

in the social sectors and on infrastructure development in rural areas, and raise civil service salaries by 2008. Such expenditures would require an increase in government revenues to 13.1 per cent of GDP. The current account deficit is projected to decline to 7 per cent of GDP by the end of 2008 owing to increased competitiveness and tourism. A projected external financing gap of \$119 million is expected to be covered with assistance from international financial institutions.

Foreign direct investment in the Lao People's Democratic Republic will increase with the elimination of duties

In the Lao People's Democratic Republic, GDP growth is projected to range between 7.5 to 8.1 per cent during the period 2006-2008. Although growth in the agricultural sector is expected to continue, its share in GDP may decline. Both the industrial and the service sectors are projected to grow more rapidly, led by mining and quarrying and tourism. Private savings in the banking system are projected to grow, with foreign currency deposits expected to drop to half the total outstanding deposits by 2008. Private investment is forecast to rise in line with private savings. Inflation is estimated at an annual average rate of 7 per cent in the medium term. The central bank is expected to absorb any excess liquidity while the Government aims at balancing the budget. The volume of imports of capital equipment for infrastructure projects is likely to mean that imports will keep growing faster than exports. FDI is expected to increase with the elimination of import duties on production machinery, equipment and raw materials and of export duties on finished products. Other factors expected to increase FDI are the right to employ expatriates and the provision of profit tax incentives tailored to specific activities, the establishment of investment areas and the size of investments.

Myanmar recognizes need for structural reforms to promote private investment

Barring unforeseen economic shocks, Myanmar is expected to maintain its economic growth rate, given its location in one of the world's most dynamic regions and its abundant natural resources. Myanmar recognizes the need to continue making structural reforms in order to

promote a more conducive environment for private investment and productivity growth. To ensure better governance and transparency, the Government has introduced measures to promote improved accounting practices and greater disclosure and to enforce financial and non-financial rules and regulations. Implementation of international best practices and recommendations is expected to require substantial resources over time.

Large fiscal surpluses averaging nearly a third of GDP are expected in Timor-Leste

The economic growth rate in Timor-Leste is expected to double to 5 per cent in 2006 as a result of increased investment spending. Assuming normal weather conditions, the expansion of technical extension services to subsistence farmers, the development of agro-businesses and the licensing of fishing are expected to accelerate growth in the agricultural sector. Higher public spending would also increase private sector activity, especially in the construction and service sectors. The higher economic growth necessary to absorb the expanding labour force requires improved budget execution and strengthening of the legislative and regulatory framework to attract private investment. Inflation is expected to be moderate in view of the current exchange and monetary regime. Based on anticipated oil and gas production, large fiscal surpluses averaging nearly a third of GDP are expected in the medium term. Enactment of pending economic legislation, finalization of bankruptcy legislation and development of a strong and independent judiciary and a comprehensive land-titling system are measures essential to ensure sustainable growth and higher employment in Timor-Leste.

DEVELOPED COUNTRIES

Australia, Japan and New Zealand

Overview

Growth slackens but remains strong in all three developed countries in the region

GDP growth in Australia and New Zealand lost some momentum in 2005. Australia and New Zealand are primarily commodity-producing

and commodity-trading economies. Japan is driven more by manufacturing and relies less on trade, as measured by nearly the trade to GDP ratio. GDP growth declined by 1 percentage point in Australia but went up by 0.2 percentage point in Japan. The slowdown was much sharper in New Zealand, at more than 2 percentage points.

Domestic factors were primarily responsible for the slowdown in Australia and New Zealand. In Australia, households appear to have entered a phase of consolidation after a period of unsustainably rapid growth in borrowing and spending, and this has been accompanied by a mild downturn in housing construction. In Japan, there was a modest drop in public consumption, although private consumption and net exports maintained the relative buoyancy shown in 2004. In New Zealand, domestic demand declined considerably as interest rates rose and the contribution of net exports to GDP growth in New Zealand diminished visibly in response to an appreciating exchange rate. The current account widened further, and this holds monetary policy implications for the near term.

Prospects for 2006 are for a slight loss of momentum in Japan and New Zealand while growth should pick up in Australia. Although the external environment is expected to remain broadly stable, albeit with substantial downside risks as discussed in chapter I especially with regard to high and volatile oil prices and growing international imbalances, there is unlikely to be any noticeable change from the domestic side in the momentum for output growth. The principal components of growth, the macroeconomic background and the policy trade-offs and challenges confronting the three economies are discussed at greater length below.

GDP growth performance

Domestic factors drive output growth in the developed countries

Australia recorded its fourteenth year of continued economic growth in 2005 (see figure II.48). The 2.5 per cent growth rate in 2005 was a more sustainable pace for the Australian economy than its rapid growth in the previous

