

2006 and over the next few years, supported by both the increases in the factors of production and productivity. For Turkey, the long-awaited European Union accession negotiations began in October 2005. Negotiations are likely to be long and difficult, lasting perhaps 10 years. If the negotiations proceed well and the economy of Turkey converges towards the economies of the European Union, the growing confidence of investors should attract increasing flows of foreign investment. The Government recently negotiated a new stand-by arrangement with the International Monetary Fund to support a three-year economic programme aimed at sustaining growth to raise living standards and reduce unemployment, delivering price stability and moving towards convergence with the economies of the European Union. Success in the programme would greatly aid the negotiating process.

South-East Asia

Overview

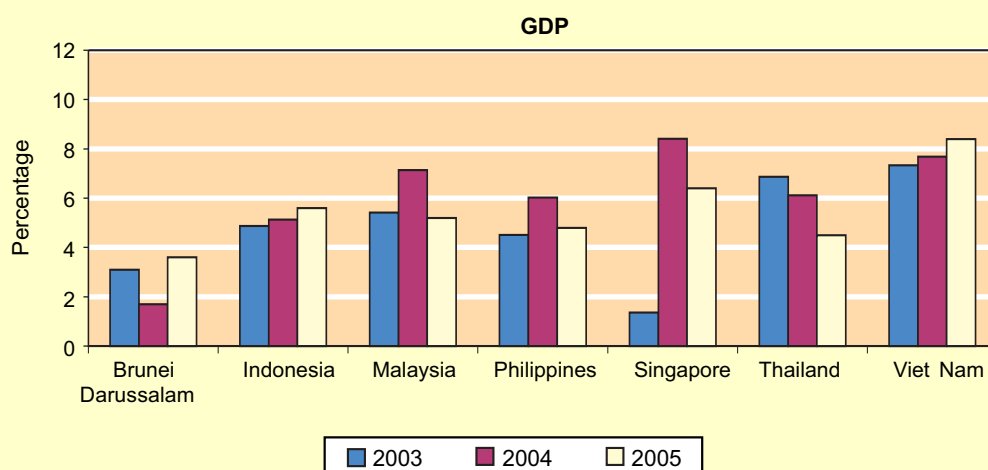
Growth eases in the subregion

Economic growth in the South-East Asian subregion eased in 2005 after an unusually good performance in 2004 when strong global demand

for manufactures, especially electronics and information and communication technology products, drove the GDP growth rate up to 6.4 per cent. With the global electronics cycle subsequently experiencing a downturn, economic growth fell to about 5.4 per cent in 2005. The sharpest decline was in the trade-dependent economy of Singapore, which grew by 6.4 per cent after achieving an unusually high growth rate of 8.4 per cent in 2004. Against the general trend of the subregion, Indonesia and Viet Nam grew faster in 2005 than in 2004 (see figure II.27).

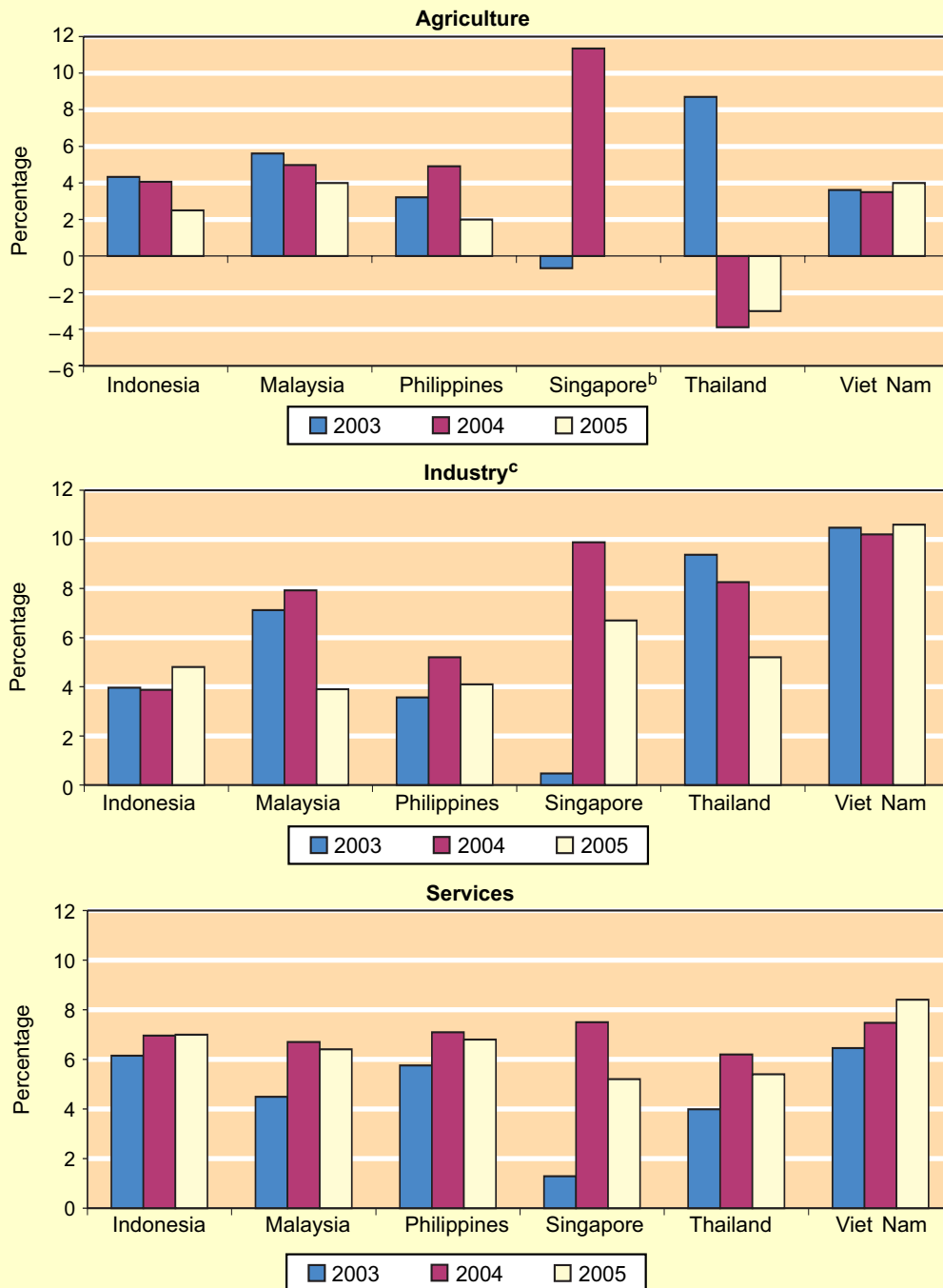
Fiscal and monetary policies in the subregion were tight during 2005, responding to the build-up of inflationary pressures caused by high oil prices. While oil prices doubled between 2002 and 2004, inflationary pressures did not emerge until the second quarter of 2005, because huge oil subsidies insulated final goods and services from the effects of the oil price increases. However, the high fiscal burden made the continuation of subsidies unsustainable from the middle of 2005. Many countries began phasing out oil subsidies, and inflation inched up to 5.8 per cent in 2005. In general, individual country policy responses to oil subsidies influenced the magnitude of their fiscal deficit. Thailand's elimination of oil subsidies in July 2005 increased the budget surplus, making it easier for the Government to finance the large infrastruc-

Figure II.27. GDP and sectoral growth in selected South-East Asian economies, 2003-2005^a



(Continued on next page)

Figure II.27 (continued)



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005), and Economist Intelligence Unit, *Country Forecasts and Country Reports* (London, EIU, 2005 and 2006), various issues.

^a Growth rates for 2005 are estimates.

^b Includes quarrying.

^c Industry comprises mining and quarrying; manufacturing; electricity-generation, gas and power; and construction.

ture projects planned for 2006. A drastic cut in oil subsidies in Indonesia reduced the fiscal deficit. Malaysia, the Philippines and Viet Nam, however, retained substantial oil subsidies, managing the adverse fiscal effects through lower public expenditure.

Monetary policy in 2005 tightened across the subregion in line with international trends. Tight policies are expected to continue into 2006, keeping in view the upward trajectory of oil prices. Interest rates, though rising, were generally low except in the Philippines and particularly in Indonesia, where they rose to double-digit levels as the central bank attempted to neutralize the threat of spiraling inflation following a sharp cut in oil subsidies in October 2005.

