U.S. PACIFIC COMMAND ASIA PACIFIC ECONOMIC UPDATE

• 2005 EDITION •

FOREWORD

Welcome to the 2005 edition of the *Asia Pacific Economic Update (APEU)*, our flagship economic document at the U.S. Pacific Command. We have expanded some of our older topics and introduced new ones.

- In Volume I, Northeast Asia, we added the U.S. dollar and Asia chapter to the global financial turmoil section and also included a new section on the rise of China and its shared prosperity.
- In Volume II, Southeast Asia, we added two case studies in the South Pacific.
- Volume III looks at transnational issues. Once again, we have expanded some of our older topics and introduced new ones.
  - We discussed the socio-economic strategy to counter terrorism and how to implement it via creative partnerships with the private sector.
  - We expanded our energy chapter to reflect the increasing importance of energy security in the region.
  - We put a new emphasis on the strategic importance of food and water in Asia and around the world.

In addition, we're introducing a totally new idea in hopes of keeping our readers as well informed as possible by adding periodic daily updates to our baseline studies of individual economies, with informed comments from our economic advisor.

We are pleased to publish the 2005 edition of the U.S. Pacific Command Asia Pacific Economic Update as a military perspective on the seamless web of economic and security interdependence.

W. V. ALFORD, JR.
Rear Admiral, U.S. Navy
Chief of Staff
U.S. Pacific Command

ACKNOWLEDGEMENT

• VOLUME I •

I want to take this opportunity to thank Admiral Thomas Fargo for his steadfast support and encouragement for this project. In fact, his interest in China's economic interdependence in the region is the reason why we devoted so much time and energy to the rise of China section. I also want to thank Admiral William Fallon for his support. Interestingly enough, Admiral Fallon was in China at the time this product was completed. His creative efforts to develop a more constructive U.S. relationship with China have inspired our economic analysis as well. I'd also like to thank Admiral Gary Roughead, formerly our Deputy Commander at PACOM (and now the Pacific Fleet Commander), for our enjoyable one to one discussions on international economics, and Rear Admiral Michael C. Tracy, J5 at PACOM, for reading the whole study and providing useful feedback.

A special thanks goes to my deputy, Major Miemie Winn Byrd, for her infectious enthusiasm, collegial contributions, tireless research support and coordination of all three volumes of the 2005 issue of this publication. Without her labor of love there would be no product line. In addition, we want to thank Mr. Mark Harstad of Asia-Pacific Center for Security Studies for his data and graphic support, Ms. Faith Goodwin for her graphic support at PACOM, Mr. Brad Babson, formerly of the World Bank, for his excellent chapter North Korea and Ms. Delia Stoehr of Northeast Asia Policy Division at PACOM, for diligently reviewing all three volumes of Asia-Pacific Economic Update 2005. We'd also like to thank Ms. Kelly Mark of Virtual Information Center (VIC), Mr. Edward F. Smith, Jr. of the Institute for Defense Analyses (IDA), Navy Captain William Stacia, Special Assistant to Admiral Fargo and Admiral Fallon, and Mr. Stan Louis from the Pacific Fleet for their assistance and support. Finally, I want to dedicate this Asia Pacific Economic Update to my wife Regina, the love of my life. Without her patience, support and encouragement, none of this would have been possible.

Dr. Leif Rosenberger
Economic Advisor
U.S. Pacific Command
Camp Smith, Hawaii
07 September 2005

Memorial Day
2004

To
Rosey and Regina –

It is wonderful to have you
both as members of our Pacific family.
Leif, your insight into our most
important security interests in Asia have
been of immense value to us all.
My thanks and appreciation
Tom Fargo, Admiral, US Navy
US PACOM

United States Pacific Command

BIOGRAPHY

Dr. Leif Rosenberger

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Dr. Leif Rosenberger has been the Economic Advisor at the U.S. Pacific Command since 1998 and has worked for four Commanders-in Chief. He has a dual reporting chain: He reports to Rear Admiral Michael C. Tracy, Director for Strategic Planning and Policy (J5) and Admiral William J. Fallon, Commander, U.S. Pacific Command. He is also a member of Admiral Fallon's Special Staff.

Dr. Rosenberger analyzes the strategy and performance of 43 economies in Asia and the Pacific. As Chairman of PACOM's Economic and Security Working Group, he harmonizes the economic and security elements in all aspects of PACOM activities (including maritime security, the war on terrorism, war plans, and theater security cooperation activities with all the countries in Asia and the Pacific.

Dr. Rosenberger also plays a large role in strategic outreach activities to shape the socio-economic environment in Asia and the Pacific.

- He collaborates with U.S. embassies in Asia and U.S. economic agencies in Washington (such as U.S. Agency for International Development, Commerce, Treasury and the Federal Reserve) on the formulation and execution of U.S. economic policies.
- He initiated and stood up the first U.S. interagency conference to address the Underlying Conditions that Foster Terrorism held at the Army War College in 2005. The second conference is planned for PACOM in March 2006.
- He performs outreach with academe, International Government Organizations (such as the UN Development Program, the World Bank and the IMF), Asian regional organizations (such as the Asia Pacific Economic Cooperation (APEC) forum and the Asian Development Bank), Non-Government Organizations (NGOs), and last but not least the all important private sector.
- He works closely with Professor Stuart Hart at Cornell University Business School to harmonize U.S. military activities with ground breaking activities in the private sector and NGOs to reduce poverty and tap into the fortune at the bottom of the socio-economic pyramid.
- On the military side he collaborates with the Civil Military Affairs branch of the U.S. Army to improve the lives of Asian and Pacific people at the grass roots level.

Dr. Rosenberger is on the Board of Advisors at World Info in Silicon Valley, California and the Board of Southeast Asian Advisors at the National Bureau of Asian Research (NBR) in Seattle, Washington. In recent years he has done pro bono work as the Senior Fellow for International Finance and Vice Chairman of the Board at Trans-Oceanic International Limited, a humanitarian organization based in Hawaii with global reach.

Before coming to PACOM, Dr. Rosenberger worked for ten years at the U.S. Army War College, where he held the General Douglas MacArthur Academic Chair of Research. In October of 1993 Dr. Rosenberger was promoted from Associate Professor of Economics to full Professor of Economics. He won five faculty-writing awards. His *America and the World Economy* course was one of the largest and most popular two semester courses ever given at the Army War College. He also worked at the Strategic Studies Institute, CIA and DIA.

With the exception of the chapter on North Korea, Dr. Rosenberger is the author of each chapter in Volume 1 and Volume 2 of *Asia-Pacific Economic Update, 2005.* He also wrote two chapters in Volume 3 ("Towards Food Security" and "A Socio-Economic Strategy Against Violent Extremism"). In addition, he is the author of Volume 1 of *Asia-Pacific Economic Update, 2002 and* co-author of *Asia-Pacific Economic Update, 2000.*

Former Drug Czar General (Ret) Barry R. McCaffrey favorably reviewed his book, *America's Drug War Debacle*, Avebury, 1996. In recent years he has published: "The Major Economic Challenge in the Global Security Environment: Competing in an Interdependent World," Max G. Manwaring, Edwin G. Corr, Robert H. Dorff, *The Search for Security A U.S. Grand Strategy for the Twenty-First Century, 2003,* "The Changing Face of Economic Security in Asia," in Sheldon Simon, (edit.), *The Many Faces of Asian Security*, NBR, 2001; "Understanding Changes in Asia's Economic Landscape," in Paul Taylor (edit.), *U.S. Strategic Traditions and Regional Realities*, U.S. Naval War College, 2001; and "Asia's New Economic Volatility" in *The Journal of East Asian Affairs*, Fall/Winter 2000.

Dr. Rosenberger currently teaches International Finance and Trade in the Executive MBA Program at the University of Hawaii. He spent his sabbatical year of 1997 as a Visiting Scholar on the Economic Faculty at Harvard University, funded by a Secretary of the Army Research and Study Fellowship. He was also a Visiting Professor of International Relations at Providence College and an Adjunct Professor of Economics and Political Science at Dickinson College.

He is a 1989 graduate of the U.S. Army War College, where he was a winner of the student writing award. He also attended the Senior Leaders in National Security Program at the Kennedy School of Government at Harvard University. He holds a BA with honors from Harvard University, a Masters from Boston University and a Ph.D. from Claremont Graduate School. He studied Chinese politics and foreign policy at UCLA and did post-doctoral work in International Business at Brigham Young University.

Dr. Rosenberger attended St. Mark's School in Southborough, Massachusetts, where he was a four year-high scorer and captain of the ice hockey team and the high scorer on the soccer team that finished first in the private school league in 1967. He was captain and first team All-New England on the lacrosse team that went undefeated in 1968. He was a scholar-athlete at Harvard University where he won 6 letters in hockey and lacrosse. He played on the Harvard ice hockey team that won the ECAC Championship in 1971 and made it to the Final Four in the NCAA. After Harvard he played professional ice hockey in the Hartford Whaler and Boston Bruin organizations. He was the Most Valuable Player in the Pacific Southwest Hockey League. In Hawaii he is an avid swimmer and tennis player.

ASIA-PACIFIC ECONOMIC UPDATE 2005

TABLE OF CONTENTS

• VOLUME I •

• VOLUME II •

• VOLUME III •

SOUTH ASIA

Although Bangladesh may appear to be one of the poorest countries in the world, it has made remarkable progress in recent years. Nevertheless, Bangladesh could do a lot better.

- Bangladesh is desperately short of power despite being blessed with abundant energy resources
- The potential for attaining higher growth has not been harnessed. Bad governance contributes to less than 7% to 8% growth rates.
- The growth projections for 2005 (circa 5.4%) fall well short of the 6.5% to 7.0% growth to halve poverty by 2015.

On the positive side, Dhaka has started to implement economic reforms.

- International donors have responded favorably and have boosted foreign aid.
- Remittances, a good harvest and stronger exports have also helped economy.
- All of this has spurred relatively good economic growth.

On the negative side, political instability, crime and economic nationalism deter foreign direct investment (FDI).

- The end of 30-year-old Multi Fiber Arrangement (MFA) in January 2005 is causing havoc in the Bangladesh garment industry. A potential of 1 million personnel layoffs -- fanning possible social unrest and a prospective fertile ground for terrorist recruitment.

At 1st glance, India is shining and its growth is impressive. However, not enough of the Indian- population enjoys the fruits of this prosperity.

300 million poor Indians are frustrated that they have been left behind. They voted out a complacent BJP that ignored their needs and aspirations.

The new government's challenge is to sustain the economic boom while delivering on social promises to the poor. The focus will be on strengthening agriculture and improving education.

- An inherited fiscal nightmare will make it difficult to execute these objectives. (However, three 1st rate economic strategists currently give the government a fighting chance.)
- A grass roots strategy will be used to avoid bureaucratic sabotage.
- Communists in coalition are a new asset to achieve rural objectives.
- Business is onboard and supports the strategy because it modernizes infrastructure and will boost rural consumer spending.

Nepal continues to struggle with poverty.

- The government and donors try to reduce poverty.
- But Maoist insurgents sabotage their efforts and target development projects.
- In the face of terrorist threats, donors have suspended foreign aid.
- But donors also chide the government for chaotic governance.
- Catastrophic flooding and the end of garment quotas on 1 January 2005, also undermine the economy.

On the positive side, a ceasefire in 2003 spurred the current recovery.

- A new middle class is emerging and boosting consumer spending.
- Remittances from 700,00 Nepalese overseas boost robust foreign reserves.
- GDP grew at 3.5% in 2004, however this is not enough.

Sri Lanka was economically weak and vulnerable even before the tsunami wave smashed into Sri Lanka's eastern coast in December 2004.

- Sri Lanka's high budget deficit and national debt constrained its ability to finance the tsunami's reconstruction costs.

Of all the Asian nations hit by the December 2004 tsunami, Sri Lanka and the Maldives suffered the greatest damage.

- Fishing and tourism were hit the hardest.
- Capital inflow was mismanaged and led to a rising Sri Lankan currency against the dollar, which in turn resulted in overpriced exports.

That said, foreign aid will help with reconstruction needs:

- World Bank provides $ 400 million in reconstruction aid in 2005.
- The Asian Development Bank (ADB) plans to disburse a $150 million grant in May to help Sri Lanka rebuild.

The Paris Club (consisting of the world's top 19 creditor nations) offered Tsunami-hit states a debt repayment freeze through 2005. The IMF did much the same.

- The "Paris Club" is an informal group of 19 predominantly wealthy creditor nations -- including the U.S., Western Europe and Australia – who came to agreement in January 2005 to suspend all tsunami-hit Asian state debt payments to the Paris Club, and to instead use the money to cover costs of reconstruction.
- However, Indonesia was – and remains --not enthusiastic about freezing repayment of its debt to the Paris Club, correctly perceiving that it would send a wrong signal to financial markets, raise borrowing costs and likely reduce desperately needed foreign investment.
- Recently, Sri Lanka has also expressed similar sentiments. It remains to be seen if the offer of a debt moratorium will be accepted.

Unfortunately, tens of thousands of hungry, helpless survivors of the 2004 tsunami disaster failed to get help.

- In a stunning revelation in early February 2005, the Sri Lankan central government admitted that only 30% of those affected by the tsunami had received aid.
- Local government officials plundered aid and demanded bribes to deliver it.
- Thankfully, the distribution of the aid has improved since February.

SOUTHEAST ASIA

Thanks to the high price of oil, the oil rich country of Brunei is on a roll -- moving ahead with new economic reforms and liberalizations schemes.

- The oil revenue is also boosting GDP.

- Unfortunately, Brunei has been less successful with its investments and its attempts to broaden the economic base.
- The government is also over-centralized.

Brunei must guard against complacency in the good times.

- Unless reforms are implemented Brunei is vulnerable to a fall in the price of oil.
- For instance, the 1997-1998 financial crisis caused oil revenues to decline in 1998 and 1999, which in turn pushed the economy into a painful recession.

Cambodia's pervasive poverty reflects serious economic mismanagement.

- The government is dramatically over-borrowed and in danger of defaulting on its large foreign debt.
- The country is over-dependent on foreign exchange from two volatile sectors – tourism and garments.
- Cambodia's economic outlook turns on 4 factors -- Cambodia's entry into WTO, the tourism/SARS link, the corruption/economic reform link and political instability.

In 2005, Indonesia's economy is clearly back on track.

- It grew as much as 6.7% in the 4th Quarter of 2004 (its fastest quarterly pace in four years).
- Overall growth for 2004 was 5.1% (its strongest yearly performance since 1996), and investment grew 15.7% (the highest growth since 1997).
- The Indonesian stock market recently set new highs, and macroeconomic strategy and performance over the past year were impressive.
- Exports also performed well.

