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## **The Outlook for Asia's Emerging Markets**

Purpose: Information

Submitted by: Ian Thompson

Asia-Pacific section, Standard & Poor's, Melbourne



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## RESEARCH

## Economic Research:

## Global Economic Outlook: All Systems Are Go For A Fourth Year Of Solid Growth

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The world economy is poised to maintain a healthy rate of expansion in 2007, with an unprecedented fourth consecutive year of more than 4% growth likely, in large part because of China, India, and the U.S.

U.S. real GDP expanded 3.5% in the fourth quarter of 2006 and likely kicked off this year on a strong note. Of course, any prolonged deceleration in the U.S., which accounts for more than one-fifth of global GDP and is the world's biggest importer, would naturally curb growth globally. Even so, most economies in Europe, Asia-Pacific, and Latin America will likely carry their recent momentum into 2007, posting strong years all around.

The world owes much of its economic growth to a changing reliance on oil. In short, wealthier countries have become less dependent on it—and thus less susceptible to crude price spikes. Even as incomes in the U.S., Europe, and Japan have doubled in the past 35 years, per capita energy use has remained essentially flat. Thus, the global economy has survived the recent surge in oil prices—if not unscathed, then certainly with fewer ill effects than many had forecast.

Perhaps paradoxically, then, global economic growth is disproportionately riding on India and, to an even larger degree, China—both of which have seen energy demand rise sharply, as befits industrializing economies. India's economy makes up just 6% of global GDP (on a purchasing power parity basis as defined by the IMF) but will likely account for 10% of global GDP growth. China's contribution is yet more startling: It accounts for about 15% of global GDP, yet it provides 31% of global economic expansion. The U.S. economy, by contrast, makes up 21% of global GDP and just 15% of GDP growth.

Standard & Poor's Chief Economist David Wyss points out that the developing world overall is only 47% of the world economy but 69% of global growth. "For the first time in my life, 'developing country' is not a euphemism; they're actually doing it," he said.

Even though the world is generally more energy efficient, rising energy prices remain a risk to strong global growth. Although consumers and businesses have faced higher energy prices with belt-tightening and conservation, expansion in the Chinese and Indian economies could keep prices elevated for a protracted period, thus hampering economic growth.

Meanwhile, core inflation around the globe appears to be under control, and the prospects of higher interest rates to keep it that way—in the Eurozone, for example—aren't likely to stifle growth significantly. The recovery of the Japanese and Eurozone economies allows the central banks to raise interest rates, and strong world growth provides enough export demand to offset the negative impact of the higher rates.

### U.S.: The Economic Porridge Is Just Right

Real GDP in the U.S. grew 3.5% in the fourth quarter of last year, and although mild weather might have contributed much of that strength, 2007 has started off on a better note than expected, delaying any Federal Reserve rate cut. Clearly, the central bank believes it has cooked the porridge just the way Dr. Bernanke ordered.

The housing market remains depressed, but the recent bounce hints that it might have seen its nadir. Although housing starts are expected to remain near their current 1.5 million rate, we don't expect them to

set new lows. In any event, the concern that weakening home prices would curb Americans' spending hasn't materialized.

With U.S. core inflation moderate and growth stronger than expected, the central bank will keep the federal funds rate at 5.25%, at least until something changes. We expect a rate cut late this year, after the economy cools. But for now, the Fed maintains its slant toward inflation as the primary worry, which indicates that a rate increase is a greater risk than a cut in the near term.

## **Europe: The Weak Growth Streak Is A Distant Memory**

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After a likely mild economic slowdown in Europe in the first half of 2007, signs are pointing to a resumption of last year's expansion, which outpaced Standard & Poor's expectations. Europe's major economies seem to have entered a virtuous circle in 2006, in which strong corporate profits spur increased capital spending, laying to rest the long period of weak growth seen from 2001 and 2005.

The implementation of restrictive fiscal packages in Germany and Italy will likely curb growth in the first half of this year. However, the fundamental drivers for economic activity—capital spending stimulated by rising corporate profitability, consumer demand boosted by stronger labor markets, and exports benefiting from robust world trade—lead us to expect that GDP growth will accelerate later this year and into 2008.

Declining unemployment across virtually all of Europe since the middle of last year is helping to spur a recovery. And while real incomes have remained flat, the bright outlook on labor markets is bolstering consumer confidence and retail sales.

Amid a strengthening overall economy—and the resultant tightening in capacity utilization—the European Central Bank is concerned that inflation could reaccelerate. So far, a decline in oil prices and a stronger euro have kept headline inflation fairly low. However, upcoming wage negotiations involving influential union IG Metall in Germany and continued growth in money supply could prove troublesome.

## **China And India: Going Above And Beyond**

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Real GDP in China will likely grow in the neighborhood of 9.5% this year after the economy notched its fourth consecutive double-digit expansion in 2006. Although recent governmental administrative and tax measures are dragging somewhat on fixed asset investment, we still expect it to be the main impetus of growth.

Net exports will also continue as a boon to real GDP. China's 2006 trade surplus reached another record high, partly because falling crude prices helped cap the rise in the value of oil imports. In spite of the government's wishes to see trade moving toward balance, the country is likely to register another record surplus—amounting to 8.5% of GDP—this year. The still-healthy rate of global economic growth this year should continue to pull Chinese exports higher.

Standard & Poor's expects domestic consumption and spending to accelerate amid some employment gains and quickening wage growth. But this will probably lag overall GDP growth because of the uneven disbursement of the fruits of China's economic growth.

In India, the recent consumption-led growth is shifting toward investment-led expansion and near 8% growth for a fourth straight year. At the same time, the robust global economy has bolstered external demand for Indian goods and services, despite a rising rupee.

An increasing reliance on oil means the Indian economy is vulnerable to spikes in international crude prices. And while the economy would also suffer from a slowdown in global expansion, a more immediate risk is domestic inflation. The Reserve Bank of India has raised lending rates to curb inflationary pressures caused by high credit growth and excess liquidity. Using monetary policy to curb demand-side inflation will naturally come at some cost to growth, however moderate.

## **Japan: Stronger Growth, But Deflation Remains A Threat**

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With 2006 economic growth at 2.2%, the Bank of Japan must be careful in its efforts to bring interest rates up to more normal levels while maintaining economic expansion. This is especially true given that the

country's inflation rate remains close to zero, domestic consumption is recovering only slowly, and investment is likely to moderate.

Although industrial production reached a record high in December 2006, domestic consumption has stagnated. And although employment improved further, recent data indicate that household spending is, at best, flat. At the same time, the pace of investment in the corporate sector will likely slow in 2007, albeit after very strong increases in the past several years.

External factors are likely to have smaller effects on GDP growth than they did in 2006, though oil prices, the strength of the global economy (particularly the U.S. economy), and the yen's exchange rate will remain issues for the economy. The stronger economic performance will increase the international pressure on Japan to reduce its trade surplus.