Developments in the financial sector continue to be influenced largely by the assessment and lessons drawn from the Asian financial crises of 1997-1998, which placed much of the blame on the fast-paced financial liberalization undertaken in the subregion during the boom years of 1985-1996. While there were no major reform reversals, countries have been extremely reluctant to add to reforms already undertaken. Major financial sector liberalization during 2005 was therefore meagre, although there were important developments in some countries.

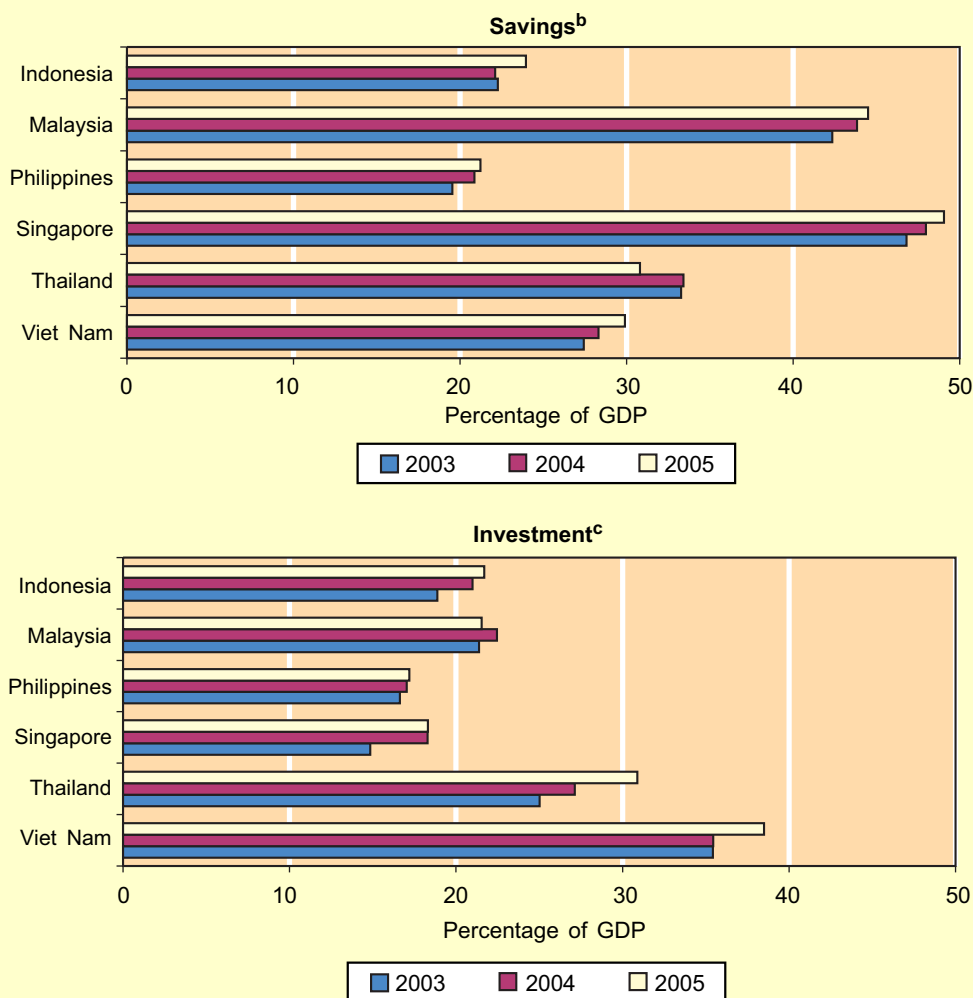
In the external sector, the major South-East Asian economies except for the Philippines and Viet Nam had merchandise trade surpluses in 2004. In 2005, the rate of growth of exports slowed in response to slower global demand. Only Indonesia registered a sharp rise, driven by an increase in non-oil and gas exports. In a largely oil-importing subregion high oil prices meant rising import bills, resulting in the narrowing of current account surpluses in several countries. In Thailand, pressure from oil imports turned the current account negative following several years of positive balance. Inflows of FDI increased from \$17 billion in 2003 to \$25 billion in 2004 for the subregion, with Singapore alone receiving nearly two thirds of the inflows. Indonesia, the only country to have had outflows of FDI in 2003, witnessed inflows of \$1 billion in 2004 due to an upswing in mergers and acquisitions. International portfolio capital flows to the subregion were subdued, with investors preferring emerging markets in East and South Asia where potential returns were higher.

GDP growth performance

Higher oil prices and lower information and communication technology exports led to slower GDP growth in several economies

With a growth rate of 8.4 per cent, Viet Nam was the fastest growing economy in South-East Asia in 2005. Growth in Viet Nam remained dependent on domestic demand rather than exports; this was reflected in increasing import demand for capital and intermediate goods for the public sector. Private domestic consumption remained strong, with retail sales including sales from rapidly increasing consumer durable outlets rising nearly 20 per cent in 2005. Manufacturing was the main driver of the economy, and industrial production registered a growth rate of 10.7 per cent in 2005. Sectors showing impressive growth rates were fertilizers, automobiles, machine tools and coal. The service sector, including retail, financial and telecommunication services and the rapidly expanding tourism industry, also contributed significantly. A slight slowdown in economic growth is expected in 2006 owing to the effects of the avian influenza outbreak and the competition from China in textiles and garments, the second largest export of Viet Nam. However, the high rate of investment is likely to ensure that growth is sustained at about 8 per cent in the coming year (see figure II.28).

In Indonesia, improved business confidence, following the ending of political uncertainty with the October 2004 elections, appears to have contributed to the 5.6 per cent economic growth rate achieved in 2005. The service sector, led by the continuing expansion of telecommunications, drove economic growth during the year. Economic growth in Indonesia was also broad based, with both private consumption and external demand contributing to that growth. The inflationary impact on private consumption following the slashing of oil subsidies in October 2005 came too late in the year to seriously affect 2005 growth. The tsunami disaster of December 2004 also did not seriously affect GDP growth since Aceh Province contributes just 2 per cent of national income. The Government hopes to make the economy grow by 6.2 per cent in 2006 by increasing its spending. However, the actual growth rate may fall short of this target as high oil prices are likely to weaken private consumption. The Bali bomb blast of September 2005 may also dampen investor (in particular Australian) sentiment and reduce tourist arrivals.

Figure II.28. Savings and investment in selected South-East Asian economies, 2003-2005^a

Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; and Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005).

^a Data for 2005 are estimates.

^b Gross domestic savings.

^c Gross domestic investment.

A downswing in global demand for electronic products caused GDP growth in Malaysia to decline from 7.1 per cent in 2004 to 5.2 per cent in 2005. The momentum for growth during the year was provided by the service sector, which grew faster than manufacturing, spurred by strong consumer spending and low interest rates, growth in financial and telecommunications services and a rise in tourism. Within manufacturing, commod-

ity-based products such as rubber goods, petroleum products, paper and palm oil expanded faster during 2005 than electronic goods. GDP in Malaysia is expected to grow at a faster rate of 5.9 per cent in 2006, aided by the bottoming out of the global electronics cycle. Higher oil prices are also likely to provide short-term benefits to Malaysia, a net oil exporter. Economic growth in the coming year could be even higher except that

rising global interest rates are likely to reduce overall demand for the country's exports.

After an outstanding performance in 2004, when the Philippine economy grew by 6 per cent, the growth rate declined to 4.8 per cent in 2005 as negative factors operated in different sectors of the economy. In the service sector, which makes the largest contribution to GDP, oil price-induced inflation and higher interest rates dampened private consumption and its contribution to GDP growth. The export of manufactures was adversely affected by lower global demand for electronic products, the country's main export, and stagnant growth in ready-made garments following the end of the Multifibre Arrangement. Positive contributions to economic growth came from the transportation, communication and storage service sectors and overseas workers' remittances, which rose considerably during 2005, boosting private domestic consumption. In 2006, the growth rate is projected to reach 5.2 per cent based on rising workers' remittances, which are increasing because of sustained demand for Filipino workers in high-income countries, improved tax revenues following successful implementation of the value added tax and renewed global demand for electronic products.