Poverty-plagued Laos has been struggling in recent years.

- Heightened security concerns have scared off any upsurge in tourism.
- An unattractive business climate and instability also discourage FDI.
- Foreign aid and remittances prop up this struggling economy.
- Thankfully, a booming Thai economy is coming to the rescue.
- The Lao future is looking brighter since Thailand has agreed to buy electricity from Laos.

Malaysia is back on track and moving in the right direction.

- Its economy is on a roll.
- New PM Abdullah has stabilized things politically.
- He is decisively reducing the budget deficit.
- His resounding victory in the March elections gives him a clear mandate to push through even tougher economic reforms.

During much of Philippine President Gloria Macapagal Arroyo's time in office, the economy seemed to drift.

- Poverty and high unemployment seemed intractable.
- Credit agencies kept downgrading Philippine government debt.
- President Arroyo and her government dithered.

But in 2004 and early 2005 things began to improve.

- The Philippines enjoyed its strongest economic performance in 15 years.
- The government finally raised taxes.
- That helped reduce the budget deficit and move the country away from the brink of an Argentine-style default on repayment of its government debt.
- Financial markets reacted positively.

But is the strong Philippine economic performance in 2004 sustainable?

- On balance, the economy will likely not perform as well as in 2004.
- In fact, the economy was almost flat in 4 Q 2004 due to typhoons and storms.
- The economy will recover.
- But a number of domestic and global factors will likely slow down the economy in 2005.

To make the economy more resilient in the future, the government must redouble its efforts to attack the structural problems.

In 2004, Singapore had a spectacular economic yearly performance -- growing 8.4%, its best in 4 years -- de facto making Singapore Asia's best economic performer after China. However, in 2005, Singapore's economy has been struggling.

- In fact, in 1Q 2005, Singapore's economy suffered its first quarter-on-quarter contraction in nearly two years.

Singapore's economic problems in 2005 are both structural and cyclical in nature.

Thaksin's 1st economic strategy depended on cheap credit to pump up consumer spending. While the economy boomed, household debt grew unacceptably high.

In Thaksin's 2nd economic strategy, the government is boosting infrastructure spending. This fiscal stimulus should offset the economic drag from bird flu and the insurgency in the south.

The biggest economic concerns are the high level of off-budget government debt and over-borrowed consumers. As a result, neither of Thaksin's economic strategies is sustainable. In many ways, Thaksin is sacrificing medium term financial health for politically popular, short-term economic gains. What's needed is a more durable market driven strategy.

At 1st glance, the Vietnam's economic strategy appears successful.

- Economic growth is booming.
- Donors are happy and are increasing their aid.

But below the surface danger signals are flashing.

- Industrial overexpansion far exceeds market demand, fosters financial problems and could well lead to a boom and bust scenario down the road.
- Therefore, Vietnam is jeopardizing its economic future without a more serious effort at economic reform.
- Vietnamese are scrambling to contain Avian flu.

OCEANIA

At 1st glance the Australian economy looks solid.

- Australia's economy has done so well since the launch of deregulation and reform in the 1980s.
- Liberalization of the Australian economy has generated 14 years of strong, uninterrupted economic growth.
- The economy is back on the growth track with GDP at 3.6% in 2004.
- Consumer and business confidence are both picking up. Grain prices are rising, the export earnings are improving and housing is on the rebound.

But economic upswings do not last forever.

- Too much of the economy is now driven by the wealth effects for consumers of an overheated housing market.
- In addition, the high current account deficit is worrisome.
- Australia is also becoming complacent and losing its enthusiasm for further economic reform.
- The Australian dollar is at a new low of 52 U.S. cents.
- Stagnation and recession in the United States, Japan and the rest of Asia are still causes for concern.

Finally, Australia is increasingly dependent on its robust commodity and service exports to China.

> *That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.*

Following several years of stagnation and decline, Guam's economy is headed for recovery and growth.

- In 2004, most of the economic, financial and security factors affecting Guam's tourism were moving in directions favorable to the U.S. territory's economy.
- The two main engines of growth -- tourism and national defense spending -- are rising.
- Japan's recovery is driving the rise in tourism.
- That said, Guam's financial mismanagement is a formidable obstacle.

The two main CNMI economic growth engines -- tourism and garment industries -- are on two different tracks.

Threat to Garment-Makers.

Until recently, the garment industry had been a remarkable success story.

- But with the end of the Multi-fiber Agreement (MFA) in January 2004, Saipan lost its export quotas.
- Garment makers in China are now arguably cornering the garment market.
- The Chinese threaten to drive Saipan garment-makers out of business and trigger rising unemployment and social unrest on the island, unless Saipan can reinvent itself in a hurry.

BANGLADESH

· CHAPTER 1 ·

Executive Summary.

Although Bangladesh may appear to be one of the poorest countries in the world, it has made remarkable progress in recent years. Nevertheless, Bangladesh could do a lot better.

- Bangladesh is desperately short of power despite being blessed with abundant energy resources.
- The potential for attaining higher growth has not been harnessed. Bad governance contributes to less than 7% to 8% growth rates.
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On the positive side, Dhaka has started to implement economic reforms.

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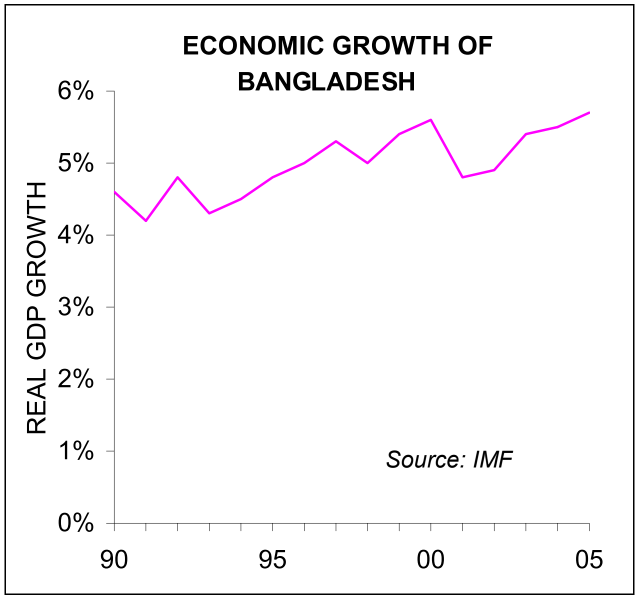
Figure A. Selected Historical Data

Bangladesh	2001	2002	2003	2004
Purchasing Power $B	225	238	255	273
GDP $B (Nominal)	46	50	54	59
GDP Growth (Real)	4.8%	4.9%	5.4%	5.5%
Inflation	1.5%	3.8%	5.4%	6.4%
Exports $B	6.1	6.1	6.8	...
To U.S. $B	0.3	0.3	0.2	0
Imports $B	8.4	7.9	9.7	...
From U.S. $B	2.4	2.1	2.1	2
FDI from U.S. $B	0.2	0.2	0.2	...
In U.S. $B	0.0	0.0	0.0	...
Intl Reserves $B	1.3	1.7	2.6	...
Savings /GDP	17.2%	23.6%	22.7%	23.0%
Fiscal Balance /GDP	-5.0%	-4.6%	-4.2%	-4.2%
External Debt /GDP	31.3%	34.3%	...	...
Current account/GDP	-0.8%	0.6%	0.4%	-0.5%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Poverty.

At first glance, Bangladesh appears to be just another poor third world country.

- With a per capita income of $380, the country is extremely poor.
- It has a 52% illiteracy rate.
- It's overcrowded, with a woefully inadequate infrastructure.
- On the other hand, according to the World Bank, the country also has one of the highest primary-school enrollment rates in the developing world.
- Bangladesh has also achieved gender parity at primary and lower-secondary levels.
- Infant mortality has been cut in half over the past two decades and immunization rates have significantly improved.
- The population-growth rate has been reduced to an unprecedented 1.5%, well below the rates in India and Pakistan.

Steady Progress.

The stereotypical descriptions of Bangladesh's economy fail to convey Bangladeshi progress over three decades. Unnoticed by most outsiders, in the past two decades Bangladesh has made considerable progress on many important social and economic fronts.

- The country attained near self-sufficiency in food production in 2000.
- A flourishing micro-credit movement has reached over 15 million families, in particular empowering women through income-generation and decision-making in the family and the community under a 3-year poverty reduction program.
  - The World Bank raised its financial assistance by $ 536 million.

Recent Progress.

More recently, Dhaka opted for a number of successful economic reforms. These included –

- Prudent macroeconomic management.
- Reform of the ailing banking sector.
- Closing down of loss-making state-run manufacturing units.
- Reduction of losses in the power sector.
- Improvement in tax revenue collection.

Foreign Aid Up.

The international financial institutions (IFIs) were impressed and responded favorably.

- They rewarded Bangladesh by boosting foreign aid in 2003.

For instance, IMF provided Bangladesh with $ 490 million

- Slowly but surely, the international community is realizing that the negative stereotypes, while founded in reality, are a bit misleading and don't tell the whole story about Bangladesh.

Positive Drivers.

In addition to more money from international donors, the economy benefited from a number of economic drivers in 2004. These included:

- Remittances from Bangladeshis working abroad rose to over $3.37 billion during the fiscal year that ended in June 2004, providing valuable support to the country's balance of payments.
- Foreign trade also registered healthy growth during the year, with exports growing by about 16% to $7.52 billion and imports growing by about 13% to $9.81 billion.
- The taka's real effective exchange rate depreciated by 3% during last fiscal year, modestly boosting merchandise exports. As of March 2005, the currency was 63 Taka per U.S. dollar.
- Agricultural performance was good earlier in the year.
- Inflation, which rose to 6.5% late last year, eased to around 5.5% in 2004.
- Foreign-exchange reserves stood at $3.3 billion at the end of August 2004.

Economic Growth.

These economic drivers and positive economic reforms have provided the foundation for stronger economic growth:

- The country's GDP growth averaged 3.7% in the 1980s, accelerating to 4.4% in the first half of the 1990s and to 5.2% in the second.
- Between 2001 and 2004, GDP grew annually by 5.3%, 4.4%, 5.2% and 5.5% respectively.
- Economic growth in 2003 was mostly led by the manufacturing sector (7.1%) as agriculture grew by only 2.7%, while the services sector chipped in with about 5.7%.
- The government's target of 5.5% in the current 2005 fiscal year, which began in July 2004, is unlikely to be met because of the widespread damage caused by the floods.

- GDP is on track to grow the economy is on track to grow at least 5.1% in 2004.

Growth in Perspective.

That said, Bangladesh could still do better.

- The country has great potential. For instance, it has virtual oceans of natural gas.
- However, Bangladesh will probably come up short in providing the economic governance needed for the country to achieve 7 % to 8% growth rates.
- Such high growth rates are needed if the country is ever to surge ahead and make a serious dent in poverty reduction.

Political Stability.

Violence has been particularly pronounced in recent months.

- A grenade attack on an opposition Awami League rally in August 2004, which killed 19 and injured over 200 party activists, devastated the business climate.
- The violence that followed continued for over a week.
- That served to scare away prospective investors who, despite years of confrontational politics and social unrest, appeared to be willing to invest once again in this South Asian country.

Devastating Flooding.

This 2004 upsurge in political violence hammered a country that was still reeling from the ravages of one of the worst floods in its history.

- These “twin misfortunes” – political violence and flooding -- could slow down the government’s institutional reforms.
- These reforms could even be put on hold till the next parliamentary polls due in late 2006 and delay the inflow of foreign direct investment.
- Unless reforms are carried out on time, the progress made and successes achieved so far in different areas could arguably be put in jeopardy.

Two Opportunities Lost.

In addition, Bangladesh has squandered two opportunities to dramatically improve its economy. It has failed to --

- Boost its economy by sending natural gas to India.
- Upgrade its infrastructure to make its garment industry more competitive.

Natural Gas: Untapped Potential.

A U.S. study says Bangladesh could earn $600 million annually from natural exports to India over 25 years.

- Thus, gas exports to India would seem to be a good way to fund development.

Government Dithers.

But the government continues to dither over the potentially lucrative export of its rich natural-gas reserves.

- In fact, opposition to gas exports to India continues to grow.
- Economic nationalism on this issue runs across party lines.
- Dhaka intends to hoard its natural gas for its own use for 25-30 years.
- The lack of export opportunities has forced Western energy companies like Chevron-Texaco to pull out of Bangladesh.

Difficult Garment Industry.

Even in the best of circumstances, Bangladesh would have difficulty competing against garment makers from many other countries in Asia.

- Unlike China or India, it does not grow a cotton crop and has to rely on imports for most of its fabric needs. And it doesn't enjoy economies of scale.

Poor Infrastructure.

But Dhaka could have made some effort to upgrade its infrastructure to be more competitive in the garment industry. Instead, it refused.

- As a result, its ports and infrastructure are now in bad shape.
- In fact, the Gherzi Textile Organization, a Swiss consultancy, was asked how to improve the competitiveness of its garment industry.
- Its recommendations boiled down to improve the infrastructure (improve ports, roads and telecommunications) and reduce bureaucracy.

Case Study: Chittagong

Consider Bangladesh's main port, Chittagong.

- The port is continually racked by delays and strikes, forcing exporters to hire expensive air-cargo space to get orders to market in time.
- Dock workers and state companies recently killed Stevedoring Services of America's plan to invest over $200 million to build a container terminal.

No Surprise.

Given its weak comparative advantage in garments, it is particularly difficult to understand why Bangladesh has done so little to either take steps to make the garment sector more competitive or develop alternative sources of jobs.

After all, it isn't as if the end of the textile-quota regime sneaked up on anyone.

- The end of the 30-year-old Multi-fiber Agreement (MFA) that regulates $500 billion world trade in textiles -- was set with the founding of the WTO in 1995.

Time Bomb.

Bangladesh now faces a challenge that will test it like nothing since its bloody 1971 independence revolt against Pakistan.

- Bangladesh faces the potential collapse of a garment industry.

- That would be devastating. Why?

Primacy of Garments.

The garment industry anchors the economy and sustains millions of families.

- Bangladesh gets 75% of its hard-currency earnings from garment exports.
- Garment factories employ as many as 2 million workers, or half the nation's entire industrial workforce.
- About 85% of these workers are women.

End of Garment Quotas.

The expiration of MFA as of January 1, 2005, has the following ramifications.

