PACIFIC ECONOMIC OUTLOOK

Economic Prospects for the Asia Pacific Region

2005 | 2006

PACIFIC ECONOMIC COOPERATION COUNCIL

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Special thanks to the PEO forecasting panel whose names are listed on the page 63, and to the management and staff of the Japan Committee for PEO at Kansai Institute for Social and Economic Research, especially Mr. Hidehiko Sugimoto.

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http://www.asiapacificbusiness.ca/peo/index.cfm

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ii FOREWORD

The *Pacific Economic Outlook* (PEO) came under new management in 2004, with Yuen Pau Woo of the Canadian Committee for Pacific Economic Cooperation (CANCPEC) taking over from Ross Garnaut as Coordinator for this flagship product of the Pacific Economic Cooperation Council (PECC). As in previous years, the Japan Committee for PEO at Kansai Institute for Social and Economic Research provides substantial support for this activity, including hosting a forecasters' meeting in Osaka in April 2005. The forecasters had met previously in Vancouver in December 2004 to launch a new PEO cycle, the first time such a meeting was held in Canada.

With new management comes a new look. This year's publication has undergone a modest re-design to improve the presentation and readability of the report. There is no change in the substance of the report, however, which contains valuable insight and analysis on the economic outlook for 18 PECC member economies, as well as an overview of the region as a whole. These forecasts are prepared by analysts from leading research institutes across the Pacific Rim, and are the product of extensive discussion, peer review, and collaboration. I would like to thank and congratulate the PEO forecasters for their excellent work.

I am pleased that the PEO group expects continued "robust growth" in 2006-07, but note the warning in the overview chapter that "the region continues to be characterized by an acute imbalance in trade and financial flows" and that there is a serious risk of growing protectionism and disorderly adjustment of exchange rates. As part of an organization committed to Pacific-wide cooperation, PECC members are working on a number of projects that we hope will better inform policymakers and opinion leaders on the importance of harmonious trans-Pacific economic relations. We are planning, for example, a major conference in Seoul, September 5-7, 2005, that will focus on "Renewing the Commitment to a Pacific Community." The PEO is very much a part of our effort to strengthen the Pacific Community and I am delighted that this year's publication once again contributes to this important goal.

Dr Kim Kihwan
International Chairman
Pacific Economic Cooperation Council
June 2005

iii PECC BACKGROUND

THE PACIFIC ECONOMIC COOPERATION COUNCIL

The Pacific Economic Cooperation Council (PECC) is a tripartite, non-governmental organization devoted to promoting economic cooperation in the Pacific Rim. PECC brings together government officials, academics and business people to share perspectives and expertise in search of broad-based answers to regional economic problems. Founded in 1980, it is the only private observer body in the ministerial forum, APEC.

PECC is comprised of Member Committees representing the economies of Australia, Brunei, Canada, Chile, China, Colombia, Ecuador, Hong Kong China, Indonesia, Japan, South Korea, Malaysia, Mexico, New Zealand, Peru, Philippines, Russia, Singapore, Chinese Taipei, Thailand, the United States and Vietnam as well as the South Pacific Forum and Associate Members France (Pacific Territories) and Mongolia. Each committee sends a tripartite delegation to the PECC General Meeting approximately every two years. In the interim, policy matters are handled by a Standing Committee, and day-to-day administrative and coordinating functions are carried out by a Secretariat based in Singapore.

In addition, PECC establishes task forces, fora and working groups to concentrate on particular policy areas. These groups meet periodically, organize seminars and workshops, conduct studies and publish their conclusions and recommendations for the benefit of the Pacific community. Task forces operate in such areas as finance, trade and community building as well as the *Pacific Economic Outlook* Project.

For more information on PECC, contact the PECC Secretariat, 4 Nassim Road, Singapore 258372, or
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0 OVERVIEW

Yuen Pau Woo, *Asia Pacific Foundation of Canada*

REGIONAL IMBALANCES THREATEN ROBUST OUTLOOK

After a blistering economic expansion in 2004, the Asia Pacific region is poised for slower but still robust growth in 2005. Last year's growth in real GDP was the strongest in East Asia since the 1997 financial crisis, and represented a sharp rebound from 2003, which was marked by the Severe Acute Respiratory Syndrome (SARS) outbreak in parts of the region. For the global economy as a whole, real GDP growth in 2004 was the strongest in about 20 years.

Most analysts — including the Pacific Economic Outlook forecasting panel — were surprised by the region's very strong showing in 2004. The traditional growth engines in the region — the United States and Japan — turned in very robust growth of 4.4% and 2.6% respectively, pulling along the rest of the Asia Pacific. Last year also brought confirmation of a new growth engine for the region. Despite fears of overheating followed by a "hard landing," the Chinese economy ended the year with 9.5% real GDP growth, led by fixed asset investment and consumption. Total trade grew by 36%, with imports expanding by as much as exports and providing a much-needed source of demand for raw materials and intermediate goods exports from around the region. In the course of 2004, China overtook Japan as the second most important trading partner for many Asia Pacific economies. The People's Republic also overtook the United States as Japan's most important trading partner.

SLOWDOWN IN 2005 AND 2006

The PEO economies as a whole grew by a weighted average of 5.4% in 2004, with East Asian economies expanding by 6.4% and the other PEO economies growing by 4.1%. In 2005, growth for the region as a whole will moderate to 4.2%, with East Asia and other Asia economies also slowing to 4.8% and 3.4% respectively. We expect the growth outlook in 2006 to be roughly the same, at 4.25% for the region as a whole, 5% for East Asia, and 3.3% for other Asia.

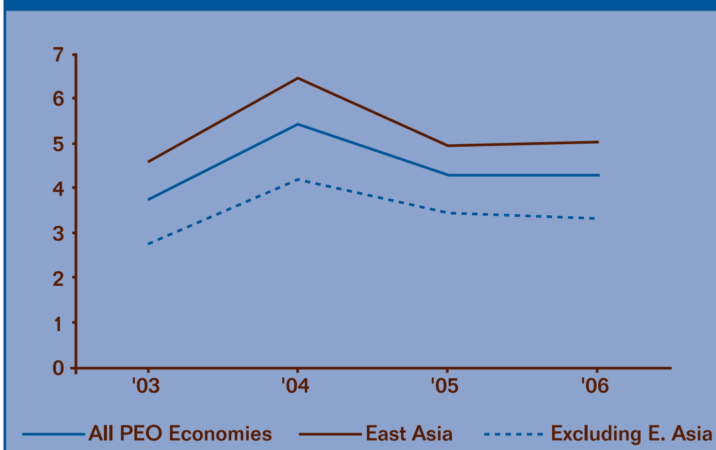
Inflation remains muted throughout the region, notwithstanding higher energy and non-oil commodity prices. We have assumed that West Texas Intermediate crude will average US$49.40 per barrel in 2005, up 19.3% from the 2004 average, before falling to an average of US$41 a barrel in 2006. Deflation in Hong Kong came to an end in 2004, and appears to have also ended in Japan.

US STILL HOT, BUT COOLING

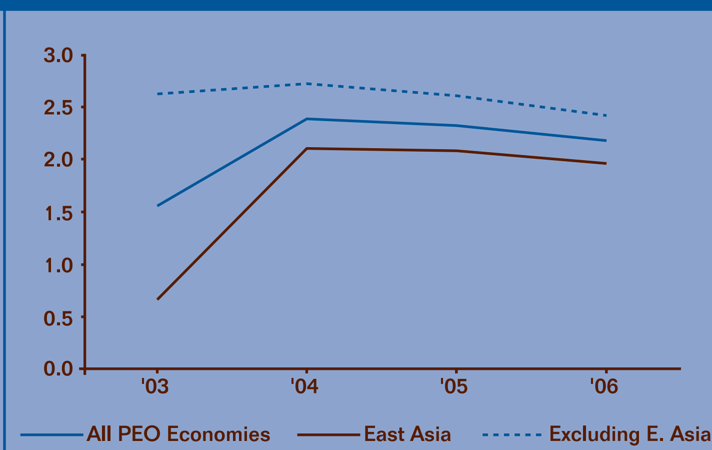
The United States economy expanded at a record-breaking clip in 2004. At 4.4% real GDP growth, last year's expansion was well above the historical average of 3% in the last 25 years. Last year's growth was led by very strong domestic demand, which saw a sharp increase in imports and further widening of the current-account deficit. We expect growth to taper off to around 3.5% in 2005 and 3.3% in 2006. After the sharp fiscal stimulus of the last two years, we expect fiscal policy to be neutral in 2005 and beyond. Monetary policy, on the other hand, remains expansionary despite a steady increase in interest rates since the middle of 2004. Tightening will continue through 2006 and 2007, but will not have a contractionary effect on the economy until the beginning of 2007.

Inflation will pick up in 2005 but not to the extent that it will pose a problem. Core inflation

REAL GDP GROWTH (%)



CPI INFLATION (%)



will rise to 2.2% in 2005 and 2.6% in 2006, with the all-items consumer price index at 2.6% in 2005, falling to 2.2% in 2006 (because of lower oil prices). The inflation outlook is a source of much uncertainty, however, because of the volatility in energy and non-oil commodity prices.

JAPAN IS COMING OUT OF A SOFT PATCH

The Japanese economy ended 2004 on an anti-climax, with fears that the nascent recovery had hit a speed bump and might even slip back into recession. More recent data suggest, however, that the second half of 2004 was a soft patch due to special circumstances (a warm winter and earthquakes that led to disruption in production) rather than the start of another slump. Despite this, real GDP growth in Japan was a very robust 2.6% in 2004, which is well above the 0-1% range of recent years. There was a rebound in the January-March quarter of 2005, but growth momentum has been easing because of inventory adjustment. For 2005 as a whole, real GDP growth is expected to be 1.3%, which still counts as a decent performance for Japan given the past decade or so of recession-like conditions. The economy will continue to expand in 2006, with real GDP growth around 1.6%. The economy will be supported almost entirely by private investment and personal consumption, a reflection of improving business and consumer confidence in the country. Higher oil prices should translate into flat overall price levels in 2005, possibly marking an end to a prolonged period of deflation. The Consumer Price Index is expected to edge up 0.2% in 2006.

CHINESE GROWTH STILL AT A BREAKNECK PACE

Fears of a hard landing in China did not materialize in 2004. Rather, the economy has continued on its breakneck pace of expansion into the first half of 2005. Real GDP growth in 2004 was 9.5%, led by fixed asset investment. By the fourth quarter, however, the pace of investment growth had fallen to 23% year-on-year (down from 43% in the first quarter) with other components of demand picking up some of the slack. Retail sales rose by 13.3% in 2004 on the back of higher disposable incomes in urban and rural areas. The outlook for 2005 is for continued robust growth of 8.5%, tapering to 8.2% in 2006. Personal consumption will continue to gain importance in supporting Chinese growth, contributing 2.7 percentage points in 2005 and 3.2 percentage points in 2006. The primary driver of growth, however, will continue to be fixed asset investment, which is expected to slow to 16% in 2005.

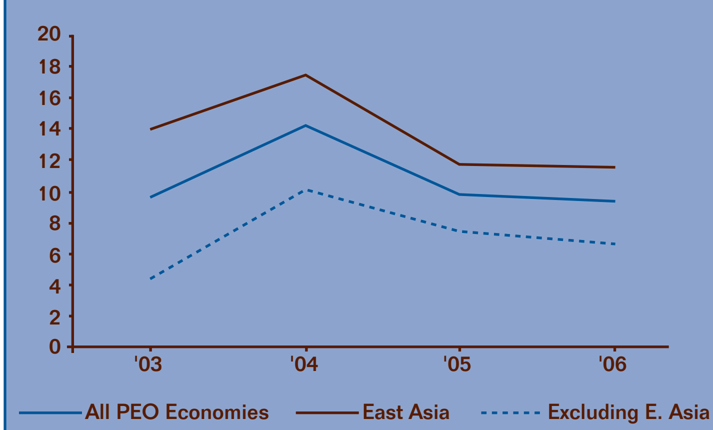
China has been experiencing "inflationless overheating" — a condition of sharp price increases in certain food products, raw materials, intermediate inputs and property markets even as the rest of the economy is characterized by excess capacity and falling prices. The all-items consumer price index is expected to rise by a modest 2.7% in 2005, down from 3.9% in 2004.

The integration of Hong Kong's economy with the mainland was deepened in 2004 with the implementation of the Closer Economic Partnership Agreement (CEPA). A sharp rise in tourist arrivals from China contributed to Hong Kong's 8.1% real GDP growth in 2004. Weaker external conditions, however, will result in more modest growth of 4.7% in 2005 and 4.1% in 2006.

SLOWDOWN IN SOUTHEAST ASIA, AUSTRALIA AND NEW ZEALAND

Elsewhere in the region, Southeast Asia in 2004 produced its strongest growth performance since the 1997-98 financial crisis. The outlook for 2005 is for slower growth throughout the region, in part due to excessive expansion in such areas as construction and consumer spending, and also due to the less buoyant external demand. Despite the catastrophic human toll of the Indian Ocean Tsunami in the last days of 2004, the impact on overall economic output in affected Southeast Asian economies was relatively small. There are many risks in the Southeast Asia outlook, however, including widespread human transmission of Avian Flu or other diseases, and a possible

IMPORT GROWTH (%)



EXPORT GROWTH (%)

debt crisis in the Philippines that could have contagion effects on the region.

Growth in Australia and New Zealand will fall to under 3% in 2005, reflecting the less rosy outlook for the global economy. Both economies are running large current-account deficits relative to GDP, which will temper the upward pressure on their currencies arising from a weak US dollar.

SOUTH KOREA AND CHINESE TAIPEI FACE STRUCTURAL CHANGES

The South Korean economy has been struggling with high levels of consumer indebtedness and the ongoing restructuring of the corporate sector. Growth will remain low by historical standards, at around 4% in 2005, but rising to nearly 5% in 2006. Chinese Taipei will also see a slowdown in 2005 and 2006, due to weaker external conditions. Both economies are undergoing structural changes brought about by the relocation of production to China and, especially in the case of Korea, the growing importance of foreign ownership in domestic industry.

WHEN AMERICA SLOWS, THE AMERICAS SLOW

There is a similar story in the PEO economies of the Americas, with slower but still respectable growth across the board for Canada, Mexico, Peru and Chile. Canada and Mexico in particular are heavily dependent on the US as a source of export demand, and will slow to growth rates of 2.7% and 4% respectively in 2005. Chile had a banner year in 2004 on the back of strong global demand for copper (with prices rising by 60%) and is expected to grow by about 6% again in 2005, with domestic demand playing a greater role. Peru will grow by about 4.3% in 2005, in part due to public spending in the run-up to the 2006 presidential elections.

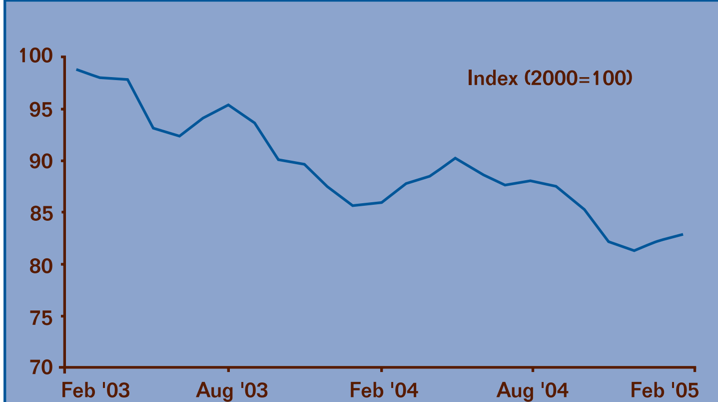
REGIONAL IMBALANCES WILL GET WORSE BEFORE THEY GET BETTER

On the external front, the region continues to be characterized by an acute imbalance in trade and financial flows, with the US current-account deficit on the one side, and current-account surpluses in many East Asian economies on the other. The forecast for 2005 is for a further widening of this imbalance, with the US current-account deficit expected to reach a record US$755 billion or 6.1% of GDP by the end of the year. The dollar value of the deficit will remain stubbornly high for some years to come, but should start to fall as a share of GDP in 2006, to around 5.8%. By 2006, the lagged effects of dollar depreciation should start to show up in higher levels of exports and lower growth of imports, but the longevity of these effects would depend on future exchange rate movements. The PEO is forecasting a fall in the trade-weighted US dollar of 6.1% in 2005 and 5.6% in 2006.

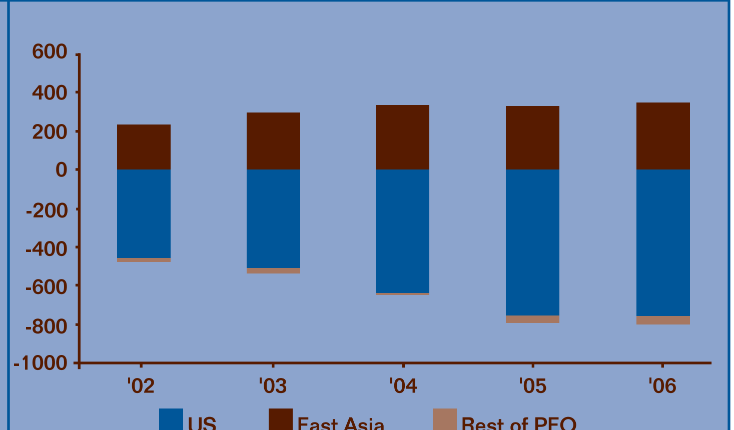
RISK OF DISORDERLY ADJUSTMENT IN CURRENCIES

Herein lies one of the major risks for the 2005-06 outlook. While the US current account may be characterized as "stubborn but improving," foreign exchange markets may choose to focus on the "stubborn" rather than on the "improving." Whether currency traders consider a 0.3 percentage point fall in the deficit/GDP ratio to be a sufficient "improvement" is not clear, but there is no question that the ratio will remain stubbornly high well into 2007. A sudden loss of confidence in the US dollar could lead to a disorderly decline in the value of the US currency, which could spill over into financial markets and the real economy. Asian central banks play a key role because of the substantial foreign reserves that they hold in US dollar-denominated assets, estimated at US$2 trillion in 2004. Comments by central bankers, finance officials and heads of government about the need to diversify foreign reserves away from US dollars have led to volatility in foreign exchange markets. While such comments have died down in recent months, many Asian governments still face a dilemma: On the one hand, benign neglect over a gradually falling US dollar will lead to an erosion in the value of their overseas assets; on the other hand, a sharp withdrawal from US currency assets could precipitate an even sharper fall in the US dollar and hurt the competitiveness of export-dependent Asian economies.

US REAL EFFECTIVE EXCHANGE RATE



CURRENT ACCOUNT BALANCES (US$)



THREAT OF PROTECTIONISM

Even if the decline in the US dollar is orderly, as our forecasts assume, there is a growing risk of conflict between Washington and Asian trading partners, especially China and other economies perceived to be "manipulating" their currencies. The expiry of the World Trade Organization's Agreement on Textiles and Clothing at the beginning of 2005 has led to a sharp increase in Chinese apparel exports to industrialized countries, including the United States, which is adding to protectionist sentiment. In fact, China is not the main source of the US trade deficit. In 2004, the US-China bilateral deficit accounted for only 25% of the overall US deficit, little changed from the level the year before. Beijing will, however, be the focus for US attention in 2005 and 2006 because of the perceived unfairness of the current level of the yuan peg to the US dollar.

Even though Chinese export growth is expected to slow in the years ahead, import growth is also slowing, which will result in an increase in the current-account surplus. Expectations that the Chinese current account would be in balance or even in deficit by 2004 did not materialize. On the contrary, the current-account surplus as a share of GDP will rise from 2.4% in 2004 to 3.1% in 2005 and 3.3% in 2006. This will fuel the calls for early revaluation of the yuan and fan protectionist sentiment in industrialized countries. Beijing's response to these threats will be a barometer of financial stability in the region, and remains a major risk factor in our forecast.

ASIAN ECONOMIC INTEGRATION AND THE ASIA PACIFIC COMMUNITY

India is not part of the PEO group of economies and still a long way from joining the ranks of growth engines for the region, but it is emerging as an increasingly important trading partner for Southeast Asia, China, Japan and South Korea. East Asia's share in Indian trade rose by a quarter from 2000 to 15.6% in 2004. India-China trade has expanded by almost 300% in the past three years, and leaders have pledged to increase trade another 50% by 2008. More fundamentally, India is beginning to participate in the kind of regional production networks that have been key to the economic integration of East and Southeast Asia. The recent establishment of electronics manufacturing and design facilities in India, as well as Indian investment in the South Korean automotive industry, are indicators of the sea change that is starting to take place.

Even as India integrates more deeply with Asia, East Asian economies are pushing ahead with new institutional mechanisms for regional cooperation and dialogue. The Chiang Mai initiative of 1997, which is a self-help mechanism for Asian economies to fend off speculative attacks on their currencies, was given a modest boost at a recent ASEAN + 3 meeting, with commitments of increased lines of credit, the introduction of a multilateral mechanism, and relaxed conditions for accessing these monies. As a result, there is renewed talk about the establishment of an Asian Monetary Fund, even though the idea remains embryonic and unlikely to materialize in the near future. In December 2005, the ASEAN + 3 countries will be meeting for the first time as the "East Asia Summit," perhaps with India, Australia and New Zealand, marking another step forward in Asia-only regionalism.

In the context of a trade and financial imbalance across the Pacific, the evolution of Asia-only regionalism could have adverse consequences for trans-Pacific economic and political relations. It is by no means inevitable that deeper integration on either side of the Pacific should lead to increased tension between the two sides, but there are a number of flash points around currency management, trade disputes and financial architecture — not to mention differences on political/security issues — that could lead to a more pronounced divide across the Pacific. The Asia Pacific Economic Cooperation (APEC) forum is the best (and only) body to forge stronger Pacific-wide ties, but there is a real danger of APEC members being increasingly distracted by regional and sub-regional priorities, eroding the commitment to the idea of an Asia Pacific community that has long been espoused by members of the Pacific Economic Cooperation Council.

KEY VARIABLES UNDERLYING PEO FORECASTS

	2003	2004	2005	2006
US Real Effective Exchange Rate 2000=100	94.3	86.6	81.3	76.8
3-month US T-Bills (%)	1.01	1.38	2.98	3.78
West Texas Intermediate Crude Oil (US$/barrel)	31.1	41.4	49.4	41.0

Note: 2005 and 2006 figures are PEO forecasts.

Source: United States, Board of Governors of the Federal Reserve System. 8 June 2005.
http://research.stlouisfed.org/fred2/series/TB3MS/116 and Wall Street Journal. 8 June 2005.
http://research.stlouisfed.org/fred2/data/OILPRICE.txt as found at
Federal Reserve Bank of St. Louis, Economic Research. 8 June 2005.
http://research.stlouisfed.org/. International Monetary Fund, International Financial Statistics Online. 29 April 2005.
http://ifs.apdi.net/imf/

T1 REAL ECONOMIC GROWTH AND INCREASE IN CONSUMER PRICES FOR PEO ECONOMIES, 2003-2006 (%)

	REAL GDP				CPI			
	2003	2004	2005	2006	2003	2004	2005	2006
Australia	3.3	3.6	2.9	3.0	2.8	2.3	2.0	1.7
Canada	2.0	2.8	2.7	3.2	2.7	1.9	2.0	2.1
Chile	3.7	6.1	6.0	5.5	2.8	1.1	2.6	3.0
China	9.3	9.5	8.5	8.2	1.2	3.9	2.7	2.0
Hong Kong, China	3.2	8.1	4.7	4.1	-2.6	-0.4	1.5	2.0
Indonesia	4.9	5.1	5.5	6.1	5.2	6.4	8.1	6.0
Japan	1.4	2.6	1.3	1.6	-0.3	0.0	0.0	0.2
Korea, Republic of	3.1	4.6	4.0	4.9	3.6	3.6	2.9	3.0
Malaysia	5.4	7.1	5.0	6.3	1.2	1.4	1.5	1.5
Mexico	1.4	4.4	4.0	3.5	4.5	4.7	4.1	4.2
New Zealand	3.4	4.8	2.9	2.4	1.8	2.3	2.7	2.1
Peru	3.8	5.1	4.3	4.0	2.3	3.7	1.7	2.5
Philippines	4.7	6.1	5.7	5.6	2.9	5.5	8.4	7.3
Singapore	1.4	8.4	4.7	5.2	0.5	1.7	1.5	1.7
Chinese Taipei	3.3	5.7	4.0	4.1	-0.3	1.6	1.9	1.9
Thailand	6.9	6.1	5.0	6.0	1.8	2.8	3.2	3.0
United States	3.0	4.4	3.5	3.3	2.3	2.7	2.6	2.2
Vietnam	7.2	7.7	8.5	8.3	3.0	9.5	8.0	8.0
Weighted Average	3.71	5.39	4.20	4.25	1.55	2.38	2.32	2.17
WA: excl. US & Japan	4.55	6.47	5.17	5.29	1.58	2.74	2.69	2.55
WA: East Asia	4.53	6.43	4.84	5.02	0.66	2.10	2.08	1.96
WA: Latin America	1.76	4.62	4.24	3.74	4.21	4.25	3.82	3.99
WA: excl. East Asia	2.73	4.14	3.44	3.33	2.62	2.71	2.60	2.42

Note: National currency based. The weighted average is based on the respective economies' 2002-2004 total merchandise trade (see Appendix Table 4).

Source: PEO forecasters.

T2 REAL EXPORT AND IMPORT GROWTH FOR PEO ECONOMIES, 2003-2006 (%)

	EXPORTS				IMPORTS			
	2003	2004	2005	2006	2003	2004	2005	2006
Australia	-2.2	4.6	10.3	13.4	10.5	13.9	9.3	4.4
Canada	-2.4	4.9	4.8	7.2	3.8	8.2	9.3	7.9
Chile	5.9	12.8	8.8	6.7	9.5	18.6	12.8	9.5
China	30.1	25.2	22.9	21.8	34.2	27.1	22.2	22.4
Hong Kong, China	12.7	15.2	10.0	9.1	11.3	13.8	9.8	8.9
Indonesia	8.2	8.5	11.5	9.0	2.7	24.9	20.0	18.0
Japan	9.1	14.3	4.7	5.1	3.8	9.2	5.1	4.3
Korea, Republic of	15.7	20.2	9.0	9.2	9.7	12.4	10.8	10.3
Malaysia	6.3	20.8	9.7	7.1	5.0	19.8	8.9	7.3
Mexico	1.1	11.9	8.3	7.4	-1.0	10.3	8.9	7.5
New Zealand	1.9	5.2	3.8	5.5	8.1	15.7	6.8	5.9
Peru	5.9	15.2	7.5	7.5	3.3	9.5	3.8	4.0
Philippines	4.4	14.0	6.1	6.1	10.2	6.3	4.0	3.3
Singapore	11.0	19.5	9.0	9.7	7.1	22.7	9.8	10.2
Chinese Taipei	10.9	15.3	4.3	7.9	6.7	18.6	5.0	6.6
Thailand	7.0	7.8	3.8	6.3	7.7	12.1	6.4	8.7
United States	1.9	8.5	5.1	7.1	4.4	9.9	6.4	6.3
Vietnam	19.0	28.9	25.0	25.0	26.7	25.0	25.0	25.0
Weighted Average	8.88	13.52	8.77	9.49	9.45	14.08	9.72	9.27
WA: excl. US & Japan	12.30	15.85	11.46	11.61	13.16	17.20	12.35	11.80
WA: East Asia	15.41	17.97	11.28	11.16	13.82	17.40	11.64	11.45
WA: Latin America	1.85	12.15	8.32	7.33	0.36	11.19	9.10	7.56
WA: excl. East Asia	0.99	8.15	5.73	7.46	4.17	10.07	7.39	6.64

Note: Export/Imports of goods and services. National currency based. The weighted average is based on the respective economies' 2002-2004 total merchandise trade (see Appendix Table 4).

Source: PEO forecasters.

T3 CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS FOR THE PEO ECONOMIES, 2002-2006 (US$B AND % OF GDP)

	2002	% of GDP	2003	% of GDP	2004	% of GDP	2005	% of GDP	2006	% of GDP
Australia	-16	-4.1	-29	-5.9	-37	-6.0	-41	-6.0	-41	-6.3
Canada	13.5	1.8	13	1.5	22	2.2	27	2.4	30	2.7
Chile	-0.6	-0.9	-1.1	-1.5	1.4	2.1	-0.6	-0.6	-0.9	-0.8
China	35	2.7	46	3.1	42	2.4	59	3.1	70	3.3
Hong Kong, China	12	7.8	16	10.3	16	9.7	17	9.9	17	10.0
Indonesia	8	3.9	8	3.4	3	1.1	3	0.9	3	0.9
Japan	113	2.8	136	3.2	172	3.7	164	3.4	179	3.4
Korea, Republic of	4	0.8	12.3	2.0	27.6	4.1	19	2.3	11	1.2
Malaysia	8	8.4	13	12.9	16	13.4	17	13.4	17	12.6
Mexico	-13	-2.1	-9	-1.3	-9.4	-1.4	-12	-1.6	-17	-2.4
New Zealand	-2	-3.6	-3	-4.2	-6	-6.4	-7	-6.5	-6	-5.7
Peru	-1	-2.0	-1	-1.8	0	-0.1	0	-0.1	0	-0.1
Philippines	4	5.7	3	4.2	3	4.0	4	3.7	4	3.5
Singapore	16	17.7	28	29.2	29	26.1	23	19.3	23	18.0
Chinese Taipei	26	9.2	29	10.1	22	7.2	19	6.0	21	6.3
Thailand	7	5.5	8.0	5.6	7	4.5	4	2.0	1	0.5
United States	-458	-4.4	-511	-4.6	-639	-5.4	-755	-6.1	-759	-5.8
Vietnam	-1	-3.1	-2	-4.8	-2	-3.2	-2	-5.0	-2	-5.0
Total	-245.1		-243.8		-332.4		-461.6		-449.9	
Total: excl. US & Japan	99.9		131.2		134.6		129.4		130.1	
Total: East Asia	232.0		297.3		335.6		327.0		344.0	
Total: Latin America	-14.6		-11.1		-8.0		-12.6		-17.9	
Total: excl. East Asia	-477.1		-541.1		-668.0		-788.6		-793.9	

Source: PEO forecasters.