In Thailand, at least three factors contributed to the economic slowdown from a 6.1 per cent growth rate in 2004 to 4.5 per cent in 2005. The tsunami disaster that struck coastal areas in the Andaman Sea in December 2004 severely reduced the number of tourist arrivals during the first half of the year. The elimination of oil subsidies in July 2005 resulted in a sharp rise in inflation, from 2.8 per cent in 2004 to more than 4 per cent in 2005, slowing growth in private consumption. Lower global demand for electronics products, the country's leading export, also had an adverse impact on the country's economy. Manufacturing, the mainstay of the economy, grew 5.2 per cent. The electronics goods sector did particularly well, with hard-disk drive production being the top performer. The performance of the ready-made garments and vehicle manufacturing sectors was satisfactory, while textiles and the food and beverages sectors grew slowly during the year. In 2006, Government expenditure on large infrastructure projects, the normalization of tourist traffic and an upswing in the global electronics cycle are expected to contribute to a higher growth rate of 5.7 per cent.

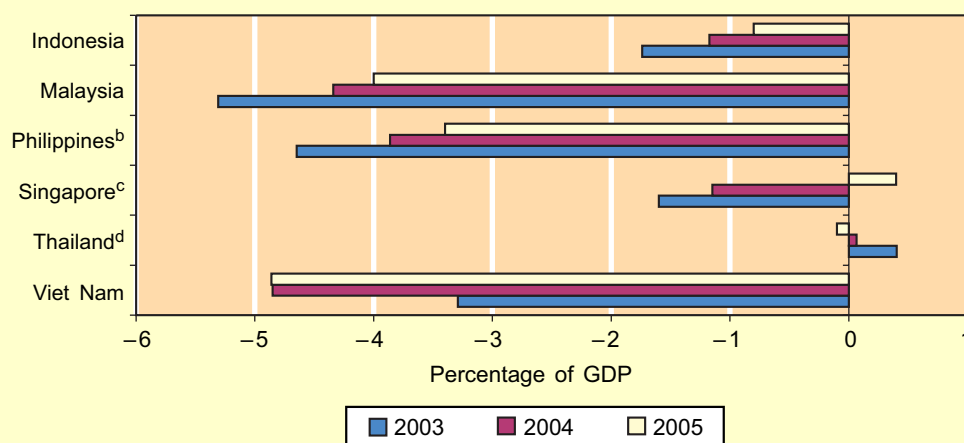
Growth in Singapore, the fastest growing economy in South-East Asia in 2004, fell from 8.4 per cent to 6.4 per cent in 2005. The sharp decline in the rate of growth was the result of weaker global trade, particularly in information and communication technology products, the country's largest export. Export revenues, which had increased by 16.2 per cent in 2004, grew by only 4.4 per cent in 2005, and the rate of growth of imports, which in *entrepôt* Singapore are closely linked to exports, also declined from 19 to 5.5 per cent. However, the 6.4 per cent growth rate achieved in 2005 was impressive by the standards of the Organisation for Economic Co-operation and Development. Both the manufacturing and service sectors contributed led by a sharp revival in biomedical output, good performance by the transport and engineering industry and buoyant retail sales (especially of cars) and financial services. In 2006, improved global demand for the country's exports and an increase in capital inflows, particularly in real estate as the Government relaxes rules restricting foreign ownership of property, are likely to keep the GDP growth rate close to 6 per cent.

High oil prices meant a rise in the GDP growth rate for oil-exporting Brunei Darussalam from 1.7 per cent in 2004 to 3.6 per cent in 2005. The rest of the manufacturing sector, based largely on textile and garment production, remained depressed, however, following the abolition of quotas under the WTO Agreement on Textiles and Clothing. Agriculture, fisheries and livestock production also fell during 2005. The service sector, led by cars and retail sales, remained fairly buoyant, however. The rate of economic growth in 2006 will depend on international oil prices since the economy of Brunei Darussalam continues to be largely dependent on oil and gas exports, which contribute more than one third of GDP.

Key macroeconomic policy developments

Fiscal policy developments

After providing a fiscal stimulus to the economy for several years, the Malaysian Government has been following a policy of consolidating the fiscal deficit. In 2005 the deficit was 4.0 per cent of GDP (see figure II.29), well

Figure II.29. Budget balance in selected South-East Asian economies, 2003-2005^a

Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2005 and 2006), various issues; and website of the Ministry of Finance of Singapore, <www.mof.gov.sg/budget_2005/budget_speech/downloads/>, accessed on 20 November 2005.

^a Data for 2005 are estimates.

^b Includes grants.

^c Computed from government operating revenue minus government operating expenditure minus government development expenditure.

^d Government cash balance comprising the budgetary balance and non-budgetary balance.

below the Government's target of 3.8 per cent. This was achieved in part by a reduction in government expenditure on development and construction projects. On the revenue side, there was strong growth in direct tax revenues, especially from the higher petroleum income tax and an increase in road toll charges. Indirect revenues also increased, owing mainly to higher duties on cigarettes and liquor. Non-tax revenues were also buoyant, including income from the government-linked oil giant Petronas. Despite cuts in oil subsidies, fuel prices in Malaysia are among the lowest in the subregion. A substantial subsidy remains, and a sales tax exemption on diesel and petrol costs the Government an additional 8 billion ringgit per year. With oil prices expected to remain high, the opportunity costs of the subsidy and concessions in terms of the developmental expenditure forgone appear to be considerable, particularly in view of the 7.7 per cent annual growth rate estimated to be required

to achieve the country's Vision 2020 goal of becoming a fully developed country.

In the Philippines, the fiscal consolidation that began in 2003 continued, and the budget deficit shrank from 3.9 per cent of GDP in 2004 to 3.4 per cent in 2005. Lower government spending was assisted by an unexpected saving in interest payments as rates remained lower than projected. Not much headway was achieved in tackling the country's long-standing shortfalls in the collection of personal income tax and customs duties, which remained below annual targets. Extra revenue did begin to flow towards the end of the year after imposition of a wider value added tax in November that ended exemptions on power, fuel for air transport, medical and legal services and several other items. The Government has used administrative measures such as staggering working hours to curb fuel consumption instead of eliminating

or reducing oil subsidies. Some pressure on the fiscal deficit can therefore be expected in 2006.

Indonesia has taken a conservative fiscal policy stance in the past few years in line with its structural adjustment package. The budget deficit in 2005 was 0.8 per cent of GDP, down from 1.2 per cent in 2004. The most important fiscal development in 2005 was the drastic cut in oil subsidies in October, which raised fuel prices 126 per cent. While this reduced the oil subsidy bill by 25 trillion rupiah per year, the Government sought to ease the contractionary effect on consumption spending by providing cash grants of 100,000 rupiah to each of the 16.5 million poorest households in the country. Notwithstanding the likely positive fiscal impact of this measure, questions remain about the efficacy of the policy package for the economy of Indonesia. How will the local government machinery ensure that the cash compensation reaches eligible households without leakage? Since the cash compensation payout is targeted only at low-income households, which are not major contributors to aggregate demand, can the payout prevent national consumption levels from falling and adversely affecting GDP growth? In view of these questions, it seems that additional steps may be required to boost demand since the economy is already facing both rising interest rates and a depreciating currency.

In July 2005, Thailand became the first South-East Asian economy to eliminate subsidies on petroleum products; the bold approach helped to increase the budget surplus slightly in 2005. Specifically, diesel subsidies that had cost the Government 92 billion baht in the year and a half prior to July 2005 were abolished. In order to compensate for the higher fuel costs, the Government introduced an economic stimulus package, including a higher minimum wage, a 5 per cent salary hike for civil servants, higher pensions and an additional outlay of 20 billion baht for a village fund. The overall budget impact for the year was neutral. With GDP projected to grow faster in 2006, by 5.7 per cent, tax revenues are also likely to rise. However, other policies are likely to cause a small budget deficit in 2006, including debt relief, investment in infrastructure and a delay in the privatization of State-owned enterprises such as the Electricity Generating Authority of Thailand.

In contrast to the fiscal consolidation occurring in most of South-East Asia, Viet Nam has maintained a relatively expansionary fiscal policy over the years. The budget deficit in 2005 was 4.9 per cent of GDP, the same as in 2004 and the largest in the subregion. A significant portion of the national budget was financed through oil revenues, which, owing to high oil prices, contributed 21 per cent of total receipts during the year. Other government revenues were also on the upswing because of higher corporate tax collections in an expanding economy. On the expenditure side, an important portion of outflows went to clear the wage burden of workers in an economy that is still dominated by the public sector. Even with fuel prices revised upwards three times during 2005, there is considerable scope for fiscal policy reform in Viet Nam as oil subsidies, particularly on diesel and kerosene, remain large.