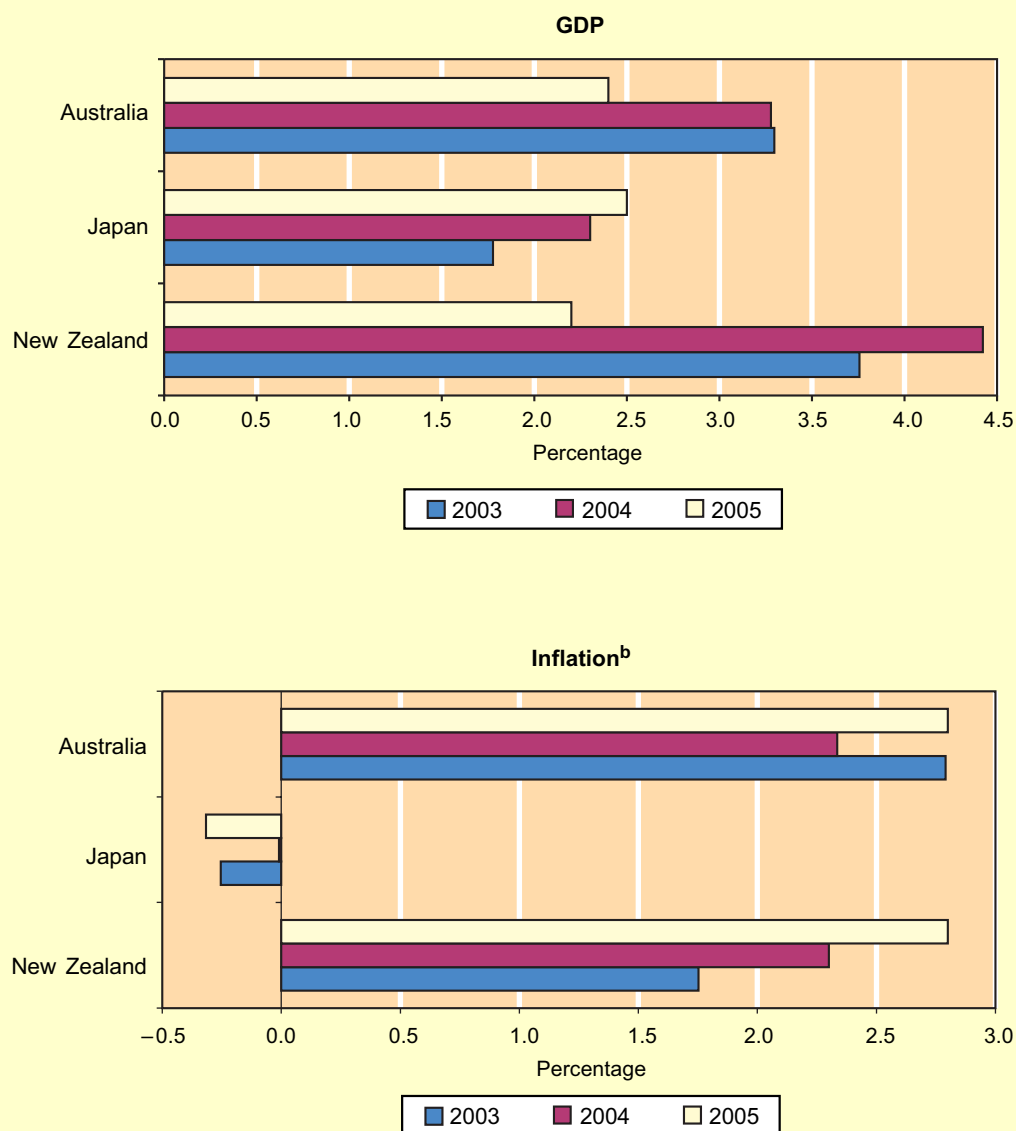
few years, reflecting a significant shift in the composition of growth. Improved terms of trade and stronger business investment led the growth in domestic demand in 2005 at a time when the increased household consumption growth seen in earlier years began to decelerate. With the housing boom clearly cooling, residential investment fell for three consecutive quarters following the second half of 2004 and housing prices declined after several years of strong growth. As a result, household expenditure slowed as households attempted to reduce their increasing debt-servicing costs. Private consumption nevertheless maintained a degree of buoyancy, growing at a yearly rate of 3 per cent up to mid-2005, as employment growth and tax cuts strengthened otherwise weaker consumer confidence.

Business investment rebounded following a decline in the first quarter of 2005, owing to the continuing strong global demand and the increasing corporate profits. This virtuous combination prompted both business investment and employment demand. For instance, orders for machinery and equipment expanded by more than 18 per cent on an annual basis in the second quarter of 2005, reflecting substantial expansion of operations in the resource-processing sector.

The unemployment rate recorded a 28-year low of 5.1 per cent, with wages growing by nearly 4.5 per cent for the year to June 2005. However, towards the middle of 2005 a tightening labour market, high levels of capacity utilization and higher energy prices narrowed slightly the profitability of the business sector, thereby weakening business confidence. These constraints tended to limit the growth of production, which would otherwise have expanded vigorously in response to the more favourable external environment, in particular the solid demand for exports at a time when commodity prices were at historic highs. However, overall business investment continued to grow.

Despite the slowdown in the second half of 2004, Japan recorded significantly stronger economic growth in the year as a whole than at any time since 1997, confirming the view that Japan had finally recovered from its decade-long virtual stagnation. Growth picked up in 2005, as

Figure II.48. Economic growth and inflation in developed countries of the Asian and Pacific region, 2003-2005^a



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Japan, Statistics Bureau and Statistical Research and Training Institute, *Monthly Statistics of Japan*, January 2006; Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2006), various issues; and International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

^a Data for 2005 are estimates.

^b Inflation rates refer to percentage changes in the consumer price index.

domestic investment and consumer expenditure actually appeared to have recovered, offsetting the decline in export demand in the second half of 2004. Growing optimism over the economic outlook in 2005 attracted foreign investors, as reflected in the strength of the stock market. The Nikkei stock market index reaching 15,778 in December 2005, its highest level in five years, an increase of more than 40 per cent during the year.

The strength of domestic demand in Japan can be attributed essentially to an increase in corporate profitability, following the restructuring of corporate balance sheets that began in the mid-1990s. The process has been supported by the removal of obstacles that had been undermining corporate performance since the economic bubble burst more than 10 years ago, namely, excess capacity, excess employment and excess corporate debt burden. Recent issues of the Short-term Economic Survey of Enterprises in Japan confirm that considerable progress has been achieved in reducing surplus plant and equipment and in introducing new technology in many manufacturing firms in the last few years. Encouraged by the growth of external demand, the corporate sector in Japan has now turned to expand capacity in a range of manufacturing firms and thus has increased capital investment (figure II.49). As a result, unemployment has started to decline, albeit gradually. That, in turn, has invigorated domestic demand and consumer confidence. However, slower growth of external demand and rising costs, particularly for wages and energy, might be discouraging factors for further investment growth in 2006.