## Australia, Canada, And Latin America: Hot Commodities

Australia is in the midst of an unprecedented 16th year of economic expansion as it evolves from an agricultural economy into a diversified commercial center. The country has also benefited greatly from a commodities boom that has bolstered business investment, particularly in mining and related infrastructure. High commodities prices have combined with strong local equity prices and a modest upturn in the housing market to support the economic expansion. Standard & Poor's expects growth of 2.7% in 2007. But because the agricultural sector remains an important contributor to growth, we expect the severe drought affecting large parts of the country to wipe half a percentage point off economic growth for fiscal 2006-2007.

By contrast, the Canadian economy lost some momentum in the second half of 2006, though growth in consumer spending has continued to exceed 4%, supported by a strong labor market. This has coincided with a 35% appreciation in the Canadian dollar since the end of 2002, which has effectively reduced import prices and helped to offset rising commodities prices. The recent decline in energy prices has also had a moderating effect on inflation, allowing the Bank of Canada to maintain a neutral monetary policy stance.

The meteoric rise in energy and nonenergy commodities prices since 2002 has boosted Canada's GDP growth because the country is a net exporter of commodities. The recent pullback in some commodities, notably oil and natural gas, will have the reverse effect, although a rebound in exports will mitigate the weight on Canadian GDP growth from these influences.

To the south, Latin America continues to recover from the aftermath of the Argentinean debt crisis. Although the deceleration in the U.S. will slow exports, sound prospects elsewhere and robust growth in emerging Asia should support strong global trade flows and commodities prices. This beneficial global environment and firm commodities prices are key factors pushing projected real GDP growth to about 5% in Chile and Colombia, 6% in Peru, and 7%-8% in Argentina, Panama, and Venezuela.

However, the outlook for economic activity in Brazil and Mexico, which account for almost two-thirds of the region's GDP, is comparatively subdued. Growth in both countries is projected at 3.5%.

World growth will slow slightly in 2007, reflecting the slowdown in the U.S. and the delayed impact of last year's energy price increases. However, world GDP growth is still likely to remain above 4.5% on a purchasing power basis for the fourth consecutive year. With world inflation at its lowest since the 1960s, the world economy seems poised for several more years of solid growth.

World Economic Forecast						
	2004	2005	2006	2007	2008	2009
<b>Real GDP growth, annual (% change)</b>						
World	4.1	3.4	3.9	3.5	3.5	3.5
U.S.	3.9	3.2	3.4	2.6	2.9	3.2
Canada	3.3	2.9	2.7	2.1	3.0	2.9

<b>World Economic Forecast (cont.)</b>						
U.K.	3.3	1.9	2.7	2.6	2.7	2.9
Eurozone	2.3	1.8	2.7	2.0	2.3	2.4
Australia	3.7	2.8	2.5	2.7	3.3	3.5
China	10.0	10.5	10.7	9.5	8.5	8.5
India*	8.5	7.5	9.0	9.2	8.0	7.6
Japan	2.7	1.9	2.2	2.0	1.9	1.7
Latin America	5.9	4.0	4.9	4.3	4.0	4.0
<b>CPI inflation, annual (% change)</b>						
World	2.7	3.0	3.1	2.6	2.8	2.7
U.S.	2.7	3.4	3.2	1.5	2.3	2.1
Canada	1.8	2.2	2.0	1.5	2.1	2.0
U.K.	1.3	2.0	2.3	2.3	2.0	2.1
Eurozone	2.0	2.1	2.0	2.0	1.8	1.9
Australia	2.3	2.7	3.5	2.7	2.5	2.5
China	3.9	1.8	1.5	2.0	2.5	2.5
India	3.8	4.2	5.8	4.9	4.7	4.8
Japan	(0.0)	(0.6)	0.2	(0.4)	1.2	1.6
Latin America	6.6	6.1	6.0	4.6	5.3	5.3
<b>Exchange rate, annual average (per U.S.\$)</b>						
Canada	1.30	1.21	1.13	1.17	1.15	1.14
U.K.	0.55	0.55	0.54	0.50	0.50	0.47
Eurozone	0.80	0.80	0.80	0.72	0.69	0.67
Australia	1.36	1.31	1.33	1.26	1.24	1.23
China	8.28	8.19	7.95	7.66	7.40	7.17
India	45.32	44.10	45.27	44.61	45.53	46.52
Japan	108.14	110.13	116.34	116.76	105.42	99.33
<b>Short-term interest rate, annual (%)</b>						
World	3.1	3.9	4.8	5.3	5.3	5.2
U.S.	1.4	3.1	4.7	5.0	4.5	4.5
Canada	2.2	2.7	4.0	4.2	4.3	4.5
U.K.	4.6	4.7	4.8	5.6	5.3	5.3
Eurozone	2.1	2.2	3.1	3.8	3.5	3.5
Australia	5.5	5.6	6.0	6.3	6.3	6.3
China	5.2	5.2	5.6	5.9	5.9	5.9
India	10.9	10.8	10.9	10.6	10.9	11.0
Japan	0.0	0.0	0.2	0.7	1.7	2.1
Latin America	11.1	13.0	11.3	10.4	9.8	9.8
<b>Long-term interest rate, annual (%)</b>						
World	4.3	4.1	4.5	4.9	5.1	5.2
U.S.	4.3	4.3	4.8	4.9	5.2	5.6
Canada	4.6	4.1	4.2	4.4	4.8	5.2
U.K.	4.9	4.4	4.5	4.8	4.8	5.1

<b>World Economic Forecast (cont.)</b>						
Eurozone	4.1	3.4	3.8	4.0	4.2	4.0
Australia	5.6	5.3	5.6	6.6	6.5	6.4
China	5.9	6.1	6.5	6.8	6.8	6.8
India*	5.1	6.7	7.5	7.8-8.0	N.A.	N.A.
Japan	1.5	1.4	1.7	1.9	2.7	3.1

**Merchandise trade balance, % of nominal GDP, annual**

U.S.	(5.8)	(6.4)	(6.4)	(5.6)	(5.3)	(5.2)
Canada	5.1	4.8	3.8	3.3	3.2	3.0
U.K.	(5.2)	(5.6)	(6.2)	(5.8)	(5.7)	(5.4)
Eurozone	3.0	2.5	1.9	2.6	2.6	2.7
Australia	(2.8)	(1.9)	(1.3)	(1.2)	(1.1)	(1.0)
China	3.1	6.0	7.0	7.8	8.5	9.1
India	(3.2)	(5.0)	(6.1)	(5.9)	(5.9)	(6.0)
Japan	2.8	2.1	1.9	1.9	1.8	1.8
Latin America	3.3	3.6	3.9	2.9	2.2	1.6

**Fiscal balance, % of nominal GDP, annual**

World	(2.8)	(1.8)	(1.2)	(1.0)	(0.9)	(0.8)
U.S.	(3.4)	(2.6)	(1.6)	(1.6)	(1.6)	(1.4)
Canada	0.5	1.4	0.9	1.4	1.3	1.0
U.K.	(3.3)	(3.3)	(3.1)	(2.7)	(2.3)	(1.9)
Eurozone	(2.7)	(2.3)	(1.9)	(1.4)	(1.3)	(1.1)
Australia	0.2	0.9	0.1	1.0	0.9	0.8
China	(1.4)	(1.3)	(0.5)	(0.4)	(0.3)	(0.3)
India	(4.0)	(4.1)	(3.9)	(3.7)	(3.6)	(3.4)
Japan	(6.3)	(5.3)	(4.3)	(3.8)	(3.4)	(3.2)
Latin America	(1.2)	(0.7)	(0.3)	(0.6)	(1.0)	(1.0)

