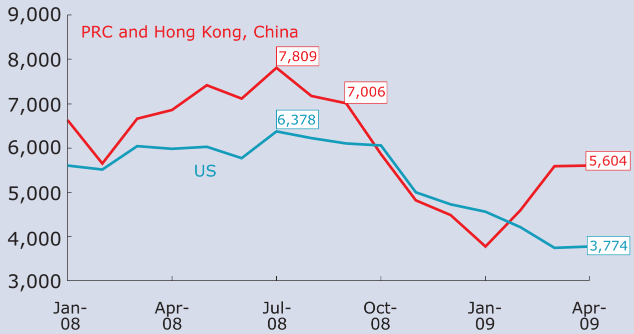
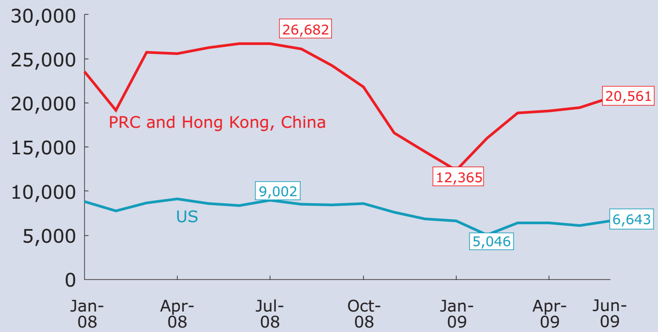


Figure 1.1b: Destination of NIE-3 Exports
(USD million)



ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; NIE-3 = newly industrialized economies (Hong Kong, China; Korea, Republic of; Taipei,China); PRC = People's Republic of China; US = United States.
Source: OREI staff calculations based on data from CEIC.

However, there is a limit to what the PRC can do by itself. During the first 6 months of 2009, the PRC's total exports have dropped 21.8%. But imports fell faster, at 25.4%. This is because a substantial portion of PRC imports include intermediate goods for further processing into final exports to other countries. Therefore, as global demand for its exports fell, PRC imports fell further. Analysis using the Global Trade Analysis Project (GTAP) estimates that 60% of Asian exports' final destination is the G3—European Union, US, and Japan—compared with 32% in terms of direct trade **(Figure 1.2).** This suggests that the advanced economies remain the primary destination of Asian exports, if one includes trade in intermediate goods within the region. Given that PRC demand for imports from emerging East Asia depends on its ability to export, without a recovery in global demand, the PRC cannot be expected to be the major driver for the region's recovery.

In addition, the PRC exports many of the same manufactured goods—such as electronics and garments—that other emerging East Asian economies export. Therefore, exporters may find it hard to enter PRC markets if PRC factories shift production to domestic markets instead of concentrating on export markets. This means that economies whose products do not directly compete with PRC exports will do better. NIEs like Taipei,China and the Republic of Korea, which produce high-tech products, will likely benefit. But economies such as Malaysia and Thailand, which produce goods similar in technological development to the PRC, will find it hard to crack the PRC market. Additionally, prices obtained for exports from emerging East Asian economies in China will be lower than those in G3 economies.

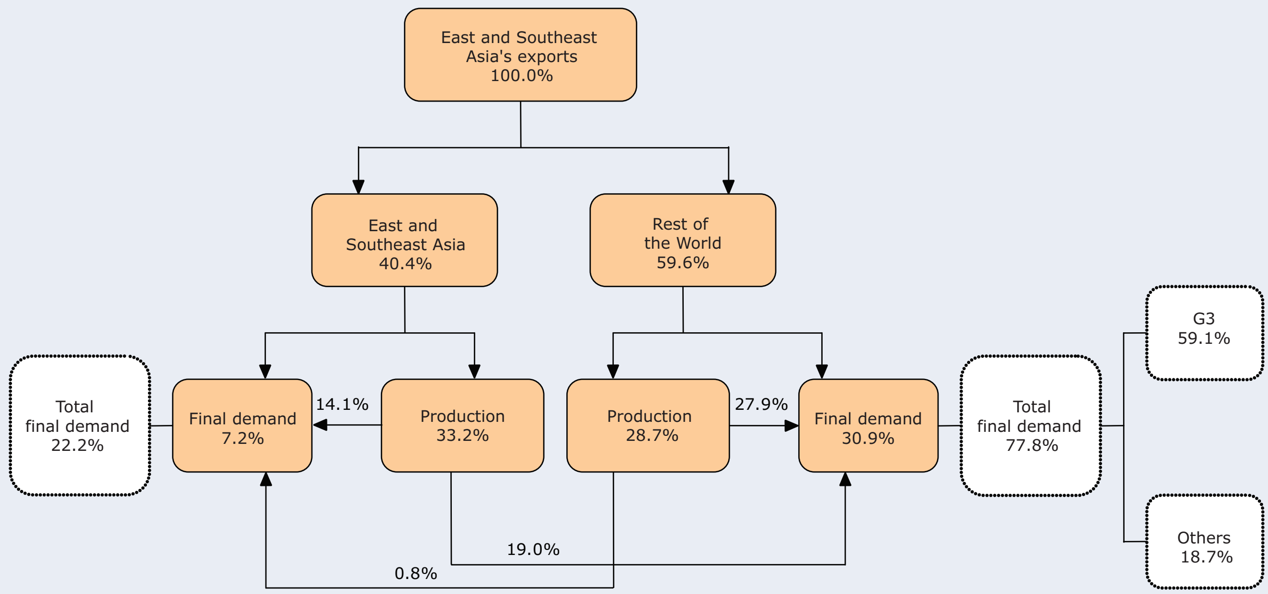
Another reason that PRC growth may not help the regional economies much is that the fiscal stimulus spending currently driving PRC growth is mostly focused on improving infrastructure. This is admirable as the PRC still needs better infrastructure in rural areas. This will particularly help stimulate growth in the western regions that have been lagging behind the rest of the country. While infrastructure spending will help boost construction and imports of raw materials, it is unlikely to help increase much of the demand for goods that other emerging East Asian economies export. The local authorities that are implementing these infrastructure projects are also eager to ensure that stimulus benefits local producers.