T4 FORECAST OF CONTRIBUTIONS TO REAL GDP/GNP GROWTH RATE FOR PEO ECONOMIES, 2005-2006 (% PER YEAR)

		GDP Growth Rate	Personal Consumption Expenditure	Gross Private Domestic Investment	Government Purchasing	Net Exports
Australia	2005	2.9	2.3	1.4	1.0	-0.3
	2006	3.0	1.6	0.6	0.5	1.6
Canada	2005	2.7	2.1	1.3	0.8	-1.7
	2006	3.2	1.8	0.8	0.8	-0.3
Chile	2005	6.0	3.7	2.9	0.6	-1.5
	2006	5.5	3.4	2.2	0.6	-1.2
China	2005	8.5	2.7	5.0	0.0	0.8
	2006	8.2	3.2	4.6	0.0	0.4
Hong Kong, China	2005	4.7	2.5	0.5	0.1	1.5
	2006	4.1	1.9	0.7	0.1	1.4
Indonesia	2005	5.5	3.0	2.2	0.1	-3.1
	2006	6.1	2.7	2.7	0.1	-3.0
Japan	2005	1.3	0.4	0.8	0.0	0.1
	2006	1.6	0.7	0.7	0.0	0.2
Korea, Republic of	2005	4.0	1.2	2.1	0.4	-0.1
	2006	4.9	2.2	1.4	0.3	0.3
Malaysia	2005	6.0	3.8	1.1	-0.6	1.7
	2006	6.3	4.0	0.1	1.8	0.4
Mexico	2005	4.0	3.0	1.4	0.2	-0.4
	2006	3.5	2.5	1.1	0.1	-0.2
New Zealand	2005	2.9	3.0	0.1	1.1	-1.3
	2006	2.4	2.1	0.1	0.8	-0.5
Peru	2005	4.3	2.2	0.8	0.4	0.9
	2006	4.0	2.1	0.9	0.2	0.9
Philippines	2005	5.7	3.4	1.3	0.1	0.6
	2006	5.6	3.2	0.9	0.1	1.0
Singapore	2005	4.7	1.3	2.2	0.2	1.0
	2006	5.2	1.3	1.9	0.2	1.7
Chinese Taipei	2005	4.5	1.5	1.2	0.1	1.5
	2006	4.1	1.4	0.7	0.2	1.6
Thailand	2005	5.0	2.5	0.0	1.6	-0.9
	2006	6.0	3.0	0.0	0.8	-0.6
United States	2005	3.5	2.5	1.2	0.3	-0.5
	2006	3.3	2.6	0.7	0.3	-0.3
Vietnam	2005	8.5	4.9	4.3	2.0	-2.0
	2006	8.3	4.9	4.3	2.0	-2.0

Note: National currency based. Components of GDP/GNP do not total overall growth rates for some economies due to statistical discrepancies.

Source: PEO forecasters.

T5 ACTUAL AND FORECAST LEVELS OF SHORT-TERM, LONG-TERM INTEREST RATES FOR PEO ECONOMIES, 2003-2006 (%)

	SHORT-TERM INTEREST RATES					LONG-TERM INTEREST RATES				
	Type	**2003**	**2004**	**2005**	**2006**	**Type**	**2003**	**2004**	**2005**	**2006**
Australia	90-day bank bill	4.80	5.50	5.80	5.30	10-yr treasury	5.20	5.60	5.80	5.80
Canada	90-day t-bill	2.86	2.22	2.63	3.56	10-yr GOC bond	4.71	4.59	4.65	5.14
Chile	real monetary policy rate	0.00	-0.47	1.30	2.00	PRC 8 rate	2.9	2.4	3.0	3.4
China	1-yr deposit	1.98	2.25	3.00	2.25	/	/	/	/	/
Hong Kong, China	HIBOR 3 mth	0.97	0.39	2.80	3.20	10-yr exchange fund note	4.23	3.95	5.20	5.60
Indonesia	/	/	/	/	/		/	/	/	/
Japan	Overnight call rate	0.001	0.001	0.001	0.001	10-yr govt bond	0.991	1.498	1.493	1.865
Korea, Republic of	Call rate	4.00	3.70	/	/	3-yr treasury bond yield	4.60	4.10	/	/
Malaysia	3-mth, commercial bank	3.00	3.00	3.00	3.00	12-mths, commercial bank	4.00	3.70	3.70	3.70
Mexico	Cetes 28 days end	6.10	8.50	9.40	8.00	10-yr govt bond	8.30	9.70	/	/
New Zealand	90-day bank bills, end yr qtrly avg	5.85	6.71	6.50	5.99	10-yr govt bonds, end yr qtrly avg	6.20	6.66	6.66	6.76
Peru	Interbank avg.	3.40	2.70	3.00	3.50	Loans & discounts > 360 days	27.00	26.50	24.50	25.00
Philippines	91-day t-bill	5.85	7.32	8.02	8.46	364-day t-bill	7.50	9.24	10.49	11.75
Singapore	3-mth IBR	0.75	1.44	1.70	2.00	10-yr LCY	3.20	3.20	3.70	4.00
Chinese Taipei	Overnight call rate	1.10	1.10	1.80	2.60	Call loan (2-6 mths)	4.50	1.50	2.50	3.00
Thailand	MLR	5.63	5.63	5.63	6.00	5-yr govt bond	2.99	3.75	4.25	5.50
United States	3-Mth T-bill	1.01	1.38	2.98	3.78	10-Yr T-bond	4.02	4.27	4.63	5.40
Vietnam		0.20	0.28	0.25	0.25	1-yr deposit, %/month	0.60	0.65	0.60	0.60

Source: PEO forecasters.

T6 EXCHANGE RATES, 2003-2006 (LOCAL CURRENCY PER US$)

EXCHANGE RATES

	2003	2004	2005	2006
Australia	1.59	1.37	1.32	1.46
Canada	1.40	1.30	1.22	1.28
Chile	691.40	609.53	590.00	605.00
China	8.27	8.27	8.27	8.27
Hong Kong, China	7.78	7.78	7.78	7.78
Indonesia	8571	8985	9200	8900
Japan	115.93	108.16	104.40	98.50
Korea, Republic of	1191.65	1146.11	1050.00	1000
Malaysia	3.80	3.80	3.80	3.80
Mexico	10.80	11.30	11.50	12.00
New Zealand	1.72	1.51	1.41	1.46
Peru	3.48	3.41	3.31	3.37
Philippines	54.20	56.04	55.88	56.56
Singapore	1.70	1.63	1.62	1.62
Chinese Taipei	34.40	33.40	30.70	30.20
Thailand	41.5	40.3	38.5	38.5
United States	1.00	1.00	1.00	1.00
Vietnam	15,700.00	15,750.00	16,100.00	16,200.00

Source: PEO forecasters.

T7 GDP DEFLATOR INDEX

GDP DEFLATOR INDEX

	Base Year	2003	2004	2005	2006
Australia	1995	101.48	105.01	108.80	110.56
Canada	1997	111.20	114.80	117.30	119.50
Chile	1996	128.07	129.64	132.83	136.62
China	1995	105.97	112.68	117.19	119.53
Hong Kong, China	2000	89.63	87.10	85.40	84.00
Indonesia	2002	109.83	116.86	126.33	133.91
Japan	2000	96.04	94.92	94.36	93.98
Korea, Republic of	2000	108.90	112.40	116.20	118.99
Malaysia	1997	170.20	180.40	184.01	187.32
Mexico	1993	420.90	446.50	465.00	484.50
New Zealand	1996	113.72	118.18	121.32	123.54
Peru	1994	159.95	168.63	170.31	174.57
Philippines	1995	167.4	177.7	186.2	194.6
Singapore	1995	96.70	100.00	101.60	103.40
Chinese Taipei*	2001	-2.1	-1.9	1.2	1.1
Thailand	1988	171.4	179.2	185.7	192.2
United States	2000	106.00	108.20	110.70	113.60
Vietnam	1994	182.40	196.90	211.90	227.90

* *Annual percentage change. Base year = 100*

Source: PEO forecasters.

1 AUSTRALIA

Philip D. Adams, *Centre for Policy Studies, Monash University*

2004 IN SUMMARY

Real GDP in 2004 grew by 3.6%, following an increase in 2003 of 3.3%. The economy grew strongly despite a deterioration in the balance between export and import volumes. Australia recorded a current-account deficit in 2004 equal to around 6% of GDP, reinforcing concerns about rapidly growing international debt. A major factor underlying the weak external accounts in 2004 was the strong Australian dollar which rose by 10% against a trade-weighted basket of foreign currencies.

Reflecting strong growth in GDP, the unemployment rate fell from an average of 6% in 2003 to 5.6% in 2004. This was achieved with little change in core inflation. Policy debate in 2004 focussed on a variety of issues, including: the appropriateness of monetary policy settings, and the challenges arising from a strong exchange rate. Also subject to debate have been issues relating to the environment, especially water quality/availability and greenhouse gas emissions.

2004 IN DETAIL

Stimulated partly by tax cuts, real private consumption in 2004 grew by 5.5%, up from 4.4% in 2003. In addition to tax cuts, consumption has been stimulated by strong growth in household wealth fuelled by rises in housing prices: the household savings rate has now turned negative with consumers apparently content to be net borrowers on the strength of their capital gains. Dwelling investment in 2004 increased by 1.4% after rising by almost 7% in 2003. Dwelling construction surged in 2002 and 2003, driven by low mortgage rates, supplemented by the effects of a top-up to the First Home Owners Grant scheme. In 2004, without the one-off effects of the top-up, the path of dwelling investment has returned to its cyclical pattern with slowing growth from a historically-high level. Forward indicators suggest that dwelling construction in the first two months of 2005 fell, with signs that the fall off will continue for some time. Real business investment in 2004 rose strongly (up 8%) for the third successive year. The major positive factors being low real interest rates, high rates of profitability, and tightening capacity.

Public final demand is dominated by government consumer spending — wages of public servants and current spending on goods and services. Government consumption in 2004 grew faster than the economy as a whole, boosted by a large-spending program on defence, border protection and airport security.

Export volumes in 2004 rose by 4.6% after falling by 2.2% in 2003. In each of these years import volumes rose by over 10%. There have been a number of factors underlying Australia's poor export performance in recent years. Some are transitory — such as drought-related shortfalls in agricultural exports in 2003 — while some are medium term, such as the decline in tourism growth. Though these special factors are important, together they account for only a small part of the story. The main influence on export growth have been adverse changes in the real exchange rate.

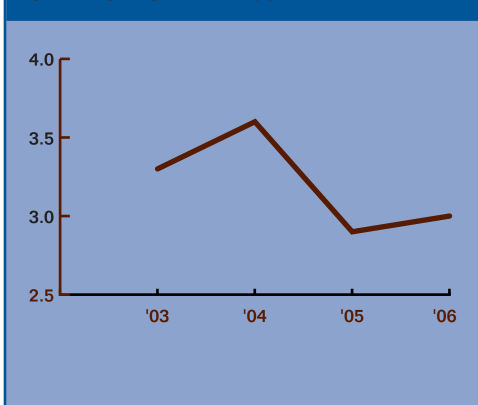
Over the past three years, Australia's currency has steadily appreciated against a trade-weighted basket of currencies. With inflation rates steady, the nominal appreciation has been translated into a real appreciation, reducing considerably the international competitiveness of Australia's export industries. Real appreciation has also been a factor underlying the strong growth in imports.

Somewhat surprisingly, the deterioration in the balance between export and import volumes in 2004 had little impact on the trade-account balance. In 2003, Australia had a trade deficit equal to around 2.2% of GDP. In 2004, that had fallen slightly to a deficit of 2.1% of GDP. The offsetting factor was a sharp improvement of 9.4% in the terms of trade. Reflecting little change in the trade-account balance, the deficit on current account in 2004 averaged around 6% of GDP, little changed year-on-year from the average level in 2003.

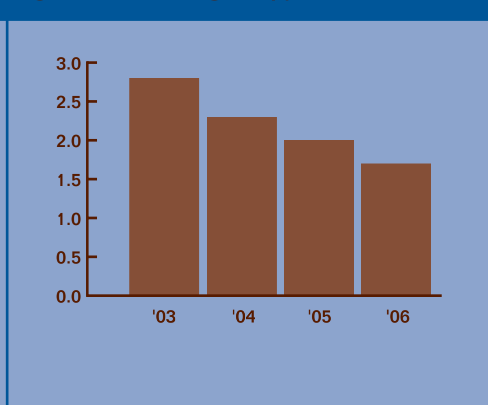
Employment in 2004 increased by 1.9%, precipitating a further fall in the average unemployment rate from 6.0% in 2003 to 5.6% in 2004. Headline CPI-inflation in 2004 was 2.3%, compared with 2.8% in 2003. Some of the moderation can be attributed to a reduction in housing prices and to the rising nominal value of the Australian dollar which has seen prices of imported consumption goods fall.

The Reserve Bank held its official cash rate steady at 5.25% throughout 2004. This and the fact that inflationary expectations changed little during the year meant that interest rates

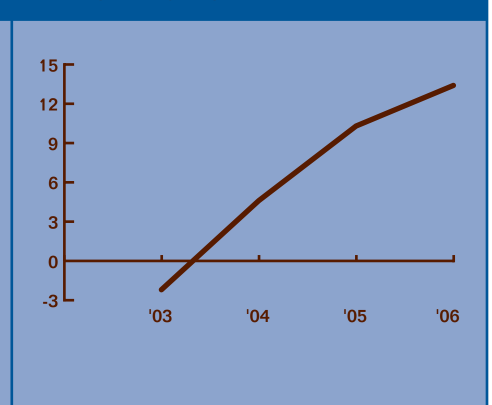
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



across the board changed little. The story for 2005, however, will be quite different. The official cash rate rose 0.25 percentage points at the start of March with the Reserve Bank reacting to concerns about inflationary pressure building up due to local supply-side constraints.

THE STRONGER AUSTRALIAN DOLLAR

Historically, the value of the Australian dollar has been determined by economic fundamentals: interest rate differential, the strength of the world economy and the position on the commodity price cycle. However, between the start of 1999 and the middle of 2002, the traditional rules seemed not to apply: the Australian dollar fell when the global economy grew strongly and then remained low when the global economy weakened even though commodity prices were relatively strong. The major factor influencing the Australian dollar during this period appeared to be the strength of the US dollar: regardless of the fundamentals, the Australian dollar was out of favour.

Since the middle of 2002 the situation has been reversed. Now the Australian dollar is moving in line with commodity prices and investors appear to be taking notice of the fact that Australian interest rates are well above most international rates. As a consequence, the Australian dollar has increased significantly in value. Against the trade weighted index, the Australian dollar rose in value by almost 19% between the middle of 2002 and the end of 2004, while against the US dollar the increase has been almost 50%. In real terms, the increases have been of a similar magnitude, implying a significant deterioration in competitiveness for Australia's traded goods industries. This is a key risk for Australia's trade balance, and is likely to slow the improvement in the current-account deficit which would otherwise come with a general pick-up in world demand. On the positive side, though, a stronger currency reduces inflationary pressures, which will ease the pressure on the Reserve Bank to further raise interest rates.

OUTLOOK FOR 2005 AND 2006

Key assumptions underlying the forecast for 2005:

(a) Interest rates, on average, a little higher than in 2004 reflecting a 0.25 percentage point increase in the official cash rate in March and a further 0.25 percentage point increase around the middle of the year;

(b) A significant cyclical decline in housing investment through the year resulting in a year-on-year decline of 8.9%;

(c) An increase of 6.2% in real private business investment (in line with the latest data from the Australian Bureau of Statistics' survey of business investment intentions);

(d) Growth in real public final demand of 4.5% (the spending increase reflects, in part, some of the promises announced in the run-up to the 2004 Federal election);

(e) Little change in Australia's terms of trade following the sharp increases in 2003 and 2004;

(f) A strong pick-up in Australian exports, with a robust rural rebound coupled with a strong increase in mining exports;

(g) No change in the high level of oil prices; and

(h) Little change in the value of the currency from levels at the start of the year (TWI = 62 and A$/US$ = 0.78).

Overall, GDP growth will likely weaken to 2.9% in 2005. Underpinning this decline will be falls in growth in real private consumption (-3.8%, compared with 5.5%) and in real private dwelling investment (-8.9%, compared with 1.4%).

The volume of net trade in 2005 is expected to deteriorate again, but at a much slower pace than in 2004, thus partly arresting the rate of deterioration in the current-account balance. In 2005, we are forecasting a current account-deficit at 6% of GDP. Our forecast for CPI-inflation in 2005 is 2%.

For 2006, we are forecasting real GDP growth to be about the same as in 2005 (3% *c.f.* 2.9%), with a worsening in the current-account deficit as a share of GDP.

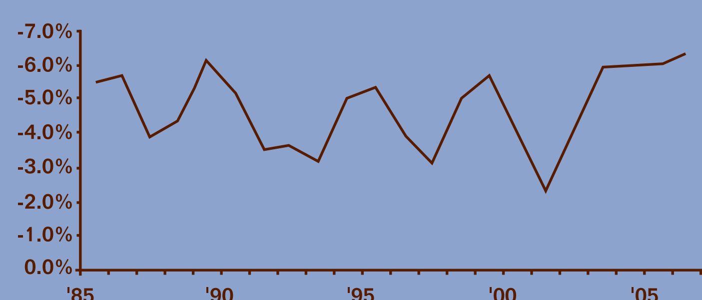
UNCERTAINTIES

Global imbalances. Strong global growth seems to be in place at the start of 2005, but there are considerable risks for later in the year and beyond. Currently many countries face large structural budget deficits and have unsustainable current-account balances (surpluses or deficits). The adjustments necessary to correct these imbalances may put at risk most of our forecasts. For example, in correcting the US current-account deficit, we may see a further dive in the value of the US dollar. If this were to translate into real appreciation for the Australian dollar, it would adversely affect the global competitiveness of Australian industries beyond that currently assumed, and make the forecast for the Australian current-account balance too optimistic.

6% FOR FOUR YEARS!

Australia's current-account deficit rose to 6% of GDP in 2003 and 2004, and is likely to remain at about this level through to 2006. Reducing the deficit and curtailing growth in the stock of net foreign liabilities by encouraging saving and by easing supply-side impediments is a major challenge facing Australian policy makers.

CURRENT ACCOUNT DEFICIT (% OF GDP)



2 CANADA

Jim Storey, *Senior Manager, Portfolio Strategy, Royal Bank of Canada*

2004: DOMESTIC DEMAND CARRIES THE DAY

2004 was a relatively good year for Canada overall. Built on robust consumption growth, solid machinery and equipment investment, and a still very strong housing market, the Canadian economy grew by 2.8% year over year. At 1.9%, inflation was a shade under the Bank of Canada's 2% target. Trade in goods and services expanded briskly. And Canada enjoyed a fourth straight year with a current account surplus in excess of 2% of GDP.

However, the annual figures hide some weaknesses that are more apparent in the quarterly numbers. After a strong start, the economy softened through the third and fourth quarters, with the bulk of the slowdown resulting from falling export receipts. Expressed in annualized terms, exports declined by more than 3% in each of the last two quarters of the year. Over those same two quarters, imports grew at a double-digit rate. Also worth noting is the important role played by inventory accumulation in the second half, with the Q4 and Q3 increases respectively representing the largest and third-largest quarterly results of the past four decades. The inventory expansion likely reflects not only the unintentional build-up resulting from export weakness but also intentional growth related to concerns about the cost and stability of input supply. Shipping and port bottlenecks, commodity scarcity and price rises, and an increasing use of inputs sourced offshore combined to induce firms to hold higher levels of inventory than they might normally do. Thus the net export weakness and robust inventory builds seen in the second half can be interpreted as two sides of the same coin.

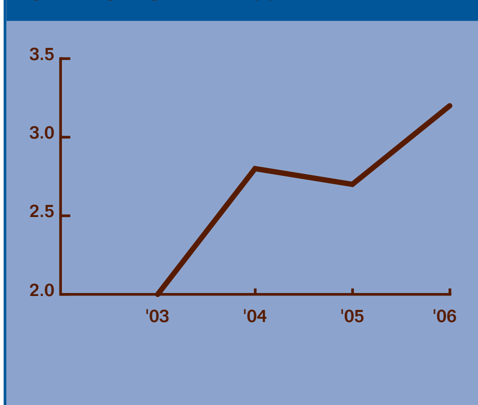
One influence behind the export weakness was the strength of the Canadian dollar, which followed a dramatic 2003 appreciation against the currency of the country's most significant trading partner, the United States, with more of the same. After remaining in the 1.30-1.375 range for most of the first eight months of the year, the Canadian dollar once again began to appreciate in earnest in September, moving to a low point near 1.18 — meaning a peak-to-trough US dollar depreciation of almost 16% against the Canadian unit between mid-May and late November. On an annual basis, the 2003 US$ depreciation amounts to a more reasonable but still meaningful 7%. The C$/US$ rate had moved from 1.575 at the beginning of January 2003 to 1.204 by end-2004. Canada has not experienced an appreciation of this magnitude in the modern era.

The dramatic movements in the exchange rate (and in commodity prices) have had a very significant impact on Canada's terms of trade. In real terms, net exports have fallen significantly, from more than C$55 billion in each of 2001 and 2002 to C$34 billion in 2003 and barely C$22 billion last year. Despite the significant contraction of real net exports, the current-account surplus has expanded in robust fashion, increasing by C$11 billion (about 0.7% of GDP) last year. The expansion reflects both the terms of trade impacts (import prices fell by 2% while export prices rose by a similar amount, meaning that despite the decline in real net exports, *nominal* net exports grew by almost C$10 billion) and a modest improvement in the investment income account. The income balance result is also a reflection of the stronger dollar, as interest paid on non-residents' foreign currency denominated accounts, and debt service accruing to US$-denominated debt held by non-residents, both declined in Canadian dollar terms.

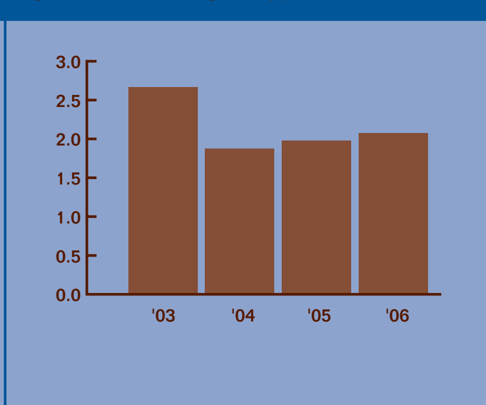
OUTLOOK FOR 2005 AND 2006

The RBC Economics forecast for 2005 and 2006 is for two years of relatively solid growth, at 2.7% and 3.2% respectively. As was the case last year, in 2005 domestic demand will underpin the growth, with consumption expanding at about 3.7%. Investment should have another strong year in 2005, reflecting several factors, including a gradual tightening of capacity, continued low interest rates, ongoing strength in commodity prices, and the influence of the stronger dollar on the prices of imported capital goods. Recent investment

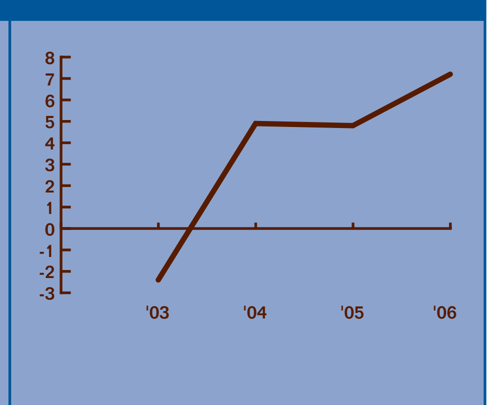
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



intentions survey data lend support to this interpretation. The heightened investment will more than offset a return to much lower levels of stock building. Government expenditures and investment are also expected to accelerate over the coming two years.

Net exports will continue to make a negative contribution to GDP growth. This will reflect two key factors: continuing adjustment to the Canadian dollar appreciation and somewhat slower (though still quite solid) growth in the United States. In real terms, Canada's trade surplus will have essentially disappeared by the end of 2006. In fact, it has all but done so already, with the final quarter of 2004 generating annualized net exports of only C$5 billion (down from C$37 billion in Q2). Seen in this light, it is clear that while net exports will be a significant damper on growth in 2005, it is also fair to suggest that the most significant impacts (at least as measured by net exports) are, or soon will be, past us.

The outlook for 2006 is quite similar to that for 2005, albeit with a gradual deceleration of domestic demand growth. On an annual average basis, net exports will continue to act as a drag on growth, although with much smaller impact in 2006 than in 2005. However, viewed quarter over quarter, net exports are expected to begin making positive contributions to growth by the second quarter of 2006.

The C$/US$ rate is projected to spend most of this year and next between 1.17 and 1.29, averaging 1.22 this year and finishing 2006 at around 1.29. One factor in the exchange rate forecast is the anticipation of relatively more aggressive tightening of monetary policy in the US, and a second is the expectation that while commodity prices will remain relatively robust, they are not likely to move appreciably higher on average.

All-items CPI inflation is forecast to hover around the Bank of Canada's target of 2% in both 2005 and 2006. The economy is expected to add new jobs at a 1.6% growth rate this year, with the labour force expanding at a slightly slower rate. The divergence between jobs creation and labour force growth should widen a bit in 2006, pushing the unemployment rate down below 7% for only the second time in the past decade. The improving jobs picture will reflect not only the solid growth prospects, but also growing capacity utilization levels in the US and a corresponding increase in demand for Canadian goods and services.

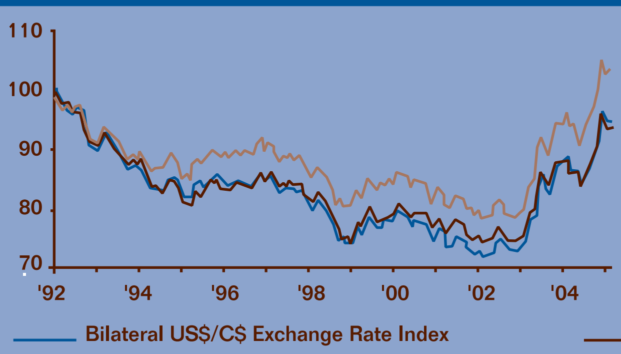
RISKS TO THE FORECAST

A perennial risk factor in the Canadian outlook is the outlook for the US. There are many interrelated ways one can come at this — US current account deficit rationalization, further US$ weakness, or the possibility that the US consumer will significantly scale back consumption growth — but each would imply a measure of downside risk for the outlook. That said, expectations are for growth in the US to be slightly slower this year than last, and a further modest slowing in 2006. A positive US growth surprise would translate into upside risk in the Canadian forecast.

The outlook is predicated on commodity prices retaining much of their recent gains. Rapid commodity price movements, which could result from a number of influences including geopolitical instability, shifting sentiment regarding emerging market growth prospects, or further currency realignments, would have a significant impact on the current account, and possibly also on exchange rates. Depending upon the nature of the underlying shock, such movements might also be associated with adjustments in real variables, especially investment.

Finally, the ongoing process of adjustment to the impacts of a stronger currency, and the potential for another bout of exchange rate movements, represent a risk to the forecast. Initially, the impacts of the appreciation were somewhat muted, reflecting robust external demand, high commodity prices, and the offsetting impacts of hedges, both financial and "natural." This gave way to more meaningful adjustments as the rise in commodity prices and external demand growth slowed, prior contractual and hedging arrangements expired, and firms began incorporating the stronger currency into their strategic planning and operational decisions. Business survey data compiled by the Bank of Canada suggest that heightened import competition and narrower export margins are leading an increasing number of firms to exit certain business lines, locate operations offshore or source additional inputs from abroad, or to engage in additional productivity-enhancing investment. The Canadian outlook is conditioned on these anticipated adjustments to the recent currency realignments. However, renewed US$ depreciation beyond that reflected in the forecast would represent another source of downside risk, potentially stalling the net export recovery.

THE CANADIAN DOLLAR'S REBOUND



Movements in trade-weighted and real C$/US$ indexes are highly correlated with movements in the C$/US$ nominal exchange rate, reflecting the substantial role played by the US in the Canadian trade profile, and the broadly similar inflation experiences in the two countries. As the accompanying chart illustrates, approximately a decade of trend Canadian dollar depreciation was almost entirely unwound in the space of two years. While some firms have welcomed the appreciation, those that benefited from the weaker Canadian dollar — whether or not internationally active — have little choice but to adjust.

3 CHILE

Felipe Morandé, *Universidad de Chile*

2004: TAKING OFF

Last year was a good one for the economy. GDP growth accelerated over 6% by year end, a figure not seen since 1997, before the Asian crisis. The leading factors were exports that grew more than 50% in nominal terms following an increase of around 60% in the world price of copper, Chile's main export, and substantial growth in the world economy. This, in turn, produced growth of around 13% in export volume. This compares to a 7.8% increase in domestic demand. Among components of domestic demand, gross investment was clearly the most dynamic, showing a rate of growth of 12.6%, well above the 5.6% rise in total consumption. Most of the investment growth was linked to the import of capital goods (up 22.8%), while investment in construction grew much less (5.9%).

Even though growth has been essentially export-led, it is interesting to note that domestic demand has been accelerating, after being somewhat depressed in previous years. Fiscal policy and especially monetary policy have been very expansionary since 2002 in order to boost local spending. The monetary policy interest rate reached an all-time low of 1.75% in January 2004, but investor and consumer sentiment did not improve until there was clear evidence that the world economy was picking up. That did not happen until around the second quarter of last year, and investment was the first sector to speed up. It is not surprising that the investment upsurge has been focused on natural resources activities (mining, pulp, fish factories), in commodities that are exported, like copper, cellulose, and salmon.

Net capital inflows picked up strongly in 2004, although they still remain well below the high level achieved before the Asian crisis. The reappearance of inward foreign investment is reflected in the increase in asset prices and expanded lending by the banking sector. The stock market increased just over 27% during 2004 in nominal terms (after growing over 42.1% in 2003), and its momentum is continuing. Early on, most of the action was in natural resources shares but more recently stocks of retail and inward-oriented services companies have soared, based on the expectation of sustained growth of domestic demand. Private credit to the private sector has increased to approximately 26% of GDP in the fourth quarter of 2004, up from 23% the year before. Meanwhile, FDI flows totaled US$7.148 million last year, an increase of 460% compared with 2003, but still well below the level of the late-1990s.