**Unemployment rate (%)**

World	10.3	9.9	9.4	9.2	9.0	8.8
U.S.	5.5	5.1	4.6	4.7	4.8	4.6
Canada	7.2	6.8	6.3	6.4	6.5	6.5
U.K.	4.8	4.8	5.5	5.8	5.6	5.1
Eurozone	9.4	9.5	8.8	8.3	8.0	7.7
Australia	5.5	5.1	5.3	5.0	5.2	5.3
China	4.2	4.2	4.1	4.3	4.5	4.5
India	13.5	12.9	12.2	11.8	11.4	11.1
Japan	4.7	4.4	4.1	3.9	3.8	3.9
Latin America	10.4	9.5	8.8	8.4	8.3	8.3

\*Fiscal year is April through Mar, so fiscal year 2004 would be April 2003 through March 2004. N.A.—Not available.

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## RESEARCH

## Guest Opinion:

## ASEAN Four Power Ahead, But Can They Keep Up The Pace?

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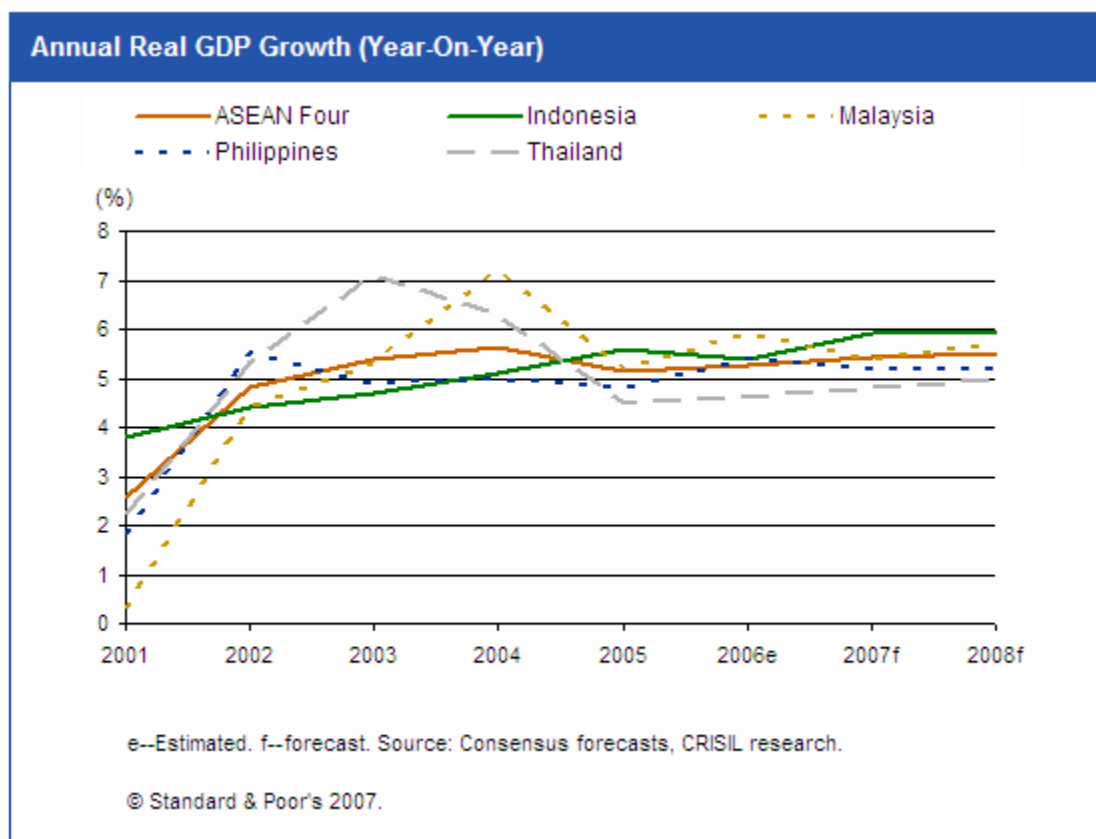
**(Editor's Note:** This article is authored by Subir Gokarn and Radhika Anand of CRISIL Ltd., Standard & Poor's India-based subsidiary. The thoughts expressed in Guest Opinion are those of the writers and do not necessarily reflect the views of Standard & Poor's.)

Indonesia, Malaysia, the Philippines, and Thailand continue to stoke up their red-hot economies. GDP growth of the "ASEAN Four," as they're collectively known, rose to an estimated 5.3% in 2006. That would keep growth above 5% for four years running, largely led by buoyant exports. While healthy growth is also forecast for 2007 and 2008, clouds are on the horizon. The ASEAN Four are vulnerable to the widely expected slowdown in the U.S. and Chinese economies. Other risks include rising political turmoil and the re-appearance of avian flu, which could weaken consumer confidence and slow public spending programs. The bottom line: Domestic demand will be more important than ever in 2007.

Malaysia heads the pack, with estimated GDP growth of 5.9% in 2006. Indonesia and the Philippines are likely to be close behind, at 5.4% each. That would mark a slowdown for Indonesia, the largest economy in the region. Thailand is trailing behind the other three, at a projected 4.3%. (See chart 1.)

We expect the ASEAN Four to maintain their momentum for the next two years, at least. Macroeconomic indicators suggest their combined growth will hit 5.4% in 2007 and 5.5% in 2008. The four countries are likely to post similar rates of growth, led this time by Indonesia. Thailand should also continue to grow at a much slower pace.

Chart 1



## Consumption Cushions Falling Exports

Net exports powered the region's growth in the first three quarters of 2006, but we expect this demand to simmer down. Even as global industrial production cooled off in the second half of 2006, resurgent demand for electronics and electrical products from the U.S. and China boosted exports. Export growth was slightly weaker in Malaysia, however, owing to a high base effect--i.e. very high rates of growth in the previous two years. Export growth improved particularly in Indonesia and the Philippines.

But while export demand remained strong, investments leveled off in the second half of 2006, with major corrections to inventory. Fixed investment slumped in Indonesia (from 9.9% in 2005 to an estimated 2.3% in 2006) and Thailand (11.1% to 4.3%). It continued to contract in the Philippines, and rebounded slightly in Malaysia.

### Indonesia: Cuts in fuel aid choked private consumption

A slowdown in private consumption in Indonesia dragged down its economic growth rate. The decline was largely due to the removal of fuel subsidies in mid-2005 that triggered double-digit inflation until the end of 2006. However, planned increases in public spending in 2007 and projected lower inflation should stimulate domestic demand and therefore support growth.

### Thailand: Political coup sparked investment fears

Political concerns--particularly fears of a policy paralysis until elections are held in October 2007--have dampened Thailand's investment climate and domestic demand. But as these concerns recede, private investment demand should pick up. One reason for optimism: The government has announced that it will spend Thai baht (THB) 100 billion this year on infrastructure projects that had stalled due to political uncertainty. If the package materializes, it would boost consumption and imports of capital goods.