Despite the recent strength of private consumption a degree of uncertainty remains. Private consumption represents more than half of GDP and is the key to sustained growth in domestic demand in the economy of Japan. While the labour market is buoyant, consumer confidence is becoming clouded by fiscal measures such as those requiring employees to increase their contributions to the public pension scheme and the planned removal of the 1999 income tax cuts in 2006. On the upside, there appears to be a longer-term shift in propensity of households to consume when income growth is low, which should soften any slowdown in domestic consumption in the near term. In view

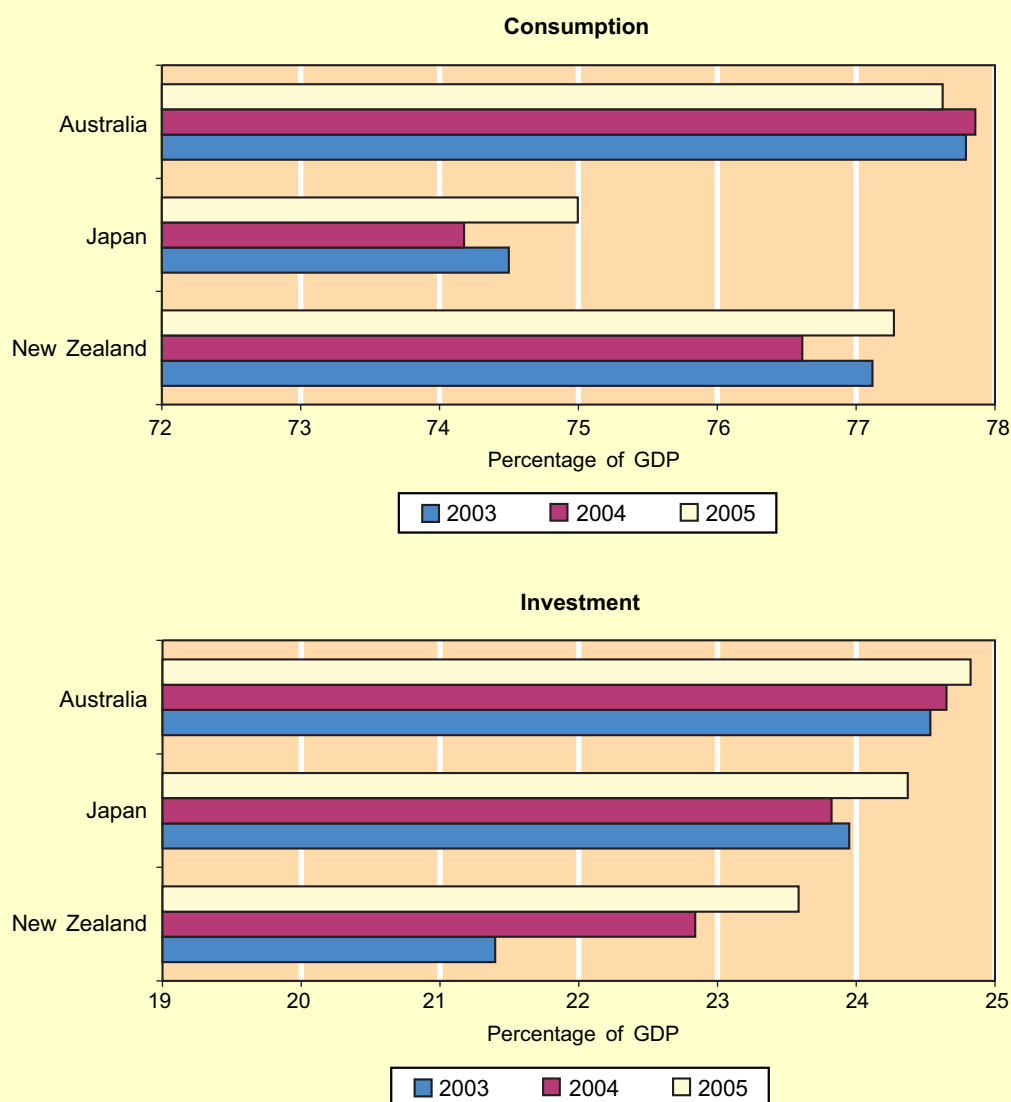
of the significant role of consumer expenditure in the growth of domestic demand in the past, the near-term growth prospects of Japan depend on whether the current momentum of household consumption can be maintained. The overall signs are positive, but longer-term trends are less sharply defined.

The economy of New Zealand weakened significantly in 2005

The economy of New Zealand experienced considerably weaker growth in 2005, following robust growth of nearly 4 per cent annually in the previous four years. Domestic demand, the primary source of strength in output growth since 2002, declined to 4.4 per cent in 2005 after growing by 3.8 per cent in the previous year, responding to the end of the property-market boom and a slowdown in employment growth. Export growth lagged far behind import growth, worsening the trade balance and making a negative contribution to GDP growth in 2005. While stronger export growth was recorded in 2004, the strength of the New Zealand dollar against the currencies of major trading partners to some degree eroded the impact of stronger external demand in 2005. The exchange rate facilitated more robust import growth in 2005, although with somewhat weaker domestic demand the pace was slower than the double-digit growth experienced in 2004.