The PRC also has a lot of money to invest. Emerging East Asian economies could benefit if the PRC looks for investment opportunities within the region. So far, however, the PRC has focused its investment in raw material production or advanced technology. Thus, regional economies may not benefit that much from PRC foreign investment in the region.

The PRC economy looks set to stage a quick recovery. This will provide a much needed boost to the region's economies. Nevertheless, despite its growing importance to the region, the PRC cannot be the sole driver for the region's recovery. Europe, the US, and Japan all remain important sources of demand for the region's exports.

Box 1 ...continued

Figure 1.2: Breakdown of Emerging Asia's Exports



Note: Emerging Asia includes China, People's Republic of; Hong Kong, China; Indonesia; Korea, Republic of; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.
Source: Kim, S., J.-W. Lee and C.-Y. Park. 2009. Emerging Asia: Decoupling or Recoupling. *Asian Development Bank Working Paper Series on Regional Economic Integration No. 31*.

After virtually stagnating this year, the four middle-income ASEAN economies are expected to grow moderately in 2010, thanks to fiscal stimulus, its effect on domestic demand, and a slight recovery in external demand.

Economic activity among ASEAN-4 countries (Indonesia, Malaysia, Philippines, and Thailand) should start to strengthen from the second half of 2009. Indonesia and the Philippines, which are both less reliant on exports, managed to maintain some positive growth during the worst of the global downturn. In the face of contagion through trade and finance channels, their governments rolled out larger stimulus packages than previously announced, with their central banks cutting interest rates as well. For 2009, GDP growth in Indonesia is projected to be a relatively robust 3.6%. The 2009 growth forecast of 2.5% for the Philippines has downside risks, as remittances from Filipinos working overseas may not stay robust. In contrast, Malaysia and

Thailand, which rely more on external demand, have been more severely affected by the crisis. The worst appears to be over for both countries, however, and authorities have been increasingly aggressive in using fiscal policy to support growth. While the stimulus measures should begin showing results in the second half of this year, the two economies are expected to shrink this year with risks on the downside, before recovering in 2010.

A significant slowdown is also likely for the remaining ASEAN economies in 2009, with weak to moderate growth in 2010.

The newer members of ASEAN are also feeling the crisis pinch. Vibrant domestic demand in Viet Nam is offsetting slowing external demand and declining foreign direct investment, leading to a forecast GDP growth of about 4.5% in 2009—growth in the second half is expected to be better than in the year to June. Economic growth should be about 6.5% in 2010, slightly below the trend growth of 7%. Following slower growth in 2008, Cambodia and Lao People's Democratic Republic (Lao PDR) are projected to slow further in 2009, with Cambodia’s GDP growth slipping to 2.5%, and Lao PDR maintaining relatively healthy GDP growth of 5.5% due to its resilient mining and hydropower sectors. Highly dependent on oil and gas exports, Brunei Darussalam will likely remain in negative territory, contracting 0.4% in 2009, after an estimated contraction of 2.7% in 2008.

Inflation will likely fall further and remain low across emerging East Asia, largely due to weak demand and below-potential economic growth.

After having peaked in the third quarter of 2008 on record oil and other commodity prices, inflation has been dropping rapidly in 2009 (see Figure 12). In fact, several economies—PRC; Singapore, Taipei,China, and Thailand—have already seen some deflation. It remains too early to say that a bout of deflation has begun. Yet continued depressed economic conditions, worsening labor markets, and lower food and energy prices are expected to increase disinflationary (and possibly deflationary) pressures throughout the region in 2009. As economies gradually pick up in 2010 (though with growth remaining below potential) inflation should stay under control. Further rapid increases in commodity prices, however, may be inflationary and hurt the pending recovery.