After three years of deficits, Singapore delivered a budget surplus of 0.4 per cent of GDP during fiscal year 2005 owing mainly to higher tax revenues and the continuing good performance by State-owned enterprises, which are run on commercial lines. A budget surplus is in keeping with stated government policy that is aimed at sustaining surpluses over the medium term, possibly with the objective of containing inflationary pressures under the prevailing oil price conditions. Budget surpluses also provide the necessary flexibility for social security and pension schemes in a society with adverse demographics.

With oil revenues constituting the bulk of government income, the budget of Brunei Darussalam remained in surplus in 2005, aided by high global oil prices. However, the Government's plans to increase expenditures on several new initiatives, including the Pulau Muara Besar port project which is largely financed by the Government, and the improvement of the country's information and communication technology infrastructure, may cause the budget surplus to narrow in the coming year.

Monetary policy developments

In Indonesia, investor frustration over legislative delays in improving the investment climate triggered capital outflows in mid-2005, causing the rupiah to slide in international cur-

the Bank differs from the prevailing practice among most central banks, which favour incremental changes in monetary policy. While the rate of inflation might slow, the net impact of the policy on consumer spending and GDP growth is likely to be adverse. High interest rates will also increase the burden of servicing domestic debt and add to the fiscal costs of servicing foreign debt, which is due to commence in 2006 when the moratorium granted to Indonesia by the Paris Club of creditors expires.

In the Philippines, with inflation rising from 6 per cent in 2004 to 7.6 per cent in 2005, the central bank tightened monetary policy by raising the overnight borrowing rate to 7.25 per cent and lending rate to 9.25 per cent and raising the reserve requirement by 1 percentage point. This squeezed domestic credit significantly compared with the situation in 2004. On the positive side, commercial banks began responding to incentives offered by the Government to eliminate bad debts, and the percentage of non-performing loans declined to single digit levels. On the whole, monetary policy was driven more by the need to check inflation than to promote growth, which is not inappropriate in an environment where inflationary pressures induced by oil prices were coupled with a 19 per cent increase in the price of utilities (fuel, light and water) and an increase in the money supply faster than the 13 per cent target during the first three quarters, owing to a rise in net portfolio inflows and a surge in workers' remittances.

In Thailand, the non-performing loans of commercial banks declined to 10.5 per cent of total outstanding loans by August 2005 from 11.6 per cent in July 2004. With inflation climbing from 2.8 per cent in 2004 to 4.5 per cent in 2005, the central bank continued tightening monetary policy by raising overnight borrowing rates to 3.75 per cent in two phases, in September and in October 2005. In November 2005, the central bank announced its intention to keep interest rates above international levels in order to attract foreign capital. This is likely to have had important signaling effects. In anticipation of the rise in interest rates domestic investment is likely to have risen in the last quarter of 2005. Foreign capital inflows may have been postponed, however, as foreign investors waited for rates to go up, taking the announcements as credible.

Inflation peaked earlier in 2004 in Viet Nam, at 7.8 per cent, than in most other South-East Asian countries, which felt the impact of oil prices only in 2005. Tight monetary policy accordingly came into play as early as July 2004, when the State Bank of Viet Nam increased the reserve requirements of commercial banks. With inflation running at 8.4 per cent in 2005 due to commodity production shortfalls caused by drought and the avian influenza outbreak and the continuing high prices of imports, including petroleum products, steel ingots and chemical fertilizers, the authorities took further steps, including raising interest rates in September 2005. Deposit rates went up by between 0.24 and 0.6 percentage point (to between 7.56 and 8.4 per cent) while lending rates rose by 1.2 to 3.4 percentage points (to between 9.6 and 12.39 per cent), indicating greater concern over lending, especially the rapidly expanding credit lines to State-owned enterprises. A lending ceiling of 40 per cent of short-term funds available with credit institutions was imposed. Despite these steps, growth in Viet Nam is likely to continue unabated, riding on the momentum of broad-ranging structural reforms.

In Malaysia, despite the build-up of inflationary pressure, the overnight policy rate held steady at 2.7 per cent for most of 2005 except for 90.25 point increase in November 2005, enhancing the credibility of the central bank, which had announced in 2004 that, in order to sustain economic growth, interest rates were unlikely to be raised. In July 2005 the fixed exchange rate policy, under which the ringgit had been pegged to the dollar, was abandoned in favour of a managed float against a basket of currencies. The fixed exchange rate had outlived its utility. The Malaysian economy had fully recovered from the effects of the 1997 financial crisis, with a strong build-up of foreign exchange reserves from \$44.9 billion in early 2004 to \$75.7 billion by mid-November 2005 and regional initiatives under way to prevent currency volatility. The switch to a managed float restores to the central bank a critical policy tool for handling external shocks in a relatively open economy such as that of Malaysia.

There was little change in the exchange-rate-based monetary policy of Singapore. Despite the stance of the Monetary Authority of Singapore to allow a gradual appreciation of the Singapore dollar to prevent imported inflation,

the unexpected strength of the United States dollar in the international currency markets in the second half of the year meant that the currency depreciated nominally by 1.18 per cent during 2005. Inflation, which declined to just 0.3 per cent, was contained by slower growth in the demand for imports as well as weakening domestic demand. The end result was a small real depreciation consistent with the parallel policy objective of sustaining export growth. Interest rates in Singapore have been following the movement of interest rates in the United States, with the three-month domestic interbank rate falling to 2 per cent at the end of July and rising to 2.38 per cent by the end of September. There was no dramatic change in foreign exchange reserves, which rose from \$112 billion at the end of 2004 to \$115.6 billion by November 2005, the highest reserves in the subregion.

The monetary policy of Brunei Darussalam remained unchanged during 2005, with the reserve requirement for banks and finance companies maintained at 6 per cent of liabilities. The country does not have a central bank but the Brunei Currency and Monetary Board. Its monetary policy is focused on managing the exchange rate which is pegged to the Singapore dollar on a 1:1 basis. This has provided the economy with an effective instrument for price stability. Inflation remained modest at 1 per cent during the year. Broad money increased significantly during the year as a result of higher oil income. However, because the Government expected the price rise to be temporary, most of the extra revenue was saved, so there was no effect on inflation. Domestic interest rates have remained low in contrast to international trends, but credit growth has been moderate, except for consumer lending. One weak link in the monetary system is non-performing loans, which remain high compared with neighbouring countries. Official foreign exchange reserves rose from \$534 million at the end of 2004 to \$590 million at the end of 2005, supported by the higher oil revenues.

Financial sector developments

Symbolic of the steady transition to a market-based economy in Viet Nam, a second stock exchange was inaugurated in Hanoi in March 2005, five years after the first one opened in Ho Chi Minh City. In September 2005 the Government agreed to partially privatize the Bank for Foreign Trade of Vietnam (Vietcombank), one of the country's four large State-owned commercial banks. This was an important

policy breakthrough in a country where the pace of public sector reforms has otherwise been slow.

The Indonesian economy witnessed both positive and negative developments in the financial sector. On the positive side was the replacement of the blanket sovereign guarantee on bank liabilities with a new deposit insurance scheme. That scheme provides for a gradual decrease in coverage so that by March 2007 a maximum of 100 million rupiah (\$10,000) per depositor will be covered by a guarantee. The blanket guarantee had been introduced in 1998 during the Asian financial crisis to prevent a run on the banking system. The limited guarantee substantially reduces the moral hazard risk in commercial bank lending in Indonesia. On the negative side was the crisis in the country's mutual fund business, one of the fastest growing in Asia. Panic withdrawals took place when fixed-income instruments started falling in value in March 2005, with investors claiming that risks were not adequately explained by the fund managers. As a result, the net asset value of mutual funds fell 60 per cent on average by September 2005, temporarily disabling mutual funds as instruments for converting household savings into investment capital for the Indonesian economy.

The first Philippine Fixed-income Exchange became operational in March 2005. While only government bonds were initially listed on the exchange, the long-term benefits to the economy of an alternative system of credit allocation are likely to be substantial, given that net domestic credit distributed by commercial banks has been sluggish, rising by only 2.8 per cent in July on a year-on-year basis, down from 9.4 per cent per year in 2004. The Philippine economy also witnessed a sharp rise in net portfolio inflows, resulting in a surge in domestic liquidity. The stock market index was by nearly 13 per cent higher by November 2005 over the level at the end of 2004, although this hides the fact that portfolio investments were volatile during the year, with outflows rising sharply in response to such domestic shocks as the political crisis surrounding the country's president in June and the Supreme Court's decision to postpone implementation of the value added tax in July.