- The MFA gave rise to Bangladesh's garment industry a generation ago by guaranteeing it reliable access to apparel racks in the U.S. Europe.
- In turn, the MFA used quotas to limit competing garment exports from more efficient behemoths like China.
- In the MFA's place, starting in January 2005 will be a more open market for textiles and garments overseen by the WTO.

China Corners Market.

World Bank estimates that China will corner the market by controlling 50% of global garment exports by 2010, up from about 20% today.

- Why?
- The Chinese garment makers enjoy vast economies of scale, a deep pool of cheap labor easily bent to the political will, and fully integrated cotton, textile and garment industries.

Bangladesh Loses Market Share.

China's growing market share in garments does not bode well for Bangladesh once the remaining quota barriers disappear.

- The end of MFA will sharply diminish demand for garments stitched in Bangladesh.

Unemployment Could Soar.

Most experts estimate the country will lose 1 million garment jobs.

- Also at risk are the jobs of many of the 15 million people who work in related industries, whether button-makers or truckers.
- For them, there is no state social-security plan, no unemployment benefits.

Dangerous Context: Lawlessness.

What does Bangladesh do with a million laid off, urbanized garment workers in a country with no other industry to absorb them?

- That prospect couldn't come at a worse time for Bangladeshi society.

- Bangladesh is a nation in which lawlessness is rising.
- Watchdog group Transparency International recently named Bangladesh the most corrupt nation of the 133 it surveys.

Poverty and Extremism.

The garment industry in Bangladesh punctuates an issue raised since the breakdown of WTO talks in Cancun, Mexico in 2003.

- Does poverty provide opportunities for extremism?
- If so, can the world afford unfettered free trade if the price is the potential erosion of social stability in marginalized states?
- The question is not just academic in Bangladesh.
- Sadly, free trade in Bangladesh could prove a disaster.

Dangerous Context: Islamic Conservatism.

Bangladesh is also a nation where Islamic conservatism is fast gaining ground.

- In fact, Bangladesh's secular political tradition is in retreat.
- In October 2001, the Muslim fundamentalist Jamaat-e-Islami (JI) party surprised many by capturing 17 seats in the 300-seat parliament.
- The JI calls for an Islamic state.
- Senior JI members control ministries of industry and social welfare.
- The popularity of Islamic religious schools is growing in rural and urban areas.
- Remote areas of the country have become ungovernable havens for militant Islamists opposing the governments in neighboring India and Burma.

Breeding Ground.

Bangladesh exporters stand to lose their overseas markets and, with them, 1 million jobs, as the result of MFA expiration.

- That threatens social and political stability.
- Bangladesh could also become a prospective and fertile recruiting ground for terrorist organizations.

CONCLUSIONS

The Bangladeshi economy continues to be that of one of the poorest and most densely populated countries in the world. The government is addressing the poverty. The government has started to implement economic reforms. International donors have responded favorably to these economic reforms. They have rewarded the country with rising amounts of foreign aid.

The economy has also been helped by a good agricultural performance, strong exports due to a revival in global economy, and rising remittances form Bangladeshi people overseas. These drivers have spurred relatively good economic growth.

On the negative side, endemic political instability, devastating and economic nationalism deter any significant rise in foreign direct investment.

A final note regarding negative trends -- the 30-year-old Multi-fiber Arrangement had provided Bangladesh with a guaranteed garment export quota. With the expiration of the Agreement since January 1, 2005, Bangladesh faces the potential collapse of a flagship garment industry.

- China wasted no time exploiting this new playing field in January and February 2005.
- The World Bank, WTO and IMF are unanimous in their pessimistic assessment of the Bangladeshi garment and textile industry's outlook.
- Bangladesh could lose up to 1 million garment jobs.
- That could trigger social unrest, political instability and the rise of terrorism.

SUBSEQUENT ECONOMIC UPDATES

02 May 2005

Socio-economic instability is rising in the Muslim world and is challenging U.S. interests.

- Recent trends in social and economic activity in numerous Muslim-majority countries – including Bangladesh, Indonesia and Malaysia -- paint a grim picture and point to significant challenges ahead.
- Socioeconomic woes are creating environments in which discontent is growing and in which activist or radical Islamic messages have increasing resonance.
- Islamic activism often finds strong support among populations buffeted by poor economic conditions and young people whose aspirations for a better life have been thwarted.
- Though not the only factor, socioeconomic frustrations are among the key drivers of alienation and radicalism.

Economic Advisor's Comment:

These adverse trends provide conceptual justification for the following:

- National Strategy for Combating Terrorism Goal # 3 -- Diminish the Underlying Conditions that Terrorists Seek to Exploit;
- 9/11 Commission Report Recommendation # 7 – Provide Hope and Socio-economic Opportunity;
- National Military Strategy Plan for the War on Terrorism (NMSP-WOT) Pillar on Environment Development;

In addition, these trends provide new impetus for the PACOM J5/Joint Interagency Coordination Group for Combating Terrorism (JIACG-CT) and National Intelligence Council (NIC)/CIA co-sponsored Conference at the US Army War College (USAWC) on Addressing Socio-economic Conditions that Foster Terrorism, 8-10 June 2005.

- This PACOM/CIA/USAWC conference discussed the US inter-agency process that is trying to drain the swamp (or reverse these grim socio-economic conditions), identify gaps in the process and recommend creative and decisive new ways to overcome them.

INDIA

• CHAPTER 2 •

Executive Summary.

At first glance, India is shining and its growth is impressive. However, not enough of the Indian population enjoys the fruits of this prosperity.

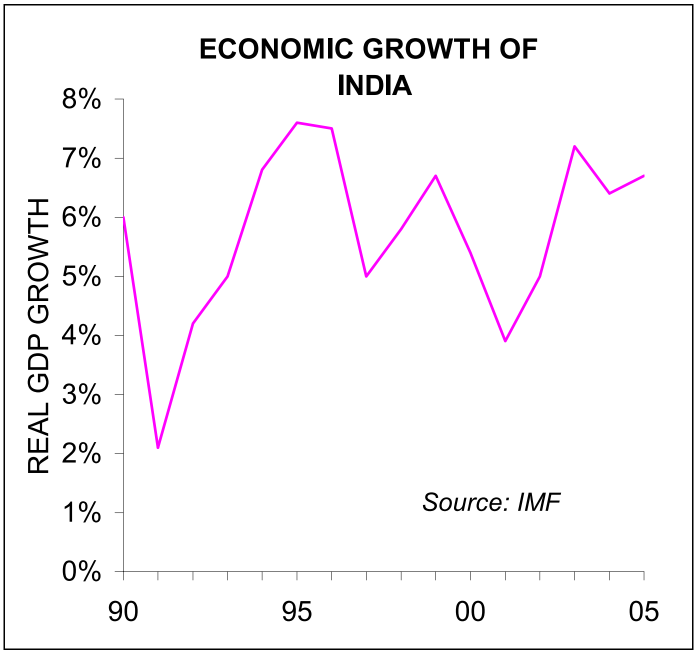
- 300 million poor Indians are frustrated that they have been left behind. They voted out a complacent BJP that ignored their needs and aspirations.
- The new government's challenge is to sustain the economic boom while delivering on social promises to the poor. The focus will be on strengthening agriculture and improving education.
- An inherited fiscal nightmare will make it difficult to execute these objectives. (Three first rate economic strategists, -- Manmohan Singh, Prime Minister, P. Chidambaram, Finance Minister and Montek Singh Ahluwalia – who currently give the government a fighting chance.)
- A grass roots strategy will be used to avoid bureaucratic sabotage.
  - Communists in coalition are a new asset to achieve rural objectives.
  - Business is onboard and supports the strategy because it modernizes infrastructure and will boost rural consumer spending.

Figure A. Selected Historical Data

India	2001	2002	2003	2004
Purchasing Power $B	2,594	2,769	3,023	3,291
GDP $B (Nominal)	471	495	576	661
GDP Growth (Real)	4.8%	4.4%	7.5%	7.3%
Inflation	3.8%	4.3%	3.8%	3.8%
Exports $B	43.4	49.3	57.1	72.5
To U.S. $B	3.8	4.1	5.0	6
Imports $B	50.4	56.5	71.2	95.2
From U.S. $B	9.7	11.8	13.1	15
FDI held by U.S. $B	2.5	3.3	3.6	...
held in U.S. $B	0.3	0.3	0.2	...
Gross Intl Reserves $B	51.0	71.9	107.4	134.6
Savings /GDP	23.4%	24.5%	24.1%	25.2%
Fiscal Balance /GDP	-10.0%	-9.5%	-9.4%	-9.1%
External Debt /GDP	21.0%	21.3%	19.4%	20.0%
Current account/GDP	0.3%	1.4%	1.2%	0.3%

Sources: IMF, Asian Development Bank, World Bank,
U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Introduction.

Initially, India's recent macroeconomic performance would appear impressive.

- GDP surged a respectable 7.5% and 7.3% in 2003 and 2004.
- A 15% rise in corporate earnings in FY 2004.
- Foreign direct investment (FDI) also poured into Indian sectors such as stocks, manufacturing and tech start-ups.

GOOD ECONOMIC NEWS

Is India Shining?

The campaign slogan of ruling BJP was – "India is Shining."

- The ruling BJP figured that this amazing economic growth – second only to China in Asia -- would make it invincible in an early general election.
- So the BJP called for an election in May 2004.

BAD ECONOMIC NEWS

Privileged Few.

But not enough Indians enjoy the fruits of its current prosperity. India's IT sector accounts for fewer than 1 million employees in a total labor force of 430 million people.

- This "2nd India" includes 65% of the Indian people, who live on agriculture -- a sector that has stagnated.
- This "2nd India" also includes urban poor living in wretched slums.
- Moreover, this "2nd India" includes 380 million Indians who are illiterate.
  - 300 million Indians – or 40% of the world's poor -- live on less than $1 a day.1
  - 160 million Indians have no access to clean water.
  - Over half of India's rural and urban poor have no electricity.

What's Wrong?

There are a number of reasons for why this "2nd India" exists.

- Government spending on rural India has been miserly.
- The money that does go to the countryside is poorly managed.
- The result?
  - Rural roads, electrification, irrigation, health care, basic education and sanitation are poor.

2nd India Vents.

Not surprisingly, this 2nd India is frustrated that it has been left behind.

- How did this 2nd India vent its frustration?
- It voted.

BJP Voted Out.

In the recent election, poor Indians shocked the world.

- They rose up and voted out the complacent ruling BJP party that ignored their needs and aspirations.
- The poor had their voice, and the Congress Party heard their voice.
- But that vote should not be construed as a vote against reform.
- It was a vote against the complacency of urban elites who had neglected the countryside where two-thirds of Indians live.

Second Shock.

Subsequently, Mrs. Gandhi gave her victorious Congress Party supporters a second shock:

- She renounced the chance to become prime minister of the world's largest democracy.

Market Jitters.

At first investors feared that communists and other leftists in the new Indian government would stop economic reform in its tracks.

- They panicked and the stock market plummeted.

ECONOMIC BACKGROUND

Market Euphoria.

Then Mrs. Gandhi executed a political masterstroke, choosing Manmohan Singh to be her Prime Minister.

- Singh is a national hero who rescued India from financial crisis of 1991 and put its old socialist economy on the path to free-market reform.
- With Singh in charge, investors see no repudiation of reform and no all-out lurch to the left.
- Investors rejoiced and the stock market bounced back.
- Investors cheered again when Prime Minister Singh picked P. Chidambaram, a fellow architect of the reforms in the 1990s, to be his new Finance Minister.

Government's Challenge.

That said, the government's challenge is daunting. The challenge is broadly two-fold in nature:

- Keep the economic boom going.
- Deliver simultaneously on its social promises to an angry electorate.

Information Technology (IT) Sector Unbroken.

One part of the economy that's still healthy is the IT sector.

- Therefore, it's unlikely that a government headed by Singh and Chidambaram will derail the IT sector.
- The IT sector has grown with little public spending.
- Most software firms and call centers have their own power generators, water supplies and high-speed telecom links.

Broken Sectors. [2]

But if IT looks good, the new government is determined to fix two broken sectors in the countryside:

- Agriculture
- Education

Agriculture.

The agricultural sector, on which 2/3 of the population depends, is facing serious problems.

- Annual growth in the past 6 years has averaged less than 1%.

- With an annual population growth of about 1.9%, rural incomes are at best stagnating.
- Government machinery in rural India is woefully weak.
- Big, politically connected farmers benefit by getting half of the free fertilizer, water and power which the government hands out.
- About 75% of the land has no irrigation at all.

Education.

India will never attain sustained high economic growth unless it has better human capital.

- The size of the financial pie for primary education is pathetically small.
- The teachers' slice of the pie (97% in salaries) means that there's virtually no money left for books and other requirements.
- Little wonder that India's literacy rate of 62% lags far behind China's at 85%.
- The new government correctly argues that India must spend on education at least twice as much as spent by the BJP.

Fiscal Woes.

Of course, all these programs will cost additional billions of dollars.

- Unfortunately, the new government inherits a fiscal nightmare from the BJP.
- The consolidated budget deficit, split half and half between the center and the states, has lodged stubbornly above 10 % of GDP in recent years.
  - The 10% deficit figure is one of the highest rates in the world.
  - The 10% figure is also well beyond the 3% figure that rings alarm bells for financial instability.

Why the Fiscal Mess?

The fiscal mess reflects a number of factors --

- Inadequate tax revenue is eaten up by wages and subsidies, amounting to nearly 15% of GDP.
- These wages and subsidies mostly benefit rich farmers -- and amount to about 4 times total public investment.
- In an investment-starved country, the result is significant financial shortfalls in –
  - Public investment (infrastructure, education, health care) to underpin the growth India needs to lift more than the poor out of abject poverty.

A NEW POLITICAL AND ECONOMIC ERA

Singh: Right Skill-Sets.

If anyone can solve the budget mess, it's arguably Singh.

- When Singh became Finance Minister in 1991, India was in a full-blown balance of payments crisis.

- Singh devalued the rupee, liberalized strict controls on industrial investment, lowered import tariffs and opened numerous industries to competition.
- He also whittled down India's massive budget deficits and its national debt, as well as its foreign financial obligations.
- Thankfully, the July 2004 budget finally reflects Singh's golden rule for government budgeting:
  - "The government only borrows to invest."

Bureaucratic Obstacles.

Even if Singh can solve the budget mess, these social programs must then be efficiently implemented. That's a hard task.

- India's dysfunctional bureaucracy can sabotage Singh's vision and strategy.
- But the new government has a secret weapon:
  - Meet Montek Singh Ahluwalia.

Ahluwalia's Grass Roots Vision.