For most of emerging East Asia, balance of payments and foreign reserve positions will likely deteriorate on falling trade balances and capital flows.

With trade balances falling, the combined current account surplus of emerging East Asia is expected to narrow in 2009, after peaking at 8.6% of GDP in 2007. While exports fell precipitously across much of the region, in several economies imports might be less constrained on relatively robust domestic demand. Thus, for 2009, current accounts are expected to remain in surplus in the PRC; Hong Kong, China; Korea; Malaysia; Singapore; and Thailand. In contrast, they should be closer to balance in Indonesia and the Philippines, while Cambodia, Lao PDR, and Viet Nam will likely continue to run large deficits financed mainly by official aid and foreign investment. Capital inflows to the region are expected to weaken significantly in 2009 due to tight credit conditions and risk aversion, though returning risk appetite from the second quarter may encourage capital flows into the region in the second half. The region's currencies are likely to strengthen over time, yet the outlook remains uncertain in the near term **(Box 2)**. While promoting exports in the face of weakening external demand may lead authorities to prevent currencies from appreciating, worsening balance of payments positions are likely to reduce foreign exchange reserves across the region.

Risks to the Outlook

Major risks to the above outlook include (i) a more prolonged recession and weaker recovery in developed countries than currently envisaged, (ii) unintended consequences of economic stimulus or premature policy tightening, (iii) falling inflation becoming deflation; and (iv) non-economic events with low probabilities but potentially large impacts.

The crisis resolution and stimulus measures in the US and elsewhere may have started to gain traction, as evident from growing investor optimism and surging stock prices. Signs of stabilization point to an improved outlook for the real economy as well. However, the global outlook remains uncertain, as it takes time for problem assets to be removed from balance sheets. Deleveraging is continuing and a massive shift in

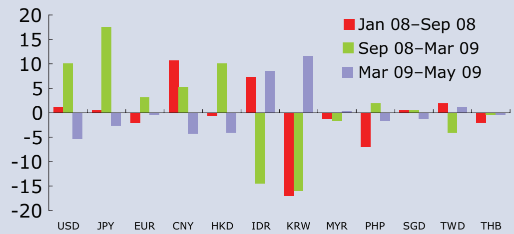
Box 2: Emerging East Asian Currency Outlook

Emerging East Asian currencies experienced a rollercoaster ride during the global financial crisis. Most of them—with the exceptions of the People's Republic of China's (PRC) yuan and Indonesian rupiah—began to weaken at the start of 2008 when the United States (US) subprime crisis began to spread globally. The sharpest declines occurred after the bankruptcy of Lehman Brothers in September 2008, which intensified the global crisis substantially. Most currencies, however, showed signs of recovery after March 2009, suggesting that the worst of the crisis for Asian currency markets was over. Emerging East Asia's currencies are likely to strengthen over time, yet the outlook remains highly uncertain in the near term.

Since the 1997/98 Asian financial crisis, emerging East Asian policymakers have implemented a wide range of initiatives to reduce the risk of balance of payment crises and increase exchange rate stability. As a result, Asian fundamentals improved significantly over the past decade. Many crisis-affected economies, including Indonesia, Republic of Korea (Korea), Malaysia, and Thailand, have maintained current account surpluses. The PRC's current account surplus even reached 11.3% of GDP in 2007. External borrowing was also lower. The most remarkable gains were in the accumulation of foreign exchange reserves, which rose from $465.3 billion in 1996 to $3.11 trillion in 2008 for the region as a whole.

These positive developments, however, were not sufficient to shield Asia from the global financial meltdown and ensuing recession—which saw the region's exports collapsing, economic growth slowing, and currencies weakening. This mainly reflected the region's close economic ties with the US, the epicenter of the crisis. In the two quarters following September 2008, both the Indonesian rupiah and Korean won depreciated in real effective terms by about 15.0% **(Figure 2.1)**. The New Taiwan dollar, and Malaysian ringgit lost 4.0% and 1.7%, respectively; the Singapore dollar and Thai baht barely moved. However, the PRC yuan, Hong Kong dollar, and Philippine peso strengthened in real terms by 5.3%, 10.1%, and 1.9%, respectively, as these currencies are linked closely to the US dollar. As the most open developing region globally, it was unrealistic to expect emerging East Asia to remain unscathed by the financial turmoil. This provided strong evidence refuting the once-popular "decoupling" thesis—at least as far as financial markets are concerned. But the very volatile

Figure 2.1: Changes in REER[1] of Asian Currencies (%)



[1]REER = Real effective exchange rate.
USD= US dollar; JPY= Japanese yen; EUR=euro; CNY=Chinese yuan; HKD=Hong Kong dollar; IDR=Indonesian rupiah; KRW=Korean won; MYR=Malaysian ringgit; PHP=Philippine peso; SGD=Singaporean dollar; TWD=New Taiwanese dollar; THB= Thai baht.
Source: OREI staff calculations based on data from the Bank for International Settlements.