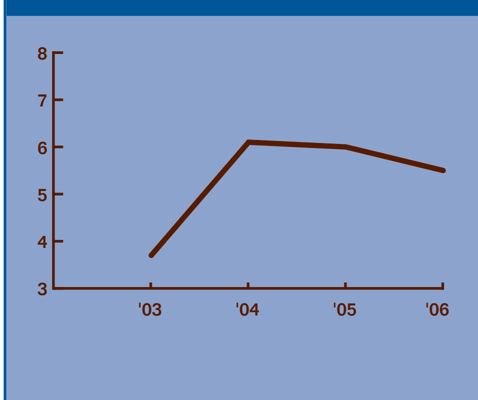
Increased international demand for commodities has led to a sharp rise in prices. This is in general good news for Chile. Terms of trade, though, did not improve as much because Chile imports most of its oil and gas needs and these commodities also rose. Still, terms of trade improved by 20% in 2004. From other perspectives, high copper prices also bring relief to the fiscal accounts, since CODELCO, the state owned copper consortium, accounts for about 30% of Chilean copper output and contributes generously to government coffers when the price of copper is high. Actually, last year the central government had a surplus of 2.2% of GDP, much of it accounted for by the price of copper that reached an average of US$1.30 per pound.

The Chilean peso moved in 2004 very much in tandem with the euro, appreciating 4.4% against the US dollar by the year end compared to December 2003. Some real appreciation was also observed as GDP growth prospects consolidated and as the current account moved into a significant surplus for the first time since 1976 — US$1.4 billion, or a 2.1% of GDP — mostly as a result of the huge increase in the value of exports. The Multilateral Real Exchange Rate index calculated by the Central Bank indicates that competitiveness is comparable to that of 1986, a reduction from higher levels in 2003.

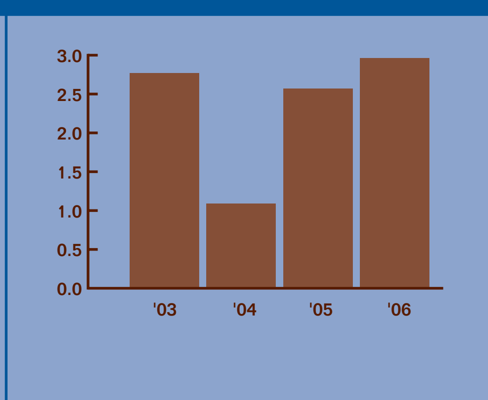
In spite of rapid growth, the unemployment rate remained high at 7.6% as of February. Job creation saw a healthy 3.2% growth yoy by the same date, but the labour force is increasing faster as women and young workers are entering in large numbers. The good news is that much of this job creation is in formal markets (people working under wage contracts, as opposed to self-employed workers). Still, unemployment rates this high when the business cycle is in an expansionary phase is a new phenomenon that many analysts attribute to reforms approved in 2001 that introduced a number of new rigidities in labour hiring and firing.

Inflation remains fairly under control, notwithstanding the fact that it is slowly rising. As of

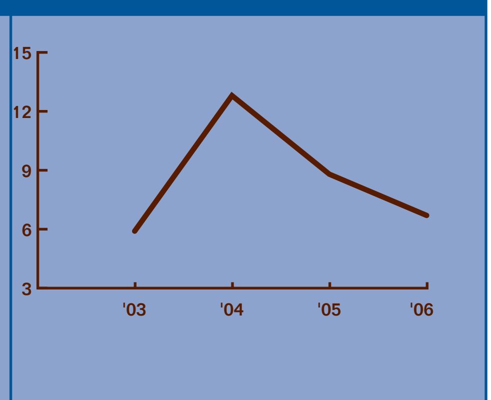
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



February, core inflation was 1.4% yoy, below the Central Bank target range of 2-4%, but up from its lowest level of 0.4% reached in April 2004. The Central Bank initiated in September last year a gradual upward adjustment in its monetary policy interest rate in order to move over time to a more neutral stance. The consolidation of domestic demand growth will eventually close the long-lasting output gap that in turn will push prices upwards in due time. Actually, the increase already seen in domestic prices beyond those caused by external factors (like oil price hikes), albeit slow, is an early sign of inflationary pressures in the near future.

The fiscal surplus of 2.2% of GDP is not a minor outcome. It was the first surplus since 2000 and the favorable conditions in terms of high copper prices and economic recovery pose a challenge to the official policy of achieving a 1% of GDP "structural" surplus. Indeed, between 2001 and 2003 the actual fiscal deficits were justified on the grounds that the copper price was well below its long run value and that the economy was operating below its potential. So, in spite of accounting deficits, the "structural" account implied achieving the 1% of GDP target. In 2004, when the price of copper went well above its long-term value and economic activity accelerated, some skeptics had doubts as to whether the government would honour its commitment. There was political pressure to increase government spending when income increased, but the administration remained firm in its commitment and accepted an increase in spending in line with its "structural" target.

Proof of the government's resolve, added to strong external accounts to explain the drop in sovereign risk. Indeed, EMBI's index for Chile declined to just over 50 basis points by the end of 2004, among the lowest for emerging economies.

2005 AND 2006: GROWTH AGAIN

As usual the Chilean economy will continue to follow closely the fluctuations of the world economy. As the US, Japan and Europe will show slower growth this year than in 2004, the world economy at large is expected to decelerate somewhat, implying less demand for Chile's exports. However, the demand for copper will continue to be strong as China and India will keep growing rapidly. Capital flows will probably go up steadily during the year as foreign investors increase their appetite for risk and look to emerging economies with more enthusiasm.

A consensual growth forecast for 2005 would be 6%, but an increasing number of analysts are revising their projections to slightly higher figures. Although exports will contribute less than in 2004 due to a less dynamic world economy, domestic demand should keep up its momentum and grow by 7%. Investment will go up by 11.5% and interestingly, investment in construction should be a strong pillar with a rate of growth around 8%. The available information on capital formation indicates a number of large investment projects in mining and cellulose production, as well as some others in electricity generation. Private consumption growth, too, will be higher than last year, at 6.3%, based on an improvement in job creation, a slight increase in real wages and an overall optimistic mood.

Inflation should accelerate during the year but stay within the Central Bank's target range although closer to the lower bound of 2%. The market expects the inflation rate to converge to the center of the target range (3%) by 2006, as a consequence of a reduced output gap. The speed of convergence has been an issue though, as inflation has remained below the Central Bank target range for much longer than anyone expected in the past three years.

Job creation should remain strong and unemployment rates should decline through 2005 and 2006 as labour force growth recedes somewhat. The current account of the balance of payments should show a slight surplus in 2005 before turning moderately negative in 2006. This should come as a surprise as terms of trade are likely to deteriorate, although not dramatically, both in 2005 and 2006.

RISKS AND UNCERTAINTIES

The main uncertainties for the Chilean economy come from the external front. On one side, the fiscal and current-account deficits of the US are still pending and threaten to further depreciate the US dollar and/or to press world interest rates upwards. This in turn could harm the world economy, bringing a slowdown and with it, less space for Chile's exports and lower terms of trade. Another risk on the external front comes from China and a sudden stop in its economy or an unexpected revaluation of its currency. Domestically, some risk could be attached to the presidential and legislative elections in December this year, as populist pressures tend to emerge on such occasions. However, none of the leading candidates is proposing any dramatic changes to the economy, all of them value a conservative fiscal policy and macroeconomic stability, and all of them emphasize economic growth as the means to progress and poverty reduction.

4 CHINA

Yue Guoqiang, *Research Institute of Investment, National Development and Reform Commission*

2004: ACCELERATING GROWTH

China's economy experienced accelerating growth in 2004. The GDP growth rate was up to 9.5% from 9.3% in 2003, driven by fixed asset investment (FAI). In the first quarter of 2004, GDP grew by 9.8% and FAI surged by 43%. Concerned at the over-investment resulting in economic overheating, the government introduced polices in April 2004 focusing on land control, credit control and stricter project approval. Reflecting the implementation of macro controls, the economy then decelerated gradually. GDP grew by 9.6%, 9.1% and 9.5% for the second quarter, third quarter and fourth quarters, respectively. The FAI growth rate was down to 22.5% by the fourth quarter.

FAI for the full year increased by 25.8%, 1.9 percentage points lower than in 2003, but still rather high. The FAI-to-GDP ratio was up to over 50% in 2004. The rapid investment growth was supported by local governments seeking rapid growth in their areas: projects under central government authority increased by 3.1%, while local projects surged by 31.5%. In addition, FDI recorded accelerating growth. Total actual FDI registered was US$60.6 billion, a rise of 13.3%, or 11.9 percentage points higher than in 2003. Contracted foreign investment, an indicator of future trends, rose by 33.4% year-on-year to US$153.5 billion.

Over the year, exports accelerated slightly, rising by 35.4%, 0.8 percentage points higher than that in 2003. The continued rapid growth was attributed to global economic recovery, the renminbi's relative depreciation, and the increase in FDI. Foreign-funded enterprises have played a very important role in exports in recent years, accounting for 57% of total exports in 2004. The number of foreign-funded manufacturing enterprises accounts for 70% of the all foreign-funded enterprises. In 2004, the number of approved foreign-funded manufacturing enterprises accounted for 72% of the total, focusing on communication equipment, computers, electronic equipment, and general and special machinery.

Imports grew by 36% in 2004, down nearly 4 percentage points from 2003. The merchandise trade surplus swelled to US$32 billion in 2004, rising by 25% compared with 2003. The import growth rate continued to outpace the export growth rate. Since China joined the WTO, tariffs have been cut gradually. The export VAT rebate rate was cut by 3 percentage points from an average 15% to 12% in 2004. In addition, domestic demand increased significantly. All these factors supported the import increase.

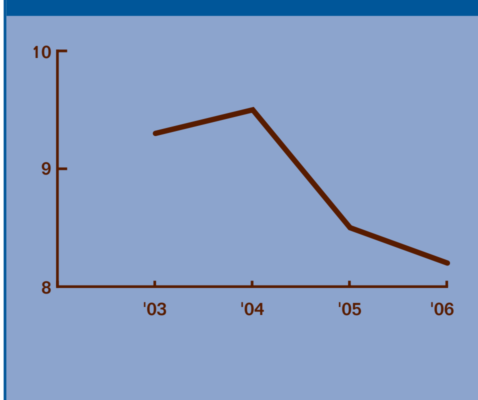
Consumption increased faster in 2004 than in 2003. Total retail sales grew by 13.3%, 4.2 percentage points higher than in 2003. Due to grain price rises, farm household per capita income increased by 6.8% in real terms, the highest since 1997, while urban household per capital disposable income increased by 7.7% in real terms. Those factors also supported the consumption growth.

China's CPI has risen rapidly since November 2003, as inflation pressure increased. CPI peaked at 5.3% year-on-year in July and August 2004. After August, it decreased gradually coming down to 2.3% in December 2004, due to the government's macro controls. Over the full year, CPI rose by 3.9% year-on-year, against 1.2% in 2003. The rapid CPI rise was due to soaring food prices – food prices rose by 9.9% in 2004, with grain prices up 26.4% and eggs up 20.2%. Residential prices rose by 5.4%. The summer grain harvest reduced the inflation pressure somewhat in the second half of the year. Due to over-investment, China's economy is suffering from shortages of energy and transportation, also increasing inflation pressures.

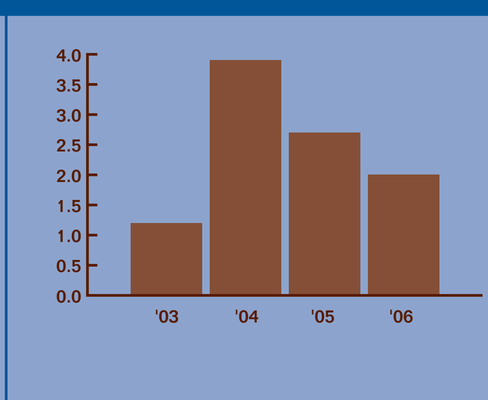
OUTLOOK FOR 2005 – 06

The government announced it would adopt neutral economic policies to achieve sustainable growth in 2005, ending years of expansionary policies. The target GDP growth rate for 2005 is 8%. It is estimated that the macroeconomic control measures taken in 2004 will continue to impact on the economy in 2005. We expect the economy to still keep growing rapidly in the next two years, but the growth rate will be lower than in 2004, at 8.5% in 2005 and 8.2% in 2006. The economy will make a gradual soft-landing. The positive factors for the forecast are FDI inflow, financial and state-owned enterprise reform, and rapid urbanization. The negative factors include the shortage of energy and transportation, and the government's neutral economic policies. Energy and

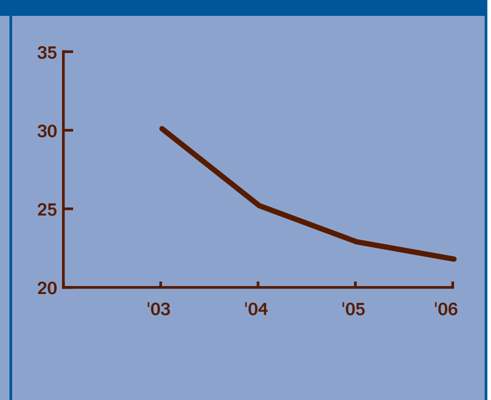
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



transportation have become bottlenecks in the economy, which will not be eased in short term.

Investment will continue to be the major driving force of the economy. The FAI growth rate will be around 16% in 2005, lower than in 2004. The positive factors behind this forecast include the low real interest rate, strong FDI inflow, and the government's policies to encourage private investment. Private investment increased by 51% in 2004, while state-owned investment rose only 14.5%. FDI increased by 10.7% in the first month of 2005 compared to the same period of 2004. The negative factors include the macroeconomic controls implemented in 2004 and the neutral fiscal and monetary policy adopted for 2005 to prevent investment growth rebounding.

Consumption demand will keep growing steadily in 2005 and 2006, with the growth rate of total retail sales 9% in nominal terms. Although interest rates have been raised, the real interest rate is still negative. In addition, consumption patterns have been changing, with demand for goods such as private cars growing rapidly in recent years; expenditure on building decoration materials has also increased significantly, due to the increase in private house purchases. All these factors will stimulate consumption growth.

We expect China's export growth to remain strong. Merchandise exports grew by 36.6% in the first two months of 2005, against 28.7% in the same period of 2004. The export growth rate should be 30% for the whole of 2005. This forecast is supported by global economic growth in 2005, the continuing effects of WTO entry, and US dollar depreciation. It is estimated that the US dollar (to which the Rmb is pegged) will depreciate continually in 2005, and the Rmb/US$ exchange rate will remain stable. This will benefit China's exports. The negative factor is the change in the policy on the export VAT rebate. The export VAT rebate for some products will be cancelled, and some export commodities will be taxed in 2005.

It is estimated that China's import of goods will grow by 29% in 2005, slightly lower than the growth rate of exports. Import growth is supported by domestic demand, which will ease in 2005. Statistics show that China's imports of goods grew by only 8.3% in the first two months of 2005, much lower than for exports, and the trade surplus reached US$11.1 billion. It is estimated that China's foreign trade will maintain this trend for the whole year. According to the conditions of WTO entry, the average tariff level will decrease to 10.1% in 2005, with the average tariff on industrial products down to 9.3%, and agricultural products down to 15.6%. These factors will benefit imports.

China's CPI should rise by 2.7% in 2005 and 2% in 2006, 1.2 percentage points and 1.9 percentage points lower than that in 2004, respectively. It is expected that the economic growth rate in 2005 will be lower than in 2004, due to the government's neutral macro-economic policies, which will reduce domestic demand. Statistics show that CPI rose by 2.9% for the first two months of 2005, which seems to indicate a slow decrease in inflation. Due to the rapid CPI rise in 2004, many local governments have delayed the adjustment of residential charges including water, electricity and fuel etc. These charges will probably be raised in 2005. All these factors support the forecast.

Preventing inflation and maintaining sustainable growth are still the main tasks for China's economic managers. The government has said it will implement neutral fiscal and monetary policies in 2005. The amount of special treasury bonds will be reduced to Rmb80 billion in 2005 from Rmb110 billion in 2004. The deficit will be cut by Rmb19.8 billion, and the ratio of deficit-to-GDP will be down to 2% from 2.5% in 2004. Concerned about inflation and investment rebounding, the central bank announced that the target of money supply growth is 15% in 2005, 0.4 percentage points lower than that in 2004. It is believed that interest rates will be raised again, if inflation pressure increases in 2005. As for the foreign exchange rate, the central bank has announced it will reform the exchange rate system step by step, while keeping the exchange rate stable in 2005.

UNCERTAINTIES

It is expected that the global economy will keep growing in 2005. But, there are still some uncertainties — including external trade conflicts, oil prices, US dollar depreciation — that would impact on China's economic growth.

The depreciation of the US dollar will cause the depreciation of the Rmb relative to other currencies, which will strengthen the competitiveness of Chinese-made goods. This will benefit China's export growth. However, US dollar depreciation would also have some negative impacts on China's economy. Firstly, the export growth flowing from depreciation of the US dollar will intensify trade conflicts. Secondly, owing to robust FDI inflows and a large trade surplus for many years, China's foreign reserves accumulated quickly, reaching US$600 billion at the end of 2004, most of which are in US-dollar assets. Rapid export growth would cause foreign reserves to increase further. The depreciation of the dollar will have a negative impact on the security of the foreign reserves. Thirdly, the foreign reserve increase will result in the an increase in base money, which would impact on monetary policy.

5 HONG KONG, CHINA

Alan Siu, *University of Hong Kong*

2004: STRONG GROWTH

Underpinned by solid export growth and a robust recovery of domestic demand, Hong Kong's economy experienced strong economic growth in 2004, with real GDP growing by 8.1%. A major contributor to GDP growth was net exports of goods and services which accounted for 3.5 percentage points to the overall 8.1% growth. Following 12.7% growth in 2003, the export of goods and services grew by 15.2% last year. This stellar performance was a result of strong regional trade, robust import demand in Europe, as well as the high growth in the Mainland. The weakening US dollar also helped Hong Kong's external competitiveness.

In 2003, private consumption spending, ravaged by SARS, shrank by 0.3%. The rebound started in the 3rd quarter of 2003, and the growth momentum picked up considerably in the 2nd quarter of 2004 when private consumption grew by 2.5% on a seasonally adjusted quarter-on-quarter basis. For the year as a whole, it went up by 6.7% – the highest rate since 1993. The strong growth in consumption reflected improvements in labour earnings as well as employment prospects, with the unemployment rate dropping by more than two percentage points to a three-year low of 6.5% by year-end, and more than 100,000 new jobs created during the year.

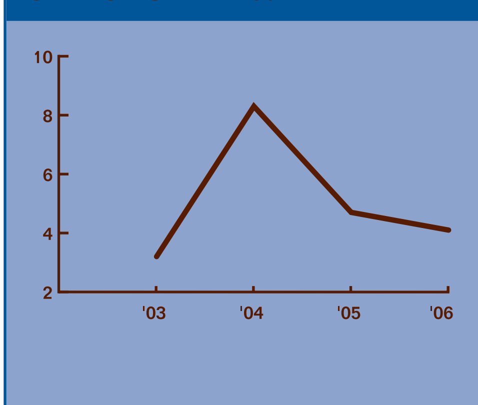
Another factor in the strong growth in consumption spending was the wealth and balance sheet effects brought on by improvements in stock and property markets. The stock market had recovered significantly since mid-2003. The benchmark Hang Seng Index (HSI) of share prices surged by 35% in 2003 and went up further by 13% in 2004. HSI climbed to 14,230 points, the highest level in almost four years. The property market had experienced a prolonged slump since 1998. However, property prices increased significantly at the beginning of 2004, consolidated in mid-year and then rallied again after land sales in October 2004 recorded higher than market-expected prices. Residential property prices on average increased by 27% by the end of 2004. As a result the number of homeowners with negative equity fell to about 19,215 by year-end, accounting for only 4% of all mortgage borrowers. This represents a big improvement over the peak of about 105,697 cases in mid-2003.

Strong growth in private consumption spending was reflected in the retail and catering sectors. For 2004 as a whole, retail sales surged by 10.8% in value and by 9.1% in volume, while spending at restaurants increased by 10.1% in value and 10% in volume. On top of the reviving local demand, the influx of Mainland visitors was another major growth driver. As part of the Closer Economic Partnership Agreement between the Mainland and Hong Kong, travel restrictions on mainlanders to Hong Kong had been lifted in phases since July 2003 under the Individual Visit Scheme. By July 2004, an estimated total of 150 million residents from Guangdong and 11 other Mainland cities were eligible to visit Hong Kong on an individual basis. This scheme quickened the revival of tourism and related sectors. In 2004, 34.6% of the visitors from the Mainland, amounting to 4.24 million arrivals, visited Hong Kong under the Individual Visit Scheme. Overall hotel occupancy rate reached 88% for 2004 as a whole, a significant increase compared to the rates of 84% and 70% recorded in 2002 and 2003, respectively.

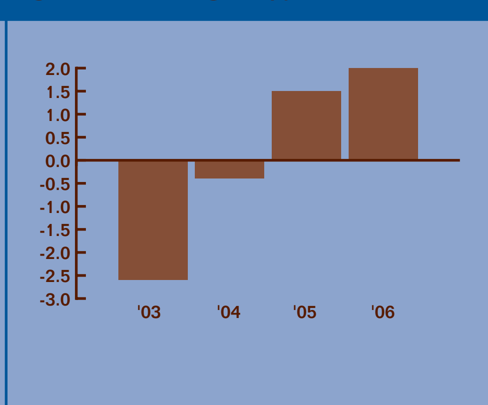
Stimulated by the positive economic outlook, investment in machinery and equipment shot up 12.2% in 2004. On the other hand, the recovery in the property market had not filtered into an increase in construction activities. Investment in land and construction shrank by 5.1% in 2004. Overall gross investment in fixed assets grew by 4.5% in 2004, a substantial increase over the 0.1% growth recorded in 2003.

The persistent deflation since November 1998 came to an end in July 2004. The 68-month long deflation was arrested mainly by the strengthening of local consumer demand. Rising import prices resulting from the weak US dollar and high world commodity prices, as well as increasing rentals, also put upward pressure on the general price level. In 2004,

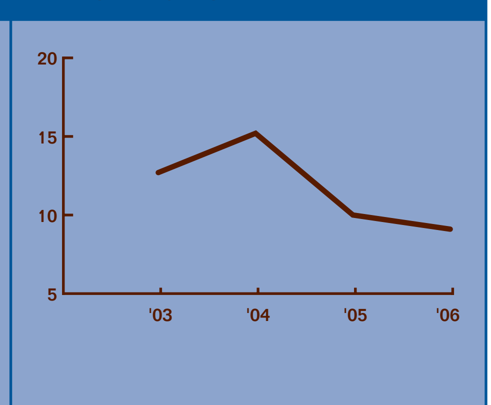
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



the Composite CPI is estimated to have decreased by only 0.4%, a sharp turnaround from the 2.6% drop in 2003.

Resulting from the economic recovery, the fiscal balance in the 2004-05 financial year turned out to be a surplus of $12 billion, much better than the shortfall of $42.6 billion originally projected. The improvement in the fiscal position was largely due to an increase in revenue from land sales and profit taxes.

Hong Kong's external position continued to be very strong in 2004, with the current account estimated at about 9.7% of GDP, and the net international investment position to be more than two times GDP.

OUTLOOK FOR 2005

Global economic growth is expected to decelerate from the high level achieved in 2004, with further monetary tightening. The US and Japan are both projected to slow down. Of particular importance to Hong Kong, growth in Mainland China is forecast to slow to around 8.5% from 9.5% in 2004 as investment is projected to continue to decline, but its exports growth is expected to remain strong at around 20%. Given a weaker external environment, Hong Kong's exports of goods and services are expected to grow more slowly in 2005, at 10%, compared with the estimated 15.3% in 2004. Concomitant with the deceleration in export growth, the import of goods and services is forecast to grow by 9.8% in 2005, dropping from the estimated 13.8% growth in 2004. Tourism-related sectors are expected to continue to do well in 2005. The opening of the Disneyland theme park in September will draw in a record number of visitors from the region, particularly from the Mainland. The thriving tourism industry will continue to provide stimulus to the domestic economy.

Developments in the property market will be crucial in providing support to domestic demand. Recent strong land sales reflected expectations of a sustained property market recovery. The further weakening of the US dollar will continue to make Hong Kong's assets more attractive to foreign investors. The increase in nominal interest rates is expected to be around 2%. On the other hand, consumer prices are expected to increase further, together with rising rentals. The Composite CPI is forecast to rise by 1.5% in 2005. Hence, real interest rates would remain low in Hong Kong. Further appreciation in property values will help underpin continued growth in private domestic demand. Private consumption spending is forecast to grow by 4.7% and investment by 2.8% in 2005.

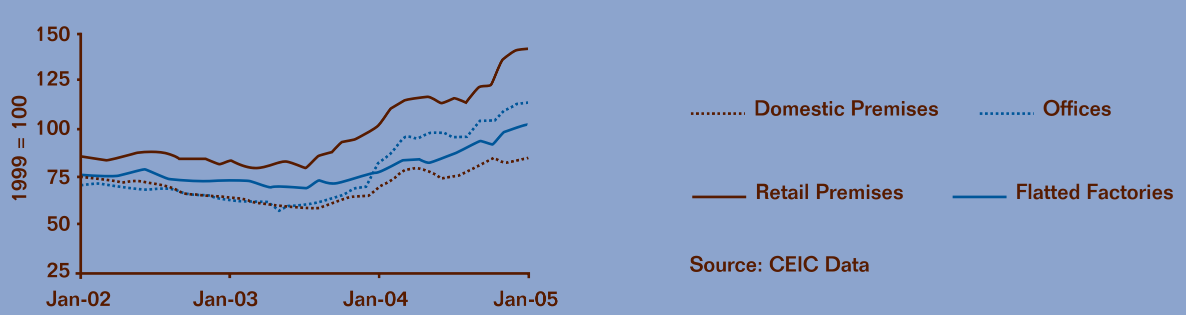
Led by strong growth in domestic demand and supported by robust growth in the net export of goods and services, real GDP is forecast to grow by 4.7% in 2005 and moderate to 4.1% in 2006. The employment situation will keep on improving, albeit at a slow rate, with the unemployment rate projected to be around 6% by the end of 2005.

UNCERTAINTIES

Given the huge current-account deficit of the US, the dollar is set to continue to weaken. While a slow and orderly depreciation of the US dollar tends to enhance Hong Kong's external competitiveness, given Hong Kong's Linked Exchange Rate System, a sharp depreciation could lower growth by unsettling the global financial markets, and by dragging interest rates to a higher level than currently expected in the market.

US interest rates are expected to increase further in 2005, and Hong Kong interest rates are expected to follow suit. In 2004, the spread between Hong Kong and US interest rates widened, as substantial fund inflows in the latter part of the year drove local interest rates substantially below those of the US. The divergence between the Hong Kong and US interest rates last year is highly unusual. Given the Linked Exchange Rate System, interest rate arbitrage will work to close the gap over the long term. Whether the gap would be closed this year depends on the uncertain fund flows. There is a risk that sharp hikes in local interest rates would lower growth.

HONG KONG PROPERTY PRICE INDICES



Source: CEIC Data

6 INDONESIA

M. Chatib Basri, *Institute for Economic and Social Research, University of Indonesia*

2004: INVESTMENT BOOSTS GROWTH

Confounding concerns over political uncertainty, the Indonesian 2004 general election went very smoothly. The peaceful polling, which saw Susilo Bambang Yudhoyono and Jusuf Kalla elected as President and Vice President respectively, restored confidence to the economy. The new team brought new optimism to the country, reflected by a remarkable strengthening of the Jakarta Stock Exchange Index, strong investment growth, as well as improved forecasts of Indonesian economic growth and higher foreign credit ratings by all major international rating agencies. This induced investors, largely foreign, to buy select Indonesian blue chips in the stock market. Gains in several other Asian markets also buoyed the market.

Following the peaceful presidential election, the economy expanded strongly (by 6.7% yoy) in the last quarter of 2004. The high Q4 growth helped the economy to expand by 5.13% over the full year. In fact, economic growth has remained broadly on track, evolving largely as expected when the previous *Pacific Economic Outlook* was published last year. GDP growth of 5.1% in 2004 (based on 2000 prices) or 4.8% (based on 1993 prices) was slightly higher than our prediction of 4.7% (based on 1993 prices). The tsunami disaster which severely affected Aceh and North Sumatra at the end of December 2004 has had only limited impact on the overall Indonesian economy. The area impacted by the tsunami is estimated to generate less than 3% of the total GDP so the disaster is unlikely to affect overall economic growth in any significant way.

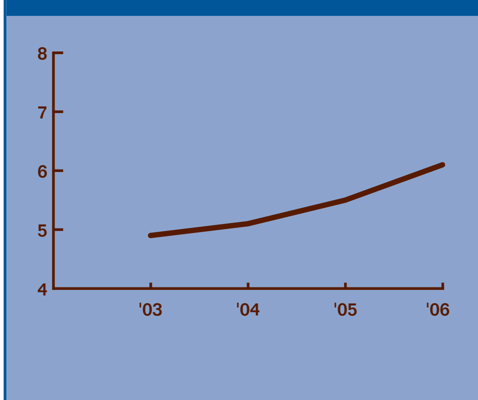
Despite the tsunami and external shocks, including high oil prices, the economy is shifting from consumption-led growth toward more balanced export-, consumption- and investment-led growth. Since the economic crisis in 1998, growth has continued to depend heavily on consumption. However the reverse was true in 2004. Contrary to the speculation of many economic observers, investment grew much faster than expected, by 15.7%. This made investment the largest contributor to growth (60% of total GDP growth of 5.1%). Nevertheless, the investment climate remains a major problem for Indonesia. With the many obstacles that the government faces in implementing good governance, it is difficult to expect that the costs of doing business will drop soon. The implication is that foreign investment will not return unless significant reforms are made in politics as well as to law and order. Although the investment growth in 2004 was remarkable, most of the foreign direct investment is still in the form of machinery and transportation equipment. Thus, despite the strong investment growth last year, the poor investment climate is still a major issue that must be overcome by the government.

As we predicted last year, the general election boosted both private and government consumption, by 4.9% and 1.95% respectively. Both motor vehicle and motor cycle sales rose remarkably. Motor vehicle sales reached more than 480,000 units, the highest sales in history, while motor cycle sales went from 2.7 million in 2003 to 3.8 million in 2004, up 39%.

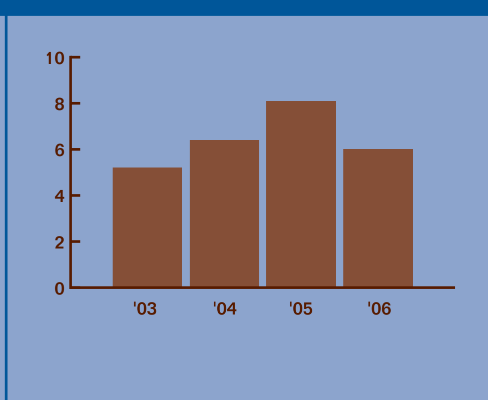
Parallel with the high growth of investment, imports of capital goods and raw materials increased significantly and helped total imports to grow by almost 25%. This is a good news for the economy, because a notable increase of imported capital goods and raw materials indicates an increase in production, both for domestic and export markets, during the year. This trend is confirmed by strong export growth, both for total exports and non-oil exports which grew by 11.5% and 10.7% respectively. Furthermore, the annual growth of electricity consumption, which is an important indicator of economic activity, was 13.8%, almost reaching its pre-crisis level. The high growth of electricity consumption was broad based — in households, industrial and business sectors.