Ahluwalia quit his job at IMF and recently joined Singh and Chidambaram as the third member of the government's holy trinity of economic reformers.

- Ahluwalia is a strong champion of "subsidiarity," an awkward EU term which in plain English is defined as "reducing decision-making authority and control to the lowest level possible."
- Skeptics accustomed to dynamic, top-down leadership with authority, say Ahluwalia's grass roots leadership without authority will never work.
  - But the skeptics tend to be Westerners whose frame of reference is the steady decline of civic organizations in the U.S.[3]
  - In contrast, India is blessed with vibrant civic organizations that include retired engineers, doctors and economists, who would be happy to participate in Ahluwalia's local governance.

Direct to the Village.

If anything, the election results are a powerful reminder of the mandate that India needs comprehensive reform at the grassroots level in the villages.

- By going right to the village council level or panchavat, the government hopes to reduce bureaucracy and circumvent obstructive state governments.

Political Constraints.

In addition, Singh's job will be complicated by the fact that the Congress Party is part of a left leaning coalition of a dozen other parties.

- Therefore, Singh will need to placate the communists in at least two ways.
  - Singh will have to slow or halt further sell-offs of state assets in sectors – or as the pithy Communist Party General Secretary AB Bardhan says, "Let privatization go to hell."
  - The communists also oppose reform of labor laws that stifle new manufacturing investment by making it hard to hire and fire as needed.
  - What's the impact of no sell-offs and more labor rigidity?

– Such moves will probably deprive the government of some badly needed revenues, curtail growth and dampen new private investment.

Communists: Net Asset.

While some slowdown in reform is to be expected with the communists onboard, it's incorrect to argue that the communists are a net liability in creating the foundation for prosperity.

- Quite the contrary.
- In actuality, the communists have done remarkably well in spreading literacy and land reform in the two states they rule, Kerala and Bengal 4
- In a country that desperately needs more FDI, the communists in Bengal and Kerala also have proved to be surprisingly flexible.
- In the party's stronghold, the state of West Bengal, the communist-led government has shut down loss-making state-owned enterprises (SOEs), promoted IT, wooed foreign investors and discouraged labor militancy.
- Such progress has started to pay off in investments from companies such as IBM, Wipro and Pepsico.

Why Business is Onboard.

On balance, the government's economic strategy contains no nasty surprises for private business.

- The Indian business community is generally quite positive towards Singh's strategy.

Infrastructure Modernization.

For instance, India's business community is delighted that the new government correctly argues that it must ease major bottlenecks to industry.

- They applaud the new government's decision to step up investment to modernize the nation's dilapidated roads, electricity, distribution routes, ports and airports.

More Consumers.

In addition, India's business community is a strong supporter of putting an emphasis on uplifting the rural poor.

- Why?
- Indians businesses applaud the prospect of bringing 400 million people at the bottom of the social pyramid into the consuming classes.
- Wider primary education lifts rural incomes.
- Tapping into rising rural purchasing power will trigger a multiplier effect, creating an even greater demand for Indian manufactured goods.

Balance Sheet.

As the government starts to pursue its new economic strategy it faces:

OPPORTUNITIES AND RISKS

Opportunities.

In this regard, the new government has an opportunity to implement new, worthwhile initiatives in three areas:

- Schools. The government pledges to boost education for the poor, which could bring hundreds of millions into the skilled workforce.
- Rural Development. Some 65% of Indians depend on agriculture. Congress promises to build infrastructure in the countryside.
- Health. Congress vows to improve rural health care and lower infant mortality.

The Risks.

That said, the new government includes communists and other left leaning members. That raises risks in three areas:

- Privatization. Left wing party supporters of the Congress-led ruling coalition will slow down or halt the sale of companies.
- Labor Reform. The new government likely won't dismantle rules that make it hard for companies to fire unneeded workers.
    - Budget Deficit. Big increases in social spending could widen India's already huge public sector debt.

CONCLUSION

At first glance, the Indian economy is shining. India's macroeconomic performance is on a roll.

- Unfortunately, not everyone in India benefits from this prosperity.
- In fact, only a small minority of Indians enjoys the fruits of this prosperity.
- Most Indians are poor and frustrated that they have been left behind.

How do poor Indians express this frustration?

- They vote.
- They rejected the ruling BJP party that ignored their needs and aspirations.

What is the new government's biggest challenge?

- The government must somehow sustain the economic boom while delivering on social promises to the poor.
- Toward this end, the new government needs to focus on strengthening agriculture and improving education.

That said, the Indian government faces a more immediate problem.

- The new government inherits a fiscal nightmare that will make it difficult to execute its strategy.
- Thankfully, the government has three first rate economic strategists.
  - Manmohan Singh, Prime Minister
  - P. Chidambaram, Finance Minister
  - Montek Singh
- That gives the government a fighting chance to manage this fiscal mess.

Can the strategists overcome bureaucratic red tape?

- Yes.
- They have a grass roots strategy that will help reduce bureaucratic sabotage.

Are the communists in the coalition a problem?

- On balance the communists are a net asset.
- They spread literacy and land reforms, shut down SOE losers, promote IT, attract foreign investors like IBM and discourage labor militancy.
- That more than offsets their opposition to both sell-offs and labor market flexibility.

Is the Indian business community onboard?

- Yes.
- Business applauds the new strategy because it modernizes infrastructure and will boost rural consumer spending.

INDIA'S QUEST FOR ENERGY SECURITY

Executive Summary.

In mid-March 2005 Secretary of State Rice told India that the U.S. is concerned about an Iranian-Pakistani-Indian gas pipeline and India's energy cooperation with Iran.

- In January, four Indian energy companies signed a $40 billion deal with Iran to import Iranian liquefied natural gas and help develop three Iranian oil fields.
- In February, New Delhi announced India's intention to build a $4 billion pipeline that would send natural gas from Iran to India via Pakistan.
- India's energy cooperation with Iran is at odds with U.S. economic policy toward Iran.
- U.S. economic sanctions against Iran are intended to dissuade Iran from getting nuclear weapons.
- In February, U.S. Ambassador to India David Mulford warned New Delhi that the Iran and Libya Sanctions Act of 1996 might require the U.S. to sanction Indian companies doing business with Iran.

While Iran's nuclear status is a vital issue to the U.S., India – a new member of the nuclear weapons club -- sees Iran's nuclear status as secondary to India's vital energy needs.

- India's energy shortfall drives it on a global quest to lock in access to reliable energy supplies wherever it can get them, even with "pariah" states like Iran.

The Indo-Pak-Iran pipeline promises India a) energy security, b) better infrastructure to attract foreign investment and c) a key confidence building measures to reduce tensions with Pakistan.

- Pakistan has offered security guarantees for the pipeline to protect it from terrorist attacks and assure uninterrupted passage of the fuel.
- India and Pakistan say the shared prosperity from this "peace pipeline" could provide the two sides with an economic incentive to avoid a third war and give peace a chance.

U.S. Strategic Calculus.

Secretary of State Rice met with Indian Prime Minister Singh on 17 March 2005 in New Delhi and said the U.S. is "concerned" about a) a gas pipeline that would run from Iran to India via Pakistan and b) India's energy cooperation with Iran.

- India's energy cooperation with Iran is at odds with U.S. economic policy toward Iran.
- The U.S. says the technology Iran is using to build a heavy-water nuclear reactor can produce nuclear weapons. The U.S. wants Iran to abandon the program.
- U.S. economic sanctions against Iran are intended to dissuade Iran from developing the capability to produce nuclear weapons.
- In February Mr. David Mulford, U.S. Ambassador to India, warned New Delhi that the Iran and Libya Sanctions Act of 1996 might require the U.S. to apply economic sanctions against Indian companies doing business with Iran.

Alternative Pipeline.

The U.S. suggests India could address its energy needs in ways that do not inadvertently appear to reward Iran's bad behavior.

- The U.S. would prefer that India imported its natural gas from Afghanistan instead of buying it from Iran.
- Therefore the U.S. is encouraging India to consider the alternative of opting for a competing trans-Afghanistan gas pipeline.
- Unfortunately, India says Iran is a more cost-effective supplier and the most geographically convenient supplier of natural gas for India.

India's Energy Shortfall.

While Iran's nuclear status is a vital issue to the U.S., India – a new member of the nuclear weapons club -- sees Iran's nuclear status as secondary to India's vital energy needs. In this regard, India faces a severe energy shortfall.

- Power outages and blackouts continue to plague India's major cities. And the demand-supply gap is widening.
- Domestic natural gas production of 74 million cubic meters is less than 40% of the projected demand of 188 million cubic meters for 2006.
- This shortfall undermines the confidence of investors and foreign companies operating in India.
- India lacks energy-efficient technologies and relies on energy heavy industries for its development.

- India's rapidly growing economy cannot reach its potential growth rates without drastic action to boost its energy shortfall.
- India's demand for oil is set to grow at an annual rate of at least 3.6% during 2005-07.

Technology Gap.

To some extent, India's energy shortage arises from technological shortcomings in its domestic energy production.

- India's low drilling recovery rates are a major part of the oil supply problem for India. Historically, recovery rates have averaged well below the world average. 5
- If New Delhi would allow foreign investment to bring in technology that is not available to Indian state firms, the overall recovery rate would go up.
- For instance, U.S. energy companies such as Exxon-Mobil could provide sophisticated, deep drilling equipment to India, which would enable India to boost its heretofore-inefficient domestic energy production.
- Unfortunately, India's economic nationalism still discourages this kind of foreign investment.

Domestic Efforts Fall Short.

India's domestic production currently satisfies only about 30% of its energy needs. New Delhi has initiated numerous policies to address the country's growing energy needs:

- For instance, India is creating 15-45 days of emergency energy reserves.
- India is diversifying beyond oil to access other energy resources such as nuclear power, coal, natural gas and other renewable energy resources.
- Unfortunately, India can't radically reduce its dependence on imported energy.
- India presently imports 70% of its energy needs, a dependence that will swell to 92% by 2020.6

Primacy of Imports.

Therefore, for the short to medium term, India will have to rely on an increasing amount of imported oil and gas to meet its energy needs.

- Unfortunately, India has active conflicts on almost all of its borders with neighboring states.
- India's difficulties in accessing energy resources on its doorsteps have propelled New Delhi further afield in its desperate quest for energy security.
- India's energy shortfall drives it on a global quest to lock in its access to energy supplies wherever it can get them, even with "pariah" states like Iran.

Indian-Iranian Energy Cooperation.

This desperate quest for energy security has provided the impetus for the acceleration of Indian-Iranian energy cooperation the past few months:

- On 7 January 2005, India signed a preliminary agreement with the National Iranian Oil Company, unofficially estimated to be worth $ 40 billion, which committed the country to import liquefied natural gas and develop two Iranian oilfields and a gas field.
- India will import 7.5m tons of liquid natural gas (LNG) starting in 2009 for the next 25 years.

- India's ONGC will also help develop the Iranian oilfields in exchange for 90,000 barrels a day of crude oil.
- In February, PM Singh's government announced India's intention to construct a $4 billion 1,700-kilometer pipeline from Iran's South Pars natural gas field (the world's largest), with 700 kilometers passing through Pakistani territory.7
- Indian officials say Iran could eventually provide for as much as 50% of India's natural gas needs.

CBM with Pakistan.

The Iran-Pakistan-Indian gas pipeline also offers a key confidence building measure (CBM) to reduce tensions with Pakistan.

- Pakistan has offered security guarantees for the pipeline to protect it from terrorist attacks and assure uninterrupted passage of the fuel.
- India and Pakistan say the shared prosperity from this "peace pipeline" could provide the two sides with an economic incentive to avoid a third war and give peace a chance.

International Support.

The international community has shown growing interest in the Iran-Pakistan-India pipeline.

- The World Bank and Japan's Sumitomo Mitsui banking Corporation are willing to finance the project.
- Russia also supports the project.

CONCLUSIONS

India's gas pipeline with Iran and Pakistan and its energy cooperation with Iran is at odds with U.S. economic policy toward Iran.

- While Iran's nuclear status is vital to the U.S., India sees Iran's nuclear status as secondary to India's vital energy needs.
- India's energy shortfall drives it on a global quest to lock in its access to energy supplies wherever it can get it, even with "pariah" states like Iran.
- The Iranian-Pakistan-Indian gas pipeline promises a) India energy security, b) a stronger infrastructure to attract foreign investment to boost economic and c) a key confidence building measure to reduce tensions with Pakistan.
- India and Pakistan say shared prosperity from "peace pipeline" could provide two sides with economic incentives to avoid a third war and give peace a chance.

SUBSEQUENT ECONOMIC UPDATES

23 February 2005

As China and India prepare for the upcoming summit in New Delhi commercial ties are an increasingly important part of their overall relationship.

- From only $1.8bn in 01, bilateral trade will hit $14bn in India's FY that ends in March 2005.
- By Chinese standards the numbers are still small - its exports are more than $300bn.

- But in 2 years China is set to overtake the EU as India's largest trading partner, having been its 9th largest in 2001.
- Until 2002 there were no direct flights between India and China: now there are five a week.

Economic Advisor's Comment:

China's superior infrastructure and India's inability to move rapidly ahead with micro-economic reform means China will still probably outperform a rising India.

- In this regard, New Delhi used to fear cheap PRC imports flooding the market in India. That didn't happen.
- India actually has a trade surplus with China, thanks to Indian raw material exports (cement and iron ore) and its manufacturing exports (plastics and steel).
- China and India's economic strengths are mostly complementary rather than clashing.
- China has become the world's workshop for manufactured goods and India is developing a highly competitive service sector.
- Thus from a commercial perspective China and India generally enjoy a positive sum game.

24 February 2005

Growing Sino-Indian commercial ties are promoting improving Sino-Indian relations, notwithstanding security concerns.

- These commercial ties are an impetus for a possible summit before long in New Delhi between PRC Premier Wen and Indian PM Singh.
- Bilateral trade has risen from just $1.8bn in 20001 to an estimated $14 billion in India's FY that ends in March 2005.
- In 2 years China has risen from India's 9th largest trade partner in 2001 to India's largest trading partner in 2003.
- Until 2002 there were no direct flights between India and China. Today there are 5 flights a week.

Economic Advisor's Comment:

- New Delhi used to fear the prospect of cheap PRC imports flooding the market in India. That's not happening.
- Indian raw material exports and manufacturing exports enable India to enjoy a modest trade surplus with PRC.
- China and India's economic advantages mostly complement rather conflict with each other.
- China has become the world's workshop for manufactured goods and India is developing a highly competitive service sector.

01 March 2005

India announced a new budget that boosts spending on defense, infrastructure and the poor.