By contrast, the efforts of Thailand to increase the role of the stock market in the economy have met with only partial success.

Stock market activity was fairly subdued during 2005, with the stock index declining marginally by 0.4 per cent in dollar terms by November compared with the end of 2004. Tax incentives granted to new firms listing on the Stock Exchange of Thailand, in place for four years, expired in September 2005, having had very little impact in encouraging new listing during 2005. The Ministry of Finance is drawing up plans to further develop the country's capital markets, including introduction of a market for futures and derivatives in 2006. There were also concerns in the country's financial sector about the fall-out from the Government's plans to grant debt relief (50 per cent debt write-off of principal and a 100 per cent write-off of interest) to about 100,000 debtors whose loans had turned bad during the financial crisis of 1997. Apart from conflicting with the central bank's efforts to reduce domestic credit at a time when inflationary pressures abound, the plan could be creating a moral hazard even before implementation in 2006 as customers of commercial banks and non-banking financial institutions could put off repayments in anticipation of similar concessions.

In Malaysia, a number of new initiatives were taken with regard to Islamic banks, which neither charge nor pay interest but share the profits on their investments with depositors. For the first time foreign ownership of up to 49 per cent was permitted for these banks. Two bond indices, called the Dow Jones – RHB Islamic Index and the Citigroup Malaysian Government Bond Index, were launched by the country's central bank, Bank Negara Malaysia. Islamic bonds contributed significantly to the Malaysian bond market in 2005, growing by 50 per cent during the year.

In Singapore, earnings from the foreign operations of several banks and financial institutions were on the rise and contributed increasingly to the acceleration in the growth of the country's financial services sector, which grew 6.8 per cent in the second quarter of 2005 on a year-on-year basis. An important cross-border bank purchase was also carried out by the Government's investment firm Temasek Holdings, which purchased \$1 billion in shares of China Construction Bank (3 per cent of the total equity), one of the four biggest State-

owned banks in China. This marks the first entry of a Singapore company into the banking sector of China and comes at an opportune moment when State-owned banks in China have begun to improve their portfolios by shedding bad debts.

A series of financial sector reforms were also announced in Brunei Darussalam, including the merger of two local banks, the Islamic Development Bank of Brunei and the Islamic Bank of Brunei. Greater financial strength of the merged institution would probably enhance the role of Islamic banking in the economy. Amendments to the Banking Act, Financial Companies Act, Insurance Act and the Pawn Broking Act have also been announced with the objective of raising the country's regulatory standards to international levels. The amendments come into effect in 2006.

Developments in the external sector

Current account positions deteriorate

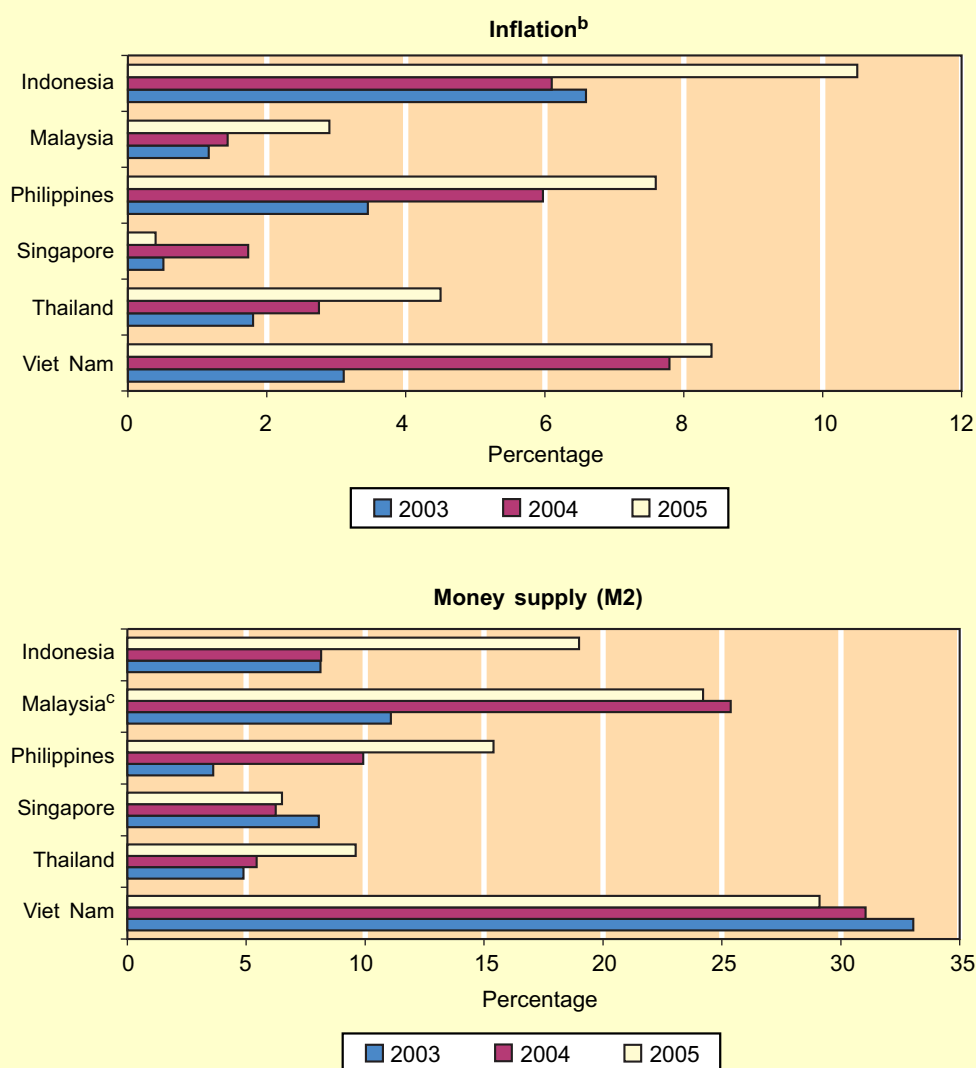
Merchandise exports from Viet Nam rose by an estimated 20 per cent during 2005 to \$31.8 billion, helped by higher international prices of crude oil, the principal export commodity, and the export of rice, wood, coal and electronics products (see figure II.31). Garment exports benefited from the imposition of non-tariff barriers against China. Merchandise imports rose by 22.5 per cent during 2005, to \$37.3 billion, as robust construction activity led to a rise in imports of steel and escalating demand for car and motorcycle components and chemicals. Counterbalancing flows took place in the services account, where earnings from a rise in tourist traffic were offset by larger imports in other service sectors. Remittances from overseas Vietnamese continued to be strong, and the current account deficit narrowed from 2 per cent of GDP in 2004 to 0.9 per cent in 2005 (see figure II.32). Exchange rates remained stable against the dollar and against other South-East Asian currencies (see figure II.33).

With regard to the capital account, the efforts of the Government of Viet Nam to facilitate FDI continued to be rewarded, with realized and committed FDI totalling \$3 billion, a rise of 14.5

rency markets. Bank Indonesia raised interest rates six times during the year, increasing the benchmark one-month rate from 8.5 per cent in July 2005 to 12.75 per cent in December. Infla-

tion had spiraled from 6.1 to 10.5 per cent when fuel prices increased rapidly following the drastic cut in oil subsidies in October 2005 (see figure II.30). The aggressive use of interest rates by

Figure II.30. Inflation and money supply growth in selected South-East Asian economies, 2003-2005^a