As for fiscal policy, the government has been quite successful in maintaining its fiscal discipline. The budget deficit declined to less than 2% in 2003-04. The government

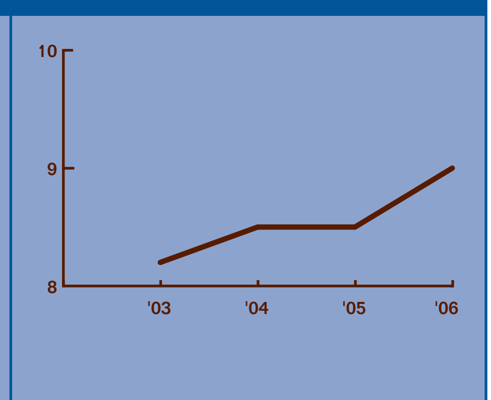
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



debt/GDP ratio also declined further, from 67.7% in 2003 to 53% in 2004. The rupiah depreciated against the US dollar due to both domestic and international factors. The rupiah was at Rps 8,985:US$1 on average, weakening from Rps 8,571:US$1 on average in 2003. The political uncertainty prior to the presidential election and the increase in interest rates in the US led to the depreciation of the local unit. In addition, excess liquidity in the banking system due to weak bank credit allocation for real sectors, provided room for speculative movements, leading to further rupiah depreciation. As for monetary policy, the central bank has succeeded in controlling inflation by absorbing excess liquidity in the banking system, thus maintaining inflation in 2004 lower than expected, at 6.4%.

OUTLOOK FOR 2005-2006 CAUTIOUSLY OPTIMISTIC

Growth is likely to pick up in 2005, rising to 5.5% and 6.1% in 2006 for several reasons. First, durable goods consumption is expected to continue to increase in 2005. Strong demand for cement, motor cycles and motor vehicles was evident in the first quarter of 2005. A higher demand for property is evident in almost all regions of the country. Cement consumption is predicted to continue to grow in the coming year along with the construction sector overall. Regional elections will also boost consumption. The impact of the national general election was evident in boosting demand in 2004. Consumption is projected to grow by 4.9% and 4.5% in 2005 and 2006. Secondly, strong growth of imported capital goods and raw materials, evident in 2004 and the first quarter of 2005, will generate investment and greater exports. Therefore exports and investment are forecast to grow in 2005 and 2006. Nevertheless, investment will not be as strong as it was in 2004 for several reasons. First, the steadily rising trend of US interest rates will force Bank Indonesia to adjust local interest rates, which in turn will dampen down the demand for investment funds. Secondly, looking at the severity of the 1998 economic crisis and the continuing shortcomings in institutional reform, an immediate recovery to considerably higher levels is not expected in the short-term. The investment climate remains bleak due to various labour and institutional problems.

A tight monetary policy is likely to continue in 2005 because of the anticipation of price hikes and depreciation of the rupiah. Inflation is predicted to reach 8.1% in 2005, easing to 6% in 2006. There are several reasons of why inflation in 2005 will be higher than in 2004. First, the depreciation of the rupiah will induce imported inflation, a major contributor to increases in the overall local price level. Secondly, price hikes due to the reduction of the fuel subsidy, although limited, will also tend to push inflation to a higher level. As a result, the interest rate is predicted to be higher than in 2004 in order to maintain a positive real interest rate.

As for trade, total exports are predicted to grow by 8.5% in 2005 and 9% in 2006. On the other hand, total imports, which are dominated by raw materials and capital goods, are predicted to grow by 20% and 18% respectively in 2005 and 2006. Higher world interest rates will increase the interest payment on foreign debt, slightly reducing the current account surplus from 1.1% of GDP in 2004 to 0.9% in 2005.

RISKS AND UNCERTAINTIES

In 2005, the expected economic expansion faces several possible challenges including the continuing rise in global oil prices and the inflationary impact of reconstruction efforts in Aceh province and North Sumatra. Although investment is expected to continue to increase, in line with the government's effort to improve the investment climate and the government's focus on infrastructure development, it has not yet reached the levels seen before the 1998 financial crisis. The problems of corruption, bureaucratic hurdles, weak legal system and problems in the labour market remain, and will take time to solve. This forecast is subject to changes in oil prices and the exchange rate. The government budget will be affected if oil prices turn out to be higher than US$45 per barrel in 2005 and 2006. Higher oil prices will potentially increase the budget deficit, although not very significantly. In addition, if the world economy grows at a slower rate than in 2004, it will impact on Indonesian exports which in turn will affect GDP growth. In addition, further rupiah depreciation will also disturb this forecast due to the impact on inflation. Imported inflation due to rupiah depreciation will push interest rates up further, which in turn will slow investment and GDP growth.

7 JAPAN

Chikashi Moriguchi, *Osaka University;* **Yoshihisa Inada,** *Konan University*

2004: THE RECOVERY PAUSES

Japan's prolonged stagnation came to an end in early 2002[1]. Since the first quarter of 2002, the beginning of the latest recovery phase, exports regained their strength, then non-residential investment and finally private consumption reignited along with an improvement in labour market conditions. The trend continued to the middle of 2004. Consumer expenditure on digital home electronics was booming.

However, the momentum was lost in the latter half of 2004 when export growth slowed in the US and Chinese markets. In the semi-conductor market, there were signs of a rising inventory/sales ratio. Strong competition among home electronics giants caused over-supply of digital home appliances. Prices of PDP and LDC TV screens kept falling and the electronics industry became cautious about new investment. Thus the seemingly-solid recovery that began in 2002 turned out to be short-lived. So, has Japan entered into recession again? The answer is "not yet." As we see in the movement of gross domestic expenditure (GDE) and components, consumer expenditure did not keep increasing, but the rate of decline in Q3 and Q4 was small: indeed we had an extraordinarily warm November and December which dampened winter retail sales.

Japan was hit by an unusual number of typhoons from June to October, and earthquakes that hit central Japan caused some delay in production activity in that area. Considering these natural disasters, Japan's macroeconomic performance was not so bad. Housing investment kept increasing, though the rate was low. Business fixed investment dropped in Q1, but it recovered and kept increasing afterwards. One could say the private sector of the economy performed well. There were two factors that worked negatively on GDE from Q2 to Q4. One was the continuing contraction of public works, with its contraction at more than an annual rate of 10%. Another factor was an accelerating increase in imports which pulled down real net exports.

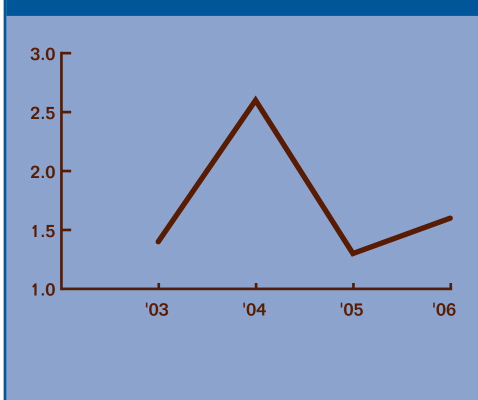
The monthly manufacturing production index showed fluctuating movements, but the recent January index gave a surprise: it increased by 2.1% over the previous month, well above a consensus rate of 1.6%. The labour market situation is also improving. As of January the unemployment rate was 4.5%, a full percentage point improvement since January 2003. The number of regular workers is turning around as firms plan for the anticipated mass retirement of baby-boomers starting in 2007.

The policy authorities (the Bank of Japan as well as the Koizumi administration) maintain their position that the economy is on a recovery track. The present "soft patch," they insist, will be replaced by solid economic growth in the latter half of this year. This view seems realistic.

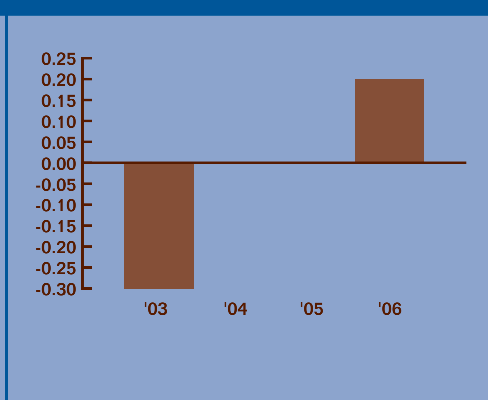
NEW TRENDS IN EXPORTS AND INVESTMENT

So far Japan's economic recovery has basically relied on exports. With the steady strong growth of China's economy, Japan's total trade with China, including Hong Kong, surpassed that with the US during 2004. Meanwhile, the unified and growing European Union is absorbing Japan's manufactured goods. Now it is well-recognized that China is the world's largest supplier of industrial goods, and the Asian Triangle of China, Japan and South Korea form a new division of labour in the world trade market. Japan and Korea export capital goods and hi-tech electronics parts to China. Chinese factories export finished products to the US and other industrialized countries. Japan's bilateral trade balance with the US is shrinking, while China's balance with the US exceeds that of Japan and is rising fast. When Japan's exports to the US or to EU increase, Japan's business fixed investment should increase. However, when Japan's exports to China increase, it may not work the same way. Rather, Japan's capital investment in China may increase and its domestic investment may well be reduced.

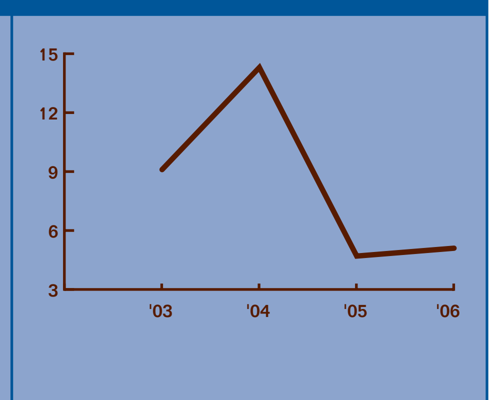
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



THE RISING REAL VALUE OF FINANCIAL ASSETS

The labour market situation is improving generally and workers' sentiment over job security has remarkably improved. This has been helped by wage rates beginning to increase in the growing industrial sectors, and particularly in the service sector. The continuing innovation in consumer electronics keeps stimulating household demand. In addition to this, we should like to point out two new factors that will further promote household spending. One is the general increase in purchasing power of financial assets. During the past decade of deflation, households have accumulated enormous financial assets while real estate prices fell precipitously. While the banking sector struggled with non-performing loans, household savings at banks remained intact. Thus the real purchasing power of financial assets (that is to say, money in a broad sense) has notably increased. The second factor is a change in the tax system: the tax rate on "gifts" is very high, but the rate has been reduced so that the pre-inheritance transfer of assets to a younger generation is encouraged[2]. The main purpose of this new measure is to encourage property transfer from wealthy elderly parents to the younger generation who are potentially heavy spenders. When the baby-boomers retire with large retirement bonuses, the new tax measure will have an impact on personal consumption and housing investment.

OUTLOOK FOR 2005

The economy is expected to register positive growth at a little over 1% this year. Exports are likely to accelerate from their recent weak trend as the US economic growth outlook is revised upward from 3.5%, and China's growth rate stays around 9%. The inventory/sales ratio in the semiconductor market is likely to improve and domestic production and business fixed investment will maintain positive trends. The yen exchange rate seems to have stabilized in the range of ¥103-108 per US dollar. Japan's trade surplus is slowly shrinking and the interest rate differential between the two countries is widening as the Federal Reserve maintains a consistent stance of raising interest rates, while the Bank of Japan will likely stick to a zero interest policy for some time to come. Household expenditure will be steady. Job market conditions will improve further, and wage income is likely to increase. Even though personal disposable income may not rise (the three-year income tax rebate is to be lifted and the social security burden will be heavier), consumer spending and housing investment could register positive growth given the rising purchasing power of household financial assets previously mentioned.

This year has there are certain *ad-hoc* positive influences at work on domestic private demand: an international airport has just opened in Nagoya (called Centrair), and the large Aichi World Exposition has opened near Nagoya. International tourism as well as domestic travel will certainly be encouraged and have some impact on Japan's GDE.

UNCERTAINTIES

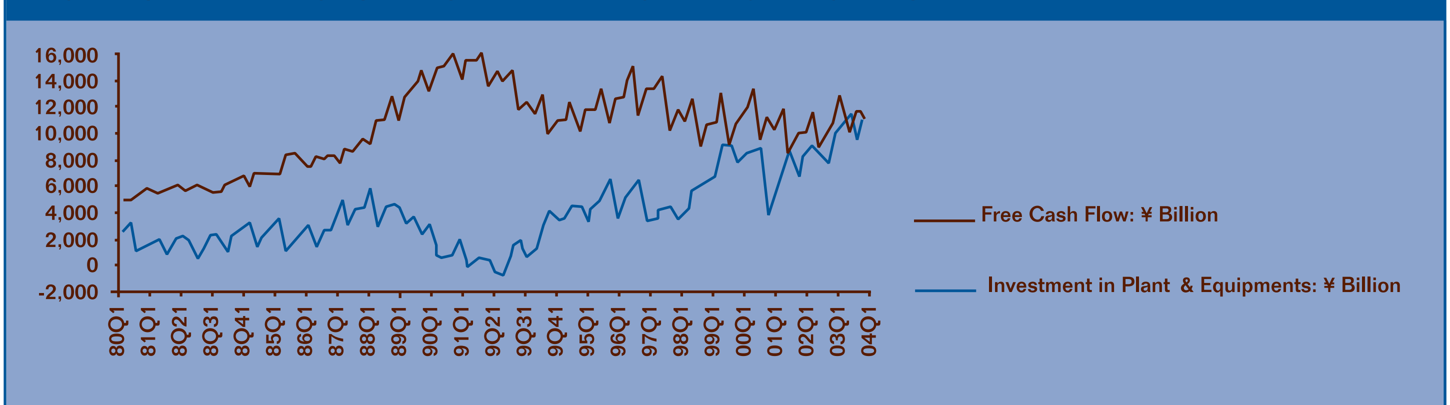
As we look ahead at 2005 and 2006, there are some uncertainties. On the political front, Prime Minister Koizumi will step down by the summer of 2006. While his reform plan for public agencies like the Post Office remains incomplete, a strong fiscal drag is likely to take place: the present 5% consumption tax is likely to be hiked to 8-10%. Even though the Asia Pacific economy has returned to a new growth phase, Japan's growth path is likely to be unimpressively low – around 1-1.5%. On the external side, higher energy prices and a sharp yen appreciation must be considered. Higher input prices and yen will squeeze corporate profits and trim investment, although their impacts on Japan's economy are not so large, as shown by simulation experiments[3].

[1] *According to the official business cycle dating committee, the latest trough in the business cycle was January 2002.*

[2] *Japan's inheritance tax rate is perhaps the world's highest. And pre-inheritance property transfer has been heavily taxed. Recently the government introduced a new scheme of tax-free property transfer. Tax is exempted until the time of inheritance.*

[3] *According to the ESRI's Japanese short-term econometric model (2003 year version) simulation, a 10% appreciation of the yen against the US dollar decreases real GDP by 0.14% from the baseline in the first quarter and by 0.2% for the year average.*

INCREASE IN FREE CASH FLOW MAY ALLOW WAGE INCREASE



8 KOREA, REPUBLIC OF

Seonghoon Cho, *Korea Development Institute*

2004: DOWNTURN AND UPTURN

The South Korean economy achieved modest GDP growth of 4.6% in 2004. Despite a number of external shocks such as oil price hikes in mid-2004 and a rapid depreciation of the US currency since October, GDP growth was mostly driven, surprisingly, by strong exports. Domestic demand, especially private consumption and construction investment, continued to be stagnant throughout 2004. The adjustment in consumer credit was thought to have been the biggest factor in explaining the negative growth in private consumption since 2003. Among other important factors discouraging domestic demand were such basic policy stances of the ruling party as an anti-speculation measure on real estate and political uncertainty stemming from the impeachment of the President and the debate surrounding the relocation of the national capital. Private consumption decreased by 0.5% in 2004 mainly due to an ongoing adjustment in consumer credit. In addition, the low growth of disposable income seems to have hindered recovery in consumption during 2003-2004. The growth rate of individuals' disposable income undershot the growth rate of GDP over 1999-2004 by about 5%, which seems to reflect low productivity among self-employed workers and rapidly growing social pension contributions: the nominal operating surplus of self-employed workers grew only by 2.1% per annum between 1999-2002, compared with a growth rate of 8.9% in wage income. Such a structural trend is expected to slow the recovery in consumption. Stagnant equipment and facility investment were also affected by the political and economic uncertainty. Even with a record operating surplus and low interest rates, a general lack of confidence in the economy drove firms to increase cash holdings rather than invest in equipment.

In contrast to the slump in domestic demand, exports continued to be surprisingly strong, recording a 31% increase. This was partly helped by the government's policy of maintaining a weak won. Despite skyrocketing oil prices in mid-2004 and a rapid appreciation of the currency near the end of 2004, the high growth rate of exports did not slow. The current-account surplus jumped to US$27 billion in 2004 from US$12.3 billion in 2003. However, a component analysis of the current account shows important structural changes in Korean industry: a huge trade surplus of US$38.5 billion was mostly driven by IT- and automobile-related firms, while contributions from SMEs to exports dwindled. The expanding gap between the large firms, and SMEs and self-employed workers worsened employment conditions and, consequently, the unemployment rate rose to 3.5% in 2004 from 3.4% in 2003. The balance in services, income and transfers marked a deficit of US$11.3 billion, implying that the service industry is losing its relative competitiveness to manufacturing.

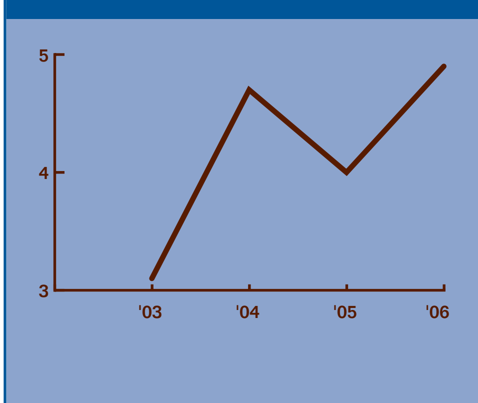
The consumer price index recorded a modest growth rate of 3.6% in 2004 partly due to weak domestic demand. The core inflation rate (excluding prices for agricultural and petroleum products) was 2.6%, implying that the inflation of consumer prices in 2004 was largely attributable to rises in oil and other commodity prices.

OUTLOOK FOR 2005 AND 2006

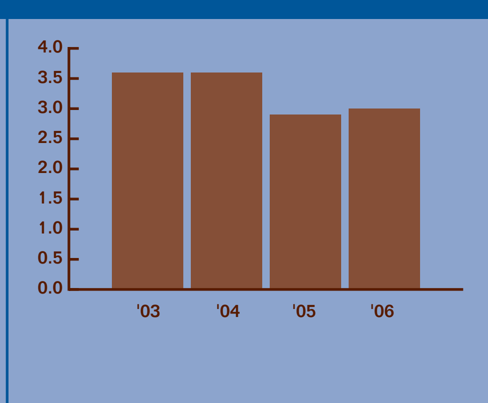
The economic outlook for 2005 is based on the assumptions that the robust recovery of the world economy will continue and oil prices will drop slightly from the level in 2004. It is also assumed that the real effective exchange rate (REER) of the won will remain at the current level. South Korea's economic growth rate is projected to be around 4% in 2005, lower than the 4.6% recorded in 2004, owing to a slow-down in export growth. As domestic demand is expected to recover gradually, the growth rate in the second half of 2005 is forecast to be in the upper 4% range, higher than the 3% in the first half.

Private consumption is expected to slowly recover to the mid 2% range, still lower than the growth rates for GDP and disposable income in 2005. While private consumption will be less affected by the adjustment in

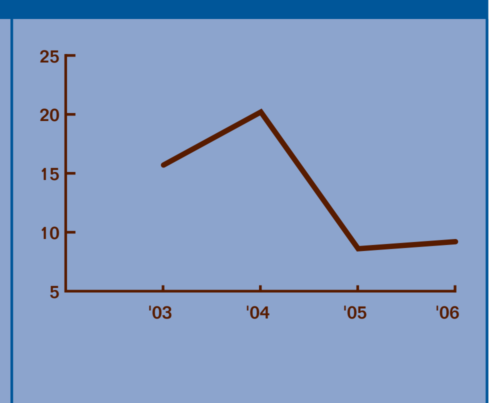
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



consumer credit, the pace of recovery hinges on how fast disposable income will grow in the long run. Equipment and facility investment is expected to grow by 8.3% in 2005 due to a gradual pickup in domestic demand and the appreciation of the won. Construction investment is projected to have increased in the low 2% range in 2004, and in the upper 2% range in 2005 as the government's "Comprehensive Investment Plan for Economic Vitality" takes effect.

The growth rate of export volume is projected to fall to 9% in 2005 from 21% in 2004 due to the expected slowdown in the world economy and the appreciation of the local currency. The growth rate of import volume will be in the 12% range in 2005 thanks to a recovery in domestic demand and the appreciation of the won. The current-account surplus is forecast to narrow to US$19-20 billion in 2005 from US$27 billion in 2004. The trade balance of goods in 2005 is expected to mark a surplus of US$34 billion, down from the surplus of US$38 billion in 2004, due to a slight letdown in world economic growth, the appreciation of the won, and the recovery of domestic consumption.

The CPI inflation rate is projected to be 2.9%, lower than the 3.6% rate of 2004, while the core inflation rate is projected to be 2.7% in 2005, similar to 2.9% registered in 2004. Unemployment is expected to increase slightly to 3.6% in 2005 from 3.5% in 2004.

RISKS AND UNCERTAINTIES

There are several risk factors to consider — higher oil and commodity prices; fluctuations in major exchange rates triggered by the rapid adjustment of the increasing US current-account deficit; an abrupt decline in housing prices in the wake of an increase in US interest rate in response to a weak dollar and inflationary pressure; and finally delayed recovery in domestic demand, provided that the Comprehensive Investment Plan announced by the government is less effective than expected or that low confidence in the national pension system leads to greater households savings.

According to a recent analysis by the Korea Development Institute, the appreciation of the REER, potentially driven by the weak US dollar, will reduce the South Korean GDP in the short run but its effect will fade away within two years. Specifically, a 5% fall in REER (an appreciation of the won) is expected to raise equipment and facility investment by 2-3% and private consumption by 0.3-0.6% in the first year, reflecting "cheaper" imported goods. It is also expected to shrink the current-account balance by US$5-7 billion. Consequently, the negative effect on the current account outweighs the positive effect on domestic demand, resulting in a fall in GDP by 0.2-0.5%. In addition, the consumer price index is expected to fall by 0.5%.

The South Korean government has been accumulating its reserves to support a weak Korean currency. With ammunition to support the won depleted and criticism about the appropriate level of the reserve, the government is not expected to increase its reserves as fast as previously. Although its stock is large enough and mismanagement of the reserve may result in serious capital loss, the government is not expected to change its portfolio drastically in favour of the Euro or other currencies by selling US dollars in the short run.

9 MALAYSIA

Rahamat Bivi Yusoff, *Economic Planning Unit, Prime Minister's Office*

2004: GROWTH FIRM AND BROAD BASED

Malaysia's economic growth remained strong, at 7.1% in 2004 after recording a solid 5.4% in 2003. Growth was broad based with all sectors of the economy expanding except for construction, which registered negative growth of 1.5%. The contribution of domestic expenditures to growth increased to 9.5% of GDP in 2004 compared with 3.3% of GDP in 2003.

Economic policies in 2004 were focused on achieving sustainable growth with long-term resilience and competitiveness. The objective was to improve the enabling environment for business activity to enhance the private sector contribution to economic growth, in particular to spearheading and promoting the new sources of growth. In line with this objective, the government put in place measures to revive private sector initiatives such as ensuring a more efficient public sector delivery system; reducing the cost of doing business, as well as increasing the sector awareness of and compliance with corporate governance and industry best practices, particularly among public-listed companies. As a result, private investment turned around in 2003 (up 0.4%) and accelerated in 2004 to register growth of 15.8%, enabling the private sector to resume its role as the key driver of growth. Steady inflows of foreign direct investment (FDI) in the oil and gas industry and greater interest in agricultural activity also contributed to the better performance of private investment.

The growing private sector financing need was supported by a more resilient banking system. Gross private sector financing through the banking system and capital market expanded by 6.3% from 2003 to RM522.9 billion in 2004, with the banking system contributing more than 90% of the total financing. Loan disbursements were higher for small and medium enterprises (SMEs), in line with efforts to increase access to financing for SMEs to enable them to become the catalyst of growth.

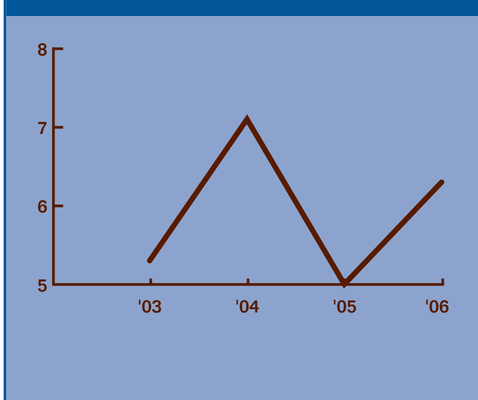
Consumer sentiment remained positive as a result of higher disposable income arising from firm commodity prices, stronger export earnings as well as better employment prospects and positive wealth effects from favourable stock market conditions. Together with low interest rates and benign inflation, these conditions led to a higher propensity to consume. Private consumption grew by 10.5% in 2004 compared with 6.6% in 2003.

Fiscal policy is geared toward a gradual and progressive reduction of the federal government deficit without constraining overall economic growth. The objective is to improve the financial position of the government as well as strengthen macroeconomic fundamentals to ensure long-term sustainable growth. In line with this, public investment declined by 3.5% in 2004, the first cutback since the 1997-98 financial crisis. The lower public sector investment, however, was compensated by more robust private investment. Public consumption also registered a moderate growth of 6.0% in 2004 compared to 11.5% in 2003.

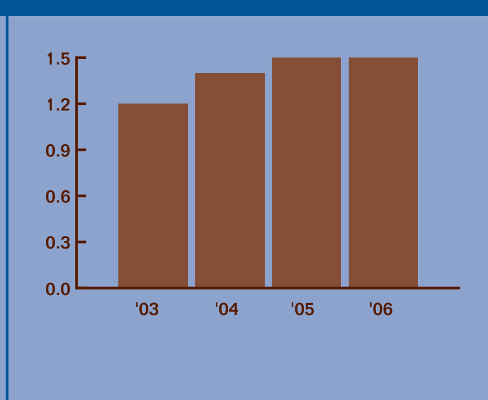
With fiscal consolidation measures in place, the Federal Government account registered a deficit of 4.3% of GDP in 2004, lower than the 5.3% of GDP recorded in 2003. The better fiscal outturn was largely attributed to higher revenue collection and lower development expenditure. Federal Government revenue increased by 7.3% to RM99.4 billion in 2004, largely due to more efficient revenue collection. Meanwhile, development expenditure declined by 26.7%, reflecting the government's decision to accelerate implementation and completion of projects in the first three years of the Malaysia's Eighth Plan, 2001-2005. Nonetheless, budgetary expenditure was directed to sectors that enhanced capacity building to improve productivity and efficiency as well as to priority sectors of agriculture, rural development, education and health. Total government expenditure in 2004 was RM120.2 billion, 2.8% lower than in 2003.

On the supply side, output of all sectors except construction increased, partly attributed to measures put in place by the government to

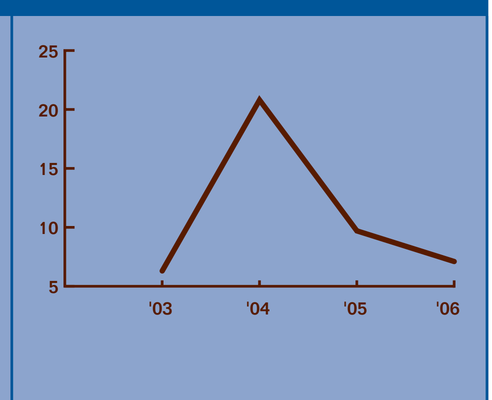
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



promote and expedite the development of new sources of growth to increase the country's economic resilience. The manufacturing sector, growing at an average rate of 9.8% in 2004, has become more diversified with higher-end, value-added and new emerging industries and products. Electrical, electronics and machinery registered the highest growth, followed by rubber and wood-based products on account of stronger global economic recovery. On the domestic front, buoyed by the expansion in domestic economic activity as well as improved consumer and business sentiments, output of transport equipment and construction-related industries expanded.

The services sector grew by 6.8% in 2004, driven by higher consumer spending and a record level of tourist arrivals. Growth emanated from strong expansion in all sub-sectors with transport and communication in the lead at 8.4% followed by wholesale and retail trade, hotels and restaurants (7.1%) and finance, insurance, real estate and business services (6.5%). Together with new growth areas in information and communications technology (ICT), the services sector was able to maintain its premier position in terms of its share of GDP at 57.4%.

In the external sector, the trade balance remained in surplus. The upswing in the global economy, coupled with the upsurge in electronics demand, as well as high prices for palm oil and crude oil, continued to propel export volume and earnings. Gross exports grew by 20.8% to RM480.7 billion. The strong growth was attributable to higher earnings from manufactured products, mining commodities and agriculture goods. Import growth was also strong, particularly for intermediate and capital goods to sustain the high levels of industrial activity and capital formation from investment initiatives, reflecting robust domestic activity. Arising from the sustained strong surplus in the goods account, as well as improvements in the services deficit, the current account of the balance of payments recorded a surplus for the seventh consecutive year, amounting to RM56.4 billion or 13.4% of GDP. Malaysia's overall balance of payments was positive for the fourth consecutive year.

Better export earnings and inflow of foreign funds increased international reserves to US$74.8 billion as at 14 May 2005, sufficient to finance 8.7 months of retained imports and 7.2 times the short-term external debt. The national resource position remains strong, with gross national savings at 37.2% of GNP, providing ample liquidity to finance both public and private sector initiatives. Inflation remained low at 1.4% despite strong domestic demand and higher commodity prices while the producer price index showed a significant increase at an average rate of 8.9% in 2004. Labour market conditions continued to be stable with the unemployment rate remaining at a low 3.5%. With stronger growth, per capita income increased to RM16,476 or US$4,336. In purchasing power parity (PPP) terms, is was at US$9,968 in 2004.