- Corporate tax cuts and openings to foreign investment in banking helped stocks to soar to new highs.

Economic Advisor's Comment:

The budget strikes a reasonable balance:

- Higher defense spending cuts delays in modernization and enhances the war on terrorism.
- Infrastructure spending reverses inadequate foundation to sustain growth.
- Poverty reduction helps to spread prosperity to rural areas and maintains communists political support.
- However, no major cut in high fiscal deficit raises financial concerns at Standard and Poor's.

21 March 2005

India and Pakistan concluded a summit this weekend that provides them with new economic incentives to avoid a third war.

- They took significant steps towards creating a "soft border" across Kashmir.
- These include allowing trade routes to re-open after a hiatus of more than half a century. As part of efforts to make the border more porous, trucks will be allowed to cross it for the first time since the two countries went to war following the 1947 partition of British India.
- India and Pakistan plan to launch a railway link between the Indian state of Rajasthan and the Pakistani province of Sindh by 01 January 2006.
- The agreement follows this month's historic re-launch of bus services from Srinagar, in Indian-administered Kashmir, to Muzaffarabad in Pakistani territory across the Line of Control.

Economic Advisor's Comment:

- Pakistan would probably reap $600 million to $700 million annually in transit fees from the pipeline.
- The pipeline would also bring jobs to the restive Pakistani regions of Baluchistan and Sind, thereby improving the social and economic environment – a key pillar in the new U.S. National Strategic Plan for the War on Terrorism (NMSP-WOT).

11 April 2005

Trade continues to be a driving force in improving relations between India and China.

- The thrust of Chinese Premier Wen's 4-day visit to India was put to commercial cooperation over commercial conflict.
- Premier Wen said bilateral trade would soar if the two nations tempered their inevitable race to secure energy and raw materials with collaboration in other areas.
- The leaders of the world's tow fastest-growing major economies agreed that they have much to gain from economic cooperation.
- Two-way trade reached $13.6 billion last year, up from $3 billion in 2000.

Economic Advisor's Comment:

To push their trade even higher, China and India agreed that a joint task force should consider a free-trade agreement (FTA) between their nations.

- If a FTA were created, it would be the world's largest tariff-free area and encompass 2.3 billion consumers or one-third of humanity.

- A Sino-Indian FTA makes good commercial sense because China and India's economic strengths are mostly complementary rather than clashing.
- Synergies exist between synchronizing India's software skills with China's hardware prowess in mass manufacturing.
- In the past, New Delhi used to fear cheap PRC imports flooding the market in India. That's not happening. In fact, India actually has a trade surplus with China.
- Thus from a commercial perspective China and India generally enjoy a positive sum game.

06 May 2005

India's long awaited economic reforms under Prime Minister Singh are finally gaining some traction. At his 4 May 05 cabinet meeting, Prime Minister Singh signed off on two pieces of legislation central to the reform agenda:

- One will allow states to introduce Chinese-style special economic zones (SEZ)
- The other will spur banking consolidation by removing a 10% limit on the voting rights of shareholders in Indian private banks.
- Other steps the government has taken include the introduction of a value-added tax (VAT); the lowering of customs duties; the passing of a controversial patents bill; and the easing of foreign direct investment in sectors such as construction.

Economic Advisor's Comment:

Prime Minister Singh has spent an awkward year trying to appease both markets and Marxists.

- His government is dependent on the outside support of Communist parties, which control 61 of the 543 seats in parliament.
- The communists wield an effective veto over privatization and much-needed labor market reform and represent a significant brake on the liberal agenda.
- Brought to power on promises to spread the benefits of economic growth to India's rural and urban poor, the government is under pressure to speed up the implementation of social elements of the Common Minimum Program, the policy blueprint agreed after the May victory.
- The government has taken a calculated risk with the high budget deficit – Finance Minister Chidambaram said in February that he was about to “press the pause button” on deficit reduction.

30 June 2005

India's economy is growing at its fastest pace in 9 months.

- India's GDP growth has accelerated to from 6.4% in 4 Q 2004 to 7% in 1 Q 2005
- India's manufacturing growth remains buoyant and its export sector is booming.

India's economic success reflects:

- Growth in the purchasing power of India's expanding middle class
- Improved competitiveness of Indian industry, particularly the manufacturing sector
- Growth in the availability of rural credit
- Cuts in the corporate tax rate and industrial tariffs

Economic Advisor's Comment:

Despite this positive economic performance, New Delhi is struggling to please both financial markets and its communist political allies.

- The communists boycotted the coalition's main coordinating body over plans to sell off 10% of the state-controlled electrical equipment group.
- That's a painful reminder of the severe political constraints facing the country's economic reformers.

Not surprisingly, the government's economic reforms lack a coherent master plan, with too many actions haphazard and piecemeal.

- The communists have forced the government to drop plans to relax rigid labor laws.
- Vital infrastructure plans are on hold, with a bloated bureaucracy undermining the effort.
- Implementation of reform plans are also weak, with plans stalled to relieve chronic electricity shortages.

18 July 2005

At the US-Indian summit, POTUS proposed US support for India's civilian nuclear program - a dramatic policy shift that would end 4 decades of US economic sanctions against India.

- Previously the US had barred providing atomic technology because of New Delhi's status as a nuclear power that has refused to sign the nuclear Nonproliferation Treaty (NPT).
- India agreed to identify and separate its civilian and military nuclear programs, continue a moratorium on nuclear testing and place civilian nuclear facilities under the UN nuclear watchdog.
- But these are all voluntary, not legal India commitments and India remains outside the NPT.

Economic Advisor's Comment:

The POTUS proposal is a creative new policy direction that addresses India's insatiable appetite for energy.

- It would boost US-Indian trade and strengthen US security ties with India as a counterweight to China.

But the Bush Administration faces major legislative and international hurdles since India is not a signatory of the NPT.

- POTUS will seek agreement from Congress to adjust US laws and policies.
- POTUS will also work with friends and allies to adjust international regimes to enable full civil nuclear energy cooperation and trade with India.

None of this will be easy.

- US congressional critics are already accusing POTUS of "playing favorites."
- They argue that it sets a bad example for Iran and North Korea.

04 August 2005

Last week India and Pakistan reopened the Wagah border in Punjab to trade for the 1st time in 58 years.

- The Wagah border in Punjab is the only road crossing between the two countries.
- Indian officials project annual two-way trade to rise from $600 million to $6 billion in the near future.

- The plan is for India to export and allow buffaloes, goats, garlic, onions, and potatoes into Pakistan.
- Just this week Pakistan ended a 4-year ban on imports of Indian sugar.
- More Indian sugar exports across a reopened border with Pakistan will help India's embattled sugar mills.
- For its part, Pakistan sees imports of low priced Indian agricultural goods as helping curb soaring inflation.

Economic Advisor's Comment:

India sees stronger Indian-Pakistani trade links as critical to its vision of shared prosperity creating stakeholders who seek to turn swords into ploughshares.

- India sees the resumption of border trade as a CBM needs before the two sides can resolve their dispute over Kashmir.
- India wants Pakistan to grant it "most favored nation" (MFN) status, a privilege India granted Pakistan back in 2000.
- But Pakistan links India's demand for MFN to a resolution of the quarrel over Kashmir.

Pakistan sees things differently and links India's demand for MFN to a resolution of the quarrel over Kashmir.

- Pakistan's misgivings about granting India MFN before a Kashmir solution reflect strategic considerations.
- If it grants MFN to India, that India's exporters will be entitled, under WTO rules, to use Pakistani road links to reach Afghanistan and central Asia with duty-free clandestine goods.
- Pakistan would also like to reduce its trade deficit with India.

Even if the two sides can boost two-way trade, foreign direct investment (FDI) in each other's country remains low.

- But this situation may be changing, with India once again taking the initiative.
- Tata, an Indian computing company, is seeking to open a training facility in Lahore, Pakistan.
- Dabur, an Indian herbal medicine company, wants to set up a factory in Pakistan.
- But cross-border FDI will remain limited until both sides develop greater trust in each other.
- In this regard, an important CBM for both sides would be the proposed gas pipeline that would run from Iran into India via Pakistan.

23 August 2005

On 22 August, a Chinese oil company outbid an Indian oil company in a bidding war to purchase an oil company in Kazakhstan.

- China's largest state-owned oil company -- China National Petroleum Corp. -- said it had struck a $4.18 billion agreement to buy Petro Kazakhstan Inc., a Canadian-based oil company whose operations are solely in Kazakhstan.
- ONGC Videsh Ltd. -- the international arm of India's state-controlled Oil & Natural Gas Corp. that initially lost out in the bidding war -- was reportedly planning a higher counter-offer.
- Whether Petro Kazakhstan would be receptive to a new Indian offer is unclear.

- But under the agreement, Petro Kazakhstan would have to pay the Chinese company a $125 million penalty if it accepts a rival counter-offer at this point.

Economic Advisor's Comment:

Although oil is a fungible commodity, Beijing and Delhi think otherwise and are fearful about their dependence on foreign oil.

- China relies on oil imports for 40% of consumption while India relies on oil imports for 70% of its consumption.
- Both want to lock up oil resource supplies as they push to rapidly industrialize.

Despite recent talk of Sino-Indian energy cooperation, the bidding war over Petro Kazakhstan shows that India and China are shaping up as fierce competitors.

- Delhi feels it must do more to keep pace with China because Indian oil companies are at a disadvantage next to Chinese companies.
- Chinese companies have access to cheaper loans through the Chinese state and are better able to stomach the exorbitant costs of buying oil assets at a time of high crude prices.

Finally, the recent fuel shortages in China have reinforced a sense of vulnerability for the Chinese, especially in southern China.

- Chinese motorists recently experienced long gasoline lines at the pump.
- The shortages bolstered Beijing's conviction that the country must secure foreign oil fields in order to guarantee a steady supply of fuel to the economy.

Nevertheless, the core PRC oil problem isn't related to crude-oil supplies, which remain tight but sufficient in China.

- The core problem is the government price controls on refined-oil products, which is forcing domestic refineries to sell gasoline and diesel at below-market prices at home.
- As a result, many refineries have been sending their gasoline and diesel to countries where they can make a profit and sell at market prices, thus creating shortages in China.

25 August 2005

After initially losing out to China in a bid to buy Petro Kazakhstan, a Canadian oil company in Kazakhstan, India is redoubling its efforts to join forces with China for other global energy resources.

- An Indian Joint Task Force visited China from 8-13 August and raised the issue of joint Sino-Indian bidding for assets.
- The Indians reportedly found strong support from Chinese state-run firms for joint bidding and cooperation in order to gain economies of scale and negotiating muscle.

The recent bidding war between China and India for the Petro Kazakhstan oil company was too far down the road to reel back.

- But the loss of the India's bid for Petro Kazakhstan has convinced India's Oil Minister Mani Shankar Aiyar to visit Beijing in November to adopt a collaborative approach.

Economic Advisor's Comment:

Whether or not China and India can somehow agree to join forces in oil bidding, the two countries face major challenges to securing new oil reserves.

- For instance, the vast reserves in the Persian Gulf states - some two-thirds of the world's total reserves - are mostly off-limits to foreign companies.
- International oil giants like Chevron and Exxon-Mobil guard their choice assets elsewhere.

Even the US - generally regarded as a free trade oriented country - is now loathe to let oil assets fall into foreign hands, as the uproar and opposition in the US Congress showed at the time of CNOOC's failed bid to buy UNOCAL.

- In addition, Western oil rival blocked CNOOC and fellow PRC oil company Sinopec's attempts to buy stakes in Kazakhstan's huge Kashagan oil field in 2003.
- Russia has thwarted China's CNPC oil company's efforts over the past few years to buy into Russian energy fields.

Admittedly, China's purchase this week's of Petro Kazakhstan would constitute the largest overseas takeover by a Chinese company.

- But this Canadian company is still a small player in the global oil market.
- Petro Kazakhstan currently produces fewer than 100,000 barrels a day, or little more than 1% of China's daily oil needs.

29 August 2005

Indian security concerns may derail Beijing's plans for a PRC telecommunications company to increase its investment in India.

- Huawei, a PRC telecommunications company, is trying to increase its investment in its Indian affiliate in Bangalore.
- Huawei seeks to invest $60 million in its Indian unit, which develops software from a large site in Bangalore.
- Huawei is anxious to expand its presence into areas where 100 % foreign direct investment is now permitted, such as turnkey projects in infrastructure, technology and telecoms.

India's security agencies say they are concerned about Huawei's links with the Chinese military, their clandestine operations in Iraq, and close ties with the Pakistani army.

- Indian intelligence officials say Hauwei's proposal should be rejected because India does not possess the capability or the technical expertise for building an adequate safeguard to address the security concerns in the sensitive area of telecommunications.

Economic Advisor's Comment:

While Delhi's intelligence and security stakeholders have deep anxieties over PRC activities in India, India's policymakers who embrace globalization have successfully warmed up relations between China and India in the $17.2 billion IT-services industry.

- In June, Mr. Wen Jiabao, the Chinese prime minister, was given a tour of India's IT and scientific research establishment in Bangalore, India's IT capital.

- Mr. Wen spoke of "greater co-operation, not competition" between China's hardware and India's software capabilities.
- In July Beijing and New Delhi announced a contract between several PRC state agencies, Tata Consultancy Services, India's largest IT company, and Microsoft, the world's biggest software company, to develop China's offshore technology services industry.

More recently, BK Chaturvedi -- the Indian cabinet secretary working the Huawei issue - warned of a possible negative impact of imposing restrictions on PRC companies.

- He says restricting the Chinese investment in India’s IT sector on the grounds of security could backfire -- adversely affecting the fate of Indian companies based in China.
- Most of India's leading technology services companies have set up bases in China.
- Initially that was as IT partners of global companies but they are now striking out independently for a slice of China's large domestic market for IT services.

ENDNOTES

[1] Source: World Bank
[2] For details, see Common Minimum Program unveiled on 27 May 2004 and the new budget that came out on 8 July 2004.
[3] The steady decline of civic organizations in modern America is discussed in a wonderful book by Robert Putnam called *Bowling Alone*.
[4] Land reform was a critical prerequisite for Taiwan and South Korea’s economic success story.
[5] Source: Energy Information Agency, U.S. Energy Department.
[6] Source: International Energy Agency.
[7] Indian-Iran energy cooperation dates back to a memo of understanding that was signed between Iran and India in 1993 for this same pipelin

NEPAL

• CHAPTER 3 •

Executive Summary.

Nepal continues to struggle with poverty.