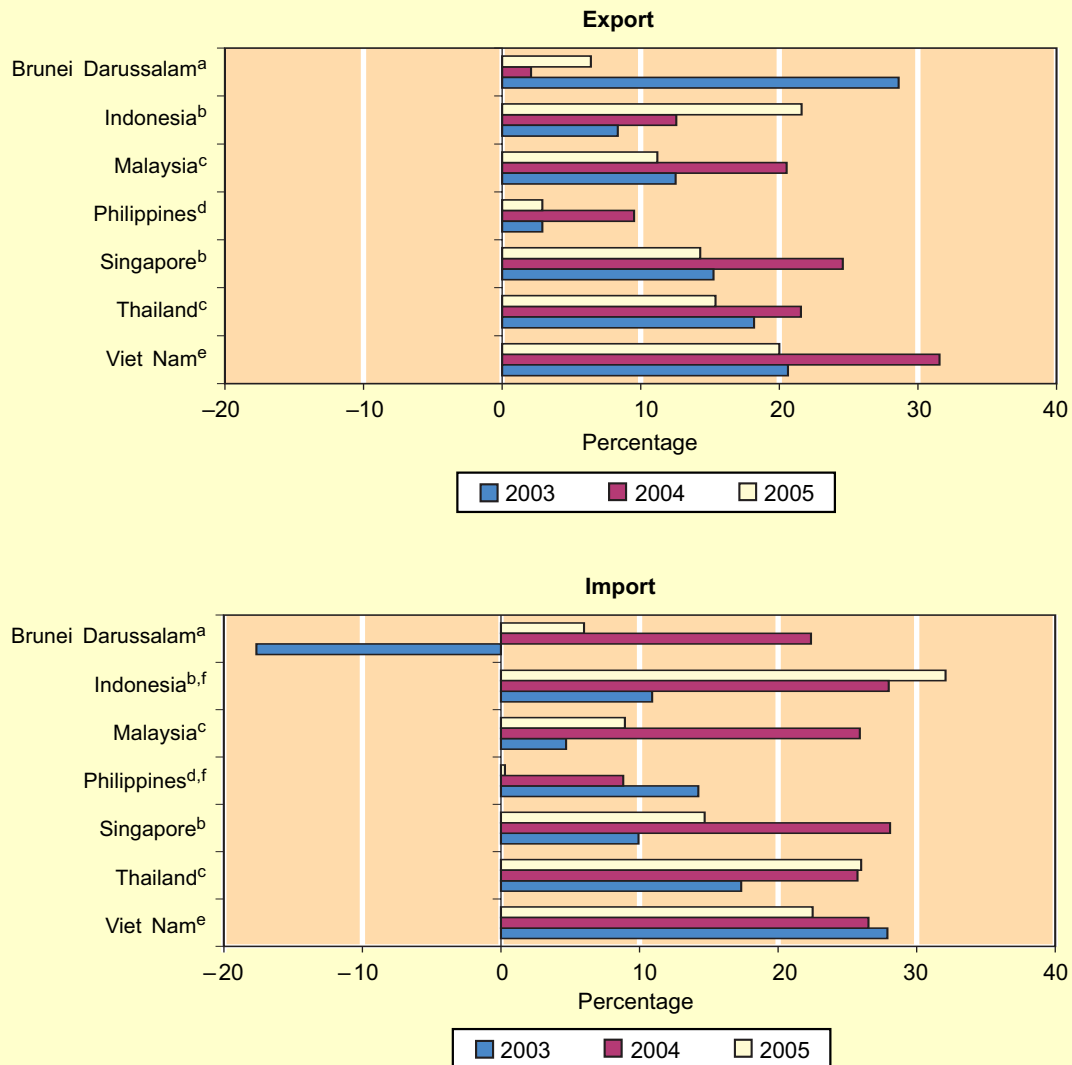


Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, January 2006); Economist Intelligence Unit (EIU), *Country Forecasts* (London, EIU, 2005 and 2006), various issues.

^a Data for 2005 are estimates.

^b Inflation refers to changes in the consumer price index.

^c Data for 2005 refer to January-September.

Figure II.31. Growth rates in merchandise export earnings and import spending in selected South-East Asian economies, 2003-2005

Sources: International Monetary Fund, *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); Bank Indonesia website <www.bi.go.id>, accessed on 20 January 2006; Malaysia Economic Planning Unit website <www.epu.jpm.my>, accessed on 6 September 2005; Department of Statistics Malaysia website <www.statistics.gov.my>, accessed on 23 January 2006; Philippines National Statistics Office website <www.census.gov.ph>, accessed on 24 January 2006; Singapore Department of Statistics website <www.singstat.gov.sg>, accessed on 8 December 2005; Bank of Thailand website <www.bot.or.th>, accessed on 24 January 2006; and World Bank, *East Asia Update*, <<http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/EAP-Brief-final.pdf>>, accessed on 8 November 2005.

^a Growth rate for 2005 refers to January-August.

^b Growth rate for 2005 refers to January-September.

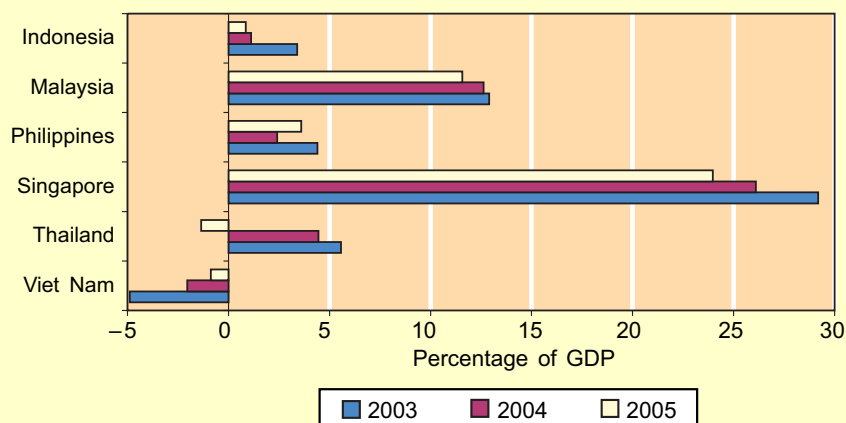
^c Growth rate for 2005 refers to January-November.

^d Growth rate for 2005 refers to January-October.

^e Data for 2004 are estimates and data for 2005 are projections.

^f Valued free on board (f.o.b.).

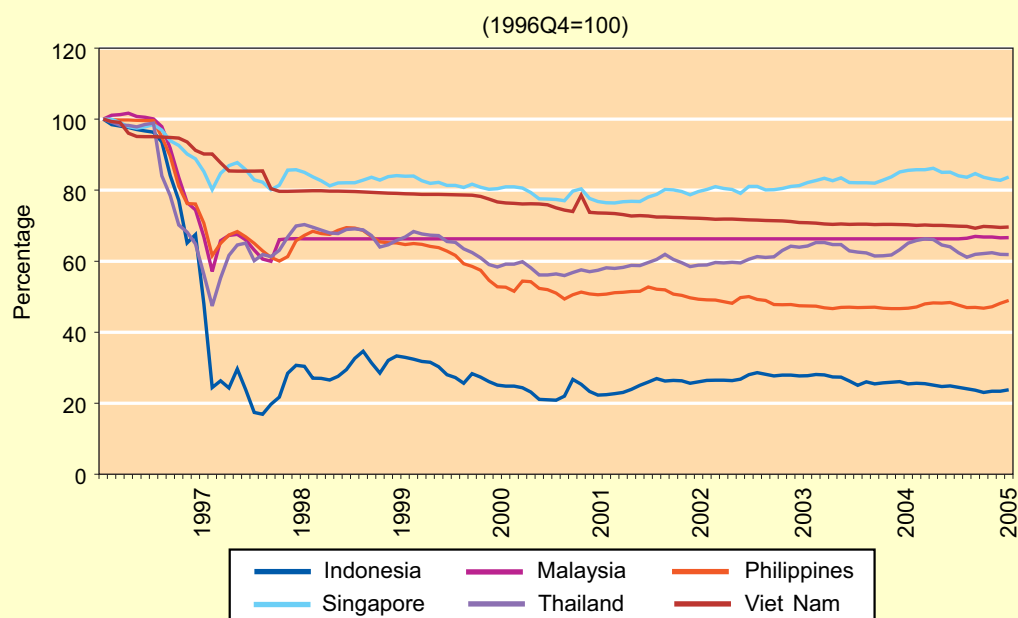
Figure II.32. Current account balance in selected South-East Asian economies, 2003-2005^a



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2005 and 2006), various issues; and website of the Ministry of Finance of Singapore, <www.mof.gov.sg/budget_2005/budget_speech/downloads/>, accessed on 20 November 2005.

^a Data for 2005 are estimates.

Figure II.33. Index of exchange rates against the United States dollar in selected South-East Asian economies, 1996-2005^a



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and *The Economist*, various issues

^a Data for 2005 are estimates.

per cent. Telephone equipment and motorcycle components were some of the favoured sectors. The attractiveness of Viet Nam as an investment destination was also confirmed by the successful sale of government bonds worth \$750 million in the international market in October 2005. The country remained an important destination for overseas development assistance, which reached \$1.72 billion in 2005, up from \$1.65 billion in 2004. On the whole, the current account deficit was more than compensated for by net inflows into the capital account, resulting in a balance of payments surplus of \$1.9 billion in 2005.