Continued overleaf

currency markets also suggest that more reforms may be needed to improve the resilience of emerging East Asia's external sectors.

The encouraging news is that during the second quarter of 2009, most of the region's currencies appreciated, except the PRC yuan. The weakening of the yuan was probably the result of a combination of both a more rigid bilateral exchange rate against the US dollar and worsening deflation in the PRC. The general trend of recovery of the region's currencies was driven by the perception that the worst of the global financial crisis might be over, and the region's currency markets had probably bottomed out during the second quarter.

It remains highly risky making firm predictions about exchange rates. Financial stress may have abated and the region's equity markets rebounded. The US dollar is likely to weaken as the US consolidates its fiscal and external accounts in the medium term. But global investors do not appear to have regained the risk appetite they had prior to the crisis. In addition, economic indicators in the region as well as at the global level are expected to remain volatile in the coming months, especially in areas like unemployment, nonperforming assets, and consumer spending. Current account balances in the region could remain weak even if the financial crisis draws to an end. Slower recovery in the industrial world than in emerging East Asia implies that the region's exports could stay weaker than imports for some time. The PRC is a good example; while the economy recovered strongly beginning the second quarter of 2009 due to effective stimulus, the recovery in exports is likely to lag. This implies that the region's current accounts may deteriorate, hurting the currency outlook.

Moreover, the ability of individual economies to deal with external shocks to financial flows also impacts currency movements differently. Post-1997/98 policy efforts raised the region's foreign reserves, in some cases far in excess of external financing needs (debt payment plus current account deficits). However, the liberalization of financial markets through much of the region attracted foreign portfolio investments to many emerging East Asian economies. And the reversal of these portfolio flows could pose significant challenges to policymakers hoping to stabilize exchange rates. Here, Korea and Indonesia look relatively more vulnerable. And this may be why their currencies were more volatile during the current crisis.

It is possible that emerging East Asia's currency markets already reached their turning points during the second quarter of 2009. So long as the global markets continue to stabilize and the world economy begins to recover, the region's currencies are likely to strengthen against the US dollar over time. But the situation in each market is likely to differ significantly. The PRC yuan, for example, may appreciate slowly in the near term until the authorities release again the de facto peg to the US dollar once again. Comparing current levels of real effective exchange rates with historical averages of the past 20 years suggest that the New Taiwan dollar, Korean won, and Malaysian ringgit still hold the greatest potential for appreciation.

consumer behavior in developed countries, the US in particular, is underway. The risks to emerging East Asia's transition to recovery, while having dissipated somewhat over the past few months, remain firmly tilted on the downside.

The recession in advanced economies could be much longer and recovery weaker than currently expected, exacerbating the external environment for emerging East Asia.

Despite extraordinary policy measures by major economies to stabilize their financial systems, hidden perils still lurk in major global banks. There remain uncertainties surrounding resolution of problem assets and the still-fragile financial system could be hit by another shock. Commercial real estate and credit card debt are danger zones. Commercial property prices are falling and vacancy rates are rising in the US and Europe, and as many banks are heavily exposed to commercial real estate, any increase in defaults would add to their financial stress. Credit card charge-off rates—debt that card insurers believe they will never collect—rose to the highest level (10.6%) in 20 years in the US, underscoring the strain consumers' finances face from rising unemployment. In addition, concerns are growing over the significant exposure of European banks to the rapidly slowing economies in central and eastern Europe. Rising defaults and deteriorating economic conditions could intensify financial stress, particularly with global banking systems struggling to repair balance sheets and recapitalize. A dysfunctional financial system reduces the ability of monetary and fiscal actions to stimulate the economy, and threatens to prolong the crisis and delay recovery. Moreover, strains in financial systems feed the global recession, which in turn adds additional stress to financial systems. The risk is that the vicious cycle continues.

Unintended policy errors—such as unplanned consequences of economic stimulus or premature policy tightening—could harm emerging East Asia's growth prospects.

Policy makers have learned to avoid the mistakes that transformed the 1929/30 crisis into the Great Depression—the recent adoption of major expansionary macroeconomic policies a case in point. However, some measures may have unintended consequences. With interest rates close to zero in major industrial economies, several central banks have started to use quantitative easing, an unproven policy tool which could impact central bank independence and affect inflationary expectations. Moreover, recent research shows that government interventions during the Great Depression in the US (and in similar depressions elsewhere) may have contributed to worsening economic conditions. In particular, policies that reduce competition in labor and product markets were especially damaging.[8] There continue to be heated debates among economists about what form of fiscal stimulus is best to maximize the size of fiscal multipliers and their effectiveness in stimulating demand. As the signs of recovery emerge, there is the dilemma facing policymakers as to when to start reining in the recovery and what the exit strategy should look like—tightening too early could kill the recovery, whereas tightening too late may result in inflationary pressures. Timing will be a critical factor.