- The government and donors try to reduce poverty.
- But Maoist insurgents sabotage their efforts and target development projects.
- In the face of terrorist threats, donors have suspended foreign aid.
- But donors also chide the government for chaotic governance.
- Catastrophic flooding and the end of garment quotas on 1 January 2005, also undermine the economy.

On the positive side, a ceasefire in 2003 spurred the current recovery.

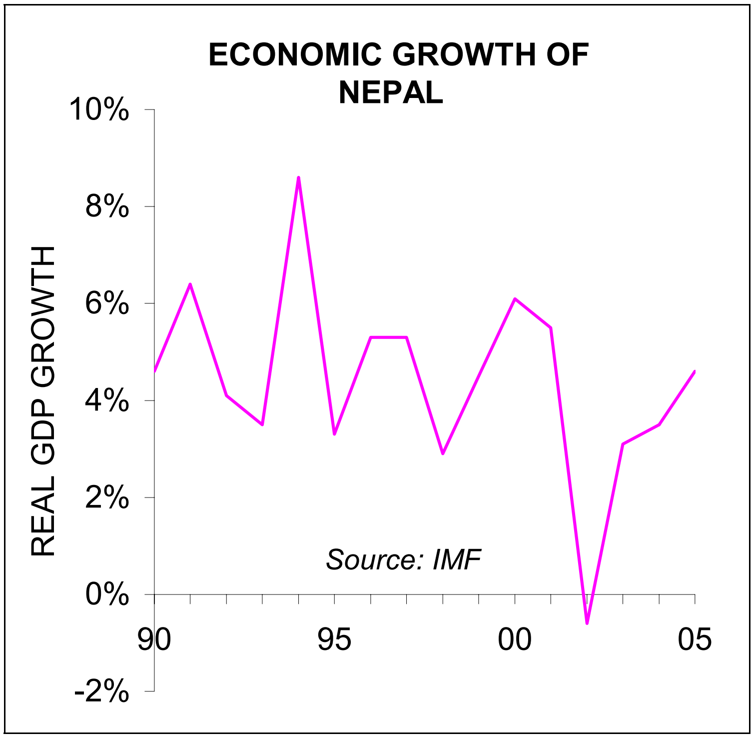
- A new middle class is emerging and is boosting consumer spending.
- Remittances from 700,000 Nepalese overseas boost robust foreign reserves.
- GDP grew at 3.5% in 2004, however this is not enough.

Figure A. Selected Historical Data

Nepal	2001	2002	2003	2004
Purchasing Power $B	33	33	35	37
GDP $B (Nominal)	6	6	6	6
GDP Growth (Real)	5.5%	-0.6%	3.1%	3.5%
Inflation	2.4%	2.9%	4.7%	4.0%
Exports $B	0.7	0.6	0.7	0.8
To U.S. $B	0.0	0.0	0.0	0
Imports $B	1.5	1.4	1.8	1.9
From U.S. $B	0.2	0.2	0.2	0
FDI held by U.S. $B	0.0	0.0	0.0	...
held in U.S. $B	...	...	...	...
Gross Intl Reserves $B	1.0	1.0	1.2	1.4
Savings /GDP	14.2%	17.4%	17.0%	17.0%
Fiscal Balance /GDP	-4.5%	-3.9%	-1.5%	-1.5%
External Debt /GDP	45.6%	47.2%	49.1%	49.4%
Current account/GDP	4.9%	4.5%	2.1%	2.5%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization

Figure B. Economic Growth



LOOK BACK

Peak Performances.

It wasn't long ago that the economy was doing relatively well.

- Tourism peaked in 1999 at about 421,000 visitors.
  - But then visitors were scared away after the December 1999 hijacking of an Indian Airlines flight from Katmandu to New Delhi.
- The rest of the economy was strong enough to generate economic growth of 6% in FY 2000.
  - But that was Nepal's peak year of economic performance.
- And it wasn't long before things started to deteriorate.

2001: Bleak Year.

Things turned ugly in 2001. Internally, the ensuing economic downturn was triggered by --

- The 1 Jun 01 Royal Palace Massacre of 10 members of the royal family

Externally, the 9/11 attack on the U.S. –

- Mugged tourism
- Reduced foreign trade

Under Siege.

As the Maoist insurgency intensified in 2002, the economy was under siege.

- Nepal's economy hit a 20 year low in the FY 2002 ending in July 2002.
- The economy actually contracted 0.4% during this time period.
- Trade and tourism fell 11% and manufacturing declined 10%.
- The 421,00 visitors to Nepal in 2002 was almost 50% of the 1999 level when tourism peaked.

Ceasefire and Recovery.

Thankfully, a ceasefire between the government and the Maoists from January to August 2003 fostered a moderate economic recovery in FY 2003.

- GDP rose 2.6% in FY 2003.
- The ceasefire helped the hard-hit manufacturing sector as well as tourism and foreign trade.

Ceasefire Breaks Down.

Unfortunately, the ceasefire broke down in August 2003.

- Did the resumption of violence hammer the economy?
- Actually the economy in 2004 could have been in a worst state.

Recovery Continues.

Thankfully the ceasefire provided an economic foundation.

- For instance, the formerly muddy, crater-riddled roads in Katmandu have been paved over.
- This upgrade has in turn provided resiliency and momentum to weather the storm now that the ceasefire is broken.
- Most importantly, a new middle class is emerging in Nepal.
- This overseas-educated, newly moneyed generation could be Nepal's ultimate savior.

Outward Signs.

What are the outward manifestations of this new rising middle class in Nepal?

- Despite the Maoist insurgency, Katmandu doesn't feel like a war zone.
- Business in the capital is bustling.
- Katmandu is jammed with new cars.
- Supermarkets are chock-full of Western goods, from boots and cosmetics to French wine.

Rising Remittances.

Obviously, all this money wasn't made in Nepal.

- In fact, a major driver of growth in Nepal has been the surge in the inflow of private remittances from overseas Nepalese.

- While these 700,000 overseas Nepalese work 19 different countries (including the U.S., Britain, Malaysia and South Korea), the bulk of them work in India and the Gulf states.
- They send home about $850 million every year.

Robust Foreign Reserves.

Thanks to these remittances the foreign reserves in Nepal are surprisingly strong.

- Nepal's foreign exchange reserves are about $1.8 billion, sufficient to cover merchandise imports for about 11 months.

Recovery.

So let's try to pull all of this together.

- Remittances, a new middle class and donor support ensure that the recovery continues in 2004, notwithstanding the drag of a Maoist insurgency.
- In addition, a strong performance in agriculture and a rebound in tourism and trade are fuelling the recovery.
- As a result, Nepal's GDP for 2004 grew at 3.5%.
- ADB says Nepal's GDP for FY 2005 should be even higher or about 5%.

Recovery in Perspective.

That said, this is no time for the government to become complacent.

- The good news is that tourism – an industry that employs more than 250,000 people – is on the rise, with a 23% increase in 2003 over the previous year.
- The bad news is that tourist arrivals are just 50% of what they were.
- To make matters worse, hotel owners and tour providers have been forced to slash prices, so earnings from tourism have fallen disproportionately.

Time to Diversify.

Nepal should begin thinking about diversifying into areas where it may have a competitive advantage. These business sectors include –

- Telecommunications,
- Herbal products,
- Light manufacturing

Primacy of Reform.

Internally, the government must start implementing a variety of economic reforms aimed at generating jobs and stimulating investment.

- Nepal would also do a lot better if it could somehow attract foreign investment.
- Unfortunately, investors cite a number of obstacles to FDI. These include –
  - Unwieldy bureaucracy

- Overly restrictive government policies and
- Lack of Infrastructure

Recommended Action:

The best way for Nepal to attract more FDI would be to ensure that those foreign investors already in Nepal are treated equitably, and that laws governing FDI are fairly and expeditiously implemented.

Poverty.

Nepal is among the poorest and least developed countries in the world.

- 38 % of the Nepal's 25 million people live below the poverty line ($1 a day).

Poverty & Insurgency.

The ruling elite claims that it is doing everything it can to reduce poverty.

- For instance, the government's poverty reduction programs are highlighted in the government's new budget, which was unveiled in July 2004.
- Its development budget rose 29% over the revised FY2004 budget.

In contrast, 5,000 Maoist insurgents blame the grinding poverty on what they perceive to be the "social and economic injustice" of the ruling elites.

- Their steadfast social and economic grievances help to fuel a deadly Maoist insurgency that has killed over 7,000 people since 1996.

Foreign Aid.

In the midst of this insurgency, donor support has propped up this poverty-stricken economy. Foreign aid funds 50% of its development budget and accounts for 6 % of GDP.

Maoist Economic Targets.

Maoist insurgents allege that foreign aid is a "capitalist ruse" by the ruling elite and is of little help for the poor.

- As a result, the Maoists sabotage government and donor efforts to reduce poverty by targeting the fruits of this development aid. The targets include –
  - Power plants, foreign investments like a Coca-Cola bottling plant, distilleries, village water supplies and teachers and doctors

The Maoists have also resorted to the use of –

- Regional blockades, general strikes and extortion of businessmen.

Costs of Insurgency.

In addition to the physical damage that the insurgents have inflicted on the economy, the insurgency has undermined business confidence and deterred foreign investment.

- On balance, the U.S. Embassy estimates the combined costs of the insurgency at $1 billion.

Donors Suspend Aid.

Over the years Maoist violence has hampered the work of foreign aid donors such as the UN agencies and the World Bank.

- At a May 2004 Nepal Development Forum (NDF), Nepal's government made a strong appeal for continuing donor support.
  - The government said it needed $ 550 million in additional foreign aid for the coming year in order to revive the subsistence economy and reduce poverty.
- Unfortunately, the government failed to get the foreign aid pledges it wanted.
  - Most of the international donors refused to provide additional foreign aid in the face of threats from the Maoist insurgents and a deteriorating security situation.
  - Local development projects in the impoverished west (where the Maoists hold sway) have been indefinitely suspended.
  - Such programs include the construction of irrigation canals, roads, power projects and drinking facilities in rural areas.
  - The announcement will affect more than 50,000 people in some of the poorest areas of the country.

Donors Chide Government.

While the donors argued that it was impossible to execute economic development in a war zone, the donors also had plenty of criticism for the ruling elite:

- The World Bank delegate said donors were not prepared to write "a blank check" for more of the same chaotic governance.
- The donors demanded democracy, a reconciliation with the insurgents and improvement in the ever-worsening human rights abuses on both sides of the conflict.

More Bad News.

But the insurgency is only the start of the country's economic woes. There's also bad news on the agricultural front.

- For starters, 76% of the economically active population live in rural areas and depend on subsistence agriculture. So any setback to farming affects large numbers of people.
- In this regard, the excessive rain in the eastern part of the country in FY 2003, which damaged rice and maize crops, was also a heavy blow.
- So was the delayed monsoon in the West, which delayed cultivation of mustard, soybean and other cash crops.

Agricultural Constraints.

Unfortunately, there is no quick fix. Agriculture suffers from several disadvantages –

- Poor performance of irrigation projects
- Falling capital formation
- Feudal land tenure system
- Unpredictable weather

Catastrophic Floods.

In regard to unpredictable weather, the catastrophic floods that struck India and Bangladesh in July 2004 also took their toll on Nepal.

- Heavy monsoon rains, resultant floods and landslides have left more than 40 people dead and affected some 13,600 families in the remote southeast and southwest regions of Nepal.

Death Knell for Garments.

In the past, Nepal has enjoyed guaranteed quotas for its exports to the U.S. and other markets.

- Not any more.
- The elimination of quotas under the Multi-fiber Arrangement (MFA) as of 01 January 2005 was the death knell for this critical part of Nepal's private sector.
- Since garments now comprise 52% of Nepal's export earnings, the end of garment quotas will have a devastating impact on the overall Nepal economy unless Nepal can reinvent itself in a hurry.
- Unemployment is almost certain to rise.

Damage Already.

Actually, the impact of the end of garment quotas in 2004 has already been felt in 2005.

- Earlier in 2004, Nepal's garment manufacturers cited a 44% decline in U.S. orders in January/February 2004 versus a year earlier.

Himalayan Challenge.

Why can't Nepalese garment makers compete head to head with regional rivals?

- The average Nepalese garment maker cost is 25% higher and takes twice as long (on average 120 days) to fill orders than regional competitors.
- These higher costs reflect --
  - The small size of the Nepalese economy
  - Its technological backwardness
  - Its remoteness and landlocked geographic location

CONCLUSIONS

What's Nepal's economy like?

- Nepal is one of the poorest countries in the world.

Is the government trying to reduce poverty?

- Yes. The government is increasing funds in the July 2004 budget for economic development.

Have donors given Nepal much foreign aid over the years?

- Yes. Foreign aid funds 50% of the economic development budget.

How do the Maoist insurgents see foreign aid?

- They target development projects as part of their armed struggle.

Is donor fatigue a problem?

- Actually, the donors suspended foreign aid in July 2004 in the face of terrorist threats and a deteriorating situation in western Nepal.
- But donors also chide the ruling elite for chaotic governance.

Are there other economic problems?

- Yes. These include catastrophic flooding in mid July and the end of garment quotas on 01 January 2005.

Is there any good economic news?

- Yes.
- A ceasefire in 2003 provided a solid foundation for current recovery.
- A new middle class is emerging and boosting consumer spending in Katmandu.
- Large remittances from 700,000 overseas Nepalese generate robust foreign reserves.

SRI LANKA

• CHAPTER 4 •

Executive Summary.

Sri Lanka was economically weak and vulnerable even before the tsunami wave smashed into Sri Lanka's eastern coast in December 2004.

- Sri Lanka's high budget deficit and national debt constrained its ability to finance the tsunami's reconstruction costs.

Of all the Asian nations hit by the December 2004 tsunami, Sri Lanka and the Maldives suffered the greatest damage.

- Fishing and tourism were hit the hardest.
- Capital inflow was mismanaged and led to a rising Sri Lankan currency against the dollar, which in turn resulted in overpriced exports.

That said, foreign aid will help with reconstruction needs:

- World Bank provides $400 million in reconstruction aid in 2005.
- The Asian Development Bank (ADB) plans to disburse a $150 million grant in May 2005 to help Sri Lanka rebuild.

The Paris Club (consisting of the world's top 19 creditor nations) offered Tsunami-hit states a debt repayment freeze through 2005. The IMF did much the same.