### Malaysia: Overall consumption remained strong

Private consumption remained robust in Malaysia, growing at 6% in the first nine months of 2006. Higher

public spending in the second half of the year also cushioned weaker demand in major export markets. Although overall external demand is likely to soften in 2007, income from major commodity exports, such as palm oil and rubber, should continue to be strong.

### **The Philippines: Remittances offset weak investment**

In the Philippines, solid growth in remittances, or the amount of money that overseas workers send home, underpinned robust private consumption and should continue to support overall growth. Investment, however, remains weak.

## **Inflation Will Beat A Retreat**

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Inflation in the entire region has inched up in the past few years, but we expect it to slip back in 2007. Rising inflation in 2005 and 2006 was largely due to supply-side factors, such as a reduction (Thailand and Malaysia) or discontinuation (Indonesia) of fuel subsidies and high commodity prices.

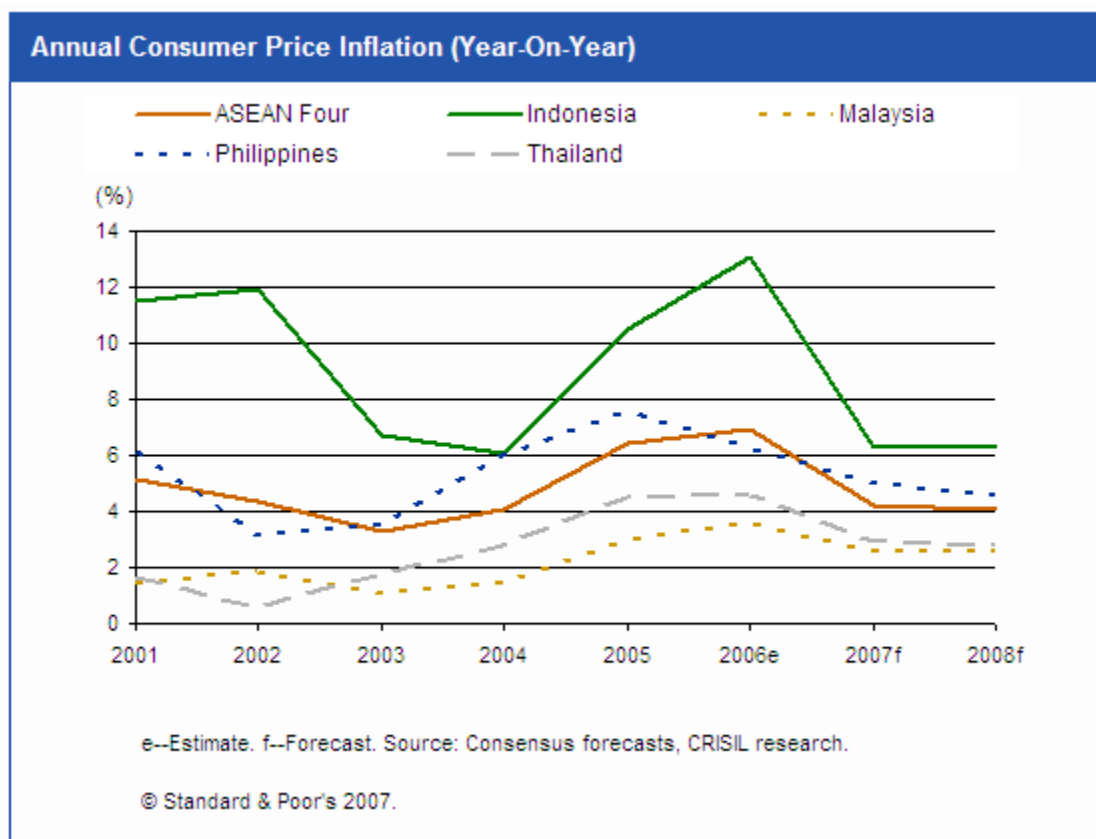
Average inflation for the ASEAN Four is estimated at 6.9% in 2006, up from 6.4% in 2005. But if we exclude Indonesia's dizzying rate of 13.1% in 2006, the average would fall to 4.8% in 2006. That's lower than the 5% posted in 2005.

In the last few months of 2006, inflation had already begun to drop, as a moderation in global expansion activities eased inflationary pressures on commodities. In the Philippines, bumper harvests erased the effect of a severe drought in 2005, pushing down prices of agricultural products and consequently inflation.

Internationally, crude oil prices have stabilized at much lower levels. While demand and supply in the oil markets remain tight, geo-political factors that triggered high speculation have receded slightly. Even so, inflation in net oil-importing countries, i.e. the Philippines and Thailand, remain vulnerable to future oil shocks.

Adjustment to higher domestic fuel prices will reduce inflation in the ASEAN countries in 2007. We expect headline inflation in Indonesia to plummet to 6.3%, followed by sharp declines in the Philippines, Thailand, and Malaysia. The region's inflation is likely to fall to 4.2% in 2006 and 4.1% in 2007. However, cuts in government subsidies for electricity may keep the inflation rate high in Indonesia for the first few months of 2007. Excluding Indonesia, the region's inflation is likely to fall to 3.5% in 2007 and slip to 3.3% in 2008. (See chart 2.)

Chart 2



## Monetary, Fiscal Policies Soften

If, as we expect, inflation starts to decline in 2007 and 2008, the ASEAN Four will have sufficient leeway to soften their monetary policies. The result? Stimulated domestic demand. In the past year, interest rates in the region have risen in tandem with hikes in the U.S. benchmark rate. This was a response to concerns about a reversal of capital flows as well as high and rising domestic inflation. Central banks now have the opportunity to ease back on the reins.

### Indonesia: Big spender cut interest rates

Indonesia's central bank has already started to reduce its policy interest rate, which peaked at 12.5% in 2006. It shaved off 250 basis points (bps) in the last three quarters of 2005 and an additional 25 bps in January 2006. The significantly lower size of its last cut underlines inflationary expectations in Indonesia and suggests the central bank has a more cautious approach to loosening its monetary policy.

The Indonesian government adopted an expansionary fiscal stance in mid-2006 to support growth. Despite big public spending plans, Indonesia still intends to reduce its fiscal deficit from 1.2% of GDP in 2006 to 0.9% in 2007. As a result, it also aims to lower its public debt ratio from 41% to 37%.

### Thailand: Revised its benchmark rate

In Thailand, average consumer price inflation for the year remains well above the central bank's 0%-3.5% target--for now, at least. However, as inflationary risks had abated, the central bank revised the benchmark rate at the ASEAN summit meeting in January 2007 from a 14-day repurchase rate to a 1-day repurchase rate. It also lowered the rate by 187.5 bps to 4.75%. Thailand raised rates by 100 bps in 2006.

Thailand intends to maintain its target fiscal deficit-to-GDP ratio at 1.5% in 2007, despite its THB100 billion infrastructure package.