Domestic demand in recent years has been strengthened by consistent inward migration and the ensuing increased domestic investment, such as in residential construction, which has generated jobs in sectors such as construction and allied services. With interest rates moving upward and the housing-market boom cooling when the flow of migration is slowing, residential investment showed signs of tapering off and private consumption became more subdued in 2005. Weaker consumer expenditure has reflected households' efforts to readjust their balance sheets in the wake of a cooler property market and higher interest rates. Nevertheless, the decline in housing prices has been moderate and the growth of employment has continued, both of which factors have supported consumer confidence. The expansion of business investment, on the other hand, did not fully reflect capacity constraints, as capital investment needs

Figure II.49. Consumption and investment in developed countries of the Asian and Pacific region, 2003-2005^a



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2005), various issues.

^a Data for 2005 are estimates.

were partly satisfied by imported capital attracted by the stronger currency. The unemployment rate stood at 3.7 per cent in the second quarter of 2005, an 18-year low. The tighter labour market, however, has translated into upward pressure on

wages, and employment growth slowed to 1.5 per cent in 2005 compared with 3.3 per cent in 2004, while nominal wage growth accelerated from 2.9 per cent in 2004 to 3.6 per cent in 2005.

Key macroeconomic policy developments

Inflation remained moderate and the strong Australian dollar exerted downward pressure on import prices

Inflation remained moderate in Australia at about 3 per cent, although producer prices increased, reflecting a tightening labour market and higher energy prices. Primary product prices rose by 6.5 per cent for the year to September 2005, while final producer prices rose by 3.4 per cent. The pressure on producer prices was not fully passed on to consumer prices. The consumer price index edged up from 2.4 per cent in 2004 to 2.6 per cent by the third quarter of 2005, remaining within the 2-3 per cent target band of the Reserve Bank of Australia.

Divergent trends were noted in the prices of non-tradable and tradable goods in 2004. The differences between the two types of goods narrowed in 2005, as the disinflationary effects of the stronger Australian dollar in 2002 and 2003 gradually diminished. Thus, tradables, including food and petrol, rose by 2.6 per cent for the year to September 2005 compared with a 3.4 per cent rise for non-tradables. While the stronger Australian dollar exerted downward pressure on import prices and thus on tradables inflation, strong growth in demand kept the prices of non-tradables at a high level.

The strength of domestic demand and the growing signs of capacity constraints in 2005 signalled a build-up of inflationary pressures in the economy. With the inflation rate approaching the upper limit of the policy target, the central bank increased the overnight cash rate by 25 basis points to 5.5 per cent in March 2005, the first such increase in 14 months (see figure II.50). With the boom in the property market cooling and the interest rate burden on household debt rising, there appears to be no immediate need for a further rise in interest rates, although inflationary pressure could resurface in the medium term if higher oil prices persist and the Australian dollar were to weaken significantly. Further monetary tightening would need to be carefully weighed against the impact that higher interest rates would have on highly indebted households, domestic demand and the exchange rate.

As in 2004, the fiscal position of Australia remained strong in 2005 (see figure II.51), in stark contrast to the case in Japan and other countries in the Organisation for Economic Co-operation and Development, many of which have large fiscal deficits. During 2005, the underlying cash surplus accruing to the federal Government was reported to have reached 1.3 per cent of GDP, following a 1.6 per cent surplus in 2004, despite the significant tax relief granted to individuals in 2005. The mildly expansionary fiscal policy in recent years has cushioned the slowdown in domestic demand without placing excessive stress on monetary policy or the budget. The surplus has been the result largely of higher corporate tax revenues and royalties flowing from the gain in corporate profits, in particular from the mining sector, which benefited from high export prices. The revenue increase more than offset the income tax cuts and extra spending on family assistance, health care and education.

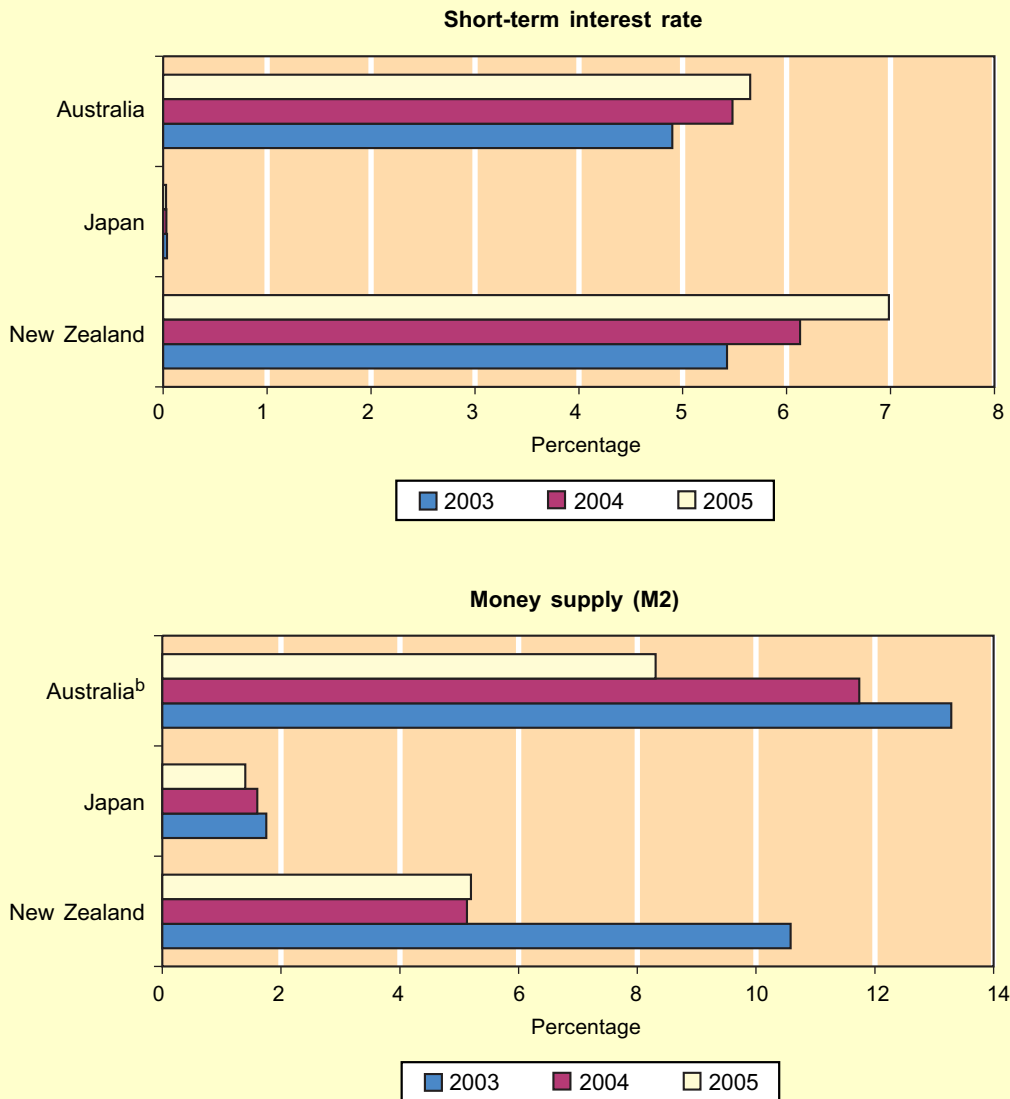
Deflation in Japan is expected to end in 2006