- The "Paris Club" is an informal group of 19 predominantly wealthy creditor nations -- including the U.S., Western Europe and Australia – who came to agreement in January 2005 to suspend all tsunami-hit Asian state debt payments to the Paris Club, and to instead use the money to cover costs of reconstruction.
    - However, Indonesia was – and remains -not enthusiastic about freezing repayment of its debt to the Paris Club, correctly perceiving that it would send a wrong signal to financial markets, raise borrowing costs and likely reduce desperately needed foreign investment.
    - Recently, Sri Lanka has also expressed similar sentiments. It remains to be seen if the offer of a debt moratorium will be accepted.

Unfortunately, tens of thousands of hungry, helpless survivors of the 2004 tsunami disaster failed to get help.

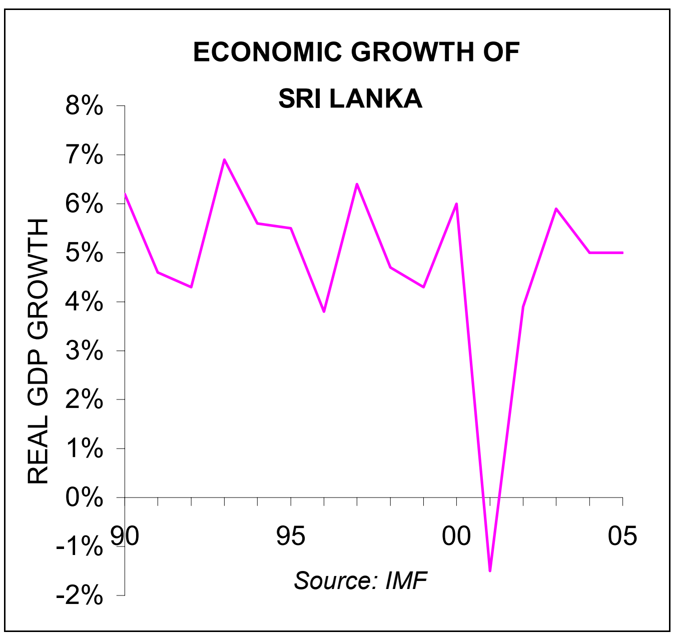
- In a stunning revelation in early February 2005, the Sri Lankan central government admitted that only 30% of those affected by the tsunami had received aid.
- Local government officials plundered aid and demanded bribes to deliver it.
- Thankfully, the distribution of the aid has improved since February.

Figure A. Selected Historical Data

Sri Lanka	2001	2002	2003	2004
Purchasing Power $B	65	68	74	79
GDP $B (Nominal)	16	17	18	20
GDP Growth (Real)	-1.5%	4.0%	5.9%	5.2%
Inflation	14.2%	9.6%	6.3%	7.6%
Exports $B	4.8	4.7	5.1	5.8
To U.S. $B	0.2	0.2	0.2	0
Imports $B	6.0	6.1	6.7	8.0
From U.S. $B	2.0	1.8	1.8	2
FDI held by U.S. $B	0.0	0.0	0.0	...
held in U.S. $B	0.0	0.0	0.0	...
Gross Intl Reserves $B	1.3	1.7	2.3	1.8
Savings /GDP	15.3%	15.8%	16.5%	17.0%
Fiscal Balance /GDP	-10.4%	-8.3%	-7.5%	-7.6%
External Debt /GDP	53.1%	56.4%	58.4%	58.3%
Current account/GDP	-1.1%	-1.4%	-0.4%	-3.2%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization

Figure B. Economic Growth



Introduction.

Before the Tsunami hit, Sri Lanka's macroeconomic situation had deteriorated over the course of 2004.

- Growth had slowed to 5.2 % in 2004.
- Inflation had accelerated to 8 % in 2004 and projected 12 % in 2005 on pressures already in place.

Negative Drivers.

This situation reflected:

- Loose fiscal and monetary policies and high oil prices.

Deterioration.

A number of economic indicators deteriorated:

- Fiscal consolidation stalled and the budget deficit increased to 8.2 % of GDP.
- Public sector debt edged higher to about 107 % of GDP.
- The current account deficit expanded to 3.2% of GDP on oil imports and investment-related imports.
- Reserves declined to $1.8 billion (95% of short-term external debt).
- In short, Sri Lanka was in a weak and vulnerable situation before the tsunami.

THE CIVIL WAR'S ECONOMIC IMPACT

The crippling effects of Sri Lanka's civil war, spanning more than two decades to date, have severely degraded the country's economic performance.

- The Liberation Tigers of Tamil Elam (LTTE), a group considered a terrorist organization by the U.S. and Britain, is made up of minority ethnic Tamils who began a rebellion in Sri Lanka in 1983, claiming discrimination at the hands of the majority Sinhalese. Originally, LTTE sought an independent homeland for the Tamils, but it eventually dropped that outright demand and settled for regional autonomy.
- The rebellion has killed over 64,000 people, displaced over one million and held back the island's growth and economic development.
- In 2002, Norway brokered a ceasefire, which is still in effect today.
- On 2 April 2004, general elections resulted in a turnover in administrations. In a major policy shift, the new ruling party, the United People's Freedom Alliance, recognized the LTTE as the "sole representative" of the Tamil ethnic minority, and invited Norway to approach the LTTE and resume mediation.

While this most recent initiative to restart the peace process brings fresh hope of progress in the stalled peace talks, the demands of the LTTE for a "blueprint for self-rule" to be at the core of the talks threatens to delay and possibly derail their resumption.

- The United People's Freedom Alliance is anxious to tap into the U.S.'s proffered $4.5 billion in aid (release is conditional upon progress in the peace process), but it is unlikely that Sri Lanka will make concessions that would amount to a "stepping stone toward a separate state."
- The Norwegian mediators will need to persuade both sides to accept the sharing of power, rather than "self rule," as a legitimate agenda item for the peace talks.

The military escalation since 2000 and the subsequent foreign exchange crisis are part of a classic case study showing the seamless web between military security and economic security.

- A military victory is unlikely if the economy is collapsing.
- Economic security is unlikely in a war zone.

- Any strategy that successfully addresses the economic and military instability in Sri Lanka must creatively harmonize all the instruments of power.
- In this regard, a negotiated settlement of the long-running civil war with the separatist Tamil Tigers is needed to help Sri Lanka dig itself out of its economic hole.
- The government needs to redouble its efforts to shape the conditions necessary to rebuild economic and military security in Sri Lanka.

Tsunami Assessment.

Of the countries hit by the tsunami, only the Maldives suffered more damage.

- The Asian Development Bank and the World Bank assessed tsunami's damage to Sri Lanka's economy and calculated its reconstruction needs.
- Sri Lanka has estimated the cost of repairing the tsunami-related damage to housing and infrastructure at $2 billion (or 9.3% of GDP) spread over three to four years.
- Most of the economic losses were due to the impact on fishing and tourism.
- Production losses could reduce growth this year by roughly 1% point.
- Higher imports for reconstruction and lower tourism receipts will put pressure on the current account deficit, which could rise by about 2 percentage points.

Over-borrowed.

The large public debt and budget deficit provided little scope for the Sri Lankan government to finance reconstruction costs without crowding out private investment and threatening longer-term fiscal sustainability.

- The IMF estimates that the budget deficit could rise by about 2 percentage points to almost 10% of GDP.
- International support would cover much of these costs.

Good News.

On the positive side, large donor and private inflows will eventually finance most of the current account impact.

- And at first glance, the overall impact of the influx of aid appeared to represent a boost for the Sri Lankan economy.

Bad News.

But appearances can be deceiving. Sometimes foreign aid – if not carefully calibrated -- can do more harm than good for domestic producers.

- That is what happened in Sri Lanka.

Rising Foreign Exchange Rate.

News of donor pledges triggered a large influx of tsunami-related foreign aid as well as financial speculation (buy low and sell high later).

- The rupee appreciated sharply against the dollar.

- For instance, the foreign exchange rate of the rupee strengthened 6% against the dollar from 26 December 2004 until 11 January 2005.

Central Bank Dithers.

Sri Lanka's central bank resisted interfering with the currency market, despite the sharp rise of the rupee.

- On 11 January 2005, the central bank said it would leave monetary policy unchanged, asserting the economy was largely unaffected by the disaster.

Unintended Consequences.

Unfortunately, the central bank was ill-advised.

- The rising foreign exchange rate of the rupee overpriced Sri Lankan exports.
- In reaction to the sharp appreciation, the IMF had cautioned that currency appreciation sparked by tsunami-related inflows could hurt competitiveness.
- Textile and apparel exports (47% of exports and 14% of GDP in 2004) already faced stiffer international competition with the lifting of international textile quotas at the end of 2004. Tea exporters were also hit hard.

Look Back.

Prior to the tsunami, things were better for Sri Lankan businesses.

- In 2003, companies such as Akbar Brothers Ltd. and Bartleet & Co. Ltd. represented 15%, or $700 million, of Sri Lanka's total agricultural exports.

Overpriced Tea Exports.

But the sudden and unexpected rise in the value of the Sri Lankan currency forced many traders to operate at a loss as they scrambled to meet their forward obligations.

Commodity Exports Fall.

Other Sri Lankan exporters of commodities products were also concerned about the sharp rise in the rupee.

- Take Adamjee Lukmanjee, one of Sri Lanka's largest exporters of coconut products and spices.
- It generated 1.5 billion Sri Lankan rupees in revenue in 2004.
- The company could sustain significant foreign-exchange losses if the rupee doesn't reverse its sharp appreciation against the dollar.

Falling Profits.

To maintain market shares, tea producers were forced to drop the average export price of tea by 40 rupees to 210 rupees per kilo since the tsunami.

- That's a devastating 16% drop in price, which in turn has wiped out the traders' already skimpy margins.

Corporate Lobbying.

A number of Sri Lanka's commodity exporters and brokers started to lobby Sri Lanka's central bank to take action.

- Lanka Commodity Brokers Ltd. sent out a circular on 11 January urging government authorities to stop the dollar's slide against the rupee.

Textile Pain.

The textile industry was also hurt.

- Textile companies – whose exports comprise nearly 50% of Sri Lankan exports – justifiably lobbied the government for relief.
- They also asked the U.S. and Europe to reduce tariffs on the country's textile exports to help it recover from both the tsunami and the rising rupee.
- On 11 January 2005, the European Union announced it would try to speed up the implementation of new rules that would allow Sri Lankan exports to enter the EU duty-free.

What's the Economic Problem?

In a nutshell, this incoming foreign aid drove up the demand for the rupee.

- The result is an exchange rate that is too strong, and thus overprices exports.

Timing is everything.

The government should have developed a process to sequence the flow of aid.

- The Sri Lankan government should have found a way to allow aid to flow into the country without disrupting businesses otherwise unaffected by the disaster.

Lesson Learned.

Sri Lanka's central bank should have done the following:

- Weaken the rupee by 6 % by intervening in the foreign exchange market.
- Sell rupee and buy U.S. dollar assets.
- Carefully calibrate the growth of the money supply for price stability.

Reconstruction Needs.

As stated earlier, Sri Lanka has estimated the cost of repairing the tsunami-related damage to housing and infrastructure at $2 billion (or 9.3% of GDP) spread over three to four years.

- How will foreign aid help finance this reconstruction?

The World Bank.

The World Bank plans to provide $400 million reconstruction assistance in 2005: $75 million reprogrammed, $75 million credit/grant (40% grant), and $250 million credit/grant for Board approval in late 2005.

ADB.

On 24 March the Asian Development Bank (ADB) said it plans to begin disbursement of a $150 million grant in May to help Sri Lanka rebuild.

- The grants are tied to projects such as housing and roadwork, and will likely be disbursed over three years.
- The ADB is considering an additional $40 million in aid, including a grant of $14 million, for reconstruction in areas affected by more than two decades of conflict between the government and Tamil Tiger rebels.

In addition, Japan plans to provide an additional aid of $105 million.

CONCLUSION

By all accounts, Sri Lanka's economy is in trouble, with no immediate prospect of getting back on an even keel.

- Most development spending is suspended as the government buys more planes, artillery, and tanks with cash that might otherwise be used to narrow the fiscal deficit or improve infrastructure.

Given the state of the government's finances, there is little hope that it will achieve its fiscal goals.

- These goals are a budget deficit of 8.5% of GDP and 25% growth in revenue.
- It is doubtful that the government can realize its long-term target commitments.

BRUNEI

• CHAPTER 5 •

Executive Summary.

Thanks to the high price of oil, the oil rich country of Brunei is on a roll -- moving ahead with new economic reforms and liberalizations schemes.

- The oil revenue is also boosting GDP.

Unfortunately, Brunei has been less successful with its investments and its attempts to broaden its economic base.

- The government is also over-centralized.

Brunei must guard against complacency in the good times.

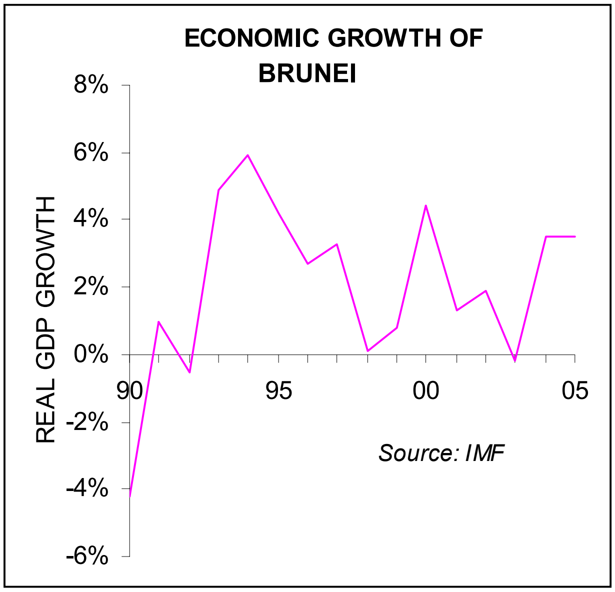
- Unless reforms are implemented Brunei is vulnerable to a fall in the price of oil.
- For instance, the 1997-1998 financial crisis caused oil revenues to decline in 1998 and 1999, which in turn pushed the Brunei economy into a painful recession.

Figure - A. Selected Historical Data

Brunei Darussalam	2001	2002	2003	2004
Purchasing Power $B	8	8	8	9
GDP $B (Nominal)	4	4	5	6
GDP Growth (Real)	3.1%	2.8%	3.1%	1.1%
Inflation	0.6%	-2.3%	0.3%	0.9%
Exports $B	3.5	3.6	4.1	4.6
To U.S. $B	0.1	0.0	0.0	0
Imports $B	1.1	1.5	1.2	1.2
From U.S. $B	0.4	0.3	0.4	0
FDI held by U.S. $B	0.0	0.0	0.0	...
held in U.S. $B	...	...	...	...
Intl Reserves $B	...	...	...	...
Savings /GDP	...	...	...	...
Fiscal Balance /GDP	...	...	...	...
External Debt /GDP	...	...	...	...
Current account/GDP	83.7%	70.7%	78.9%	76.3%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure - B. Historical Economic Growth



Good News: Oil-Based Economy.