### **The Philippines: Strong attempts to stimulate bank lending**

Falling inflation should give the Philippines room to loosen its monetary policy. The benchmark rate remains at 7.5%, but to stimulate bank lending, in January 2007 the central bank eased the interest rates on deposits that it holds. The central bank's latest inflation report suggests that the government has set an annual headline inflation target of 4.0%-5.0% for 2007 and 4.0% with a tolerance interval of  $\pm 1.0\%$  for 2008.

Government revenue rose by 19.6% and expenditure by only 8.3% in the first three quarters of 2006. This pulled down the deficit to 1.2% of GDP. The cut in spending was partly due to the legislature's inability to enact the 2006 budget. Another roadblock: 2007 elections may strain the government budget. Government finances remain vulnerable to financial turbulence because of high levels of public debt.

### **Malaysia: Low interest rate climate, but rising deficit**

Malaysia has taken little action to cut rates. Real interest rates remain low, with the benchmark overnight policy rate maintained at 3.5% at January's ASEAN summit meeting.

The Malaysian fiscal deficit-to-GDP ratio is likely to have risen to 3.5% of GDP in 2006. Last year, the government introduced corporate tax cuts and one-off payments for pensioners and civil servants, together with a Malaysian ringgit 100 billion package, aimed at fostering private investment in high-tech industries and the services sector. The structural reforms address the shortage of highly skilled labor in Malaysia and are part of an attempt to improve the country's business climate in order to promote investment.

## **Currencies Pack A Punch**

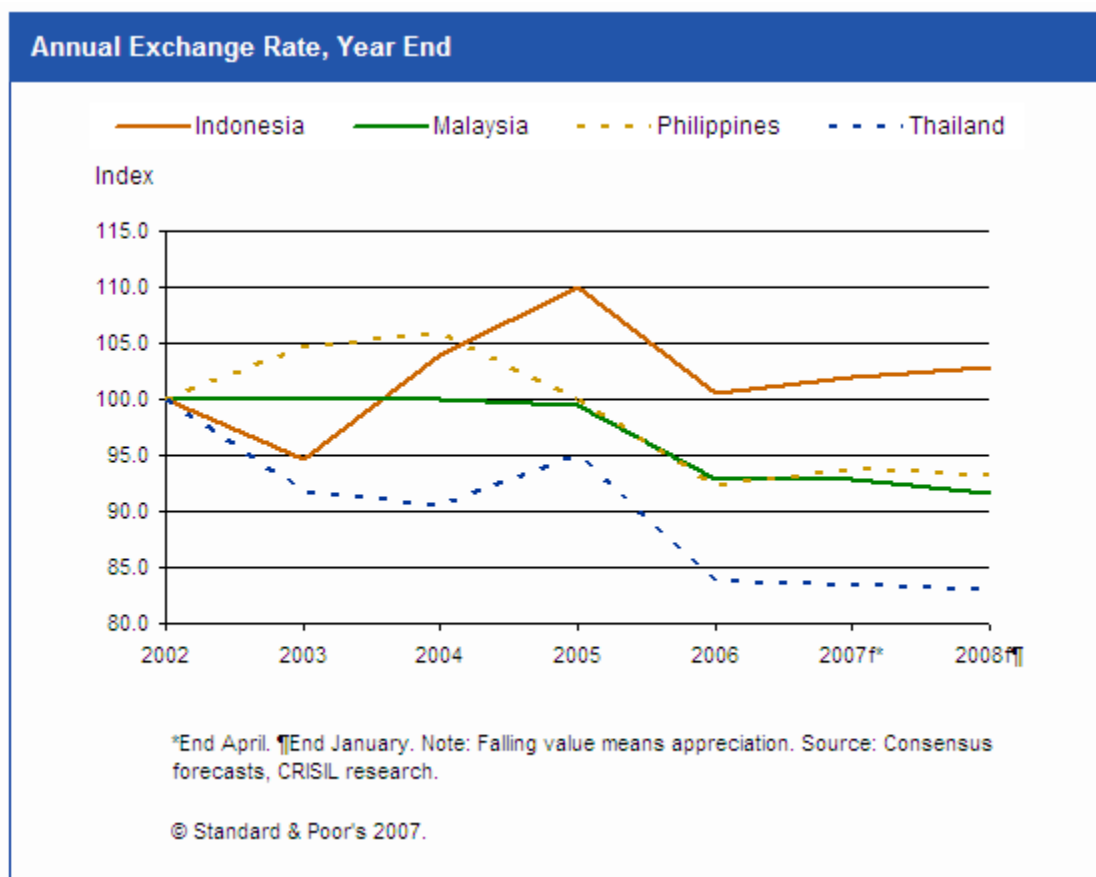
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ASEAN Four currencies appreciated sharply in 2006 in nominal terms. At year-end, the Thai baht was 11.9% higher to the U.S. dollar than at the end of 2005. The Indonesian rupiah was 8.5% higher, the Philippine peso had climbed 7.7%, and the Malaysian ringgit had risen 6.7%.

Export earnings and strong capital inflows, particularly portfolio inflows, exerted pressure on currencies to increase, despite the sharp corrections to regional stock markets in May to June 2006. But Indonesia, the Philippines, and Thailand accumulated faster reserves than in 2005, highlighting their governments' commitment to resisting appreciation as much as possible.

The baht reached its highest level in nine years at THB35.23 to US\$1 in mid-December 2006. A series of bombings in Bangkok at the start of 2007 and stricter capital controls (to contain currency speculation) introduced on Dec. 18, 2007, have slightly dampened sentiment towards the baht. Thus, the pace of its appreciation relative to the U.S. dollar is expected to slow down. In contrast, the Philippine peso faces pressure to appreciate because of increased inflows of workers' remittances, among other things. (See chart 3.)

Chart 3



## Lower Exports To Shrink Current Account Surplus

Persistently strong currencies and weaker prospects for external demand will likely lead the region's current account surplus to shrink in the year ahead (see table).

The ASEAN Four's aggregate current account surpluses rose to an estimated US\$36 billion in 2006. That's nearly double the surplus in the previous year. The improvement is mainly due to the acceleration of exports compared with relatively subdued import growth in the region. Import growth was slower, partly due to an adjustment to high commodity prices and a large inventory collection in the first half of the year. However, this effect began to fade in the second half of 2006.

Indonesia made the largest gains in its current account surplus in 2006. This stems from a recovery in its trade surplus from US\$17.6 billion in 2005 to an estimated US\$31.5 billion in 2006. The key? Export growth, particularly of mining products, remained robust.

The trade balance in Thailand also rebounded into positive territory in 2006. Easing pressure on the Indonesian rupiah should support export growth.

Malaysia maintains the largest surplus in the region, fueled by strong exports of manufacturing goods and agricultural products. The surge in manufacturing exports reflects increased exports of electronics and electrical products, as well as resource-based products.

In the Philippines, remittances from overseas workers should continue to support the country's current account, leading to an improvement in its fiscal deficit.