In Thailand, weak global demand for electronics products and supply-side bottlenecks in agriculture caused merchandise exports to grow by 15.5 per cent in 2005, down from a growth rate of 21.6 per cent in 2004. A significant rise in the oil import bill and strong demand for imports of intermediate products and raw materials caused merchandise imports to grow by 26 per cent, slightly higher than the 25.7 per cent in 2004. In absolute terms, the merchandise trade balance registered a surplus, but there was a big rise in the deficit in the services trade account as tourism revenue fell following the December 2004 tsunami. As a result of these trends, the country's current account showed a deficit of 1.4 per cent of GDP for the first time since the 1997 financial crisis.

The capital account was supported by an increase in FDI and portfolio inflows and a rise in net transfers. The surplus in the capital account more than offset the deficit in the current account, resulting in a small but reduced balance of payments surplus during 2005. As a result, the reserves of Thailand exceeded \$50 billion in December 2005 compared with \$48.6 billion at the end of 2004. A free trade agreement signed with Australia in 2005, following similar agreements signed with China in 2003 and with India in 2004 and others before that, makes Thailand a leader in bilateral free trade agreements in South-East Asia.

The current account surplus in Indonesia fell from 1.1 per cent of GDP to 0.9 per cent in 2005 owing to higher import bill for petroleum products despite a strong export performance led by high global demand for natural resources such as coal and to textile and garment exports, helped by European Union and United States restrictions on such exports from China. Mer-

chandise exports rose by 21.6 per cent to an estimated \$84.4 billion, while merchandise imports grew at a faster rate, 32.1 per cent, to reach an estimated \$62.9 billion during 2005. The main drivers for import growth were oil and petroleum products and gas, which rose as a consequence of high global prices and strong investment demand for capital and intermediate goods. The services account and net income from abroad remained negative during the year.

On the capital account, FDI outflows that had been persistent in Indonesia ever since its financial crisis in 1998 reversed for the first time in 2004 when net inflows totalled \$1.02 billion. FDI flows into the Asian and Pacific region are mostly market-seeking, and a large potential market such as Indonesia is difficult to ignore for long. Sales of State-owned enterprises and foreign acquisitions of private firms, as for example in the banking sector, were mainly responsible for the reversal of this trend. In the first quarter of 2005, international transfers in the form of tsunami aid also boosted the capital account. However, by the second quarter FDI inflows were offset by portfolio outflows, and the overall balance of payments deteriorated as the oil import bill rose. The balance of payments position is unlikely to improve in 2006 as external debt servicing is scheduled to rise considerably.

In Malaysia, merchandise exports grew by 11.2 per cent in 2005, down sharply from the 20.5 per cent growth rate in 2004, an unusually good year for electronics goods, the country's "cash cow". Exports were sustained by strong growth in terms of value for crude oil and gas exports and rubber products and palm oil. Malaysian merchandise imports, which are closely linked to exports, also grew slowly by 8.9 per cent compared with 25.9 per cent in 2004. The trade surplus along with strong earnings from Malaysian investments overseas resulted in a large current account surplus of 12 per cent of GDP in 2005. With regard to the capital account, FDI inflows in 2004 amounted to \$4.6 billion, a return to the levels seen before the crises in 1997 and 1998. These declined slightly during 2005; however, the decline was more than compensated by a surge in portfolio inflows, which kept the capital account in surplus during 2005.

Knowledgeable observers believe that the Malaysian economy is experiencing a period of excessive savings, with foreign exchange re-

serves more than doubling from \$34 billion in 2002 to \$70 billion by December 2005. Savings, at 44.5 per cent of GDP, are more than twice as large as investment. Given that the financial crisis in Malaysia began in 1997 with a run on the ringgit, government policy appears to be guided by a need to maintain a substantial cushion against currency volatility. If so, the policy is unlikely to change soon as another important protection against currency speculation, the dollar peg, has only recently been dismantled.

Philippine merchandise export growth slowed considerably from 9.5 per cent in 2004 to 2.9 per cent in 2005. Aside from weak demand in developed countries, electronic exports were also adversely affected by the transfer of a major electronic firm's processing and assembly plant to China. Although exports of textiles and garments were stagnant, automobile part exports performed better, helped by a policy decision to position the country as an automobile parts-manufacturing hub. Service receipts led by tourism increased substantially, growing by 10.9 per cent during the first half of 2005 thus far outpacing the 1.6 per cent growth rate achieved during the same period in 2004. Merchandise imports declined faster, registering growth of just 0.3 per cent compared with a 8.8 per cent growth rate in 2004. While the fuel import bill rose considerably, the increase was more than compensated by substantial declines in the import of telecommunications equipment and office machinery. On the whole, as imports were about 15 per cent higher than exports, there was a trade deficit of \$5.8 billion in 2005. However, with a surge in workers' remittances of \$4.8 billion in the first half of 2005, a 21.5 per cent year-on-year increase, the Philippine current account is estimated to have had a surplus amounting to 3.6 per cent of GDP in 2005, higher than the 2.4 per cent surplus in 2004.

Capital inflows to the Philippines have been languishing at below 25 per cent of their levels prior to the 1997 crisis for the past several years. FDI inflows in 2004 totalled \$469 million, far below the high of \$2.3 billion in 1998. During the first half of 2005, FDI rose to \$450 million compared with \$273 million over the same period in 2004, most of it going to manufacturing, real estate and the financial sector. There was a substantial turnaround in net portfolio

inflows, as \$2.1 billion entered the country in the first six months of 2005, compared with a net outflow of \$114 million in the first six months of 2004. The improvement can be traced to the successful bond and note issuance by the Government and an improved investor outlook after the Government's success in controlling the fiscal deficit. However, the country's external debt stock stood at 56 per cent of GDP, higher than the World Bank's "safe" limit of 50 per cent.

With trade at three times GDP, the external sector plays a dominating role in the economy of Singapore. The growth rate of merchandise exports slowed to 14.3 per cent in 2005 after a high of 24.6 per cent in 2004 as global demand slowed for information and communication technology products, the country's main export. Exports of integrated circuits, computer peripherals and pharmaceuticals declined sharply. The growth momentum in exports was maintained, however, by petrochemicals, civil engineering equipment and electrical machinery. The imports of Singapore as an entrepôt are closely linked to its exports, and along with the decline in export growth, the rate of growth of merchandise imports also fell to 14.7 per cent in 2005 from 28.1 per cent in 2004. The service sector registered a small surplus led by exports of financial services that more than compensated the deficit in tourism and transport services. On the whole, the current account surplus remained high at 24.0 per cent of GDP.

Net FDI inflows to Singapore rose to \$5.39 billion in 2004, and the positive trend continued in 2005 with the major recipients being finance, information and communication technology, biomedicine and food processing. However, there was a small deficit in the capital account as a result of the outflow of venture capital to overseas destinations, especially Hong Kong, China, and also by the reversal of foreign portfolio investments to more attractive destinations in emerging markets elsewhere. Other developments in 2005 were a bilateral free trade agreement with the Republic of Korea and the Closer Economic Cooperation Agreement with India, which included substantial tariff concessions on the country's imports from Singapore.

The main exports of Brunei Darussalam, oil and gas, account for 90 per cent of its export

revenue. The rise in international prices for these products more than compensated the sharp decline in exports of textiles and garments following the abolition of quotas under the WTO Agreement on Textiles and Clothing, causing the overall rate of growth of merchandise exports to rise by 6.4 per cent in 2005 from 2.1 per cent in 2004. The country's main merchandise imports are machinery, manufactured goods and food products, and these grew more slowly in 2005 at 6 per cent than in 2004, at 22.4 per cent. One reason for the slower import growth could be the food product prices driven higher by rising oil prices. The merchandise trade surplus was supported by income from the country's substantial overseas investments, leading to a large current account surplus in 2005. In that year, Brunei Darussalam also acceded to the Trans-Pacific Strategic Closer Economic Partnership, granting considerable tariff concessions to New Zealand under the terms of the agreement.