Deflation may hurt recovery in the short term, with inflationary pressures possibly returning in the medium term.

A very weak economy puts downward pressure on wages and prices. This could continue and intensify with unemployment already substantial and likely to rise further. In the short to medium term, disinflationary and possibly deflationary pressures are outweighing inflationary ones. And, if the recovery fails to start soon, low inflation in both developing and developed economies could shift into outright deflation. Deflation, if sustained, would further hurt the region's outlook, as it impairs economic activity both by raising real interest rates and by increasing the burden of debt fixed in nominal terms. Yet, unprecedented stimulus policies taken by authorities around the world could possibly become inflationary in the medium to longer term, should the authorities fail to unwind them in time. Recent sharply rising bond yields indicate that there is serious concern large fiscal deficits could eventually stimulate inflation, as could exploding balance sheets of central banks in major industrial countries and significant credit growth in some emerging East Asian economies. The recent sharp rise in fiscal deficits in many economies is in large part cyclical, rather than structural, as governments respond to severe recession and financial crisis.

[8]See Cole, Harold L. and Lee E. Ohanian. 2004. New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis. *Journal of Political Economy* 112:4. August.

When economies finally recover, governments should unwind their fiscal positions before enticing inflation. Structural fiscal deficits, due to aging populations and the chronic escalation in healthcare costs in the US and other developed countries, for example, could drive up long-term interest rates and crowd out private investment, and could be inflationary, unless central banks are determined to fight price pressures.

Non-economic events, such as geopolitical tensions or a significant increase in the spread of Influenza A(H1N1), may have relatively low probabilities but could have a major impact on emerging East Asia's growth outlook.

The World Health Organization declared Influenza A(H1N1) a pandemic on 11 June, noting that the virus has "moderate severity". H1N1 casualties continue to mount quietly **(Table 13)**. The pandemic could have a more severe impact on the region, should the virus mutate or the outbreak become full-blown in those developing countries with limited health system capacities. The recent nuclear and missile test in the Democratic Republic of Korea (North Korea) is a much more serious threat. This raises the specter of a serious shock to East Asia's financial and economic systems if the implied threat is carried out. Its seeming unlikelihood must be contrasted with the potentially damaging economic impact.

Policy Issues

Despite tentative signs that the transition to recovery is underway in emerging East Asia, it is important that policymakers stay the course in supporting domestic demand and growth.

Government and central bank policies, both globally and regionally, have stabilized financial markets and may be starting to rekindle growth. Interest rates have been cut and remain extremely low, while an increasing number of central banks are using aggressive quantitative easing to inject money directly into their economies. This is on top of the mass of large stimulus packages currently being implemented. As a result, there are some tentative signs of global and regional economies bottoming out. However, it remains far too early to say if these signs signal a recovery will be underway any time soon.

Table 13: Influenza A(H1N1) Confirmed Cases

	Apr-09		May-09		Jun-09		Total	
	Cases	Deaths	Cases	Deaths	Cases	Deaths	Cases	Deaths
Emerging East Asia[1] + Japan	0	0	430	0	4,660	1	5,090	1
China, People's Republic of	0	0	21	0	1,421	0	1,442	0
Philippines	0	0	6	0	855	1	861	1
Thailand	0	0	2	0	772	0	774	0
Singapore	0	0	4	0	595	0	599	0
Korea, Republic of	0	0	33	0	169	0	202	0
Japan	0	0	364	0	848	0	1,212	0
North America[2]	128	1	8,917	12	26,447	135	35,492	148
Other regions	129	7	5,886	79	23,993	76	30,008	162
Global	**257**	**8**	**15,233**	**91**	**55,100**	**212**	**70,590**	**311**

[1]Figures include countries in emerging East Asia with the five highest number of cases of influenza A(H1N1). There were also reported cases in Brunei Darussalam (29); Cambodia (6); Indonesia (8); Lao PDR (3); Malaysia (112); Taipei,China (61); and Viet Nam (63). [2]Includes Canada and United States.
Source: World Health Organization.

Economists are predicting that any pending recovery will most likely be weak and fragile, with fallout from the global economic crisis long-lasting. Thus, authorities would be wise to maintain expansionary policies within the bounds of medium- and long-term fiscal sustainability. However, at this stage, authorities should plan rather than implement creditable and coherent exit strategies to unwind the policy stimulus to prevent inflationary expectations from rising, which could later impede recovery and sustainable growth.

Monetary policy in the region needs to remain expansionary until the recovery gains substantial traction or large inflationary pressures re-emerge.