## Annual Current Account Surplus

(Bil. US\$)	ASEAN Four	Indonesia	Malaysia	Philippines	Thailand
2003	26.6	8.1	13.4	0.3	4.8
2004	20.9	1.6	14.9	1.6	2.8
2005	14.6	0.3	19.9	2.3	(7.9)
2006e	36.0	8.1	22.2	3.9	1.8
2007f	32.8	5.0	24.6	3.2	0.0
2008f	33.8	5.3	24.6	2.7	1.2

e--Estimate. f--Forecast. Source: CRISIL research.

## Rosy Outlook Masks Key Risks

Overall growth in the region should remain healthy over the next few years. A more positive inflationary situation will allow central banks to ease their monetary stances and stimulate domestic demand.

Risks to this outlook emerge chiefly from the vulnerability of the ASEAN Four nations to a slowdown in the U.S. In addition, increased integration with China implies that a sharper-than-expected slowdown in China's fixed investment would also influence external demand for the products of the ASEAN Four, both directly and indirectly. However, the acceleration in Japan's economic growth could cushion some of this effect.

Rising oil prices could trigger inflationary pressures. Disorderly adjustment of the still-growing global current account imbalances could also batter investor confidence. Another major risk: The spread of avian flu (more directly to poultry exports). Casualties mounted in 2006, could there be worse to come?

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## RESEARCH

## Economic Research:

**Beyond BRIC: Growth Is Busting Out All Over**

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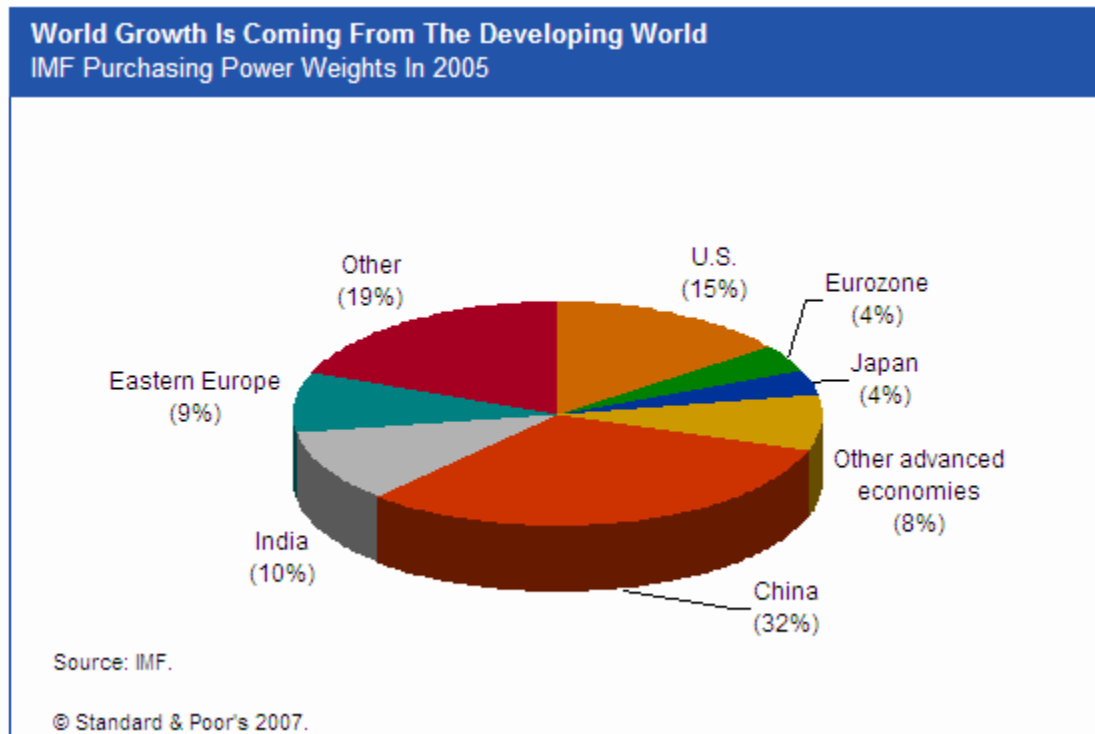
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In terms of economic growth, the BRIC countries—Brazil, Russia, India, and China—have gotten most of the press in recent years. However, growth has broken out like an epidemic worldwide, not just in the big developing countries. This ubiquitous growth has affected even regions like Africa that hadn't seen sustained growth in recorded memory. Last year's world GDP growth of 5.3% (IMF weights) was second only to the 5.4% in 2004. The developing countries together account for 47% of world GDP (using the IMF's purchasing-power weights rather than market-exchange rates) but contributed 69% of world growth.

Although half of world growth in 2005 (complete data for 2006 is still unavailable) came from China (31%), India (10%), and Eastern Europe (9%), the other developing countries contributed 19%, which is more than the 16% contributed by the industrial countries (excluding the U.S.). Growth still varies widely within the developing world, but a majority of the world's poor are beginning to see some benefit.

Chart 1

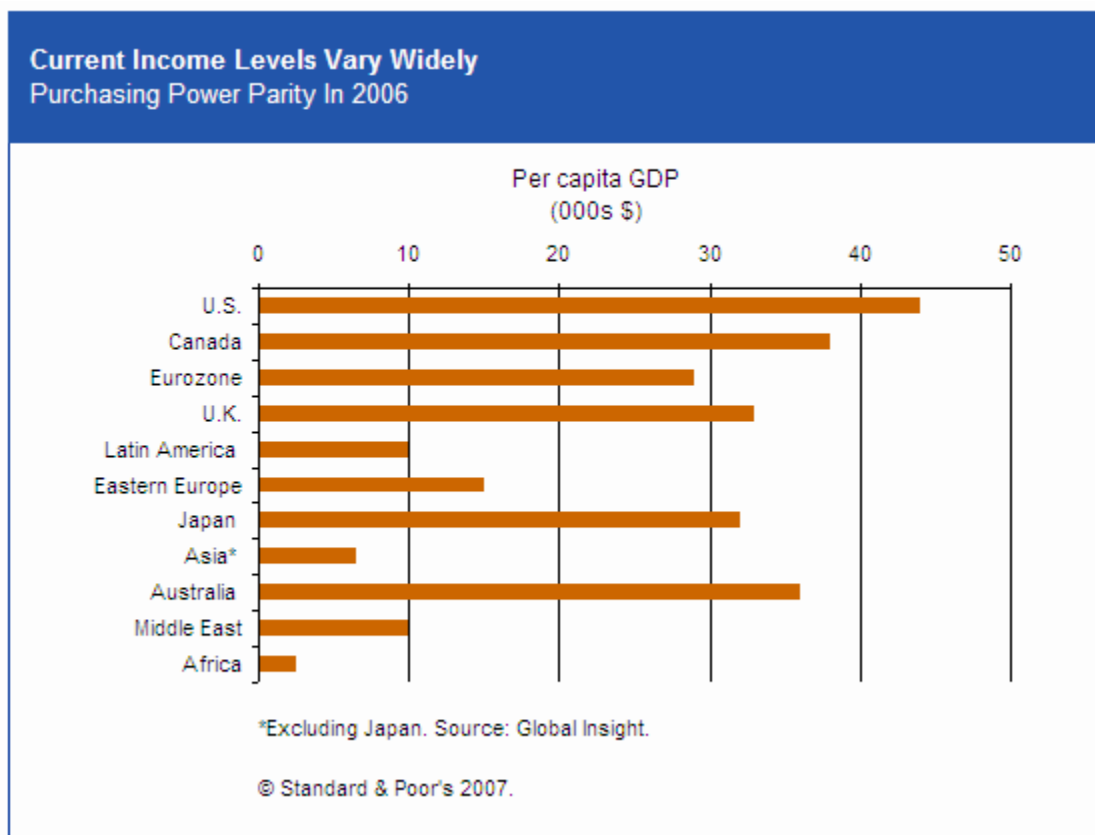


The development is highly encouraging but does result in some problems. For example, the increased demand for raw materials is driving up the prices of commodities, including energy. On the other hand, the higher commodity prices are a major driver of the strong growth in many of the developing countries, especially in Africa, the Middle East, and South America. Capital is flowing into these regions, as capital markets have become freer and more global. But more money is flowing into the U.S. than into the

emerging economies, as safety trumps return, and some countries deliberately try to avoid capital inflows.