Japan is still in the throes of mild deflation, although the pressure has eased considerably in recent months. The Bank of Japan has predicted that deflation is likely to end in 2006. Although Japan is a major importer of oil, recent high oil prices have not affected overall prices. Consumer prices were expected to decline by 0.3 per cent in 2005, and in terms of the GDP deflator, prices were likely to have fallen by as much as 1.2 per cent in 2005.

One explanation for the minimal impact of higher oil prices is the increase in energy efficiency in Japan. According to the Government's macroeconomic model, a 20 per cent rise in the price of crude oil would reduce GDP growth by a mere 0.1 per cent, owing largely to the steady improvement in energy efficiency per unit of nominal GDP since the oil shocks of the 1970s and 1980s. Furthermore, low import prices, particularly for imports from China, have been putting downward pressure on the overall price level, aided by ongoing deregulation of domestic markets.

With recent strong economic growth, the probable easing of deflationary pressure in 2006 and growing confidence that systemic risks in the financial sector have been largely overcome,

Figure II.50. Short-term interest rates and money supply growth in developed countries of the Asian and Pacific region, 2003-2005^a



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and Organisation for Economic Co-operation and Development, *Main Economic Indicators*, <www.oecd.org/dataoecd/>, accessed on 24 February 2006.

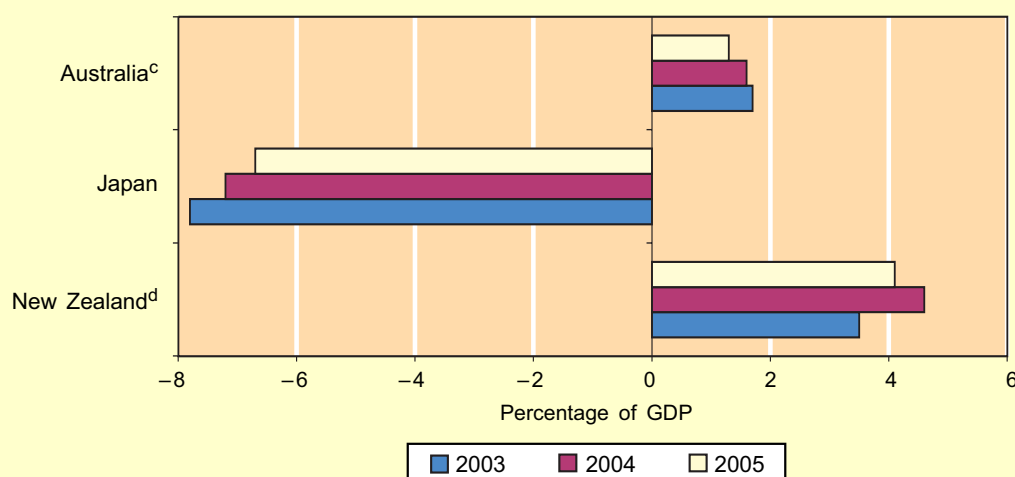
^a Data for 2005 are estimates.

^b Data refer to the period January-October.

the Bank of Japan has signaled a policy shift on deflation. Although the Bank would continue its current "easy-money" policy stance until deflation has been overcome, the zero interest rate re-

gime is expected to end as soon as deflation is technically over. The current quantitative easing framework was intended to provide enough liquidity to counter deflationary pressure; however,

Figure II.51. Budget balance^a in developed countries of the Asian and Pacific region, 2003-2005^b



Source: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *World Economic Outlook, September 2005: Building Institutions* (Washington, D.C., IMF, 2005).

^a Refers to general government fiscal balance.

^b Data for 2005 are estimates.

^c Data exclude net advances (primarily privatization receipts and net policy-related lending).

^d Derived from revenue minus expenditure plus balance of State-owned enterprises, excluding privatization receipts.

its overall effectiveness has been questionable. While the intention was to encourage commercial activity through increased bank lending, banks did not expand their extension of credit, as observed in the steady contraction of loan portfolios, despite the low interest rates. There is evidence that some secular shift in borrowing preferences has been taking place, with corporations raising more bond finance than in the past. Nevertheless, the urgent need for fiscal tightening implies that any premature tightening of monetary policy could put economic growth at risk if corporate sentiments are not strong enough to absorb the interest rate rise. Moreover, a rise in long-term interest rates would increase the cost of servicing government debt; at 150 per cent of GDP, that debt is of potentially serious concern.