With real interest rates rising fast, several economies can further loosen monetary policy—others have limited room to ease. Since September 2008, central banks across the region have dramatically loosened their monetary policy, with interest rate cuts ranging from 1.5 percentage points in Malaysia to 7.0 percentage points in Viet Nam **(Table 14)**. Despite these aggressive rate cuts, monetary conditions in the region have not been overly expansionary when considering the sharp contractions in the real economy, the benign inflation environment, and moderating bank lending growth **(Figures 49a, 49b)**. As real policy rates have continued to be largely positive (with the exception of Korea and Malaysia)—and while rising with falling inflation—monetary conditions are, in fact, tightening despite significant currency depreciations since the height of the financial crisis. Thailand's real policy rate, for example, remains above 4.0% and has been rising in recent months, suggesting more room for monetary easing. In addition, with near-term growth likely to be below potential across the region, deflationary pressures—should they become entrenched—indicate the need for further easing. In other countries, most notably the PRC—even with a 7.0% real policy rate—substantial credit and money growth in the first half of the year (see Figure 21) points to highly expansionary monetary conditions, leaving little room to loosen further.

Table 14: Policy Rates[1] (as of 13 July 2009)

Economy	Current Policy Rate	Decline (in basis points)
China, People's Rep. of	5.31%	216 basis points (from 7.47% on 15 Sep 08)
Hong Kong, China	0.50%	300 basis points (from 3.5% on 08 Oct 08)
Indonesia	6.75%	275 basis points (from 9.5% on 03 Dec 08)
Korea, Rep. of	2.00%	325 basis points (from 5.25% on 08 Oct 08)
Malaysia	2.00%	150 basis points (from 3.5% on 21 Nov 08)
Philippines	4.00%	200 basis points (from 6.0% on 18 Dec 08)
Taipei,China	1.25%	238 basis points (from 3.63% on 24 Sep 08)
Thailand	1.25%	250 basis points (from 3.75% on 02 Dec 08)
Viet Nam	7.00%	700 basis points (from 14% on 20 Oct 08)

[1]Policy rates for each economy are as follows: 1-year lending rate (People's Republic of China); Hong Kong base rate (Hong Kong, China); Bank Indonesia (BI) rate (Indonesia); Korea base rate (Korea); overnight policy rate (Malaysia); reverse repurchase (repo) rate (Philippines); discount rate (Taipei,China); 1-day repo rate from 17 Jan 2007 onwards (Thailand); and prime rate (Viet Nam).
Source: OREI staff calculations based on data from Bloomberg and Datastream.

Figure 49a: Bank Lending Growth—NIEs-4
(%, y-o-y)

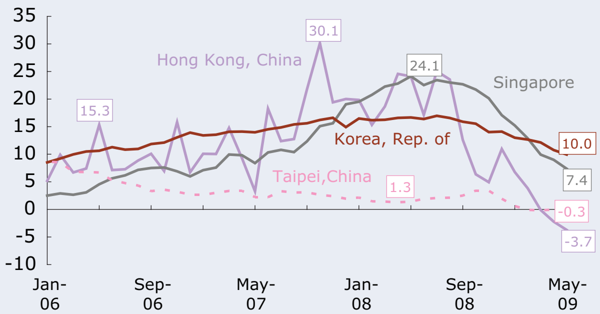
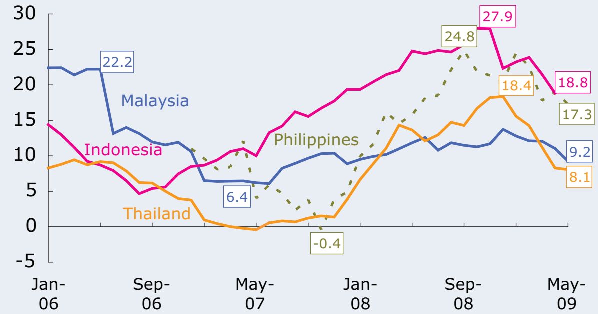


Figure 49b: Bank Lending Growth—ASEAN-4
(%, y-o-y)



NIEs = newly industrialized economies, y-o-y = year-on-year.
Data for Hong Kong, China refers to authorized institutions' loans and advances; Republic of Korea to commercial and specialized bank loans; Singapore to domestic banking unit loans and advances; and Taipei,China to domestic bank loans and advances. Data for Indonesia refers to commercial bank claims on public and private sectors; Malaysia to commercial bank loans and advances; Philippines to commercial and universal bank loans net of RRP's, starting in 2007; and Thailand to commercial bank loans .
Source: OREI staff calculation using data from CEIC and Bank of Korea website.