Despite the improved growth, the income gaps between the rich and the poor remain wide. Developed nations have per capita GDPs of \$29,000-\$44,000, while the GDP in developing countries ranges from a high of \$15,000 in Eastern Europe to a low of \$2,500 in Sub-Saharan Africa. The poorer countries have begun to catch up, but it will be a long chase, especially given the still-high population growth rates. Although birth rates have dropped to near zero-population-growth levels in most developing regions (with the notable exceptions of Africa and the Middle East), the concentration of the current population in their child-bearing years and the improvements in life expectancy mean that population growth will remain high for decades.

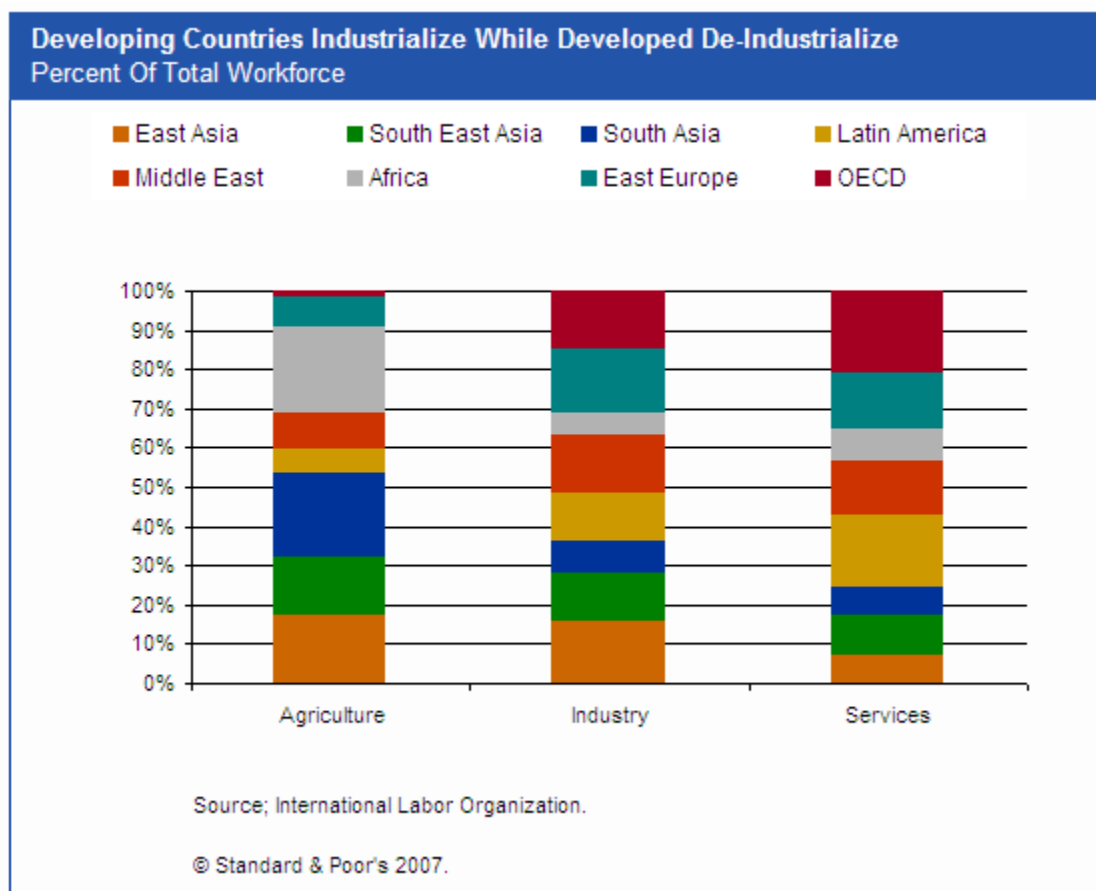
Chart 2



As countries develop, the pattern of employment shifts. Most countries traditionally viewed as industrial are actually becoming post-industrial, with industrial employment declining as employment in the service sector rises. In the U.S., for example, manufacturing peaked at 35% of total employment in 1955 and has dropped to only 10.5% today. Most developing countries, in contrast, are still in the industrializing phase, when agricultural employment shrinks as industrial employment increases. So far, only in Latin America, Eastern Europe, and the Middle East have agricultural employment dropped to less than 40% of total employment.

We expect agricultural employment to shrink in the developing countries while industrial employment continues to rise. Eventually, industrial employment will also decline as the service sector increases. Industrial employment is unlikely to be ever as large as it was in the U.S. and other developed countries during the 1950s, however, because improvements in technology mean that fewer workers are needed to produce manufactured goods even in countries that are at the peak of the industrialization process.

Chart 3



The global growth outlook appears strong. The emerging economies are expected to continue to grow more quickly than the developed economies, especially in terms of total GDP. Per capita GDP, however, will not catch up as rapidly, especially in Latin America and Africa, where birth rates are the highest. In these two areas, growth will depend crucially on the continued expansion in the developed countries and Asia because Latin America and Africa rely very heavily on exports of commodities. The recent boom in commodity prices has boosted the exports and overall economies of Latin American and African countries, but a pullback could hurt.