OUTLOOK FOR 2005 AND 2006

For 2005, the economy is expected to grow at 5%. On the demand side, private sector expenditure is expected to remain bullish. Private investment is projected to increase by 9.6%, reflecting improved business confidence as well as the government's effort to promote investment in new sources of growth in agriculture, manufacturing and services. Higher value-added manufacturing and ICT-related industries are also expected to attract stronger investment, particularly those that are able to provide inter and intra-linkages between multi-national companies and SMEs. In addition, the public-private partnership that is being promoted and nurtured through better collaboration in R&D and innovation is expected to further stimulate investment. In services, professional services, logistics, healthcare, education and tourism as well as other knowledge-based industries will be the sources of economic growth for 2005. In contrast to the strong pace of the private investment, public investment will be further consolidated in 2005 and will decline by 11.6%. Nevertheless, public consumption is expected to register a moderate growth of 4.5%. The Federal Government deficit is expected to decline further to 3.8% of GDP in 2005. Inflation and the unemployment rate are expected to remain low.

In 2006, the economy is forecast to record growth in line with its potential output. The positive outlook is premised on more resilient domestic demand, driven by strong private sector expenditure. The public sector, on the other hand, will continue to consolidate its overall financial position. Growth will accrue from increased activities in the manufacturing, services and agriculture sectors. Prices are projected to remain stable and low, while unemployment should also remain low.

RISKS AND UNCERTAINTIES

The downside risks to this growth are slower world economic and trade growth due to factors such as higher oil prices, lower demand for electronics products, higher interest rate and geo-political developments. On the domestic front, lower private investment may affect the growth target for 2005-2006. Nevertheless, the government will continue to put in place policies and strategies that will further enhance the long term resilience and competitiveness of the economy. Among the policies are:

- Improving the environment for doing business in Malaysia, including improving the government delivery system, reducing costs of doing business and better fiscal incentives;
- Consolidating the government fiscal deficit without constraining overall economic growth;
- Increasing the awareness of and compliance with corporate governance and industry best practices;
- Increasing the number of skilled manpower through improvement in education and skills training to match industry requirements;
- Supporting the development of the small and medium-scale enterprises by facilitating access to adequate and cost-effective financing;
- Revitalizing the agriculture sector into a modern and commercially viable sector with high returns; and
- Expanding the services sector by promoting the development of new sources of growth, particularly in the ICT and tourism sub-sectors.

10 MEXICO

Sergio Luna, *Grupo Financiero Banamex*

2004: A "GROWTH PUZZLE" SOLVED

After a couple of years of modest economic performance, Mexico's GDP growth reached 4.4% in 2004. The improvement was particularly strong at the close of the year, with annualized GDP growth for the 4th quarter at 4.9%. Sources of demand were also more evenly distributed. Total merchandise exports were up 14.5% from 2003 which was matched by similar increased demand for imports (up 15.6%). Private consumption remained strong: retail sales grew 4.9% during 2004 and durable goods did particularly well, with sales of new vehicles, for example, for the first time reaching more than one million units. But the main comeback was in investment. During 2001-2003, gross fixed investment registered an average annual rate of change of –2.4%. An improvement started to take shape during the first quarter of 2004 (annual change of 4.5%) which was then further consolidated; for 2004 as a whole, gross fixed investment rose 6.1%, with both construction (5.1%) and purchases of machinery and equipment (7.1%) contributing to the result.

These results can be explained by the hypothesis developed in our previous report regarding the "growth puzzle", i.e. the fact that Mexico was lagging behind the economic recovery in the US. We argued that the productive link between the US and Mexico was still working and therefore attributed the "growth puzzle" to a sectoral pattern of recovery in US import demand that was temporarily biased against Mexico´s main export lines. In particular, this anomaly seems to have been associated with the cycle of electronic goods, an activity which accounts for 23% of total US manufactured goods purchases from Mexico.

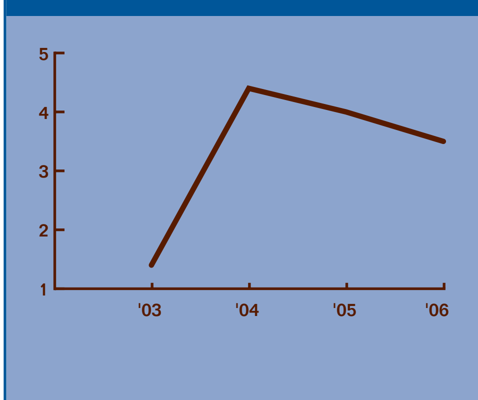
That said, more intense competition from other countries cannot be overlooked. Moreover, losses in market share have led to the expected response – gains in labour productivity. Thus, our expectations of a limited impact of the export-led recovery on job creation were fulfilled: at the end of 2004, formal employment was only 2.1% above the level of December 2003. But the impact of this weak labour market on local demand was to some extent compensated by another factor. The expansion of banking credit to consumers and mortgages amplified the initial stimulus of the export-led recovery and led to a higher contribution of local demand to overall economic growth. We underestimated this effect because it had no precedent; since the peso crisis of 1995, credit circuits had remained closed. This is the first time they interacted with recovery within the context of North American integration. Productivity gains along with weak labour-market conditions translated into lower unit labour costs and therefore, increased profitability and investment. Thus, profitability *cum* reactivation of credit circuits are behind the strong reaction of investment.

MACROECONOMIC AND FINANCIAL PERFORMANCE

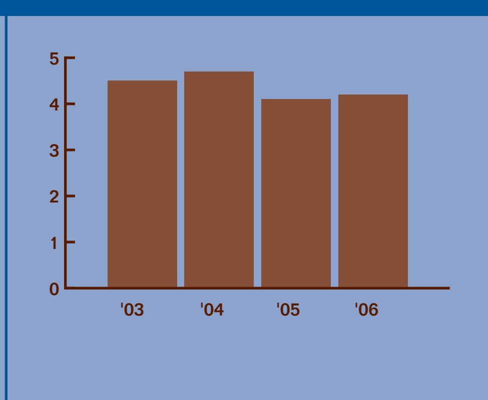
The 2004 current account deficit (CAD) stood at US$9.4 billion, or 1.4% of GDP. Three items stood out: a) high oil prices; b) tourism (a surplus of US$3.9 billion), and c) foreign remittances – mostly from Mexicans working in the US – worth US$16.6 billion. The fact that oil revenue only represented 12.5% of total export revenue should not lead to an underestimation of its importance for public finance: 33% of total government revenue came from this source and its rate of growth (14.5% in constant pesos) was far higher than the increase in non-oil public revenue (1.6%). As expenditure discipline was mantained, the public sector borrowing requirements went from 2.5% of GDP in 2003 to 1.8% in 2004. As a consequence, the debt-to-GDP ratio (39.4%) was below the original goal in the 2004 budget.

The financing of the CAD was easilly met by a capital account surplus of US$13.7 billion; in fact, FDI inflows (US$16.6 billion) more than covered the CAD. In addition, there was a renewed apetite for local currency denominated securities: the inflow of portfolio investment totalled US$7.6 billion, the largest amount since 2000. We believe this is a reflection of

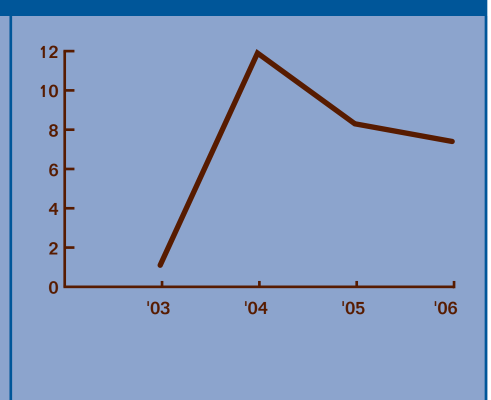
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



worlwide liquidity levels, as also suggested by the record-low level of country risk (166 basis points over US Treasuries at the close of 2004). The stronger inflow that the former implies was partially "sterilized" by a substantial reduction (US$5.9 billion) in foreign currency denominated indebtedness, which involved both the public and the private sectors.

Put together, these facts suggest that increased international liquidity during 2004 led to a portfolio recomposition which in turn could explain why the Mexican peso was one of the few currencies that did not grow stronger vis-à-vis the US dollar in 2004: fluctuations in the relative value of assets denominated in these two currencies (i.e. movements in the exchange rate) were made redundant by a stock adjustment running in the same direction (i.e. from US dollars to pesos). Such a stock adjustment could reflect the adaptation of economic agents to a growing degree of coordination — either *de facto* or *de jure* — of monetary policies in North America. As a matter of fact, Mexico's central bank already considers the Fed's decisions as an explicit factor influencing its own monetary policy decisions.

However, perfect monetary coordination requires convergence of inflation rates. This is not yet the case: inflation in Mexico during 2004 was above the upper limit of the central bank´s target (i.e. 3% plus/minus one percentage point). This was mostly explained by the performance of volatile items not included in the core CPI index, but nevertheless led to a tightening of monetary policy at the end of 2004. Thus, local interest rates are not only reflecting the gradual increases implemented in the US, but also an additional, transitory tightening in Mexico.

OUTLOOK FOR 2005

Two main forces will determine aggregate performance in the near future: the inertial effect of the 2004 recovery and the rate of expansion of the US economy. The former is expected to last a bit longer than in the past due to the reactivation of credit circuits, while the impact of the later will be below 2004 levels. Therefore, economic growth will be stronger in the first half of 2005 and then it will slow down. By then, a third force could start to exert some influence: with the 2006 presidential election approaching, political issues will become prominent in the minds of economic agents. Overall, we expect GDP growth of 4% in 2005. The contribution of the internal market to GDP growth will be slightly larger, particularly from investment. This mix of sources of growth should lead to a current-account deficit of 1.6% of GDP. This is a manageable figure, which reflects a steady improvement in Mexico´s recurrent sources of currency revenue, such as foreign remittances, the improvement in categories such as tourism and temporary conditions such as high oil prices. In this respect, public finances during 2005 should remain favourable.

Regarding financial variables, better behaviour of volatile components and a tighter stance by the central bank have led to a decline of inflation and we believe that the figure for the end of the year (3.9%) will be within the range of the central bank's target. Therefore, after high levels at the beginning of 2005, interest rates should be lower during the second half, although the beginning of the political cycle at the end of the year could somewhat limit this decline. Our forecast assumes that the 28-days Cete (treasury bill) rate will average 9.4% during the year. Therefore, our forecast also assumes that the exchange rate will close at 11.5 pesos per US$ in 2005, a figure which compares with 11.2 pesos per US$ at the end of 2004.

RISKS AND UNCERTAINTIES

Clearly, the key issue to follow is economic activity in the US and the factors that could affect it. As a major oil exporter, the direct impact of higher prices is positive for Mexico. Nevertheless, higher oil prices would also mean lower economic growth in the US and therefore, less demand for Mexico's manufactured exports. This indirect, negative impact would more than compensate for the direct, positive impact, thus leaving Mexico in a worse off situation.

Second, the international macroeconomic adjustment on Mexico has so far been limited to portfolio recomposition. Therefore, the stock recomposition toward peso-denominated assets would be validated if the peso also appreciates against the US dollar; a stronger-than-expected peso cannot be ruled out. Higher local interest rates during the beginning of 2005 have led to a strengthening of the peso vs. the US dollar and a flatter Mexican yield curve. This suggests that the temporary tightening of monetary policy has affected demand for US dollars rather than longer-term liquidity in pesos.

Last but not least, politics will become increasingly important as the 2006 presidential election approaches. Indeed, the political landscape is full of uncertainties, but so far markets have shown remarkable behaviour regarding day-to-day political issues.

11 NEW ZEALAND

John Stephenson, *New Zealand Institute of Economic Research*

2004: GROWTH SQUEEZES RESOURCES

The New Zealand economy expanded at a solid pace in 2004. Real GDP grew by 4.8%, up on the 3.4% growth recorded in 2003. The December 2004 quarter was the 18th in succession of positive growth for New Zealand and resources are stretched thin. Rising household spending was a key component of growth last year. Household spending was fuelled by very strong activity in the labour market driving income growth and surging house prices boosting households' wealth. In the year to December 2004 employment grew 4.4%, salary and wage rates grew 3.1% and two years of rapidly rising house prices led to negative real mortgage interest rates. In addition to persistent income growth, a stronger New Zealand dollar has raised the international purchasing power of that income. New Zealand's terms of trade rose 7%, on an annual average basis, by year end 2004. Increased buying power saw import volumes surge 15.7% over the year.

Three and a half years of robust economic growth has led to strong employment growth and declining unemployment. In the December 2004 quarter, New Zealand's seasonally adjusted unemployment rate reached 3.6% of the labour force — its lowest level in almost 20 years and the lowest unemployment rate in the OECD. Activity in the housing market was brisk. Real residential investment grew 4.5%, on the back of 19.8% growth in the previous year. During the latest period house prices grew by 17.1%. Residential investment has been driven by strong population growth from large net inflows of migrants in the past few years. The rise in house prices through 2003 and 2004 has provided considerable impetus for growth in private consumption. Indeed the wealth effect on private consumption can scarcely be understated in view of the fact that New Zealand households hold a little under 90% of their net financial wealth in residential property. This is very high compared with less than 40% of net financial assets held in residential property in the US, and approximately 75% in Australia.

In 2004 business investment recorded its strongest burst in a decade. Investment (excluding housing) grew 16% in 2004 following 10.3% growth in 2003. A number of factors combined to stimulate business investment last year. The persistently high value of the New Zealand dollar has lowered the price of plant, machinery and transport equipment, much of which is imported. At the same time, with labour in short supply, upward pressure on wages has provided incentive for businesses to substitute capital goods for relatively expensive labour. In addition, productive resources are stretched thin. In December 2004, the capacity utilisation measure (CUBO) from the New Zealand Institute of Economic Research reached its highest level since the survey began in 1961.

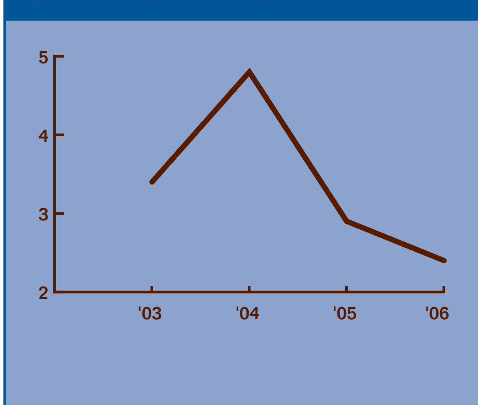
Strong wage inflation, high capacity utilization and continued high levels of activity in the housing market put upward pressure on inflation in 2004. The consumer price index (CPI) spent most of 2004 in the upper half of the central bank's target inflation band of 1-3% ending 2004 at 2.7% annual inflation. Last year saw a rapid tightening in monetary policy in response to the inflationary pressure in the economy. The Reserve Bank of New Zealand lifted its benchmark rate seven times between January 2004 and March 2005, from 5% to 6.75%. This has led to some of the tightest monetary conditions in eight years.

Strong household spending and business investment widened the current-account deficit to 6.4% of GDP for the year ending December 2004. However, the expansion of the current-account deficit has had little impact on the value of the New Zealand dollar which recorded a record high in March of $1.34 against the US dollar (a record since the kiwi was floated in 1985). The rise in the currency has been supported by high world prices for exports and high interest rates and economic growth relative to other economies. Moreover, pressure on the US dollar to devalue has been finding an outlet in floating currencies such as the New Zealand unit.

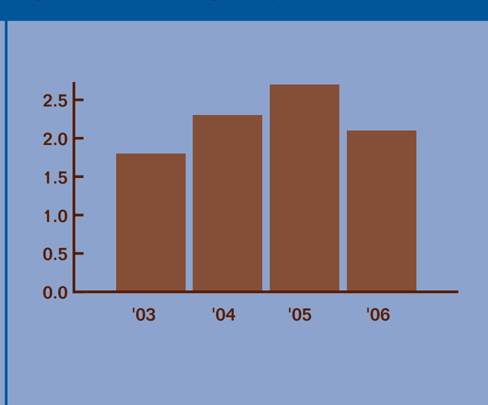
New Zealand's export performance in 2004 was solid despite the rise in value of the currency. Growth of 5.2% in the year to December 2004 was supported by solid demand and higher world prices for New Zealand's major export commodities. World prices for dairy and meat, which make up a third of the country's exports, hit historically high levels in 2004.

Robust growth in consumption, employment and profits contributed to an expansion in

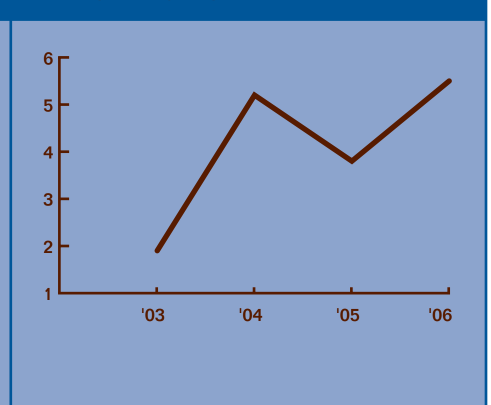
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



government surpluses in 2004. The government recorded a $7.4 billion operating surplus (5.3% of GDP) in the year to June 2004. Part of this has been used to reduce debt so that net government debt declined to 10.8% of GDP in June 2004, compared with 13.1% a year earlier. Households, on other hand, have expanded their debt positions in the past year to fund their way through the recent housing boom and to drive consumption spending. We estimate New Zealand households' consumption exceeded net disposable income by around 10.5%.

OUTLOOK FOR 2005 AND 2006

Growth is forecast to ease from 4.8% in 2004 to a more moderate 2.9% in 2005, with a further slowing to 2.4% in 2006. Net inflows of migrants, which have been a key component of growth in recent years, will decline throughout 2005. Growth in household spending will be subdued, but remain relatively firm compared to growth in other sectors of the economy. At the same time, moderate growth will be supported by continued low unemployment and rising wages. We forecast private consumption growth of 4.9%, year-on-year, in 2005 before declining to 3.4% in 2006.

The current investment boom will continue in the short term, helping to relieve capacity constraints. However, easing profit growth and reduced pressure on productive capacity will see investment growth tail-off in the second half of 2005, with overall year-on-year real growth in investment (excluding residential investment) of 6.1%. Residential investment will slow more rapidly than other investment. We forecast a 14% decline in residential investment in 2005, followed by a 0.6% decline in 2006. Total investment is forecast to record modest year-on-year growth of 2.1% and 0.4% in 2005 and 2006 respectively.

Exporters will continue to record solid volume growth despite a softening in demand among some major trading partners. Exports are forecast to grow 3.8% in 2005 and 5.5% in 2006. High world prices for our commodities are expected to persist for some time and a gradually depreciating NZ dollar will contribute to strong export revenues in the medium term.

Despite a slowdown in growth we expect tightness in the labour market to continue. As a result, the unemployment rate is forecast to decline to 3.4%, seasonally adjusted, in the December 2005 quarter, before rising to 3.6% in the December 2006 quarter. The lagged effect of low unemployment will pass through into increased wages in late 2005 and early 2006. Wages are forecast to rise 3% and 4.5%, year-on-year, in 2005 and 2006 respectively.

Easing domestic demand growth and the current capital expansion will help curb domestic price pressures at the same time as a strong New Zealand dollar will keep tradeable inflation at bay. As a result, consumer price inflation is forecast to peak at 3.1% in the year to March 2005, before declining to 2.2% by the December 2005 quarter. Wage inflation will, however, keep inflation in the top half of the Reserve Bank's 1-3% target band – averaging 2.4% annual inflation over the next two years.

Downward pressure on the currency from a ballooning current-account deficit will be partly offset by a weak US dollar. Thus, the New Zealand dollar is forecast to remain strong in the short term, before depreciating gradually over the medium term. The current-account deficit is forecast to reach 6.5% of GDP by year-end 2005. In 2006 the deficit will be pegged back slightly to 5.7% of GDP by slowing domestic demand, a depreciating currency, and export growth.

RISKS

Our forecast for economic growth represents our central view on a range of outcomes we consider possible. Key risks to the forecast for growth include

A decline in the terms of trade. A substantial fall in world prices for our key export products or further increases in the world price of oil will erode a key driver of future economic growth. A fall in the terms of trade is likely to see the New Zealand dollar decline more than expected. This could force up interest rates, reducing growth below the level forecast.

A greater ballooning of the current-account deficit, either via a fall in the terms of trade or from greater-than-expected imports. This may cause the New Zealand dollar to fall more sharply and/or further than forecast. This could halt the current boom in investment sooner than anticipated, reducing growth directly. Also, the resulting tradeable inflation from the depreciating currency would push up interest rates, depressing growth below that forecast.

A higher level of household savings than expected. The level of household dissaving is forecast to widen. However, a loss of consumer confidence could result in less desire to accumulate debt – prompting more saving from current income, less consumption and slower growth.

A larger increase in labour market participation than forecast, leading to more employment growth and stronger household spending.

Stronger labour productivity growth than forecast, following the rapid capital expansion currently taking place.

12 PERU

Elmer Cuba, *Macroconsult S.A.*

2004: PRICE SWINGS DOMINATE

Preliminary figures show the Peruvian economy grew 5.1% in 2004, led by growth in exports (15.2%) and private investment (9.4%). Exports were boosted by the sharp increase in prices of commodities such as gold and copper. In addition, agricultural and textile exports benefited from higher US demand. Throughout President Toledo's administration, exports have been the main factor in economic growth, highlighting a large positive impact coming from a healthier world economy. In fact, the value of exports in 2006 could be double the level in 2001, when Mr. Toledo came into office.

Investment has remained sluggish. In spite of a large increase in private investment in 2004, public investment increased by just 2.8%. Moreover, gross domestic investment stood at 18.5% of GDP, slightly lower than the 2003 level of 18.8%. Therefore, potential GDP growth was lower than real GDP growth, thus reducing the GDP gap. This means that in the coming years there will be less space for above-trend growth, meaning that unless investment picks up in the short term Peru will experience lower growth rates.

Inflation remained under control last year, at 3.7%. This was higher than in 2003 (2.3%), but that was largely due to higher oil prices and a domestic drought that led to lower agricultural output. Despite these shocks, the Central Bank's inflation target was met for the third consecutive year. Exchange rate developments played a big role in this situation because the sol rose against the US dollar by 1.9%, which helped reduce inflationary pressures. There were two main reasons for the sol's rise. First, solid external accounts showed a balance of payments surplus of 3.4% of GDP. This was mainly due to a large trade surplus. Second, exchange rate expectations have dramatically changed in the last couple of years. This has led to a higher demand for soles and lower demand for dollars as businesses have been switching their portfolios from dollar-denominated assets to sol-denominated assets. Therefore, broad money denominated in soles grew 24% on average, while broad money denominated in dollars just grew 3% on average. This means that Peru's economy has been trending toward a lower percentage of dollars in the economy.

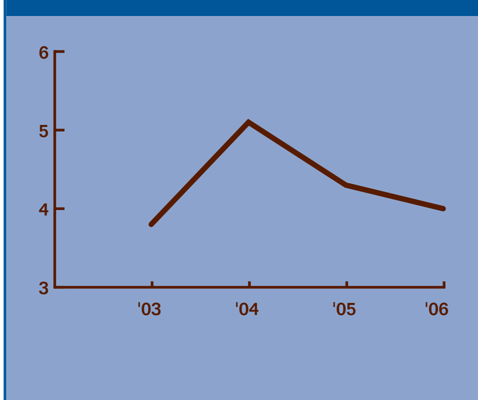
According to Peru's Central Bank, the sol's appreciation has been mostly related to the second factor. Since the appreciation was due mainly to speculation, the Central Bank responded with strong interventions in the currency market aimed at reducing exchange rate volatility. During 2004, the Central Bank bought US$2.3 billion, which amounts to almost 85% of the monetary base. This, in turn, has led to a large increase in international reserves. The Central Bank, however, seems have ignored the first reason for the sol's appreciation – the balance of payments surplus. Recent developments in the Peruvian economy show that the exchange rate needs to fall further in order to attain its long-term equilibrium level. The fact that this has not yet happened has largely been due to the Central Bank's interventions. Moreover, currency interventions have only increased in 2005, as the pressures in the currency market have strengthened.

Peru's monetary policy is guided by an inflation targeting scheme. The Central Bank's goal is to keep inflation in check. This means that the exchange rate ought to float. As long as the Central Bank continues to intervene at its current pace, there is a potential conflict between its explicit goal (controlling inflation) and its implicit goal (maintaining the exchange rate at a reasonable level).

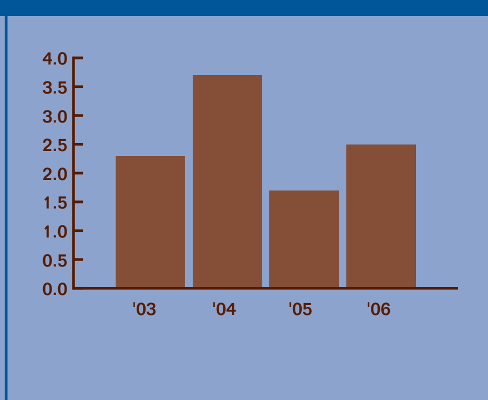
Meanwhile, fiscal policy was austere. The primary balance rose from 0.4% of GDP in 2003 to 1% in 2004, thanks to an increase in public revenues and a fall in non-financial public expenditure. The overall balance closed at –1.1% of GDP, down from –1.8% in 2003.

Nevertheless, there are still some risks. Fiscal revenues displayed very solid growth in 2004. In part, this was due to important efforts by the government to increase revenues. However, the extraordinarily high revenues may not be sustainable. First, as noted, real GDP has been growing much faster that potential GDP. This means that some of the increase in revenues comes from favourable cyclical developments, and may not be sustainable. Second, the government has also introduced a number of transitory taxes, which are due to expire in late 2006. Therefore, we can expect a significant fall in public revenues in 2007. On the other hand, public expenditure management has been very prudent. Non-financial public expenditure amounted to 15.7% of GDP in

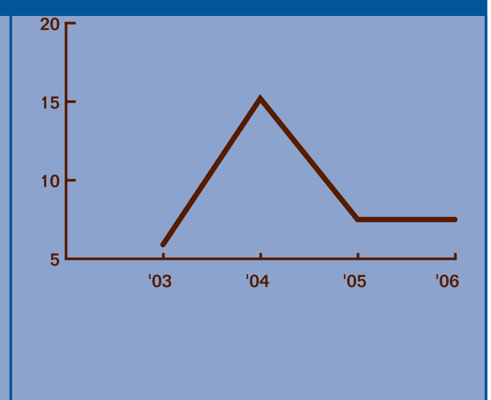
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



2004, down from 16.1% in 2003. Better results in the fiscal accounts have softened the impact of public debt, so Peru's bonds are on the path to achieving investment grade. Therefore, fiscal accounts show lower risks than they did a few years ago.

ECONOMIC POLICY ISSUES

Exchange rate appreciation during 2004 was related to the depreciation of the US dollar. The US currency has been losing value against most other currencies, especially those that float freely. As long as this trend is mostly related to the deep imbalance in the US economy, it is possible that this situation could persist despite further rises in interest rates by the US Federal Reserve. For the Peruvian economy, both factors which drove up the sol in 2004 are likely to continue in 2005. The balance of payments surplus will shrink, but it will still be largely positive. Moreover, domestic portfolio changes are likely to continue, as exchange rate expectations trigger a further reduction in the volume of dollars in the economy.

However, there is a strong likelihood that inflation will fall below the Central Bank's target. Thus, it is likely that the Central Bank will attempt to keep interest rates stable throughout the year, leading to lower capital inflows. Such a policy would open negative spreads between domestic interest rates and ever-rising international interest rates, softening appreciation pressures. Therefore, there is a rather strong likelihood that the sol will start to lose strength against the dollar, although at a very slow pace.

On the other hand, the risk of further appreciation should not be dismissed. As stated, an exchange rate equilibrium is still probably below current levels. Moreover, we have to count the possibility that Central Bank currency interventions could attract international speculative capital. As market pressures point toward an appreciation of the exchange rate, speculative capital might start flowing in with the expectation that the Central Bank could eventually give up its defence of the exchange rate. It is possible that this is already happening, as the Central Bank has strengthened its interventions.

Massive interventions are causing financial losses for the Central Bank. International reserves denominated in US dollars earn interest rates close to 1.5%, while Certificates of Deposit (instruments used by the Central Bank to reduce liquidity in soles after its currency interventions) pay interest rates close to 4.5%. These losses might well trigger a move from dollar-denominated international reserves toward euro-denominated assets.

In any case, it is very likely the sol will gain further strength against the dollar. In this scenario, those whose assets are denominated in dollars would incur significant financial losses. In spite of the current trend toward so-called "de-dollarization," some 64% of deposits in banks are still denominated in the US currency. The appreciation would mainly affect households, which seem to have been slow to move their assets away from dollars. Nevertheless, the impact should not be too strong since most households receive sol-denominated income. On the other hand, most firms and banks seem insured against financial losses, as they have already diversified their portfolios away from dollars. In addition, exports could slow down a little, but the negative impact would probably be matched by a boost in domestic demand.

OUTLOOK FOR 2005-06:

The economic outlook will be dominated by presidential elections in April 2006. It is still too soon to predict who will run in the elections, since most political groups are still in the process of forging alliances that allow them to participate. Discussions regarding negotiations for a Free Trade Agreement (FTA) with the US are also going to be at the political forefront. Talks should conclude this year, and most politicians are likely to focus their political agendas on this issue. Meanwhile, there seems to be quiet support among politicians for the FTA, but that could change as political pressures from interest groups gain strength. Should the FTA be signed, there would be a significant boost to investment and exports, leading to higher growth in the following years.

On the other hand, the government has already showed signs of its intention to increase public spending in coming months. The target for the fiscal deficit stands at 1% of GDP, just below last year's result, so it should not be to hard to attain. But, as noted, the government apparently does not intend to achieve that target and President Toledo seems to be calling for a change in the fiscal target. The first sign of this is a program announced to give direct subsides to poor families. In principle, it is not a bad idea but there are serious issues in designing such a program, not the least of which has to do with conducting a census to properly identify the poor.