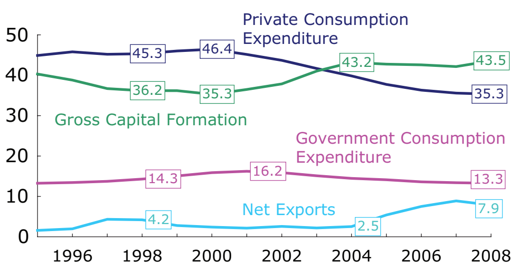
Ensuring the region's stimulus packages are implemented effectively and efficiently is key to bolstering domestic demand in the face of the continued weakness in external demand.

Emerging East Asian economies have introduced a series of new fiscal stimulus in the first half of 2009. Now they need to be implemented to shore up private sector demand to balance the weak and fragile external sector. But fiscal stimulus typically takes time to work through an economy. That is why gauging the effects of stimulus is important, either in determining the need for additional pump-priming, or in beginning to implement an exit strategy. For the moment, it would be good to retain the option for additional fiscal stimulus in 2010. But fiscal deficits are rising substantially, and the higher the deficit in 2009, the less room there will be for an additional increase in 2010. Regardless, to ensure the most direct impact on growth, fiscal stimulus should be focused on areas where it will be most effective and efficient—"shovel-ready" infrastructure, small- and medium-enterprises (SMEs), rural economies, and social safety nets.

Even as the immediate impact of the global crisis works itself out, authorities should continue with deeper, more comprehensive structural reforms needed to rebalance growth toward greater domestic demand.

In the longer term, the region should aim to rebalance its sources of growth away from exports and toward domestic demand. To achieve this, authorities can deepen and broaden structural reforms while further developing financial sectors. Given emerging East Asia's huge diversity, the optimal policy mix will necessarily differ across economies. Policy makers should address key areas of weakness in the investment climate, such as policy uncertainties, competition in product and service markets, governance, the quality of legal and institutional frameworks, and regulatory capacity. This will require more comprehensive structural reforms to improve efficiency and competitiveness through minimizing unnecessary regulatory barriers on business, encouraging private incentives and market discipline, creating a level playing field, and fostering competition to upgrade institutional capacity. In economies with lower levels of private consumption **(Figure 50)**, authorities could address income inequalities and increase public spending on social safety nets, housing, education, and health. This would increase disposable income and reduce precautionary savings, removing some of the impediments to increased household consumption.

Figure 50: Demand Components—People's Republic of China
(as % of GDP[1])



GDP = gross domestic product.
[1]Share of each component to nominal GDP.
Source: OREI staff calculations based on data from CEIC.

With the region entering the transition to recovery, policy makers can consider the medium- to long-term agenda of improving and streamlining financial regulatory and supervisory regimes in conjunction with global efforts.

The global financial crisis uncovered major regulatory and supervisory gaps in related institutional and market conduct. Reform proposals are currently being discussed at national, regional, and global levels. It is critically important for emerging East Asian authorities to both keep step with and contribute to these debates through regional and global forums. Ways to keep up with the changing landscape for financial regulation will likely include upgrading risk management, revamping information disclosure policies and transparency, enhancing governance and strengthening prudential oversight **(see *Beyond the Crisis: Financial Regulatory Reform in Emerging East Asia*, page 55)**.

Expanded regional cooperation could also play a significant supportive role in containing the ripple effects of the global economic crisis on emerging East Asia.

Regional cooperation has proven extremely valuable in coordinating policy responses to the global economic crisis. ASEAN plus the PRC, Japan, and Korea (ASEAN+3) expanded the Chiang Mai Initiative Multilateralization (CMIM) reserve pooling arrangement to $120 billion in February **(Box 3)**. More importantly, the regional grouping has agreed on voting rights, contributions, and independent surveillance and monitoring mechanisms to operate the fund. These are the institutional seeds for closer regional cooperation in general. Also, ASEAN+3 is accelerating the establishment of a credit guarantee and investment mechanism to provide credit guarantees for domestic commercial bank loans and bond issuance. It is also important that authorities in the region collectively reaffirm their commitment against protectionism, both within the region and globally, to maintain and improve a free trade environment. Expanding cooperation for infrastructure development is another initiative worth pursuing to build a cofinancing platform to pool resources from development partners, which will help further promote intraregional trade and investment flows to support the region's economic growth.

Box 3: The Chiang Mai Initiative—Multilateralization and Beyond

The Chiang Mai Initiative (CMI) was announced by the finance ministers of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China (PRC), Republic of Korea (Korea), and Japan (ASEAN+3) when they met on the sidelines of the Asian Development Bank (ADB) annual meeting in May 2000. In the aftermath of the 1997/98 Asian financial crisis, the CMI was designed to address short-term liquidity problems and to supplement existing international financial arrangements in the event of an emergency. Initially, the initiative involved an expanded ASEAN Swap Arrangement (ASA) involving all ASEAN members, and a network of bilateral swap agreements (BSAs) and repurchase facilities among ASEAN+3**.** Since its inception, however, it was clear that the CMI was much more than this—it was actually an agreement to pursue further negotiations, rather than a final agreement on swap arrangements.