The public debt and the need for fiscal consolidation remain daunting challenges for the economy. While the economic recovery in Japan

has contributed to an increase in tax revenues, it has not offset the rising interest payment obligations on the country's growing debt and increased expenditure, in particular rising welfare spending. The Government aims at achieving an operating balance in the budget by 2010, but its policy stance thus far has been one of gradualism and incremental change in its tax regime, thus creating the danger of slippage. More drastic measures such as a higher consumption tax have long been debated, but there are fears that such a policy could damage still-fragile consumer confidence. Consumer confidence and private consumption have improved in recent months but they could weaken again as contributions to the employee pension scheme rise and the income tax cuts of 1999 are reversed in 2006.

Incipient inflationary pressure has been evident in New Zealand for some time; the deflationary pressure from the stronger currency is fading and the impact of higher oil prices is

strengthening. Despite considerable divergence among the major components of consumer price inflation, the inflation rate was well contained within the monetary authority's target range in 2004. Inflationary pressures in tradables diminished in 2005 owing to moderation of the currency's appreciation; inflation in non-tradables was higher, however, reflecting still high housing costs. Overall, producer price increases accelerated from 1.9 per cent in 2004 to 3.1 per cent in 2005, reflecting capacity constraints and a tighter labour market.

In view of the continuing strength of domestic demand and the growing evidence of capacity constraints and a tightening labour market, the Reserve Bank of New Zealand gradually raised the official cash rate from 5.0 per cent in January 2004 so that it reached 6.75 per cent in March 2005. Although high oil prices and strong wage growth suggest potential inflationary pressures, the central bank's expressed policy is that it would be guided by the likelihood of inflation over the medium term, implying that further tightening may not be imminent if current pressures prove transitory. Moreover, the possibility of further monetary tightening increases the risks of a hard landing for the economy, through a sharp fall in property prices and further appreciation of the New Zealand dollar.

The fiscal position remains strong in New Zealand. The operating budget surplus was slightly higher in 2005 than in 2004, despite a relatively expansionary fiscal policy. As in the previous year, the results for 2005 reflected higher than expected tax revenues, particularly from corporate taxes and the goods and services tax, although consumer spending was less buoyant than the previous year. So far, the Government has indicated that the surplus has been earmarked for pre-funding the pension scheme and for financing a larger capital investment programme in social infrastructure, such as health and education.

Developments in the external sector

External positions worsen in Australia and New Zealand; the current account surplus of Japan increases

In Australia, with increasing export prices, growth in the value of merchandise exports rose

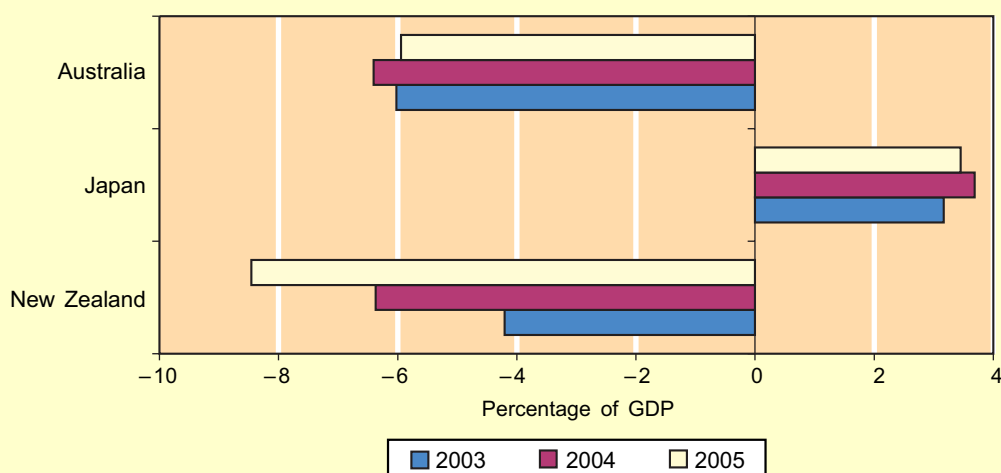
at a rate of 21 per cent in 2005, following similar growth in 2004, mainly on strong demand from China for minerals and fuel. The recovery of agricultural output and the increase in mining production underpinned export growth, although capacity constraints in transport and other sectors prevented the supplies from meeting the robust external demand. Export commodity prices were substantially higher than the 2001-2003 average as of June 2005. Import growth slowed, moderated by the slight depreciation of the currency and weakening domestic demand. Thus the trade deficit narrowed from 2.9 per cent of GDP in 2004 to 1.9 per cent in 2005. However, the current account deficit is estimated to have worsened to around 6.0 per cent of GDP (see figure II.52).

The narrower trade deficit was offset by a wider deficit on other current transactions and rising debt service costs. Net external debt rose from about 40 per cent of GDP in 1998 to more than 50 per cent in 2004. Although the debt is concentrated in the private sector, and the currency risk has been well managed so far, it remains a major concern. Debt denominated in foreign currencies constitutes about 65 per cent of the total and is well hedged.

A sharp slowdown in demand from China and the consequent slowdown of the economy of Japan at the end of 2004 were reminders of the growing importance of East Asian economies as trading partners for Japan in recent years. China is now second only to the United States as a destination for Japanese exports, and it is the most important source for imports, having supplied one fifth of Japanese imports in 2004 (see figure II.53).