In any case, Peru's economy will remain solid in the period. We estimate that Peru's GDP will rise 4.3% this year, boosted by external demand. Exports will grow 7.5%, a slower pace than last year, but still a significant increase. Regrettably, household incomes will keep growing rather slowly, so political pressures will remain.

13 PHILIPPINES

Cayetano W. Paderanga Jr., *CIBI Information, Inc.*

RAPID GROWTH DESPITE DEBT FEARS

The year started with uncertainty as people had varying expectations on the outcome of the May presidential elections, which ultimately returned the Arroyo administration to office. In her first State of the Nation Address for her second term (her first by direct election rather than succession), the President pointed to the worsening fiscal and debt situation as the country's most urgent problem. This alarm was based on the steadily increasing share of debt to national output. By the end of 2004, the national government's debt was equivalent to 73.4% of GDP. As a whole, consolidated public sector debt was more than 130% of GDP.

The administration targets a balanced-budget by 2010. To meet this target, it proposes a number of measures to wipe out the deficit in its Medium-Term Fiscal Program. The eight-points of the agenda are:

- Adoption of gross income taxation
- Indexation of excise tax on tobacco and liquor
- Excise tax on petroleum products
- Rationalization of fiscal incentives
- General tax amnesty with submission of Statements of Liabilities
- Lateral attrition system
- Franchise tax on telecoms
- Review of the Value Added Tax (VAT) system

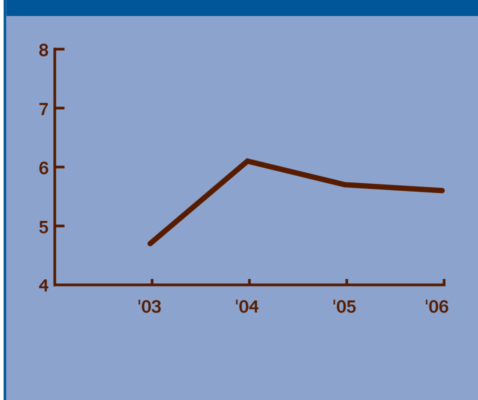
Of the eight measures, only three have been approved by the legislature. The government was able to push Congress to pass the long-debated law raising "sin taxes," that is, excise tax on tobacco and alcohol. Although the original version of the bill proposed the indexation of the excise tax to inflation, the final version failed to do so. The increase in the "sin taxes" is expected to raise Peso15B in 2005. The "lateral attrition" bill was passed in January 2005. The law aims to provide incentives to revenue-collecting agencies and is expected to increase collection by Peso10B. The more important revision of the VAT, which is currently at 10% with exemptions on some goods and services, proved to be much more contentious. After much negotiation, a VAT bill was passed in May that removes exemptions now enjoyed by sectors such as power generation and oil companies starting in July; gives President Arroyo the power to raise the VAT rate next year to 12% from 10% if VAT collection exceeds 2.8% of GDP this year, or if the budget deficit exceeds 1.5% of 2005 GDP; and raises corporate income tax to 35% from 32% starting 2006 before cutting it to 30% in 2009. The VAT changes should raise Peso28-31B this year, and as much as Peso105B in 2006 if the president raises the rate.

While 2004 was perceived as a difficult period, the Philippine economy proved its resiliency as it ended the four quarters with 6.1% growth in GDP notwithstanding the challenges that came from the fiscal deficit, oil price hikes, and natural disasters that severely affected several areas of the country late in the year. The growth was the highest since 1988, when national output growth hit a high of 6.6%. The 16-year high GDP growth was fuelled by the growth of all three major sectors of the economy — agriculture, industry and services. Although the picture was clouded by fourth quarter growth, which slowed to 5.4%, the lowest for all quarters, the overall economic expansion came on the back of favorable weather conditions and in general, strong global economic growth.

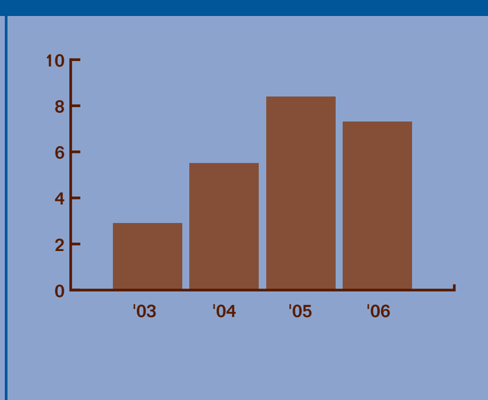
Services proved to be the strongest performer as they contributed 47% of total GDP. All of its sub-sectors posted positive growth, but the gain was led by trade, transportation, communications and storage (TCS) and private services. The telecommunications industry, contributing 51% to TCS growth, continues to expand as a result of the increasing spending on mobile communications services, both through phone subscriptions and Short Messaging Services. The industry and agriculture sectors contributed 2 and 1 percentage points to total GDP growth, respectively. Increasing from 3.8% in 2003 to 5.3% in 2004, the growth of the industry sector can be attributed to the strong performance of manufacturing and construction and, along with utilities, effectively offset the negative growth of the mining sector. On the other hand, agriculture, fishery and forestry (AFF) ended 2004 with a 4.9% growth, led by fishery, up by 1.1 percentage points from its 2003 performance.

On the demand side, consumer spending

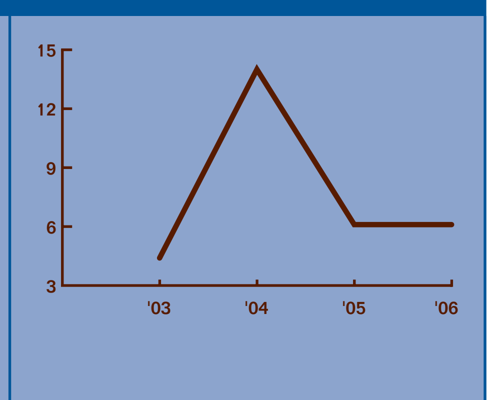
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



continued to drive the domestic economy, on the back of election-related activities last May, improved farm production and income, higher overseas worker remittances and sustained growth in the use of mobile phone services. Exports grew by 14% from 2003, while imports slowed to 6.3% growth from 10.2%.

OUTLOOK FOR 2005

For this year, the budget deficit remains as the country's biggest challenge. The government has lowered its 2005 deficit target from Peso184.5B to Peso180B following the strong economic performance in 2004. Although the lower-than-expected deficit figures for 2004 can be taken as an indication of government efforts to address the deficit, more serious action and focus on reforms are required, especially in the face of the expected global economic slowdown this year.

Most economists foresee robust growth for 2005, but at a slower pace than in 2004. This can be partially attributed to an expected slowdown in consumption by Filipinos as a result of the imposition of higher taxes and successive oil price increases. The increased consumer spending last year was due partly to election-related activities and improved farm production and incomes. In the absence of heavy election spending and with the possible adverse impact of the El Niño (expected to hit the country this summer), personal consumption expenditure is likely to ease this year. Nevertheless, it will remain one of the main drivers of the economy, as the remittances of the overseas Filipino workers have continued to rise by an annual average of 9% since 2000.

High interest rates are also expected to temper growth. The recent oil price increases may raise inflation more than expected, and this, together with an increase in volatility, is expected to increase uncertainty premiums on borrowing. Moreover, this may also affect real interest rates. As the Fed continues to raise interest rates, market expectations will most likely force the Central Bank to raise its rates to prevent capital flight.

On a positive note, the rather modest economic and political expectations for 2005 have been offset by the strengthening of the local currency as investors continue to be encouraged by the progress on fiscal reforms. It is important to note, however, that the rally of the local currency is mainly due to an influx of "hot money" as reflected by the rise in the Philippine stock market. Moreover, the positive economic outlook for the year depends on the sustained growth momentum of 2004's industry winners. We forecast that the services sector will still remain a primary growth driver for 2005, as its usual winning sub-sectors — telecommunications, trade and finance — continue their bullish growth. Tourism is also expected to have bright prospects while overseas remittances will provide support for the property market, particularly low to medium-cost housing.

Industry, forecast to grow at a modest rate in 2005, will most likely be propelled by the resurgence in construction. The impact of the flow of foreign investments to the mining industry may only be felt by 2006. On the other hand, agriculture, expected to suffer from the impacts of El Niño, will most likely slow from its 4.9% growth rate of last year.

Business expectations for investment and trade remain positive, but the mood is not as upbeat as in 2004 due to limited public investment and lower exports. The end of the Multi Fibre Agreement and softer demand in the industrialized countries, particularly for electronic products, has prompted the National Economic Development Authority to cut the projection for export growth this year from 10% to 8%, with electronics products still leading the way. Nevertheless, other trade developments such as the Early Harvest Program with China and the Japan-Philippines Economic Partnership Agreement will most likely boost the agricultural sector's export performance as they guarantee market access to Philippine products. Foreign investment inflows for 2005 will most likely enter through the IT, mining, infrastructure and energy sectors.

The year will call for careful and calculated economic and fiscal policies from the Arroyo administration as the country tries to weather a relatively unfavorable global economic climate and internal fiscal pressures. Recent ratings downgrades from three international agencies has sharply and painfully underlined the need for faster reforms. Although implemented fiscal policies have prevented the further expansion in Philippine bond spreads, it is still insufficient to earn an upgrade in the country's debt rating. In addition, the credit downgrades imply that borrowing for investments may be mostly sourced domestically.

Although fiscal problems still remain the priority of the administration, there is also an urgent need to improve the environment for private investment, should the government expect these inflows to push growth. A 2005 joint survey of the Asian Development Bank and the World Bank revealed investors' perception of weaknesses in the Philippines' investment climate in four primary areas: (1) weak macro-economic fundamentals; (2) corruption; (3) the lack of adequate infrastructure, especially in transportation and power sectors; and, (4) onerous business procedures and regulations.

14 SINGAPORE

Toh Mun-Heng, *National University of Singapore*

2004: STRONG RECOVERY

Singapore's GDP grew by 8.4% in 2004 amid relatively buoyant economic conditions in regional economies and developed industrial nations. The high growth achieved compared to the 1.4% recorded for 2003, is a reflection of the robust recovery from the adverse impact of the SARS epidemic. The expansion of the economy during the year was broad based, with every sector attaining higher growth rates or a slower contraction rate.

Favourable external economic conditions led to a 20% increase in exports. Domestic exports and re-exports grew at a faster pace of 20% and 22% respectively. The good export performance was due to strong demand for both electronics and non-electronic goods. Electronic valves, data processing machines and telecommunications equipment were the major items contributing to the expansion of merchandise exports, while travel services led the list of service exports. Strong external demand was complemented by expansion of domestic demand. In contrast to a contraction in government consumption expenditure of 1.6%, private consumption expenditure surged by 6.4%, fueled by the higher take-home pay and increased propensity to purchase cars by households due to a reduction in the excise on car imports. Meanwhile, private investment expenditure registered positive growth of 13.9% after three consecutive years of contraction. This reflected a return of confidence among investors: the outflow of domestic capital to foreign destinations has somewhat stabilized.

Looking at sectoral performance, the wholesale/retail trade sector achieved the highest growth rate of 14.6% on the back of a strong recovery of tourism and buoyant domestic demand. More than 8.3 million foreign visitor arrivals were recorded at the airports and seaports in 2004, a 36% increase compared to the previous year, with notable increments coming from China, Australia and New Zealand. The upturn lifted tourism-related industries like hotels and restaurants and transport and communications to high growth rates of 12.4% and 9.1% respectively. Stable and growing regional economies also underpinned increases in external trade and business transaction. Offshore financial services, as well as trading in Asian Currency Units enabled the financial services sector to expand by 6%.

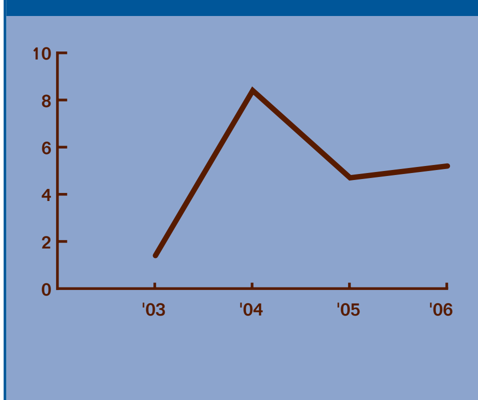
Singapore's ability to buttress itself as an important player in intra-industry trading and globalized production contributed to the resilience of the manufacturing sector to record growth of 13.6% in 2004. Biomedical manufacturing, electronics and transport engineering were the main contributors to the double digit growth rate. The promotion and development of Singapore as a logistic hub has also provided impetus for growth in the transportation sector. As one of the world's largest container ports, Singapore handled 21.3 million TEUs in 2004, a 16% increase in thoughput compared to the previous year. The construction sector continued to contract, though it is reckoned that companies in the sector secured civil engineering and construction projects overseas to earn income and contribute to Singapore's GNP.

In tandem with the good GDP growth performance, employment conditions in the economy improved significantly. Total employment grew by 71,400, more than recovering the job losses totaling 35,900 over the preceding three years. Average monthly earnings grew by 3.6%, which is more than twice that recorded in the previous year. The unemployment rate declined from 4.7% in 2003 to 4% in 2004. Cost cutting, consolidation and restructuring of business plans boosted labour productivity by 6.7% and helped reduce the unit labour cost by 4%. This, in turn, helped to rein in incipient inflationary pressure. Another factor that helped to dampen price increases, despite higher oil prices, was the change in policy stance[1] by the Monetary Authority of Singapore to allow the Singapore currency to appreciate gradually. It appreciated by 4.1% against the US dollar over the year. The inflation rate for 2004, measured by the change in CPI, was 1.7%.

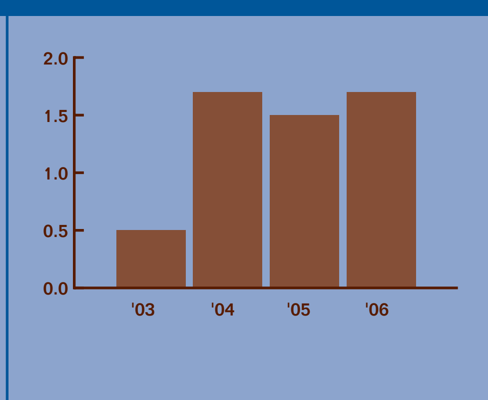
OUTLOOK FOR 2005 AND 2006

The Singapore economy is undergoing a structural review and transformation in response to new challenges posed by globalization in technology and production as well as keen competition from dynamic emerging economies such as China and India. As Singapore is lacking in natural resources, it has to rely on strong domestic infrastructure and a workforce that needs to be honed to capitalize on the opportunities offered by the external

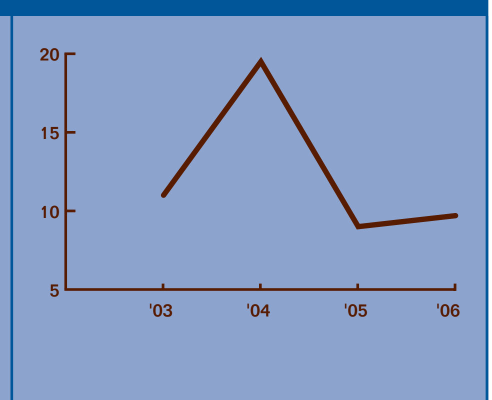
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



environment. The government has expended much effort in helping companies and workers to cope with such keen international competition and rapid technological change.

FISCAL POLICY STANCE

Far from non-intervention, the government believes in short-term discretionary measures to even out adverse impacts caused by the international business cycle and changing economic trends. Fiscal policy is a key instrument for aggregate demand management. Broadly, Singapore's fiscal policy aims to promote sustained, non-inflationary economic growth by (1) ensuring a balanced budget over the medium term; (2) creating a fiscal environment that supports investment, entrepreneurship and job creation; (3) building capabilities for longer-term competitiveness. In the process, the domestic capabilities and business environment are continually reviewed and improved. There are several instances in the past where off-budget measures have been implemented: cutting the CPF (social security contribution) rate to lower overall business costs in the 2001 recession; providing rental rebates and special help to tourist sectors during the SARS and Avian flu outbreaks in 2003 and 2004 respectively.

Meanwhile, there are also steps being taken to help displaced workers to upgrade their skill through re-training and improving labour market information by holding job fairs and establishing job matching portals through the Internet. For three consecutive years, the government budget was 'prudently' in deficit to seed growth momentum; this is being continued in 2005.[2] Government surpluses in the past have been used to build and upgrade infrastructure, enhance human capital and add to the stock of foreign reserves which in turn are invested abroad to generate income.

INFRASTRUCTURE & RESTRUCTURING FOR GROWTH

There were several initiatives undertaken in 2004 that will have impact on the economic performance of the economy in the next two years and beyond. Starting with measures to develop entrepreneurial talents, in addition to other schemes, a grant was set up in July 2004 to foster entrepreneurship through "learning by doing." Over the next five years, $25 million has been allocated to Institutes of Higher Learning to co-invest in their students' business ventures. Since its launch, seven student business ventures have been funded at a sum of $290,000. The corporate tax rate has been reduced to 20%, and new tax legislation allows companies that are making losses in the current year to claim partial reimbursement of tax paid in the previous year. Under the Local Enterprise Finance Scheme (LEFS), SMEs can seek assistance in acquiring fixed productive assets and working capital loans to upgrade and expand business operations. A total of 2,967 new companies benefited from LEFS in 2004.

In anticipation of growing travel demand in Asia, the Civil Aviation Authority of Singapore (CAAS) has undertaken a series of infrastructure upgrades. Terminal 2 at Changi Airport is undergoing a $240 million facelift and construction of a third terminal is on track to be completed by 2008. This will increase Changi's handling capacity to 64 million annually. Furthermore, runways, aero-bridges and baggage handling facilities are progressively modified to accommodate new high-passenger volume aircraft like the A380 which will begin commercial operation in 2006. Meanwhile the CAAS has restructured the franchise fees for ground-handling businesses, which will result in additional saving in business costs for operating airlines.

The competitive landscape in the air transport industry in Southeast Asia has recently been buffeted by the advent of low cost carriers (LCC) — budget airlines. Singapore is not immune to this new challenge. In 2004, a total of nine new airlines including three Singapore carriers (Valuair, Tigers Airways and Jetstar Asia) started operations at Changi Airport, while 15 new city links were added. A terminal dedicated for use by LLC operators is under construction. Currently, Singapore is discussing with Australia the implementation of an "open skies" agreement which is expected to provide travelers an even wider choice of connections and boost air travel. Also with the aim of increasing traffic performance, the CAAS has introduced a $40 million Growth Incentive Scheme, which will last for two years from January 2004. This performance-based scheme rewards airlines for increasing their passenger traffic to and through Changi Airport.

The Economists Intelligence Unit (EIU) ranked Singapore as the seventh most e-ready nation in the world. Third generation licences have been successfully rolled out, and market entry barriers for local leased circuits have also been lowered, reducing telecom costs to businesses and end-users. This is expected to provide a fillip to growth in the telecommunications sector. A three-year, $10-million plan was launched in May 2004 to develop Radio Frequency Identification (RFID) technology. It aims to build five RFID-enabled supply chain clusters by 2006 by bringing together manufacturers, logistic service providers, retailers, infrastructure providers and solution providers in the high-tech aerospace, pharmaceutical and fast moving consumer goods sectors.

Pushing the manufacturing sector into high-tech activities is vital for the sector's competitiveness and as an important source of income growth and employment. The Collaborative High-Tech Manufacturing Plan introduced in March 2004 aims to improve efficiency of high-tech manufacturing industry and promote higher value-added activities. The plan targets building within five years, 10 infocomm-enabled integrated supply chains to automate the exchange of business process information which will strengthen linkages between companies in these supply chains. Similar development has occurred in the retail sector with the setting up of the Retail eSupply Chain Management Ecosystem for management of stock.

Taking into account both external influences and domestic efforts to sustain growth, the Singapore economy is expected to grow at a rate of 4.7% in 2005, and at 5.2% in 2006. The inflation rate is expected to remain low at 1.5% for 2005 and 1.7% in 2006.

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[1] *Policy stance before 1 April 2004: a 0% appreciation path for the S$ nominal effective exchange rate.*

[2] *The budget deficit as a percentage of GDP was 1.1% in 2002, 1.6% in 2003 and 0.8% in 2004. For 2005, it is projected to be 0.4% of GDP.*

15 CHINESE TAIPEI

Miao Chen, *Taiwan Institute of Economic Research*

2004: GROWTH MOMENTUM RETURNS

The global economic upturn in 2004 helped Chinese Taipei to regain its economic growth momentum. An increase in world demand stimulated industrial output and exports, which also helped to encourage private consumption and capital investments. As a result, both the employment market and the financial market performed better than expected.

Riding on the back of a very strong recovery of 2003, GDP growth for the first quarter of 2004 was a very vibrant 6.72%, with exports of goods and services and fixed capital formation growing at 20.27% and 13.63% respectively. Then the uncertain political landscape following the presidential election of March 2004 caused the financial market to plummet. Luckily, this was short lived. The strong global cyclical upturn persisted and production output and exports remained bullish. Aided by the government's financial reform bill and a low base point as a result of the SARS epidemic in 2003, GDP growth in Q2 was better than expected at 7.88%, year-over-year (yoy). Exports of goods and services and fixed capital formation grew by 25.02% and 19.44% respectively. The strong global expansion and bullish domestic demand translated into GDP growth of 7.3% in the first half of 2004. The increase was higher than expected partly due to the change in the base year of calculation, from 1996 to 2001.

The economic performance for the second half of 2004, however, was less upbeat for a number of reasons. First, the soaring oil price has far more implications than the rise in the price of energy, especially when some 99% of total energy consumed in Chinese Taipei is imported. Secondly, China's economic tightening measures introduced in April 2004 had far reaching implications for Chinese Taipei given China's importance in the local economy's bilateral investment and trade. Thirdly, the US Fed's consecutive increases in interest rates dented business confidence as the cost of borrowing went up.

The customary booming third quarter for Chinese Taipei was repeated in 2004. Exports of goods and services grew by 15.06% and fixed capital formation grew by 13.72% in Q3. GDP growth for the third quarter was 5.27%, which is marginally less than previously forecast. The softer economic activity was due to a slowing external sector as well as the phasing out of the SARS-related low-base effect. The fourth quarter saw a sharp decline in GDP growth to 3.25%. According to the Directorate General of Budget Statistics and Accounting figures, the decline was due to lower-than-expected manufacturing output as well as lower exports of goods and services. In an effort to curb inflation, as well as to keep in line with the Fed's interest rate hike, Chinese Taipei's central bank raised interest rates in October to 1.25%, the first increase in four years. The final quarter data suggests that despite relatively strong domestic activity, an external sector slowdown is imminent.

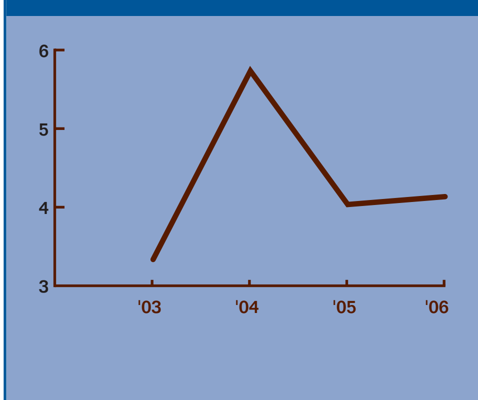
Taken as a whole, 2004 saw the highest economic growth since 1998, estimated at 5.7%. Most notably, manufacturing production, that makes up just over a quarter of the total GDP, grew by 9.36% yoy. Consumer prices increased by 1.6%, a figure that was dampened by the appreciating New Taiwan Dollar as well as softer oil prices toward the end of 2004.

Economic indicators pointed to a further slowdown due to sluggish external sector growth. The indicator of Business Climate of the Manufacturing Industry of the Taiwan Institute of Economic Research (TIER) was on the decline throughout the second half of 2004. Business monitoring indicators of the Council for Economic Development and Planning of the Executive Yuan, that include both financial sectors and real sectors, saw a yellow-red light from December 2003 to September 2004 (except for an overheating in May), signalling a fast expansion for the first three quarters of 2004. For the last quarter however, the Indicator flashed green, which indicates a slowing down of the expansion.

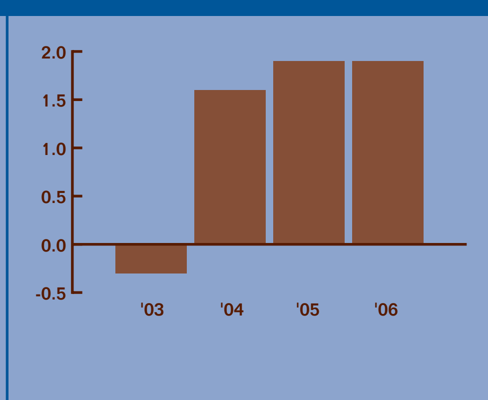
OUTLOOK FOR 2005

The soaring oil price, the continual interest rate hikes by the Fed and uncertainties associated with China's economic tightening measures, look to dampen world economic growth in 2005. All major international

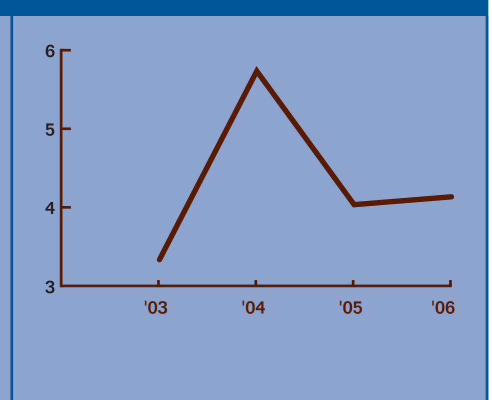
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



forecasting agencies agree that 2005 will see slower economic growth than 2004. Being a small, open economy that relies heavily on trade, this will noticeably affect Chinese Taipei's economic outlook for 2005. *Global Insight* has lowered its growth forecast for Chinese Taipei from 5.8% in 2004 to 4% in 2005. Other agencies including the World Bank and IMF have similar projections, with 5.8% and 5.6% for 2004 and 4.3% and 4.1% for 2005 respectively. In short, with external sector growth slowing, Chinese Taipei is expected to see more subdued economic growth for 2005.

On the external front, exports are expected to slow in line with a global economic downturn. The increase in exports of goods and services is expected to slow to 4.39% in 2005, from the 2004 level of 15.27%. In the same way, private consumption is expected to dampen from 3.13% to 2.94% in 2005, according to the latest TIER forecast. While large-scale private investment projects are expected to continue over into 2005 from the previous year, the growth rate is expected to ease from an extreme high of 28.2% in 2004 to a more sustainable 8.81%.

A number of policies were put in place in order to better deal with the fast-changing global climate facing Chinese Taipei. For cost-push inflationary pressure, the inter-Ministerial price monitoring taskforce that met in September 2004, has introduced a number of measures: 1) switching from "loose" to "neutral" monetary policy; lowering tariffs on energy and consumer goods imports; 2) adjusting the price for public utilities based on consumer affordability, economic climate and business profitability; and 3) the petroleum industry has been asked to avoid supply risks as well as increasing emphasis on energy efficiently for the long-run.

In terms of domestic factors, the improvement in the employment outlook has helped to stimulate domestic demand. Furthermore, there are a number of infrastructure developments worth some US$15 billion by the Chinese Taipei Government and a further US$6 billion by private sector investors planned over the next five years, including the improvement of infrastructures and construction of a new high-speed railway system. These fiscal stimuli are expected to sustain Chinese Taipei's economic growth momentum.

The latest figure from TIER's monthly survey of the manufacturing sector paints a very buoyant picture. The February figure showed the proportion of manufacturing firms that perceived business would be as least as good as currently, if not better, for the next six months soared from 26.97% in January to 54.6%. The number of firms that believed the economic outlook was worsening declined from 18.2% in January to 8.5%. Most businesses surveyed (91.5%), agreed that the business outlook for the next six-months will be as good as the business climate now, if not better! The composite indicator, after adjustment for seasonal factors on moving average, rose to 101.40 points, up from 100.55 in the previous month.

With domestic economic prospects remaining bullish, the TIER forecast for GDP growth in 2005 is an upbeat 4.03%.

RISKS AND UNCERTAINTIES

There are a number of uncertainties that might affect the economic outlook for Chinese Taipei. First, the implementation of the Kyoto Protocol at the beginning of 2005, is expected to have a great impact on Chinese Taipei's industry, in areas such as iron and steel production, petrochemicals, cement, paper pulp and synthetic fibre industries. Even though Chinese Taipei is not a party to the agreement, the government is committed to further reduce its carbon dioxide emissions. There may be costly consequences for local industries.

The fiscal deficit is another issue for concern. The government deficit has increased rapidly over the last decade as the government found it increasingly difficult to raise enough revenue to cover its outgoings. With its declining tax base, the Chinese Taipei Government will need to find ways to raise enough capital in order to maintain its public projects or risk loosing its economic growth momentum.

Thirdly, the non-performing loans (NPL) can be another area of great risk. The NPL ratio in the banking sector has been greatly improved from 8.8% in 2002 to 3.2% by the end of 2004. However, community financial institutions still saw a NPL level of 10.7%. This needs to be improved to maintain financial and social stability.

Fourthly, the economy is over exposed to a faltering technology industry. A decline in external demand might change the entire economic makeup of Chinese Taipei. Furthermore, as a highly export sensitive economy, Chinese Taipei's central bank is averse to a stronger New Taiwan Dollar, which also might affect export growth.

Last but not least, the political outlook might also affect economic development. The 2005 budget was finalized in Parliament in January 2005. The opposition parties rejected the government's plan to privatize several state-owned enterprises as well as forcing through some major spending cuts. The partisan bickering during the budget negotiations look to impede future economic policy-making and that can only cloud Chinese Taipei's economic outlook for 2005.

16 THAILAND

Pattama Teanravisitsagool, *National Economic and Social Development Board*

2004: DOMESTIC-LED STRONG GROWTH

The year was marked by continued expansion in economic activity, maintained economic stability, and an appreciable gain in employment despite temporary adverse impacts on the economy throughout the year. In Q1, Thailand was hit by an avian influenza epidemic; unrest in the three southernmost provinces turned more violent in Q2; and the impact of drought was seen in Q4 along with the tsunami on December 26. However, underpinned by accommodative monetary policy, favourable financial conditions, rising farm prices and higher corporate profits, household spending remained buoyant and businesses increased investment in capital equipment and machinery and inventories, despite the restraint imposed by surges in oil prices. In 2004 the tourism sector also rebounded from the SARS scare of 2003. Meanwhile public investment picked up significantly after many years of retrenchment.