The ASA was initially increased to $1 billion, and then $2 billion. Both the number of BSAs and the amounts involved continued to grow over time. By the time of the ASEAN+3 Finance Ministers Meeting (AFMM+3) in Madrid in May 2008, the size of the BSA had increased to $84 billion **(Table 3.1)**.

The leaders of ASEAN+3, meeting on the sidelines of the Asia–Europe Meeting in Beijing in October 2008, decided to expedite the

Table 3.1: Swap arrangements under the Chiang Mai Initiative (as of Dec. 2008, in billion US$)

From \ To	China, People's Rep. of	Japan	Korea, Rep. of	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total
China, People's Rep. of		3.0	4.0	4.0	1.5	2.0		2.0	16.5
Japan	3.0		13.0	6.0	1.0	6.0	3.0	6.0	38.0
Korea, Rep. of	4.0	8.0		2.0	1.5	2.0		1.0	18.5
Indonesia			2.0						2.0
Malaysia			1.5						1.5
Philippines		0.5	2.0						2.5
Singapore		1.0							1.0
Thailand		3.0	1.0						4.0
Cambodia									0.0
Lao PDR									0.0
Myanmar									0.0
Vietnam									0.0
Sub-total	**7.0**	**15.5**	**23.5**	**12.0**	**4.0**	**10.0**	**3.0**	**9.0**	**84.0**
ASEAN Swap Agreement (among the 10 ASEAN countries)									**2.0**
TOTAL									**86.0**

Note: Lao PDR = Lao People's Democratic Republic.
Source: Elaborations based on Japan's Ministry of Finance website.
Available:http://www.mof.go.jp/english/index.htm. Accessed: February 2009.

Continued overleaf

multilateralization of the CMI. They agreed that funds available under the CMI should be a self-managed reserve pooling arrangement, governed by a single contract, reducing costly and wasteful duplication.

At these meetings, the finance ministers also confirmed that the proportion of the contribution between ASEAN and the plus three countries to the CMI would be 20% for ASEAN, and 80% for PRC, Korea, and Japan.

At the Special ASEAN+3 Finance Ministers Meeting in Phuket in February 2009, ministers agreed to expand the pool of foreign currency reserves from $80 billion to $120 billion.

But the biggest step forward took place on 3 May 2009 in Bali, when the AFMM+3 agreed on the governing mechanisms and implementation plan for the CMI multilateralization (CMIM). Japan and the PRC would contribute identical shares of the total reserve pool (32%), double Korea's share (16%). The remaining 20% is covered by ASEAN members' contribution. Other details relating to the agreement, such as voting rights, decision making rules, and other operational aspects including activation of short-term liquidity in case of a sovereign financial emergency, can be found in the official statement.[1]

The AFMM+3 also agreed to establish an independent regional surveillance unit to monitor and analyze regional economies and support CMIM decision-making. While the formal unit is being set up, the AFMM+3 asked the ASEAN Secretariat (ASEC) and ADB to work out an interim surveillance arrangement based on the existing surveillance process.

The ASEAN+3 independent regional surveillance unit is not intended as a substitute for the International Monetary Fund (IMF), however. It is designed to enhance objective economic monitoring, supplementing the IMF, especially given the IMF's new Short-Term Liquidity Facility, which enables certain countries to borrow without conditions. Under the CMIM, a country can draw up to 20% of its quota without being subject to IMF conditionality, although the term is restricted to no more than 6 months. Should a country avail of its full quota, then 80% of the amount disbursed would be tied to an IMF program. Once the regional surveillance unit becomes fully operational, the amount that member countries can withdraw without IMF conditionality could be increased.

[1]For the full text, please visit http://www.asean.org/22536.htm.

By collectively agreeing on the main components of a process created to manage a regional pool of international reserves, the CMIM agreement has set the stage for institutionalizing Asian regionalism. It sets a workable precedent for addressing other priority areas for regional cooperation. For example, enhanced intergovernmental dialogues have spurred further cooperation in trade, investment, and—importantly in these times—financial supervision and regulation. The new institutional model could also be used to speed up financial market development, for example, by setting up a new fund to invest in developing regional bond markets, better using the region's huge savings to help finance massive investment requirements.

The agreed governance structure of the CMIM can even stand as a model outside the economic sphere—such as with regional public goods including climate change and the environment, security, disaster preparedness, and disease prevention.

Apart from issues relating to coverage and process, the impact that the CMIM is likely to have in the region over time will depend on how its membership evolves. What can we say about the likely future composition of CMIM members? Once pressing operational issues are resolved, the CMIM could expand to include India, or even Australia and New Zealand (the East Asia Summit, or ASEAN+6).