FDI flows to Brunei Darussalam fell sharply to just \$103 million in 2004, the lowest level in a decade after reaching a record high of \$2 billion in 2003. Oil companies from the Netherlands and the United Kingdom account for the bulk of FDI in Brunei Darussalam. However, the Government is concerned that the country's oil reserves may run out within 12 years or so at current rates of production. The strong policy statement of the Government on the need to diversify away from the oil and gas sector may have been responsible for the decline in FDI.

Medium-term prospects and key policy issues

Prospects are encouraging, but the subregion faces important policy issues concerning competitiveness

With the revival in the global demand for electronics products and the improved performance of the economies of Japan and the United States, the economic growth rate in South-East Asia is expected to rise from 5.4 per cent in 2005 to 5.9 per cent in 2006. Oil prices are expected to remain above historic averages in both 2006 and 2007, benefiting oil exporters such as Brunei Darussalam, Malaysia and Viet

Nam. Stronger export performance, larger remittances and higher income from overseas investments are likely to result in current account surpluses for most countries within the subregion. Monetary policy has been tightened in response to inflationary pressures since the second quarter of 2005, and this stance is expected to continue in 2006 with interest rates staying slightly ahead of international rates in order to attract foreign capital. Assuming that oil prices do remain higher than their 2005 levels, the overall inflation rate should rise modestly from 5.8 per cent in 2005 to 6 per cent in 2006 as subregional currencies are also expected to appreciate somewhat against the dollar, partially offsetting the higher prices of dollar-denominated oil imports. In addition, most countries in the subregion have been following a policy of fiscal consolidation, and this is expected to continue into 2006, with the exception of Thailand and Viet Nam, which are expected to use a moderate amount of fiscal stimulus to promote growth.

While the broad outlook for South-East Asia is promising, a number of risks and uncertainties remain because of recent regional and global developments. The phasing out of textiles and garments quotas under the WTO Agreement on Textiles and Clothing is likely to worsen the export performance of the subregion with countries such as Brunei Darussalam, the Philippines and Viet Nam losing out to China and the South Asian countries that have a comparative advantage in this sector. Economic restructuring aside, two medium-term policy options would seem to be available to South-East Asian countries for the textile and garment export problem: a move up the value chain (for example, manufacturers in Thailand developing the capacity for producing superfine luxury blends or those in Sri Lanka producing women's wear) and an emphasis on emerging niche markets, such as that for eco-friendly fabrics manufactured employing fair labour practices and high safety standards for the environment and catering to socially conscious customers.

A highly pathogenic strain of avian influenza could develop into a human pandemic and that could severely hamper the growth prospects of the subregion, especially for its fastest growing

economy, Viet Nam; the country has already reported the highest number of human cases. Such an influenza pandemic would also slow economic growth in other countries in the subregion, with tourism likely to be affected the most severely. Containment and preventive measures need to be taken, including making widely available antiviral drugs. The formulation of a regional contingency plan for strengthening integrated health surveillance systems and for creating wider awareness of the potential severity of the problem would augment those efforts.

High oil prices pose a major risk for countries in the subregion, which import most of their energy. If there is no significant decline in energy prices, firms burdened with high fuel bills could see their profits affected as soon as the first quarter of 2006, thus indirectly having an adverse impact on national economic growth rates and raising inflationary pressure across the region. Each country's policy response will depend on the options that its macroeconomic fundamentals permit. These range from providing incentives to divert production from fossil fuel-intensive processes to raising taxes to discour-

age consumption, continuing with subsidies to avoid burdening firms with higher input costs and reducing incentives to prevent unsustainable budget deficits.

South-East Asian countries are still largely dependent for economic growth on labour-intensive, export-oriented manufacturing, something that China with its much larger labour force can do better. What can South-East Asia do under these circumstances? Some East Asian economies may be showing the way. Taiwan Province of China, for instance, has attempted to take advantage of the economic growth in China by restructuring its economy. It has transferred manufacturing units to mainland China to take advantage of cheaper labour and superior government incentives. It has also invested capital in Chinese start-up companies. For South-East Asia, restructuring by moving up the value chain domestically while shifting manufacturing to lower-cost locations within other South-East Asian countries is likely to yield economic benefits in the medium term, and Singapore has already taken important steps in this direction (see box II.4).

Box II.4. Singapore: restructuring for the future

With a per capita income of \$24,220 in 2004, Singapore is the richest country in South-East Asia and the third most prosperous economy in Asia after Japan and Hong Kong, China. The remarkable success story of Singapore began in 1965, when it separated from Malaysia. Since then it has been based on a combination of sound macroeconomic fundamentals, exports (high-technology goods and services) and pragmatic policy initiatives designed to sustain the economic success of Singapore. Its strategy towards two important phenomena of current times, that is, the emergence of China and India as global economic powers and the information-technology revolution, can provide useful insights to other countries seeking innovative development strategies in an increasingly competitive, knowledge-based world.

Recognizing that labour costs and economies of scale make it difficult to out-compete the Asian giants in the production and export of manufactures, Singapore is aiming at a strategic repositioning of its economy to one that is driven by services rather than its traditional engine of growth: manufactures. An important element of this strategy is to collaborate with China and India rather than to compete with them. The recent purchase by Temasek Holdings, the Singapore Government's largest investment firm, of shares of China Construction Bank and its investments in the fast-growing cinema industry in India are part of this strategy.

The policy innovations with respect to the knowledge revolution are much more dramatic and interesting. Analysts have long been skeptical of the ability of Singapore to sustain a growth path that appeared heavily dependent on savings. In neoclassical growth economics, high savings alone help to achieve

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only limited levels of economic development. Further growth requires improvements in total factor productivity or technological and organizational improvements. Singapore has immersed itself aggressively in the knowledge economy. While most countries are focusing on technology and knowledge, Singapore has placed its objectives ahead of the curve by becoming the first country to emphasize creativity through public policy. This strategy includes inviting creative people to work in Singapore, building the infrastructure for creativity, offering creative experiences at the high end of tourism and changing the education system so that creative teaching tools are used at stages of schooling even below the university level.

The initial success of the country's strategy to become a hub of technological change can be seen from the large number of information technology, financial services, pharmaceutical and food-processing multinational corporations that have set up research and development units, attracted by the world-class research facilities.^a However, there are some doubts about the ability of Singapore to retain its acquired stock of foreign scientists, doctors, engineers and artists over the long term. Recent writings on creativity emphasize the importance of tolerance as one of three pre-requisites of a creative hub, the other two being access to technology (such as broadband) and the availability of social amenities (museums, clean air).^b While the technological infrastructure in Singapore is one of the most advanced in the world and the cultural and ecological environments are excellent, Singapore has followed a hard-line approach towards the more open and tolerant lifestyle options found in leading creative cities in North America, Europe and Australia. Recently, the Government approved construction of two large casinos, which could signal a turn towards a less restrictive approach. A proposal to permit shows along the lines of night clubs in Paris is also receiving consideration. These are signs that official attitudes are becoming much more flexible and accommodating to the requirements of a modern creative society.

^a *World Investment Report 2005: Transnational Corporations and the Internationalization of R&D* (Geneva, UNCTAD, 2005) Sales No. E.05.II.D.10.

^b Richard, Florida, *The Rise of the Creative Class and How It Is Transforming Work Leisure, Community and Everyday Life* (Cambridge, Mass., Basic Books, 2002).

LEAST DEVELOPED COUNTRIES

Since the least developed countries in the region are relatively small and narrowly based economies, their economic growth is easily affected by subregional, regional and external developments. These factors may be natural events, such as the 2004 tsunami, or external policy developments, such as implementation of duty-free and quota-free market access for products originating from these countries.

The agricultural sector accounts for a larger share of economic output and employment in these countries than in most other developing countries in the Asian and Pacific region. As a result, weather is often a major factor determining the overall economic growth and well-being of the largely rural population in these countries. Owing

to the steady growth in garment manufacturing, energy-related extractive industries and tourism, the contribution from the agricultural sector to overall economic output has generally declined.

Growth in the industrial and service sectors of the least developed countries was adversely affected by the expiration of the WTO Agreement on Textiles and Clothing, rising petroleum prices and declining tourism as a result of outbreaks of avian influenza and over-dependence on subregional markets. Since most least developed countries have limited scope for exercising an independent monetary policy, inflation is often determined largely by inflationary pressures in their major trading partners and the movement of their exchange rate. Diversification and resilience are essential if least developed countries are to overcome any adverse outcomes resulting from these possible risk factors.