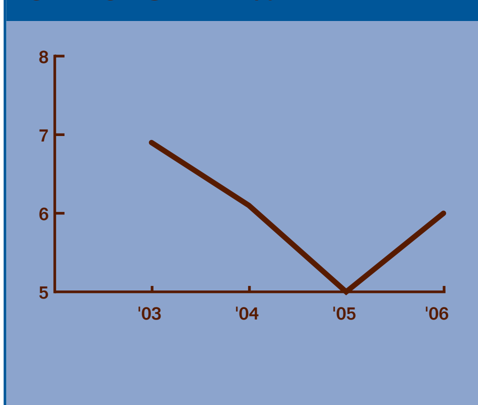
The economy grew by 6.1%, based predominantly on domestic demand. Real private consumption expanded by 5.6%, contributing 3.1 percentage points to real GDP growth. Private investment measured at 1988 price rose by 15.3%. In the public sector, government expenditure increased by 4.1% in real terms while public investment enjoyed a rapid growth of 11.7% from 2003, the first year of expansion since 1998. Private and public investment combined contributed approximately 3.0 percentage points to growth. In all, domestic demand contributed 6.4 percentage points to economic growth in 2004.

The faster increase in imports than exports led to a negative contribution of net exports of goods and services to GDP growth. Net exports of goods and services trimmed about 1.1 percentage points from real GDP growth compared to the 0.7 percentage points added in 2003. As the world economy peaked, 2004 was indeed one of the best years for Thai exports. In nominal terms, exports of goods reached US$96B, 23% higher than that in 2003. Due to the recovery from 2003's SARS epidemic, tourism revenue improved significantly, resulting in a 20.3% increase in service receipts. In real terms, exports of goods and services rose by 7.8%, with 7% growth in exports of goods and 11.2% growth in services receipts. On the other hand, imports of goods surged by 26.9% in US dollar nominal terms, led primarily by imports of oil and capital goods, in large part attributable to price rises. Over the year, import prices jumped by 13.4% on average, much faster than the 7.2% increase in 2003. Service payment also increased by 16.8% from an abnormal low base in 2003. In real terms, imports of goods and services rose by 12.1%, with 12.1% growth in exports of goods and 12.3% growth in service payments. Despite the rapid increase in import price, 2004 was the third year since 2002 that Thailand gained in its terms of trade.

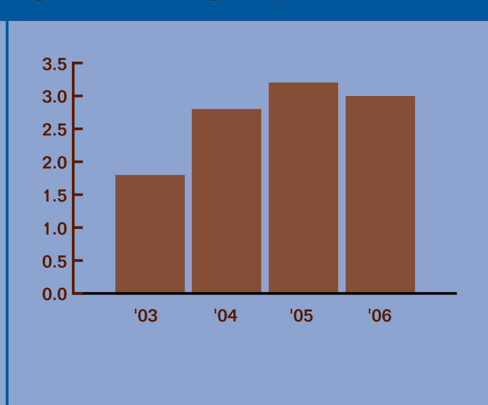
Various indicators suggested that economic stability was successfully maintained. Consumer price inflation was driven higher in 2004 by the sharp rise in energy prices, but core consumer price inflation, which excludes food and energy prices, remained well contained. The headline inflation was 2.8%, compared to 1.8% in 2003. Core consumer price inflation moved up somewhat from unusually low levels recorded in 2003, but it remained well contained at 0.4%. General price increases were restrained by severe competition from China, improving productivity, the oil price subsidy, and the stronger baht, all of which helped offset the effects of higher energy and commodity prices. Public debt ratio to GDP declined continuously to 47.8% as of December 2004. The current account remained in surplus of US$7.29B, or 4.5% to GDP, thanks to the surplus in the services account of US$5.6B, which greatly eased the pressure caused by the rapid deterioration of trade surplus. International reserves stood at US$49.8B as of December 2004, which was equivalent to 4.4 times short-term foreign debt. Supported by healthy economic fundamentals and the weaker US dollar, the exchange rate appreciated slightly and averaged at Baht 40.3:US$1.

Although economic activity increased substantially in 2004, the expansion appeared to soften as 2004 ended, in large part because households as well as corporations stabilized their spending amid rising interest rates and oil prices. Over the latter half of the year, it became clear that the expansion of economic activity was softening, judging by the quarterly growth of 6.7%, 6.4%, 6.1% and 5.1% in the four consecutive quarters. In response to continued rising household debt and expected higher core inflation, the Monetary Policy Board at its August meeting began to reduce

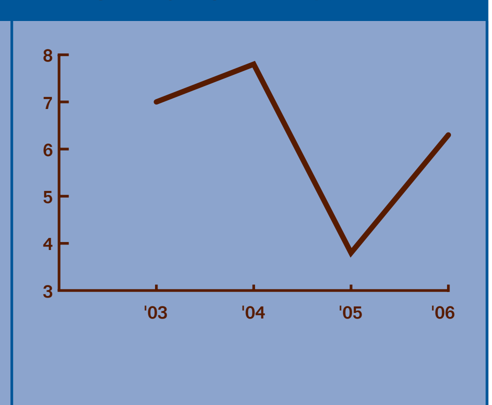
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



the substantial degree of monetary accommodation that was in place. The gradual removal of monetary stimulus continued in its October and December meetings as the economy expanded at satisfactory rates, and inflation picked up rapidly.

OUTLOOK FOR 2005 AND 2006

The moderate pace of growth in 2004 will continue in 2005 amid high oil prices and a slowing world economy at a time when Thailand continues to face the impacts of drought and the tsunami. However, the fundamental factors underlying the continued strength of the economy in 2002-2004 should carry forward into 2005 and 2006. Despite the rising trend of interest rates, monetary policy is still relatively accommodative, and financial conditions generally continue to be advantageous for households and firms. Profits have been rising steadily in the past 3-4 years and corporate borrowing costs are low. The capacity utilization rate has been in the range of 70-75% on average and this will prompt demand for further capacity expansion. Corporate balance sheets have been healthier as continued economic recovery has gradually improved the asset quality. Listed companies' return on equity has turned from a negative number in 2000 to over 20% in 2004. Similarly, the interest coverage ratio increased from a negative ratio to over three times in 2004. The improved profitability and interest rate coverage will provide a better assurance to banks as they extend private credit in 2005 and 2006. For the banking sector itself, after years of intensive balance-sheet repair, government assistance and economic recovery, several of the big banks are becoming healthier and enjoying a higher effective interest rate spread. Despite the Bank of Thailand's tightened loan classification rules, average non-performing loans (NPL) of financial institutions have continuously declined to around 10.92% in Q1/2005. The Bank of Thailand has set an ambitious target of NPLs ratio to reach 2% by the end of 2006.

Under the government's scheme of economic restructuring and logistics improvement to enhance competitiveness and sustain long-term growth, an ambitious infrastructure spending plan worth approximately Baht1.7 trillion over the next decade should start to play a bigger role from 2005 onwards. Higher investment from both private and public sectors should be the main drivers for growth in 2005 and 2006. Although there have been some delays in the contracting process for some projects in 2005, it is expected that infrastructure development will accelerate in 2006 led by projects to improve mass transit in Bangkok and vicinities. Also, there is a clear commitment toward renewing momentum in the privatization process, which in turn signals a commitment to economic restructuring as well as to greater corporate discipline. In sum, key investment themes for 2005 and 2006 are revival of infrastructure spending, stable recovery in the investment cycle, and progress in corporatization of state-owned enterprises.

Consumer spending is likely to moderate, continuing on from the latter half of 2004. Faster investment expansion and the further increases in public sector salaries should trigger higher growth in private consumption in 2006 than in 2005. Moreover, the high savings rate and relatively low household indebtedness mean there is room to tactically support private consumption over the next 1-2 years. Although household debts have been rising, households have accumulated more real estate assets as well as gains in their value. However, there has been growing concern over increasing credit card spending. According to the Bank of Thailand, 8.65 million credit card accounts were outstanding at the end of 2004, an increase of 28% from the year before. Credit card spending in 2004 was Baht 118.456B, up 25.5%, with 3% debt overhang. To prevent higher bad debt, credit card issuers are encouraged to make use of information under the National Credit Bureau more efficiently in managing risks. Credit scoring has also been recommended to improve credit worthiness appraisal.

On the external front, exports of goods are projected to moderate as the world economy slows. However, recovery from the tsunami disaster is expected to be fully fledged by mid 2006, with a boost to tourism income. With a new high equilibrium price of oil, Thailand, which is heavily import dependent, will face a higher import bill, jeopardizing the trade balance. A trade deficit is expected to persist throughout 2005 and service receipts will have to increase more strongly if a current account surplus is to be maintained in 2005 and 2006.

The economy is projected to grow by 5% in 2005 with the bias toward downside risks, particularly oil prices, world growth and the tsunami impact on tourism. Growth is projected to accelerate to 6% in 2006 as investment gains momentum and tourism enjoys a full-fledged recovery. Various indicators point to continuing stability, namely manageable inflation, ample reserves, and decreasing short-term foreign debt and public debt. Inflation rates are projected at 3.2% and 3.0% in 2005 and 2006, rising from 2.8% in 2004 in response to continuing pick up in demand and cost-push factors like rising commodity and oil prices. The average crude oil price — Dubai quoted — is assumed at US$45/barrel for 2005 and US$40/barrel in 2006, up from US$34.23/barrel in 2004. However, the flow-through effect on consumer prices of higher raw material and commodity costs has a lagged impact due to price controls and intense competition.

RISKS AND UNCERTAINTIES

The key risks associated with the economic outlook in 2005 and 2006 are mainly rising oil prices and slowdown in the world economy. With rising private credit, the monetary authority will need to keep a close watch on credit allocation. The key areas to be closely monitored will be credit card spending, the real estate sector and stock market performance. However, with the removal of government measures to stimulate the real estate sector, progress in the operation of National Credit Bureau, close monitoring of credit card spending, more stringent criteria imposed on loan classification, economic stability will be constantly in check. As for the fiscal stance, the government is determined to balance the government budget from FY2005 onward.

17 UNITED STATES

Saul H. Hymans, *University of Michigan*

2004: ANOTHER STRONG YEAR

The economic recovery from the 2001 recession really kicked into high gear in 2003 and 2004. The economy grew by 3% in calendar year 2003 and followed that with 4.4% growth in real GDP in 2004 — well above the 3% average of the past 25 years. Both years featured strong growth in domestic final demand, especially in 2004 when domestic demand contributed 4.6 percentage points to the overall GDP growth rate. GDP was further boosted by an 0.8 percentage point contribution from production for export and another 0.4 percentage points from inventory accumulation. However, a huge jump in imports, which contributed a negative 1.4 percentage points to GDP growth, held the final tally of domestic production to a "mere" 4.4% growth. US demand for final goods and services increased quite a lot last year, but proportionately, demand for imports increased even more.

After a "no change" in the job count in calendar 2001 and two years of job losses thereafter — even in 2003 when real GDP grew by 3% — the job count finally posted a healthy increase in 2004, which saw a gain of 1.5 million jobs for the year and even more, 2.1 million jobs, from 2003 Q4 to 2004 Q4. The latest reading on jobs, the count of 132.8 million for February, is 300,000 above the pre-recession jobs peak attained in January 2001. By 2004 the ability of employers to tease more and more output out of fewer workers had about run its course. That, plus renewed business confidence in the strength of the expansion, produced a sharp jump in jobs.

EARLY 2005

The best evidence we have is that the domestic economy has remained strong in the first half of this year, though it is clearly not accelerating. A few examples make this point. The Michigan Index of Consumer Sentiment edged down to 94.1 in February 2005 and survey director Richard Curtin noted, "The small decline recorded in February hardly changed the positive level of confidence that still prevails" among American households. Sentiment among the nation's independent businesses remains at least as robust, according to the National Federation of Independent Business. NFIB's February survey reports that the Small Business Optimism Index is "...unchanged from January's solid reading of 103.7" with "no sign of weakness in the domestic economy ... [and] job creation plans strengthened again, eclipsed only by readings [from] the late 1990s and early 2000." Finally, the Institute of Supply Management's March 1 report on the state of manufacturing begins with the heading:

"New Orders, Production Growing, Inventories Contracting."

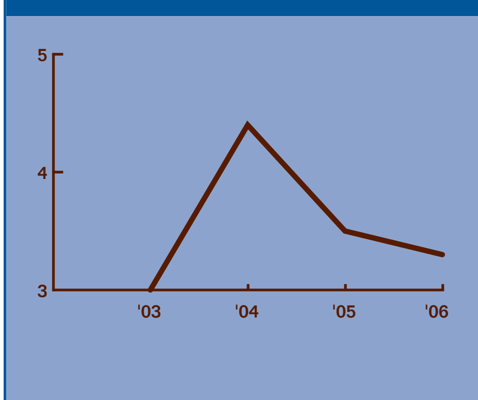
It then notes, "February was another good month in the manufacturing sector. While the ... rate of growth is slowing, the overall picture is improving... Customers' inventories declined slightly, reinforcing the probability that inventories are not yet a concern."

FISCAL AND MONETARY POLICIES ON A NEW TRACK

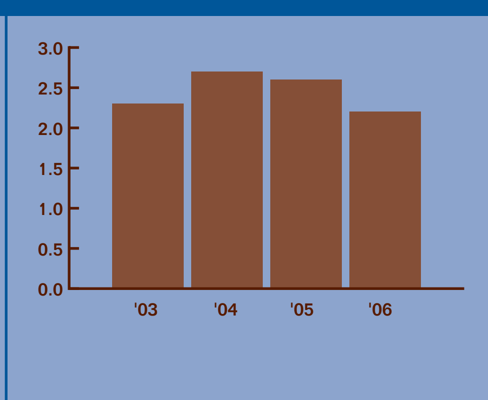
The federal budget was highly stimulative in 2003, but less so in 2004 as expenditure growth eased and the phasing in of the Bush tax cuts was virtually complete. Looking ahead, the federal budget now appears to be on an approximately neutral path vis-à-vis economic stimulus. This does not imply that the federal budget deficit — which reappeared in fiscal 2002 and hit an all-time record $381.3 billion (NIPA basis) in fiscal 2004 — is disappearing. It is expected to improve a little in the next few years — we are anticipating a decline in the deficit to about $305 billion for fiscal 2007 — but then it is likely to worsen again later in the decade, depending on the permanence of the Bush tax cuts, Social Security financing and other contentious budget reforms now under discussion.

While fiscal policy has already hit approximate macroeconomic neutrality, monetary policy is still heading that way. Although the Federal Reserve has raised the federal funds rate by 150 basis points since last June and is likely to

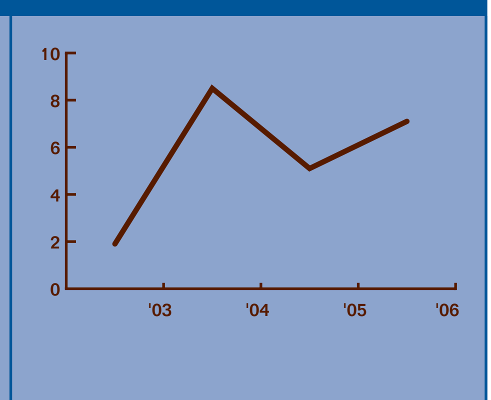
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



add another 100 basis points by the end of this year, that will take the funds rate to just $3^1/_2$%. That level for short-term interest rates is consistent with an end-of-year mortgage rate of about $6^1/_2$% and a 10-year T-bond rate of about 5% — long rates which are not likely to do much harm to housing activity, business investment, or the car market. After all, the mortgage rate averaged $7^3/_4$% and the T-bond 6.4% from 1992 through 1998.

Consistent with the current forecast of continued firm economic growth and declining unemployment through 2006 and into 2007, we anticipate further increases in the federal funds rate next year and a 2006 year-end level of $4^3/_4$%. (That is about the value that the fed funds rate had declined to in 1999 before the Fed started to raise rates to slow the economy). This path describes a monetary policy that continues to move interest rates up along a trajectory which the Fed has been characterizing as a *measured pace*. We judge that such a policy of moderate rate increases can continue over the next two years, absent an unanticipated and sustained step-up in the rate of the economic expansion and/or a significant inflation shock. Indeed, we are expecting that the policy of raising rates at every FOMC meeting that has been in place since last June will end soon — probably after the funds rate hits 3% — which explains the slower pace of increase in short rates during the second half of this year and 2006, compared with mid-2004 to mid-2005.

ECONOMIC GROWTH ABROAD

Economic growth among the nation's major trading partners and the path of exchange rates are the major determinants of the US export market. Nearly 60% of US exports is accounted for by five trading partners — Canada, Mexico, Japan, the U.K. and Germany — and we track their GDPs very closely. In terms of a trade-weighted average of their real GDPs, these five countries grew at an average annual rate of 3.6% per year during the five-year interval 1995 Q4-2000 Q4 — significantly above their long-term average of $2^1/_2$% during 1980-2004. Real exports grew at a healthy 6.6% pace during those same five years. The next three years, 2000 Q4-2003 Q4, produced a slowdown to a growth rate of just $1^1/_2$% for the five-country average GDP, and US exports fell at a rate averaging about 1% per year. Growth abroad then picked up to a currently estimated 2.8% during 2004, a bit above trend for the five-country average.

Based on the best information we can gather from the consensus of individual country analysts, we are assuming that economic growth abroad will continue at this 2.8% pace over the course of the next several years. In combination with a continuing depreciation of the US dollar over the same period, this is expected to provide a significant growth in US exports; specifically, a 6% growth of real exports during this year and an acceleration to 7.4% during 2006.

THE 2005-2006 OUTLOOK

Propelled by strong initial conditions, including still very low interest rates and pretty solid growth abroad, the economy is projected to post a 3.5% growth rate in the first half of 2005 and to ease off to 3% growth during the second half of the year. Healthy gains in consumer demand and some rebuilding of inventory stocks pace the growth of real GDP in the first half of 2005. Business investment in equipment slows during the first half as the boost from temporarily higher depreciation provisions comes to an end. The moderate slowdown during the second half of this year will result from several cross-currents. The contribution from business investment moves back up, but residential building and inventory accumulation ease back and net exports take a bigger bite out of the growth rate.

Growth edges back up again to a 3.3% rate for calendar 2006, reflecting somewhat stronger consumption growth and a strong, steady contribution from business capital investment, including commercial and industrial construction. This growth pattern goes along with continued job gains — just over 2 million this year and another 1.8 million next year — and a slow decline in the unemployment rate to a 5.1% average for calendar 2006 and to 5% or less by late '06.

Core inflation remained exceptionally low in 2004, with the core CPI increasing by just 1.8% for the year. But with oil prices up by 33% (to a calendar year average of $41.40/barrel), the all-items CPI was up by 2.7%. Core inflation is forecast to move up this year, with the core CPI increasing by 2.2%. Oil prices are forecast to be up again, but by less than last year (to a $49.40/barrel average), so the all-items CPI will be up by 2.6% for 2005, little changed from 2004. With oil prices expected to be down in 2006 (to a $41.25/barrel average), overall CPI inflation is forecast at 2.2% for 2006, while the core rate of inflation accelerates to 2.6%.

AN ECONOMIC CONCERN RECYCLED

The federal budget seems to be surfacing as the major concern *du jour*. After 28 straight years of annual deficits (NIPA basis, fiscal years 1970-97), the federal budget registered a string of four surpluses in 1998-2001. The budget returned to red ink in fiscal 2002 and has now registered three straight deficits, with the largest over $381 billion in FY 2004. Two questions come naturally to mind: 1) Why the return to deficits? and 2) Why is it a problem?

The first question has a straightforward answer. The Bush administration, with Congressional cooperation, put a series of large tax cuts on the books in 2001, 2002 and 2003 at significant direct cost to revenues. The terrorist attack of 9/11 stimulated reactions that raised federal spending dramatically for homeland security and related activities, along with the war against terrorism waged in Afghanistan, and the much bigger war to depose Saddam Hussein in Iraq. Although these were the major factors turning the budget around, there were others as well, including the revenue losses due to the collapse of the stock market bubble in the second half of 2000 and the mild recession of 2001.

The second question has a much more complicated answer, or set of answers. Fiscal deficits do not cause much of a problem unless they are large and persistent. A deficit is simply spending in excess of income, which is another way of saying demanding more resources than contributing. A bit of that — meaning a small amount relative to the size of the economy — is acceptable because its effect is swamped by the rest of the economy, which tends to be less profligate. But if enough of that goes on long enough, it eventually puts pressure on prices and interest rates and that causes a number of well-documented problems. So the question becomes: Are the deficits big and persistent? One common indicator of whether a federal deficit is large is how much it is driving up the federal debt. Since the government has to borrow to finance the deficit, its outstanding debt rises whenever there is a deficit. And if that deficit manages to raise the debt relative to the size of the economy, that's a big deficit.

Data relevant to this matter are contained in the table, covering five-year intervals from 1985 through 2000, plus the four years 2001-2004. Back in fiscal 1985, the privately held federal debt outstanding amounted to $1,338.2 billion, or 32.3% of GDP.[1] The deficits of the 1980s and 1990s drove the debt up to 44.9% of GDP by 1995. This was a period during which there was mounting concern about the deficit, but policies begun under the first President Bush and continued by President Clinton got control of the deficits and by 2001 the debt had fallen back to 27.6% of GDP. Indeed, the absolute size of the debt itself declined from $3,286 billion at the end of fiscal 1995 to $2,779.7 at the close of fiscal 2001.

The reappearance of budget deficits is once more generating concern. The debt outstanding is climbing again and reached $3,607 billion at the end of fiscal 2004. Even more importantly, the deficit is big, as indicated by the fact that it is driving the debt up relative to GDP. After bottoming at 27.6% in 2001, the debt rose to 31.2% of GDP in fiscal 2004. The debt ratio is

FOREIGN OWNERSHIP OF U.S. GOVERNMENT DEBT* AND INTEREST (SELECTED FISCAL YEARS, 1985-2004)

	U.S. GOVERNMENT DEBT			INTEREST PAYMENTS		FOREIGN OWNERSHIP	
Fiscal Year	Total Privately Held	Foreign Owned	Total Debt as % of FY GDP	Total	To Foreign Owners	% of Debt	% of Interest
1985	1338.2	222.9	32.3	166.2	23.0	16.7	13.9
1990	2207.3	463.8	38.5	232.1	40.2	21.0	17.3
1995	3286.0	820.4	44.9	285.0	51.5	25.0	18.1
2000	2936.3	1057.9	30.2	284.0	80.6	36.0	28.4
2001	2779.7	1005.5	27.6	267.8	84.3	36.2	31.5
2002	2924.8	1200.8	28.2	233.5	77.5	41.1	33.2
2003	3268.0	1455.8	30.1	216.6	72.1	44.5	33.3
2004	3607.0	1886.2	31.2	216.6	79.7	52.3	36.8

* Debt measured at end of fiscal year. Debt and interest in billions of $s.

Federal government debt outstanding rose from 32.3% of GDP in 1985 to 44.9% in 1995. From the mid 1990s to 2001, shrinking deficits and surpluses brought the debt ratio back down to 27.6% in 2001. The re-emergence of deficits has pushed the debt ratio back up to 31.2% of GDP. Meanwhile, foreign ownership of the debt has risen steadily, from 16.7% of the debt in 1985 to 36% in 2000 and to more than 52% in 2004; and foreign ownership of interest paid on the debt has gone up from 13.9% in 1985 to 36.8% in 2004.

nowhere near the 44.9% of 1995, but there is nothing on the horizon that suggests it's going anywhere but up in the foreseeable future. In the not-all-that-distant future, this could well be accompanied by enough competition for resources to begin producing upward pressure on prices and interest rates — to rekindle the inflationary process that plagued the late 1980s and early 1990s.

What's more, there is a budgetary time bomb out there. In about 2018 — a few years after the baby-boomer retirement gets under way — the Social Security Administration is going to have to start cashing in the government bonds that have been accumulating in its trust fund in order to pay retirement benefits in excess of its tax revenue from then-current workers. If the federal budget is still in deficit by then — and that appears likely — the US Treasury will have to float enough debt to finance both the operating deficit of the government and the bonds that are being cashed in by the Social Security Administration!

Lately, as shown in the table, progressively more of the federal debt has come to be foreign owned. In 1985, only 16.7% of the debt was owned abroad. Fifteen years later, in 2000, the foreign ownership share had risen to 36%, and just four years after that it had jumped to 52.3%. This is a problem for two reasons. First, with the rest of the world owning a larger share of the debt, it collects a larger share of the interest being paid on the debt. In 1985, 13.9% of the interest the federal government paid went abroad; in 2004, it was up to 36.8%.[2] The interest that goes abroad is a direct transfer of income from the US to the rest of the world. That has been rising, and the outlook is for it to continue to do so.

The second aspect of the problem of rising foreign ownership of US debt is perhaps the most complicated of all. Foreign ownership of US debt is, in fact, foreign investment in the US economy. There is now nearly $1.9 trillion in federal debt owned abroad, plus foreign investment in US stocks, corporate bonds, businesses, real estate, and the like. If foreign investors decide to diversify into other assets, a large amount of dollar-denominated assets could suddenly wind up for sale. In particular, think of the fall in bond prices and the resulting rise in interest rates if foreign owners decide to move out of US debt *en masse*. And think of how much cashing in of dollars for other currencies would suddenly flow through the foreign exchange markets, how fast the dollar might depreciate, and how that could induce a run on the dollar and a foreign exchange crisis. Not a pretty picture. It is not very likely, but it is certainly possible. And it's a risk to which the US economy becomes increasingly vulnerable as it issues more and more debt to finance a budget deficit that remains significant and persistent.

OTHER RISKS TO THE FORECAST

There are numerous uncertainties that could impact our forecast. In addition to the risks just discussed in connection with the federal budget and the foreign exchange market, we can cite the following additional risks:

Geopolitical Issues. Implicit in our forecast is a significant improvement in stability and security within Iraq in the coming year. This would allow US troop withdrawal to begin early in 2006 and would reduce the likelihood of continued disruptions to Iraqi oil production. This assumption may prove to be too optimistic.

The Price of Oil. The price of west Texas intermediate crude oil averaged $53.09/barrel in October 2004, retreated to $43.26/barrel in December, moved back above $50/barrel in late February, and flirted with new highs in March. In our forecast, the quarterly peak in the price of oil is $52/barrel in 2005 Q2. We have the price of oil down to $47/barrel in 2005 Q4, and the price hits bottom at $38/barrel in 2006 Q4. A few years ago, $20-$25 was thought to be the underlying equilibrium price. Is that no longer possible? Has stronger world demand, especially from China, revived OPEC's pricing power and raised the equilibrium permanently? Is there a significantly higher risk premium that's bound to continue for years to come? It is not hard to come up with scenarios that make our price path either too high or too low. There is real risk in the oil market and we could be wide of the mark either way.

An Inflation Surprise. The PPI for non-food, non-energy crude materials rose nearly 48% from 2002 Q4 to 2004 Q4, led by soaring prices for iron and steel scrap. We have assumed that the current cycle in crude materials prices will mirror the historical commodity price pattern. Soaring prices typically bring forth additional supply and a retreat in prices. But, just as rest-of-world growth has played a roll in pushing up oil prices, growing demand may also hold other crude materials prices up. The risk is that we may not yet be approaching the down side of the crude materials price cycle. In addition one hears more these days about the ability of firms to pass on price increases. The combination of rising commodity prices and a renewal of pricing power by firms has the potential to translate into an inflation surprise.

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1 *The gross federal debt exceeds the amount that is privately held. Most of the rest is composed of the debt held by the Federal Reserve, plus intragovernmental holdings, especially trust funds such as the $1,500 billion in the Social Security Administration's Old Age and Survivor's Insurance trust fund at the end of fiscal year 2004.*

2 *The foreign share of interest is less than the foreign share of debt because recent debt accumulation has taken place at interest rates that are lower than the rates applying to average (older) debt holdings.*

18 VIETNAM

Tran Kim Chung, *Central Institute for Economic Management*

ECONOMIC SITUATION IN 2004

There were some notable features in the preliminary indicators for 2004. GDP growth rate was 7.7%, with inflation at 9.5%, both of which were higher than estimated, especially the inflation rate. During the year, there were three negative and two positive factors that influenced economic growth and the level of inflation. The negative impacts were the outbreaks of bird flu, prolonged cold weather conditions and the increased price of input materials. These were offset to some extent by strengthened external economic conditions and the strength of investment.

The consumer price index increased by an unexpectedly high 9.5% compared to 2003. Consumption accounted for 5.48% of the GDP growth rate with the increase in consumption reaching almost 17.2%. Total domestic retail sale of commodities was up by 17.7% compared to 2003. This was accounted for mainly by the increased price of essential commodities such as food and input materials — construction materials, petroleum, metals, fertilizer and pesticides. Partly responsible for the situation was also the psychological factor of a pay-rise for nine groups of State salary earners starting from November 2004.

Total investment increased by 17.7%, to account for 36% of GDP. Investment from the State budget increased by 17.9%, to make up 23.5% of the total investment, while investment credit increased by 1.8%, accounting for 11.2% of the total. Investment by State-owned enterprises increased by 19.4%, making the source of 18.2% of the total investment. Investment by the individuals and private enterprises increased by 15.3%, accounting for 26.9% of the total investment, with foreign direct investment (FDI) up by 16%, to account for 17.09% of the total. Realized FDI was approximately US$2.8B. The estimated ODA disbursement was US$1.49B. The increased foreign investment could be attributed to the government's moves to apply National Treatment to foreign investors. As noted, private enterprises also increased investment, one response to the ongoing reform of the State sector which results in further opportunities for investment.

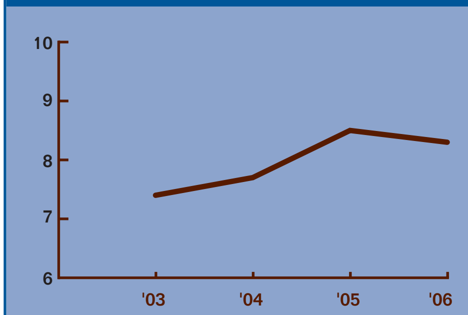
The export of goods increased by 28.9% compared with 2003. In part this can be attributed to the higher price of key commodities. The price of rice was up 27.7%, rubber 34.2%, crude oil 16.6%, anthracite coal 12% and cashew nuts 10%. In addition, shipments of a number of export products in various categories also increased. For instance, the increase in export turnover of wooden products was 85%, computer parts 60.2%, plastic products 39.2%, garment and textile products 17.1% and marine products 9%. Finally, world demand for Vietnam-made goods went up strongly in major markets (Japan 20%, China 57%, EU 25% and the US 27%).