With somewhat subdued demand from its trading partners within the Asian and Pacific region, the economy of Japan experienced modest export growth in 2005 compared with 2004. The slower export growth was the result largely of a reduction in demand for electrical machinery and slower growth in demand for non-electrical machinery from China. It is too early to say whether this represents a more generalized weakening of demand from China, which now has the capacity to produce all but the most technologically advanced manufactured goods, including capital goods, or is part of the policy-induced slowing of investment expenditures in

Figure II.52. Current account balance in developed countries of the Asian and Pacific region, 2003-2005^a



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2006), various issues.

^a Data for 2005 are estimates.

China. Whatever the case, it suggests that the current level of business investment in domestic capacity could prove unsustainable if it is predicated solely on investment demand from China.

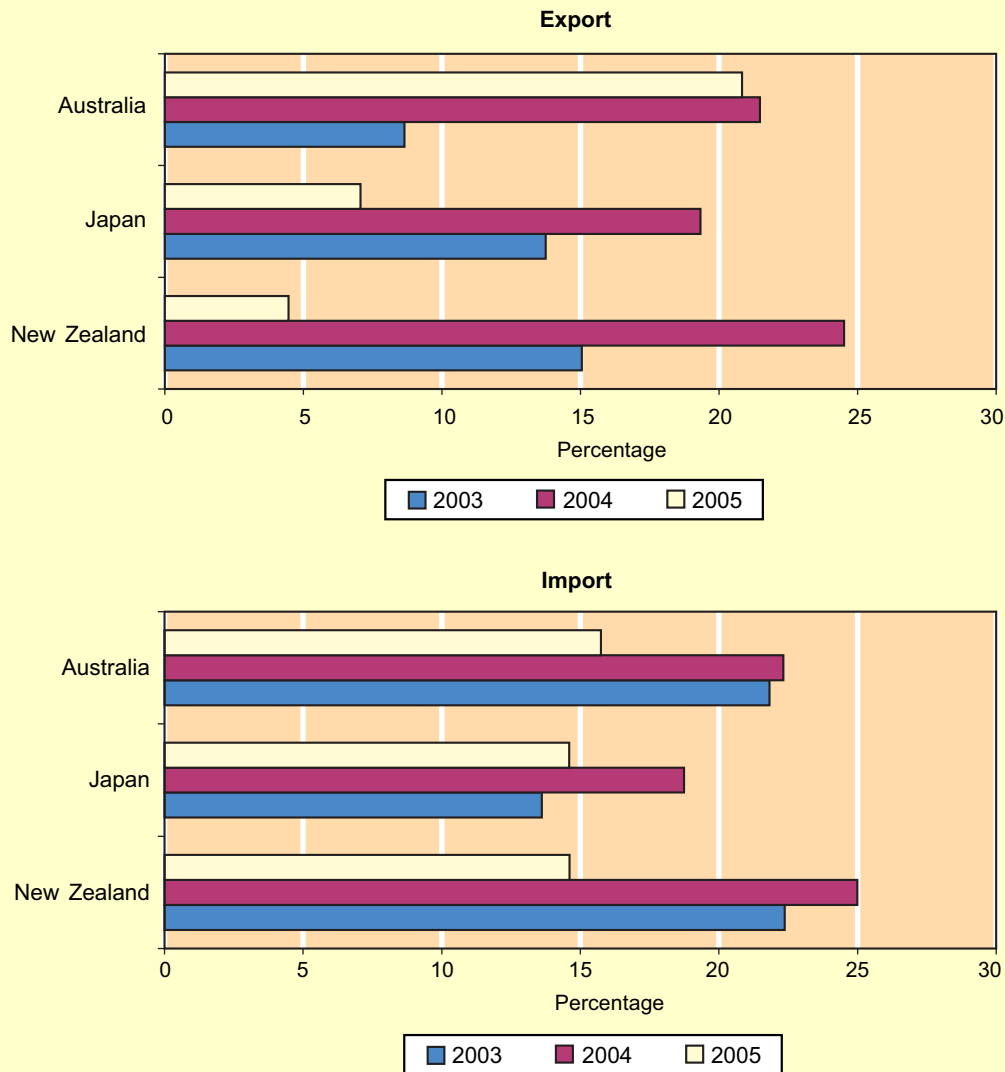
Relatively modest export growth was exceeded by robust merchandise imports in 2005. Higher oil prices inflated the value of crude oil imports by more than 30 per cent, and imports of iron and steel soared by 60 per cent in the second quarter of 2005, on strong demand from car manufacturers and shipbuilders in Japan. The current account surplus thus narrowed from 3.7 per cent in 2004 to 3.5 per cent in 2005 as the reduction of the trade surplus partly offset the higher investment income surplus. Japan continues to attract higher flows of direct and portfolio investments from abroad, and its reserves reached \$837 billion in late 2005.

The appreciation of the New Zealand dollar has started to erode the country's export performance (see figure II.54). International prices of the country's key commodities, such as meat and dairy products, have risen strongly in

recent years, reflecting strong global demand and tight international supplies. The improved commodity prices are less striking when measured in New Zealand dollars, however, owing to the appreciation of the currency. In other words, improved terms of trade have been negated to some extent by exchange rate appreciation, thus lessening the impact on domestic incomes.

More alarmingly, recent robust import demand has increased the trade deficit and widened the current account deficit to 7.6 of GDP in 2005, a level not seen since the 1980s. The main reason for the growing imbalance is the shortfall in the income account caused by the repatriation of profits by foreign companies operating in New Zealand and the unpredictable changes in indirect earnings, such as tourism receipts, occasioned by changes in sentiment in countries far removed from New Zealand. Whatever the proximate cause, the current account is unsustainable at its current level, and the authorities need to develop a more robust policy approach to deal with it in the next two to three years.

Figure II.53. Growth rates in merchandise export earnings and import spending in developed countries of the Asian and Pacific region, 2003-2005^a



Source: International Monetary Fund, *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

^a Growth rates for 2005 refer to January-August compared with the corresponding period of 2004.