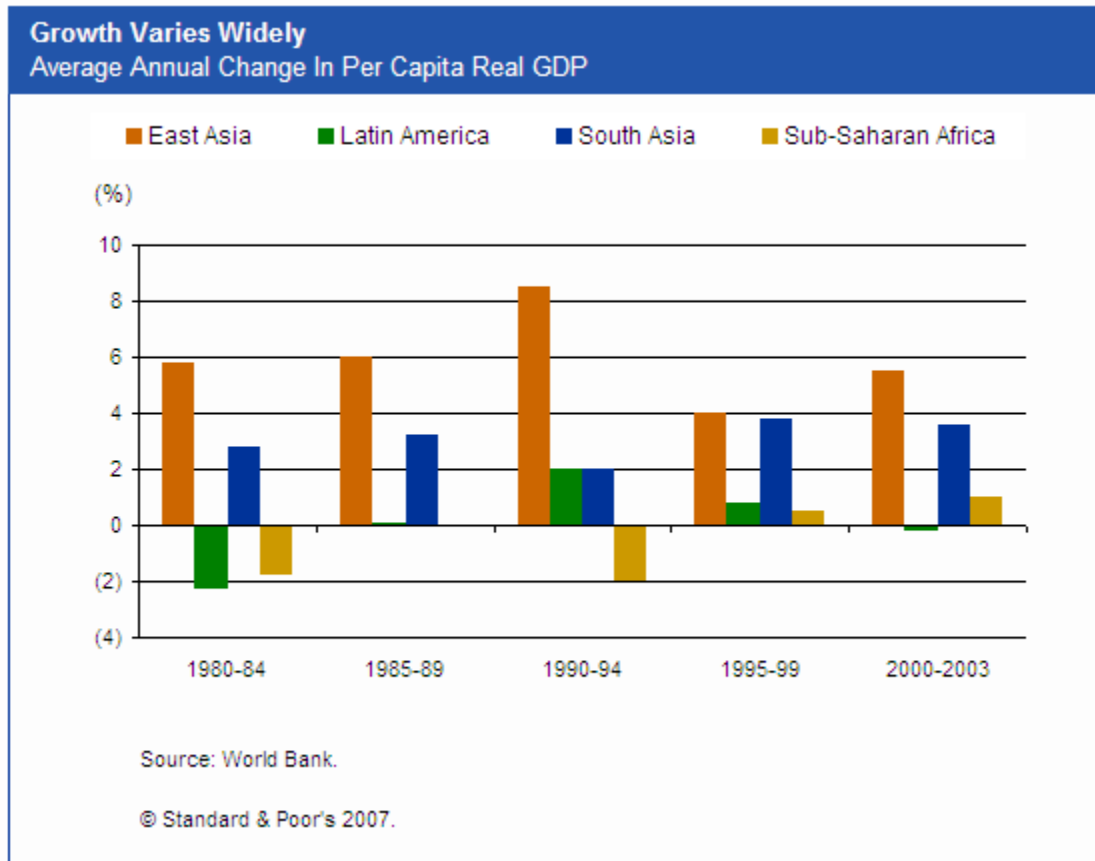
Latin America and Asia are still rebounding from recent financial turmoil: the Asian currency crisis of 1997 and the Argentine default in 2002. The recoveries appear to be proceeding well, though Argentina still has some hangover weakness. After dropping for four consecutive years, Argentina's real GDP has risen an average of 8.9% per year from 2002 through 2006. Although East Asia and South Asia have had the best growth rates during this period, the other regions are also seeing stronger growth than in any other recent period.

The stronger financial positions of the emerging markets aid development prospects. Because of strong commodity prices, most of the world's developing countries now have trade surpluses. The non-OECD countries had an estimated current account surplus of \$648 billion in 2006, which was offset by the U.S. current account deficit of \$857 billion. Strong commodity prices account for many of the positive trade surpluses, but fears engendered by the Asian currency crisis of 1997 have also pushed countries to adopt more severe policies to maintain surpluses.

Government deficits are still high but generally better than in previous decades, as fiscal discipline has forced most countries to get their fiscal houses in order. In 2005, the OECD countries had a combined government deficit of \$821 billion compared with a combined surplus of \$47 billion for the rest of the world. The industrial countries have fewer financial constraints on their government spending because of

their stronger credit positions.

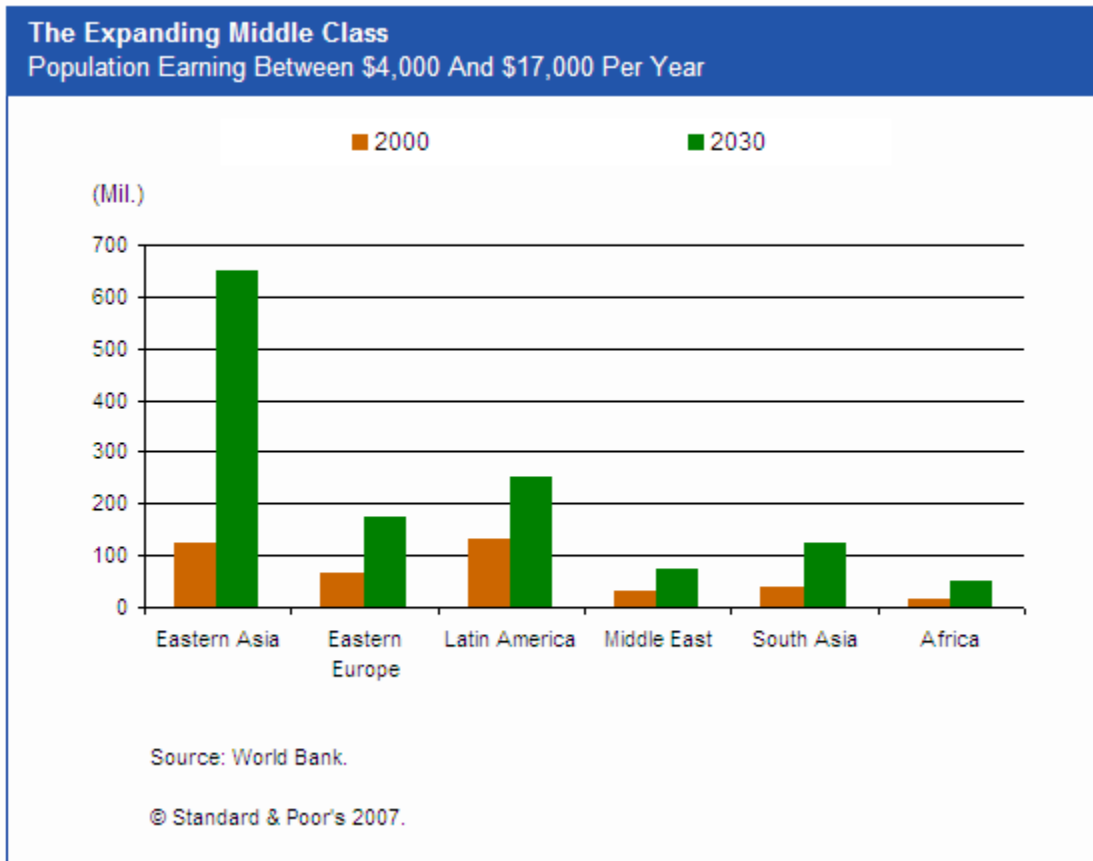
Chart 4



The economic growth is having a major impact on the quality of people's lives. For example, the middle class is expanding around the world. The World Bank defines the middle class as individuals earning \$4,000-\$17,000 per year. To give a rough idea of comparable standards of living, the low end is equivalent to the current average income in Brazil, while the high end is equivalent to that of Italy. This category is important to business because at this level of income, people are no longer focused only on earning money for their next meal but to have some income to spend on luxuries. Most people in the developed world are already above the middle class and are classified as rich by world standards.

The growth of the middle class in the current developing world will be enormous over the next 25 years. The increase in the middle-class population in East Asia (predominantly China) is greater than the current population of the EU. By 2030, the current developing countries could have more people earning more than \$4,000 per year than the current developed countries.

Chart 5



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