Imports increased by about 25%. Firstly, international prices of several materials sharply increased causing consequent increases in import values (petroleum was up 30.4%, finished steel 36.9%, steel bar 41%). Secondly, there was an increase in the volume of imports used as inputs in production, resulting in an increase in the import turnover (petroleum 46.7%, raw plastic material 55.7%, steel 45.7%, steel bars 64.5%, raw materials for textile and garments and footwear 8.9%). The estimated surplus import volume was approximately US$5B, accounting for about 20% of the total export turnover. Net exports accounted for –0.6% of GDP, with the trade deficit at around US$2B.

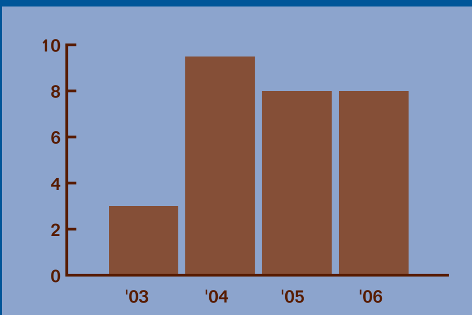
In 2004, there were significant changes in budgetary activities. Budget revenues increased by 17.4%, equivalent to about 23.4% of GDP. Domestic revenue increased by 23.8%; with revenue from crude oil production rising 18%. Budget expenditure increased by 16.7%. The proportion of expenditure for development investment was 28.6% of the total State budget, an increase of 15.7% compared to 2003. Overall, the budget deficit was roughly 4.9% of GDP.

During the year monetary policy continued to be loosened, but with caution. The increase in

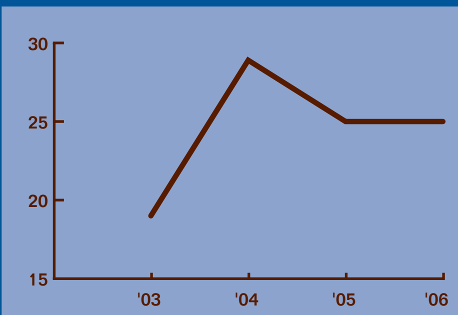
GDP GROWTH %



CPI INFLATION %



EXPORT GROWTH %



the total of payment instruments was 24.9%; credit volume was up 28.4% and mobilized capital 24% Credits to the non-State owned sector accounted for about 46% of the total credit advanced. The nominal devaluation of the Vietnam dong was 0.78%, which was much lower than the inflation rate.

OUTLOOK FOR 2005-2006

Economic growth rates for 2005 and 2006 are forecast at 8.5% and 8.3% respectively. The main source of this slightly higher growth will be the impact of the economic cycle. Investment, especially private and public, will increase. As these are the two last years of the State five-year planning period, growth will be promoted. Consumption will rise due to a likely increase in inflation, which should result in an increase in consumption expenditure. Exports will rise as a result of promotion efforts, while imports will increase due to both the increased volume of materials needed and the increased price of some imported goods.

The inflation rate for 2005-2006 will likely be steady at 8%. There are some reasons for an expected high inflation rate for 2005. Firstly, the price of imported materials (steel, fertilizer, etc.) will increase, leading to higher domestic prices. Secondly, increased investment will lead to increased consumption. Thirdly, with the pay rise for State salary earners, prices will likely increase as a result of increased demand. Consumption is expected to contribute 4.9% to the GDP growth rate for each of the years. Increased consumption will come from a greater sense of security, economic growth, and also partly from concern about inflation.

The investment increase will likely be 16% for both years as a result of efforts in attracting domestic and foreign investment and will contribute 4.3% and 4.3% to GDP growth rate respectively. Investment from the State budget will continue to increase due to efforts to promote growth in the last years of the planning period. Private investment will also go up as the investment environment will continue to be improved. As a result of strengthened integration, FDI will also rise.

Estimated net exports will probably account for -9% and -10% of GDP for the respective years. Exports are expected to increase at a steady 25% rate for both years as a result of strengthened integration (a prerequisite for accession to membership of the World Trade Organization). The import increase is also estimated to be 25% each year, driven by an increase in the volume of imported input materials and their increased prices. As a result of these movements, the deficit in the current account will continue at about 5% of GDP for each of the years. However, given the strengthened capacity of ODA disbursement and increased inflow of foreign exchange from overseas Vietnamese, the overall balance will still be positive.

RISKS AND UNCERTAINTIES

The most important risk is with the unpredictable price of petroleum. Too big a change will have unforeseeable impact on the economic indicators for the coming years as changes in petroleum price will create a chain effect on input materials for the economy. A second risk is with the price of agricultural products. As an exporter of agricultural products, any big changes in the price of shrimp or rice will largely influence the export of the products.

SOME INDICATORS FOR 2001-2006

	2003	2004	2005	2006
GDP growth rate (%)	7.24	7.7	8.5	8.3
Contribution of (%)				
Consumption	4.85	4.8	4.9	4.9
Capital formation	4.41	4.0	4.3	4.3
Government expenditure	2.0	2.1	2.0	2.0
Net exports	-2.20	-1.6	-2.0	-2.0
Errors and omissions	0.20	0.1	0.3	0.1
Agriculture growth rate (%)	3.20	3.5	3.5	3.4
As percentage of GDP	22.5	21.8	21.0	20.5
Industry growth rate (%)	10.34	10.5	13.5	13.0
As percentage of GDP	39.5	40.1	40.5	40.9
Service growth rate (%)	6.57	6.5	10.5	11.0
As percentage of GDP	38.2	38.1	38.5	38.6

A1 PEO ECONOMIES' TRADE MATRIX, 2003 (US$ MILLIONS)

Exports from	Australia	Brunei Darussalam	Canada	Chile	China	Colombia	Ecuador	Hong Kong, China	Indonesia	Japan	Korea, Republic of
Australia		28	1099	80	5929	50	9	1854	1863	12840	5253
Brunei Darussalam	369.59		2.68	-	294.78	-	-	2.42	112.9	1811.45	494.82
Canada	943	1		225	3215	215	104	799	321	5610	1312
Chile	98	/	414		1847	284	293	73	77	2247	1014
China	6263	34	5633	1283		398	239	76289	4482	59423	20096
Colombia	13	/	177	188	82		779	16	2	202	76
Ecuador	2.86		91.63	70.77	36.11	372.42		6.91	0.87	156.8	234.24
Hong Kong, China	2732	54	2927	277	95477	85	33		1001	12088	4570
Indonesia	1792	30	382	68	3803	46	12	1183		13603	4324
Japan	9966	97	7370	575	57480	575	257	29918	7179		34823
Korea, Republic of	3272	30	2682	517	35110	297	178	14654	3378	17276	
Malaysia	2614	318	606	58	6810	16	4	6784	2130	11222	3039
Mexico	199	/	3022	381	974	662	175	144	25	1173	188
New Zealand	3544	1	315	19	791	3	3	324	221	1788	572
Papua New Guinea	922.79	0.01	2	-	210.1	-	-	6.69	107.24	266.21	47.8
Peru	53.38	-	136.75	414.46	680.11	189.58	156.34	30.13	22.76	392.99	177.16
Philippines	407	3	319	9	2145	2	2	3094	296	5768	1314
Singapore	4681	462	433	19	10134	28	4	14423	/	9696	6058
Chinese Taipei	1884	12	1470	181	21416	128	67	28352	1513	11912	5880
Thailand	2168	42	943	109	5710	47	23	4332	2321	11435	1591
United States	13104	36	169481	2719	28419	3755	1448	13542	2521	52064	24099
Vietnam	1390	2	219	10	1323	5	4	315	378	2808	464

Source: International Monetary Fund, Direction of Trade Statistics, Yearbook 2004. Washington, DC: International Monetary Fund, 2004.
Republic of China, Bureau of Foreign Trade, Trade Statistics, 1 June 2005. http://eweb.trade.gov.tw/kmDoit.asp?CAT597&CtNode=649.

Malaysia	Mexico	New Zealand	Papua New Guinea	Peru	Philip-pines	Singapore	Chinese Taipei	Thailand	United States	Vietnam	World Total	Share of exports to PEO Economies (%)
1355	295	5220	547	35	619	2233	2428	1462	6141	275	70783	70.1
163.01	0.19	103.23	-	-	0.98	197.67	0.06	416.86	342.73	0.75	4422.2	97.6
342	1546	256	2	93	263	304	847	312	235241	58	271585	92.8
50	921	21	-	425	53	41	414	56	3468	17	21464	55.0
6141	3267	803	61	354	3094	8869	9005	3828	92633	3179	438250	69.7
1	358	3	/	395	6	11	52	8	6160	-	13092	65.1
1.15	54.13	17.64	-	160.74	0.23	3.62	3.6	2.76	2754.73	0.03	6492	61.2
1981	921	355	7	56	2227	4589	5436	2304	41780	979	223874	80.3
2364	238	156	34	22	945	5400	2233	1393	7386	468	60995	75.2
11250	3643	1825	43	233	9011	14858	31320	16043	117384	2623	473911	75.2
3852	2455	433	8	204	2975	4636	7045	2524	34369	2561	192750	71.8
	524	357	39	22	1437	16523	3777	4615	20540	827	104966	78.4
68		10	/	194	20	189	148	54	144466	/	164922	92.2
307	241		94	22	282	184	357	194	2370	92	16271	72.1
9.07	/	42.43		-	67.58	56.86	12	49.45	64	-	3599.5	51.8
5.53	108.59	3.74	-		11.12	16.2	147.98	26.82	2396.95	10.53	8859.3	56.2
2463	111	36	2	4		2431	2492	1234	7275	145	36225	81.6
22,793	719	573	253	11	3236		6897	6156	20570	2412	144121	76.0
3046	886	294	7	104.58	2300	4982		2565	25941	2664	144174	80.2
3887	413	267	21	20	1623	5876	2613		13691	1268	80521	72.5
10920	97457	1849	30	1707	7992	16576	17488	5842		1324	724000	65.2
332	-	37	-	1	276	931	412	305	4463		20371	67.1

A2 DIRECT INVESTMENT FROM AND INTO PEO ECONOMIES (US$ MILLIONS)

		1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Australia	*Outflow*	-1,942	-2,817	-3,267	-7,052	-6,368	-3,368	966	-829	-12,228	-7,393	-17,115
	Inflow	4,318	5,001	12,026	6,181	7,631	6,046	4,733	12,884	4,667	16,141	8,601
Canada	*Outflow*	-5,711	-9,303	-11,490	-13,107	-23,069	-34,112	-17,262	-44,487	-36,229	-26,461	-22,240
	Inflow	4,749	8,224	9,319	9,635	11,523	22,742	24,789	66,144	27,529	20,940	6,273
Chile	*Outflow*	-434	-911	-752	-1,133	-1,463	-1,483	-2,558	-3,987	-1,610	-294	-1,395
	Inflow	1,034	2,583	2,957	4,815	5,271	4,628	8,761	4,860	4,200	1,888	2,982
China	*Outflow*	-4,400	-2,000	-2,000	-2,114	-2,563	-2,634	-1,775	-916	-6,884	-2,518	152
	Inflow	27,515	33,787	35,849	40,180	44,237	43,751	38,753	38,399	44,241	49,308	47,077
Ecuador	*Outflow*	0	0	0	0	0	0	0	0	0	0	0
	Inflow	474	576	452	500	724	870	648	720	1,330	1,275	1,555
Hong Kong, China	*Outflow*	..	..	..	..	..	-16,985	-19,369	-59,352	-11,345	-17,463	-3,747
	Inflow	..	..	..	..	..	14,765	24,578	61,924	23,776	9,682	13,538
Indonesia	*Outflow*	-356	-609	-603	-600	-178	..	..	..	..	..	..
	Inflow	2,004	2,109	4,346	6,194	4,677	-356	-2,745	-4,550	-3,278	145	597
Japan	*Outflow*	-13,830	-18,090	-22,510	-23,450	-26,060	-24,620	-22,270	-31,530	-38,500	-32,020	-28,770
	Inflow	120	910	40	210	3,200	3,270	12,310	8,230	6,190	9,090	6,240
Korea, Republic of	*Outflow*	-1,340	-2,461	-3,552	-4,670	-4,449	-4,740	-4,198	-4,999	-2,420	-2,617	-3,429
	Inflow	588	809	1,776	2,325	2,844	5,412	9,333	9,283	3,528	2,392	3,222
Malaysia	*Outflow*	..	..	..	..	..	..	-1,422	-2,026	-267	-1,905	-1,369
	Inflow	5,006	4,342	4,178	5,078	5,137	2,163	3,895	3,788	554	3,203	2,473
Mexico	*Outflow*	..	..	..	..	..	..	..	..	-4,404	-930	-1,390
	Inflow	4,389	10,973	9,526	9,186	12,831	12,332	13,206	16,586	26,776	14,774	10,784
New Zealand	*Outflow*	-1,276	-1,725	337	1,533	45	-928	-803	-1,300	1,144	-185	-299
	Inflow	2,350	2,543	3,659	2,231	2,624	1,191	1,412	3,370	1,911	739	1,611
Peru	*Outflow*	0	0	-8	17	-85	-62	-128	0	-74	0	-60
	Inflow	761	3,289	2,557	3,471	2,139	1,644	1,940	810	1,144	2,156	1,377
Philippines	*Outflow*	-374	-302	-399	-182	-136	-160	29	108	160	-59	-158
	Inflow	1,238	1,591	1,478	1,517	1,222	2,287	1,725	1,345	989	1,792	319
Singapore	*Outflow*	-2,152	-4,577	-2,995	-6,234	-8,955	-380	-5,397	-6,061	-9,548	-4,082	-5,537
	Inflow	4,686	8,550	11,503	9,303	13,532	7,594	13,245	12,463	10,949	6,097	11,431
Chinese Taipei	*Outflow*	-2,611	-2,640	-2,983	-3,843	-5,243	-3,836	-4,420	-6,701	-5,480	-4,886	..
	Inflow	917	1,375	1,559	1,864	2,248	222	2,926	4,928	4,109	1,445	..
Thailand	*Outflow*	-233	-493	-886	-931	-580	-130	-346	23	-344	-106	-558
	Inflow	1,804	1,366	2,068	2,336	3,895	7,315	6,103	3,366	3,892	953	1,866
United States	*Outflow*	-83,950	-80,180	-98,780	-9,188	-104,820	-142,640	-224,930	-159,210	-142,350	-134,840	-173,800
	Inflow	51,380	46,130	57,800	86,520	105,590	179,030	289,440	321,270	167,020	72,410	39,890
Vietnam	*Outflow*	..	..	..	..	..	..	..	..	..	..	..
	Inflow	..	..	..	2,395	2,220	1,671	1,412	1,298	1,300	1,400	..

Note: .. Not available

Source: International Monetary Fund, International Financial Statistics, Yearbook 2004, Washington, DC: International Monetary Fund, 2004.
International Monetary Fund, International Financial Statistics Online. 12 May 2005. http://ifs.apdi.net/imf/

A3 NUMBER OF TOURIST ARRIVALS IN PEO ECONOMIES (THOUSAND PERSONS)

	1996	1997	1998	1999	2000	2001	2002	2003
Australia	4,165	4,318	4,167	4,459	4,930	4,856	4,420	4,354
Canada	17,285	17,636	18,837	19,557	19,624	19,683	20,057	17,534
Chile	1,479	1,736	1,759	1,626	1,741	1,722	1,412	1,614
China	22,765	23,770	25,073	27,047	31,220	33,156	36,803	32,970
Ecuador	494	529	511	509	615	641	654	...
Hong Kong, China	11,703	10,406	9,575	11,328	13,059	13,725	16,566	15,537
Indonesia	5,034	5,185	4,606	4,700	5,060	5,151	5,033	4,467
Japan	3,837	4,218	4,106	4,438	4,757	4,771	5,239	5,212
Korea, Republic of	3,684	3,908	4,250	4,660	5,322	5,146	5,347	4,753
Malaysia	7,138	6,211	5,551	7,931	10,225	12,781	13,292	10,577
Mexico	21,405	19,351	19,392	19,043	20,631	19,806	19,667	18,665
New Zealand	1,236	1,497	1,485	1,607	1,786	1,909	2,045	2,104
Peru	630	710	820	944	1,027	798	862	931
Philippines	2,049	2,223	2,149	2,349	1,992	1,796	1,933	1,907
Singapore	6,608	6,531	5,631	6,668	6,921	6,726	6,997	5,705
Chinese Taipei	1,938	2,372	2,299	2,411	2,697	2,616	2,978	2,248
Thailand	7,244	7,294	7,843	8,651	9,578	10,133	10,873	10,082
United States	46,489	47,752	46,395	48,491	50,965	44,900	43,525	41,212
Vietnam	1,600	1,750	1,520	1,782	2,100	2,300	...	...
World Total	599,035	619,718	636,676	656,933	687,300	684,100	703,000	690,900

Source: World Tourism Organization, Tourism Highlights*, various issues. 31 March 2005.*
http://www.world-tourism.org

A4 TRADE WEIGHTS, 2002-2004 AVERAGE (%)

	All economies	Excluding United States and Japan	East Asia	Latin America	Excluding East Asia
Australia	2.36	4.05			5.22
Canada	7.43	12.73			16.41
Chile	0.65	1.11		11.11	1.43
China	13.36	22.89	24.42		
Hong Kong, China	6.66	11.41	12.18		
Indonesia	1.40	2.39	2.55		
Japan	12.49		22.82		
Korea, Republic of	5.67	9.71	10.36		
Malaysia	2.80	4.79	5.12		
Mexico	4.92	8.43		84.36	10.87
New Zealand	0.52	0.90			1.16
Peru	0.26	0.45		4.54	0.58
Philippines	1.06	1.81	1.93		
Singapore	4.10	7.02	7.49		
Chinese Taipei	4.18	7.15	7.63		
Thailand	2.33	3.98	4.25		
United States	29.13				64.33
Vietnam	0.68	1.17	1.25		
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Note: Trade Weights are calculated as a ratio of each economy's total merchandise trade over the total merchandise trade of PEO economies.

Source: Compiled from World Trade Organization, Statistics Database. 31 May 2005.
http://stat.wto.org/Home/WSDBHome.aspx.

	Labour force growth rate (%)		Population growth rate (%)		Total fertility rate (births per woman)			Life expectancy at birth Male		Female		Population aged 65 & above (% of total)		
	86–96	96–02	86–96	96–02	1986	1996	2002	1986	2002	1986	2002	1986	1996	2002
Australia	19.7	8.6	14.3	7.4	1.87	1.80	1.75	72.9	76.8	79.2	82.5	10.3	11.8	12.4
Canada	17.0	6.7	13.2	5.7	1.67	1.59	1.52	73.2	76.2	79.8	82.4	10.4	12.2	12.8
Chile	28.1	18.1	17.8	8.1	2.39	2.50	2.15	75.3	73.3	...	79.4	5.9	6.7	7.3
China	18.6	5.6	14.1	5.2	...	1.80	1.88	67.0	69.0	70.0	72.4	5.3	6.5	7.2
Ecuador	37.7	17.6	24.5	10.2	...	3.60	2.76	...	68.3	...	73.5	4.0	4.4	4.9
Hong Kong, China	22.3	8.3	16.5	5.5	1.34	1.17	0.96	74.1	77.5	79.4	82.6	7.7	9.8	11.4
Indonesia	29.4	14.6	17.7	8.4	3.70	2.78	2.45	...	64.8	...	68.6	3.7	4.4	4.8
Japan	9.1	1.3	3.5	1.3	1.70	1.42	1.33	75.3	78.1	81.0	85.2	10.6	15.1	18.1
Korea, Republic of	24.8	9.7	10.5	4.6	1.62	1.70	1.45	...	70.5	...	77.5	4.4	5.8	7.3
Malaysia	36.5	19.4	30.9	15.0	...	3.30	2.85	...	70.4	...	75.3	3.7	3.9	4.3
Mexico	35.2	16.0	20.2	8.9	3.22	2.75	2.27	66.4	70.7	72.8	76.4	3.8	4.3	5.1
New Zealand	22.5	6.9	13.9	5.5	1.96	1.96	1.90	71.0	76.7	77.4	81.1	10.6	11.7	11.7
Peru	34.0	18.3	22.0	10.1	4.59	3.50	2.68	...	67.6	...	75.2	3.8	4.4	4.8
Philippines	30.9	19.0	25.9	14.4	4.20	4.10	3.24	61.6	67.9	65.2	71.7	3.0	3.5	3.9
Singapore	38.3	11.6	34.3	13.5	1.45	1.70	1.37	72.1	76.8	76.5	80.6	5.4	6.4	7.5
Chinese Taipei	17.2	7.1	10.4	4.6	...	1.80	1.40	73.1	75.7	75.9	78.8	5.3	7.8	9.0
Thailand	20.6	5.4	13.5	4.5	2.73	2.20	1.80	...	67.0	...	71.5	4.0	5.1	6.5
United States	14.9	8.2	12.2	7.0	1.84	1.98	2.01	71.2	74.7	78.2	79.9	11.9	12.5	12.5
Vietnam	26.7	11.9	23.3	8.2	...	3.70	1.87	...	67.3	...	72.2	4.5	4.8	5.3

Sources: United Nations, United Nations Common Database. 18 May 2005. http://unstats.un.org/unsd/cdb/cdb_help/cdb_quick_start.asp;
The World Bank, World Development Indicators Online Database. 21 April 2005. http://www.worldbank.org/data/;
Republic of China, Council for Economic Planning and Development, Taiwan Statistical Data Book, 2003. 11 May 2005. http://www.cepd.gov.tw;
Population Reference Bureau, World Population Data Sheet, 1996; and APEC, LMI Database. 21 April 2005. http://apeclmi.anu.edu.au/

A6 EXCHANGE RATES

	Australia	Canada	Chile	China	Ecuador	Hong Kong, China	Indonesia	Japan	Korea, Republic of	Malaysia	Mexico	New Zealand	Peru	Philip-pines	Sing-apore	Chinese Taipei	Thailand	United States	Vietnam
Jan-03	1.72	1.54	722.48	8.28	25,000.00	7.80	8,890.00	118.66	1,178.38	3.80	10.58	1.85	3.49	53.56	1.74	34.51	42.73	99.72	15,433.00
Feb-03	1.68	1.51	745.21	8.28	25,000.00	7.80	8,897.00	119.27	1,191.95	3.80	10.92	1.81	3.48	54.07	1.75	34.70	42.83	98.79	15,418.00
Mar-03	1.66	1.48	743.28	8.28	25,000.00	7.80	8,929.50	118.54	1,236.66	3.80	10.94	1.80	3.48	54.59	1.75	34.67	42.71	98.06	15,427.00
Apr-03	1.64	1.46	718.25	8.28	25,000.00	7.80	8,795.80	119.79	1,230.54	3.80	10.63	1.82	3.47	52.81	1.78	34.77	42.83	97.91	15,452.00
May-03	1.55	1.38	703.58	8.28	25,000.00	7.80	8,406.30	117.27	1,199.66	3.80	10.25	1.74	3.48	52.51	1.73	34.66	42.11	93.29	15,478.00
Jun-03	1.51	1.35	709.18	8.28	25,000.00	7.80	8,235.80	118.26	1,193.45	3.80	10.50	1.72	3.48	53.40	1.73	34.58	41.60	92.45	15,486.00
Jul-03	1.51	1.38	701.14	8.28	25,000.00	7.80	8,368.50	118.69	1,180.44	3.80	10.44	1.71	3.47	53.71	1.76	34.34	41.73	94.22	15,510.00
Aug-03	1.54	1.40	703.77	8.28	25,000.00	7.80	8,516.00	118.83	1,178.40	3.80	10.73	1.72	3.48	54.99	1.75	34.27	41.62	95.49	15,519.00
Sep-03	1.51	1.36	675.44	8.28	25,000.00	7.79	8,439.30	115.19	1,164.13	3.80	10.93	1.71	3.48	55.02	1.75	33.95	40.46	93.80	15,537.00
Oct-03	1.44	1.32	646.07	8.28	25,000.00	7.74	8,445.30	109.58	1,167.87	3.80	11.17	1.66	3.48	54.95	1.73	33.82	39.68	90.09	15,573.00
Nov-03	1.40	1.31	625.47	8.28	25,000.00	7.76	8,516.30	109.20	1,185.99	3.80	11.11	1.59	3.48	55.37	1.73	34.00	39.86	89.72	15,639.00
Dec-03	1.35	1.31	603.31	8.28	25,000.00	7.76	8,485.80	107.94	1,191.90	3.80	11.26	1.54	3.47	55.45	1.71	34.01	39.67	87.45	15,643.00
Jan-04	1.30	1.30	572.38	8.28	25,000.00	7.77	8,382.50	106.51	1,182.23	3.80	10.93	1.49	3.47	55.53	1.70	33.63	39.05	85.67	15,670.00
Feb-04	1.29	1.33	584.31	8.28	25,000.00	7.77	8,432.00	106.55	1,166.18	3.80	11.01	1.45	3.48	56.07	1.69	33.17	39.05	85.99	15,728.00
Mar-04	1.33	1.33	603.91	8.28	25,000.00	7.79	8,594.30	108.62	1,165.12	3.80	11.00	1.51	3.47	56.30	1.70	33.21	39.40	87.67	15,754.00
Apr-04	1.34	1.34	608.19	8.28	25,000.00	7.80	8,623.00	107.25	1,152.03	3.80	11.25	1.56	3.47	55.90	1.68	32.93	39.39	88.61	15,727.00
May-04	1.42	1.38	635.76	8.28	25,000.00	7.80	8,978.30	112.52	1,176.24	3.80	11.51	1.62	3.49	55.85	1.71	33.39	40.52	90.32	15,746.00
Jun-04	1.44	1.36	643.18	8.28	25,000.00	7.80	9,403.00	109.47	1,158.59	3.80	11.38	1.59	3.48	55.98	1.71	33.53	40.76	88.80	15,732.00
Jul-04	1.40	1.32	632.39	8.28	25,000.00	7.80	9,046.50	109.36	1,158.19	3.80	11.47	1.55	3.44	55.95	1.71	33.78	40.88	87.70	15,735.00
Aug-04	1.41	1.31	635.93	8.28	25,000.00	7.80	9,256.00	110.36	1,158.10	3.80	11.40	1.53	3.40	55.83	1.71	33.99	41.45	88.07	15,762.00
Sep-04	1.43	1.29	616.20	8.28	25,000.00	7.80	9,166.00	110.01	1,147.80	3.80	11.49	1.52	3.36	56.21	1.70	33.87	41.43	87.53	15,755.00
Oct-04	1.36	1.24	607.28	8.28	25,000.00	7.79	9,093.30	108.92	1,141.99	3.80	11.39	1.47	3.32	56.34	1.68	33.76	41.27	85.56	15,755.00
Nov-04	1.30	1.20	596.72	8.28	25,000.00	7.78	9,037.50	104.90	1,086.56	3.80	11.39	1.43	3.31	56.32	1.65	32.75	40.30	82.30	...
Dec-04	1.30	1.22	576.17	8.28	25,000.00	7.78	9,253.80	103.84	1,050.80	3.80	11.21	1.40	3.28	56.18	1.64	32.20	39.18	81.22	...
Jan-05	1.31	1.23	576.17	8.28	25,000.00	7.80	9,195.30	103.94	1,038.13	3.80	11.26	1.43	3.27	55.77	1.64	31.87	38.70	82.23	...
Feb-05	1.28	1.24	573.58	8.28	25,000.00	7.80	9,236.30	104.88	1,020.51	3.80	11.15	1.40	3.26	54.81	1.64	31.50	38.44	82.89	...

Notes: 1. US - Real Effective Exchange Rate Index, 2000 = 100; 2. ... indicates that the data is not available

Source: International Monetary Fund, International Financial Statistics Online. 29 April 2005. http://ifs.apdi.net/imf/ and University of British Columbia, PACIFIC Exchange Rate Service. 10 May 2005. http://fx.sauder.ubc.ca/data.html

A7 WORLD COMMODITY PRICE INDEX

Date	All Commodities Index	Energy Index	Non Fuel Commodities Index	Agricultural Raw Materials Index	Metals Index
Jan-02	77.0	69.4	90.8	85.1	86.9
Feb-02	79.1	72.0	91.8	89.6	87.3
Mar-02	87.5	83.7	94.2	90.6	89.8
Apr-02	90.9	89.4	93.6	92.7	89.0
May-02	91.7	90.4	94.1	93.2	88.0
Jun-02	90.0	86.4	96.4	96.9	89.5
Jul-02	93.6	90.7	98.7	99.2	88.4
Aug-02	94.8	93.0	98.1	100.3	84.8
Sep-02	99.0	98.1	100.6	104.8	85.0
Oct-02	98.3	96.7	101.0	105.0	85.6
Nov-02	92.7	88.2	100.5	103.3	89.1
Dec-02	98.9	98.1	100.3	100.1	89.4
Jan-03	105.7	108.1	101.6	101.2	91.3
Feb-03	111.1	116.0	102.2	101.0	93.5
Mar-03	104.9	107.1	101.0	98.6	93.1
Apr-03	94.9	91.9	100.2	101.0	90.2
May-03	96.3	93.7	100.8	96.0	93.8
Jun-03	99.9	99.6	100.5	97.4	95.1
Jul-03	100.8	101.3	100.0	98.6	96.7
Aug-03	103.7	104.9	101.6	100.3	98.3
Sep-03	99.0	96.4	103.7	101.6	98.6
Oct-03	104.8	103.0	107.9	103.6	104.3
Nov-03	106.2	103.7	110.4	103.3	108.5
Dec-03	109.3	107.6	112.4	101.7	115.0
Jan-04	114.3	112.3	118.0	104.4	124.2
Feb-04	115.7	112.1	122.4	106.4	132.0
Mar-04	122.0	120.1	125.5	105.2	133.9
Apr-04	122.8	121.1	125.6	103.4	133.3
May-04	130.6	134.0	124.4	107.0	126.8
Jun-04	127.0	128.3	124.4	108.0	130.4
Jul-04	132.0	136.2	124.4	108.1	134.3
Aug-04	138.9	148.6	121.6	108.3	132.6
Sep-04	137.8	147.0	121.3	106.9	134.5
Oct-04	149.4	164.6	121.7	106.9	140.6
Nov-04	140.1	150.0	122.2	104.9	142.0
Dec-04	133.8	140.0	122.7	100.7	143.2
Jan-05	142.2	152.3	124.0	102.7	144.2
Feb-05	146.8	157.0	128.1	107.5	148.3

Note: 2000 = 100

Source: International Monetary Fund, International Financial Statistics Online. 29 April 2005. http://ifs.apdi.net/imf/

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