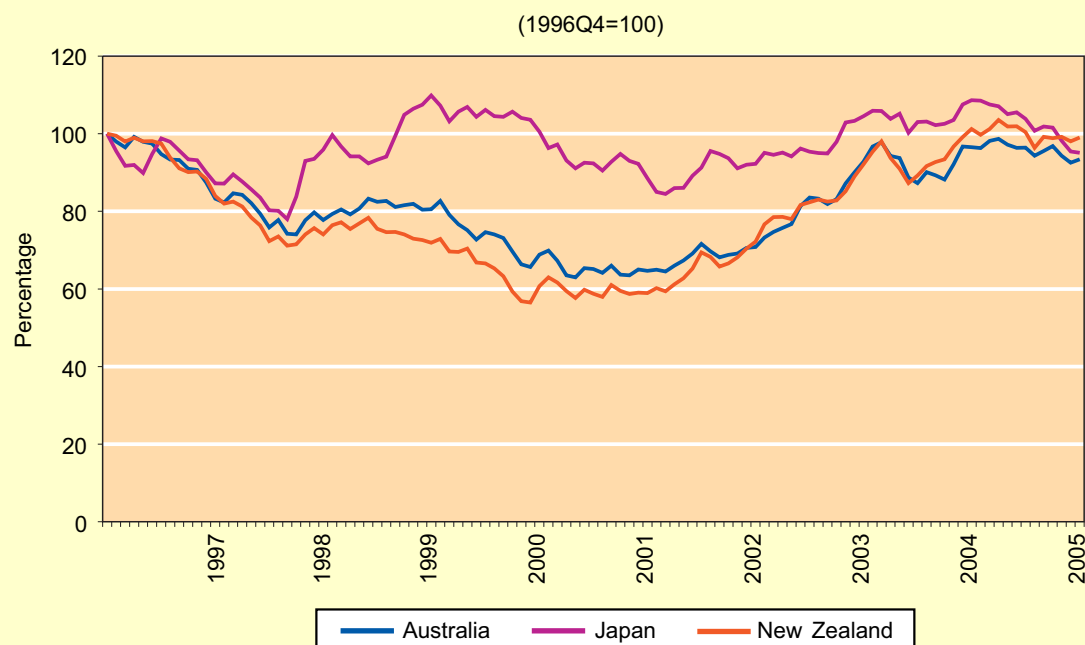
Medium-term prospects and key policy issues

The three economies should see enhanced growth, with internal and external stability

The economies of the three developed countries are too diverse to discuss them as a

group, although global developments, such as trade and rising oil prices, are likely to impinge on the three in broadly similar ways. GDP growth in Australia is expected to move back to its long-term trend in the next two to three years. Although domestic demand is likely to decline as the current increase in business investment eases and household consumption

Figure II.54. Index of exchange rates against the United States dollar in developed countries, 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.

remains subdued, export growth should retain much of its recent strength, reflecting the continuing expansion of the global economy. Domestic production should pick up as a consequence of the vigorous business investment occurring in the past two to three years and this should ease capacity constraints.

Inflation is likely to edge up as the expansion of domestic production may be accompanied by a further increase in employment and therefore in labour costs, given the low level of unemployment. Import prices might also rise, reflecting possible global inflation in raw materials and a weaker exchange rate. However, the likelihood of a general rise in raw material prices is discounted in the short term with the possible exception of new supply-side difficulties in energy markets. In addition, inflationary expectations are low, and consumers are not scrambling to ensure supplies for the future; moreover, there is little evidence of speculation in the commodity markets.

In Japan the public debt is the problem

In Japan, the critical underlying issue is the public debt. The controversial legislation to privatize the postal system, finally passed in October 2005, has significant fiscal implications. Japan Post currently holds about one fifth of the Government's outstanding bonds, a major factor contributing to the stability of the bond market and the low interest rates that have prevailed since 1999 despite the huge increase in the country's public debt. The parliamentary struggle blurred the focus of the postal reform bill and thus uncertainty remains about the process and the mechanisms of implementation as well as to what extent future public sector capital allocations might be affected. Besides the issues associated with the privatization of Japan Post, which is the world's largest deposit-taking institution and the country's largest life insurer, it remains unclear where the massive capital funds

will be deployed in the future; they amount to about one quarter of total personal assets in Japan. In theory, it is possible that government bonds would no longer be absorbed by the privatized entity in the future. If so, that would create new complexities for the Government in financing its future budget deficits.

New Zealand does not appear to face major economic issues other than the current account deficit and the risks attached to funding it. In this regard, two aspects of the country's foreign debt stand out. First, foreign debt, at roughly 105 per cent of GDP, is becoming more concentrated in the banking sector and its maturity has shortened. The foreign currency composition of the debt, at just over 52 per cent, remains a large but declining share, with the currency risk substantially mitigated through hedging. Second, interest rates need to remain higher than other circumstances might demand in order to keep funding the deficit. The higher interest rates almost certainly exert some upward

pressure on the exchange rate and make New Zealand exports less competitive, despite the improvement it has experienced in the terms of trade. At the same time, the higher interest rates do not appear to have succeeded in increasing domestic savings, the primary cause of the current account deficit. Reducing the current account deficit thus has major policy implications for the future that cannot be easily resolved.

Despite these risks, New Zealand remains well placed to absorb adverse shocks without undue stress. The Government's decisions in 2004 to increase international reserves and to intervene in the exchange market if the exchange rate deviates too far from its historical value are steps in the right direction. Fundamentally, the current account deficit needs to be viewed against the background of a prudently managed market environment supported by sound policies. Market participants see even major exchange rate swings as unlikely to pose a systemic risk for the economy.