Half of Brunei's GDP and 90% of its revenue come from exports of oil and natural gas.

- The size of Brunei's reserves is a secret but they were estimated at over $110 billion in the late 1990s.
- Oil revenues have been on the rise since 1Q 2004.
- The price of a barrel of oil has risen from $35 in 1Q 2004 to over $50 in early November 2004.
- If current trends continue, Brunei could make an extra $1.5 billion in oil revenue from 1Q 2004 to the present.[1]

More Good News.

Other economic indicators also look positive:

- Inflation is benign.
- Unemployment, at 5% last year, is moderate.

Ambitious Plans.

A government plan targets $4.5 billion in foreign direct investment between 2003 and 2008.

- That would create 6,000 new jobs.
- But this scenario is unlikely.
- Luring non-oil related FDI will not be easy given the fact that most other Asian locations appear more attractive.

[1] As a rule of thumb, for every $1 rise in oil prices, Brunei's annual export revenue increases by at least $ 100 million.

ECONOMIC SNAPSHOT

Poor Business Climate.

To become a more attractive business location, Brunei would somehow have to diversify its economy.

But diversifying this economy is difficult for a number of reasons:

Small Size.

With a population of only 380,000, Brunei is too small to provide incentives and opportunities for foreign investors.

High Cost Structure.

Manufactured goods are cheaper to import than to produce locally.

- Wages are also too high.

Government Employment Glut.

As a result, the state is the biggest employer in Brunei.

- Over half the workforce works for the bloated government sector.

Over-Centralization.

Brunei's economic decision-making is over-centralized.

- Brunei's Sultan Hassanal Bolkiah is the head of state as well as Prime Minister, Defense Minister and Finance Minister.
- As a result, bottlenecks develop.
- Investors get frustrated with the long approval process.
- Investors turn their back on Brunei and invest elsewhere -- which hampers Brunei's economic progress.
- What is needed is a healthier free market economy where economic decision-making is more decentralized.

Bad News: Overseas Investments.

Given the fact that there are not many opportunities for investment inside Brunei, the government has made efforts to invest oil revenues outside the country.

- Unfortunately, these investments have not always been successful.
- For instance, in 2000, the Amadeo group, an investment company run by the Sultan's brother, Prince Jefri, collapsed amid allegations that it squandered over $40 billion in state funds on dubious investments.

Difficult Makeover.

In any event, Brunei is trying to remake itself as an international finance center and a trade and tourism hub in the region.

- It won't be easy to attract tourists, given the sultanate's strict Islamic image: dancing, gambling and alcohol are all banned.
- Indeed, Malaysian businessmen based in Brunei's capital, Bandar Seri Begawan, say many locals prefer to spend their weekends across the border in Limbang, a Malaysian town noted for its freewheeling ways.

ECONOMIC REFORMS

East Asia Growth Area (EAGA).

Brunei belongs to the EAGA, that also includes neighboring – but economically laggard – provinces (i.e., Kalimantan, Sulawesi, Maluku and Irian Jaya in Indonesia; Sabah, Sarawak and the Federal Territory Labuan in Malaysia; and Mindanao and Palawan in the Philippines.)

- On the positive side, the exports in intra-EAGA trade are expected to grow as the small economy of Brunei has relied more on intra-regional trade with ASEAN and EAGA, and extra-regional trade has been secondary.
- The EAGA is designed to liberalize state-run companies over the long term.

ASEAN Free Trade Agreement (AFTA).

The AFTA has spurred trade in the region as economies have become more liberalized.

- The AFTA promotes the free movement of goods between Brunei and ASEAN.
- It creates a comparative advantage for regional sub-groupings (i.e., EAGA) that have not been traditionally explored.
- Reforms to wean Brunei from an over-dependence on oil and government money, which are part of the AFTA, are designed to make the private sector the engine of growth.
- The government has made significant progress in keeping with its commitment to open up and free the economy of tariff and non-tariff barriers.
- The government wants to spur the private sector with low-interest loan incentives to local businesses and corporate tax exemptions for foreign investors.
- Government-run companies have been privatized and many other reform initiatives are on the table.
- To facilitate long-term economic growth, since 2002 the government has cut back government spending and subsidies, privatizing government-run agencies and finding new sources of revenue.
- To be less dependent on oil companies such as Shell, the government created a national oil company to explore for oil and refine it.

CONCLUSION

Good News.

The economy is on a recovery path as the government moves ahead with a few new economic reforms and liberalization schemes.

Bad News.

The combination of dependence on oil imports and over-reliance on central management hurts Brunei's economy.

- Brunei is still heavily dependent on oil revenues and imports. These imports make Brunei susceptible to external inflationary conditions. Furthermore, the oil reserves are near depletion. Consequently, Brunei needs to diversify markets and practice economic discipline.
- The Sultan runs everything. Therefore, most decisions are over-centralized. In addition, Brunei still has a glut of government employees and runs a high budget deficit.
- Brunei is also a small, developing economy with overly high prices.
- It currently lacks the potential, at least short-term, to lure foreign investment.

Recommendations.

Brunei needs to continue with its privatization policy, inject sufficient capital outlays to sustain growth in the private sector, maintain price stability, enhance government transparency, reduce government labor, encourage the investment climate, and lure foreign direct investment.

Executive Summary.

Cambodia's pervasive poverty reflects serious economic mismanagement.

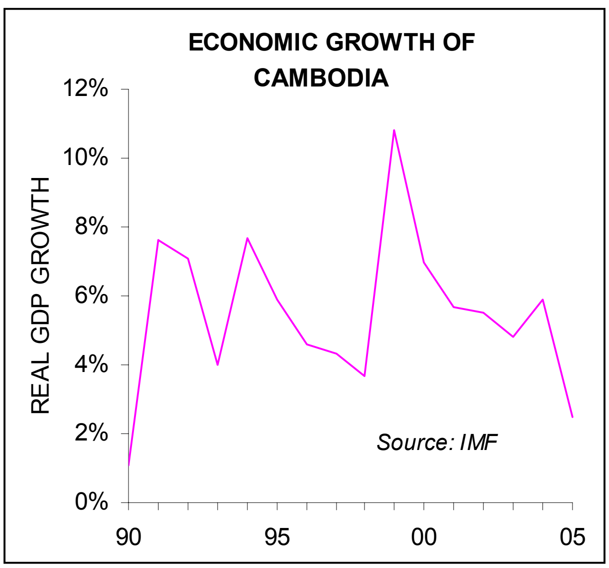
- The government is dramatically over-borrowed and in danger of defaulting on its large foreign debt.
- The country is over-dependent on foreign exchange from two volatile sectors – tourism and garments.
- Cambodia's economic outlook turns on 4 factors -- Cambodia's entry into WTO, the tourism/SARS link, the corruption/economic reform link and political instability.

Figure A. Selected Historical Data

Cambodia	2001	2002	2003	2004
Purchasing Power $B	24	26	27	29
GDP $B (Nominal)	4	4	4	4
GDP Growth (Real)	5.7%	5.5%	5.2%	4.3%
Inflation	0.2%	3.3%	1.2%	2.0%
Exports $B	1.6	1.8	2.0	2.5
To U.S. $B	0.0	0.0	0.1	0
Imports $B	2.1	2.3	2.6	3.0
From U.S. $B	1.0	1.1	1.3	1
FDI held by U.S. $B	0.0	0.0	0.0	...
held in U.S. $B	-	-	-	...
Gross Intl Reserves $B	0.5	0.7	0.7	0.8
Savings /GDP	11.4%	10.0%	9.7%	9.4%
Fiscal Balance /GDP	-5.6%	-6.7%	-7.0%	-6.4%
External Debt /GDP	67.2%	68.4%	70.8%	70.1%
Current account/GDP	-1.2%	-1.0%	-3.2%	-2.3%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization

Figure B. Historical Economic Growth



Introduction.

Poverty-plagued Cambodia continues to struggle.

- To reduce pervasive poverty and absorb Cambodia's rapidly growing labor force, the country needs to generate economic growth of at least 8% annually.
- The economy grew 5.2% in 2003 and 4.3% in 2004.

Over-borrowed Government.

The government is dramatically over-borrowed and in danger of defaulting on its large foreign debt.

Cambodia's difficulties reflect serious economic mismanagement.

- Cambodia's national debt – almost equal to 100% of its GDP – is dangerously higher than the 60% figure that rings financial alarm bells.

Nature and Extent of Debt.

A large chunk of this national debt consists of mounting foreign debt owed to IMF, World Bank, ADB, as well as bilateral donors such as the former Soviet Union, the U.S. and China.[1]

- These frustrated international donors finance about 60% of the country's annual budget.
- Cambodia's ability to service its loans to these donors is in serious doubt.

Overdependence.

Cambodia's debt service turns on its two major foreign-exchange earners -- garment exports and tourism receipts. Both are volatile.

- To dig out of its economic hole, Cambodia must diversify its economy, away from its over-dependence on the garment industry and tourism.
- It will not be easy.

ECONOMIC SNAPSHOT

Key Factors.

In many ways Cambodia's near term economic outlook turns on four factors –

- Cambodia's entry into WTO,
- Tourism/SARS link.
- Corruption/economic reform link
- Political instability.

Before reviewing these issues in depth, it's important to understand the historical context.

ECONOMIC BACKGROUND

War-ravaged Economy.

To be fair, Cambodia is struggling to dig itself out of a huge economic hole.

- Decades of war virtually destroyed the Cambodian economy.
- This dismal situation slowly began to change following the end of civil conflict and UN-sponsored elections in 1993.

Economic Transition.

The country made meaningful progress in the transition to a market economy.

- Economic reform supported macro-economic stability and increased trade and investment flows.
- Between 1993 and 1996 economic growth averaged a commendable 6%.
- Inflation, which had averaged 140% a year during 1990-92, was reduced to single digits during 1995-97.
- Per capita income doubled, from about $150 to nearly $300 in 1997.

POLITICAL INSECURITY

Political Vulnerabilities.

Yet below the surface, all was not well.

- Externally, Cambodia's economic growth relied too heavily on the East Asian economic miracle for export markets, large foreign savings and trade tax receipts. In short, at the time, it was overly vulnerable to the Asian economic crisis.
- Internally, the reform momentum in Cambodia slowed considerably in 1997.
- A coup led by Hun Sen, Cambodia's current Prime Minister, threw the country into turmoil.
- As a result of this political instability, Cambodia's structural reforms lost steam during the first half of 1997 and decelerated considerably in the second half of 1997.

A NEW POLITICAL AND ECONOMIC ERA

Stability and Growth.

The collapse of the Khmer Rouge as a threat and the formation of Hun Sen's coalition government ushered in a new era of stability. After years of conflict and political instability, the poverty-stricken country of Cambodia is starting to dig itself out of a deep economic hole.

- While it will take years to repair the damage inflicted by decades of conflict, Cambodia experienced two years (1999 and 2000) of renewed, albeit less than spectacular growth.
- During this period, Cambodia was slowly but surely moving beyond simply relief and post-war rehabilitation.

- Despite severe floods and an oil shock, Cambodia's macroeconomic discipline and generous donor aid are successfully keeping the economy afloat.

Garment Exports.

The garment industry dominates the export sector.

- It contributes 12.5% to the GDP.
- It employs 200,000 workers.
- Back in 2000 a weak global economy weakened demand for Cambodian garments.
- But Cambodia reaped some benefits from 9/11 in 2001.
  - U.S. and European clients reduced their imports of garments from Islamic countries like Pakistan, Bangladesh and Indonesia and boosted their imports of garments from Cambodia.
  - That caused Cambodian garment production to rise 23% in 2002, up from 13% in 2001.
- But 70% of Cambodia's garment industry's output was directed to the U.S. market in 2002.
  - When the garment quota granted by the U.S. under the Multifiber Arrangement (MFA) ended in January 2005, Cambodia become certain to lose its market share to China.
  - That could be a fatal blow to Cambodia's economy.

Tourism Receipts.

Cambodia's tourism sector flourished in 2002, when 790,000 foreigners visited the country, increased spending by 30% from a year earlier and generated $576 million and about 20% of GDP.

- 1 million foreigners were expected to visit Cambodia in 2003.
- Unfortunately, the SARS outbreak scared off tourists in 2003.[2]

Weak FDI.

To further exacerbate the situation, foreign direct investment (FDI) continues to slump compared to the rosy years in the mid-1990s.

- Why do foreign investors find Cambodia's business climate so unattractive?
  - Rampant corruption
  - Weak legal infrastructure
  - Political instability.

Uncertain Agriculture.

Agricultural production is always in jeopardy in Cambodia. Food crises are nothing new.

- For instance, the food situation was catastrophic in 2000 and 2001, when severe floods hit the country.
- At other times Cambodia faces drought.

Potential Food Crisis/Debt Link.

A potential food crisis could lead to an ever-heavier debt burden for Cambodia.

- To avert a financial meltdown Cambodia must rapidly increase revenue collection and cut spending.[3]
- Tougher tax collection and spending cuts are unpopular political moves, with no guarantee of success in an already shaky political environment.
- Therefore the outcome could well be an "Africanization" of Cambodia, with the country trapped in a vicious circle where by increasing debts and little revenue make real economic development almost impossible.

Outlook – Turns on 4 Factors.

Four of the biggest factors that will affect the Cambodian economy in 2004 and beyond are –

- Cambodia's entry into WTO
- Tourism/SARS link.
- Corruption/economic reform link.
- Political instability.

Entry into WTO.

On 11 September 2003 Cambodia became one of the first least developed countries to be admitted to the WTO.

Good News -- Cambodia's entry should help Cambodia get some badly needed foreign investment and broaden its manufacturing base which is still dominated by a shaky garment industry.

Bad News – At the same time, WTO entry will prompt the country to lower tariffs, leading to increased imports of agricultural goods, which could affect the livelihood of its many already impoverished farmers.

- Almost 80% of Cambodia's 13 million people are subsistence farmers, and if the floodgates are opened to subsidized farm produce from more developed countries, the consequences could be disastrous.

Uncertainty -- Therefore, it remains to be seen whether WTO membership will be able to create more stable fundamentals for the Cambodian economy than today's troubled garment and tourism sectors.

- If not, Cambodia will be even more dependent on foreign aid, which for the past decade has been running at 15% to 20% of GDP.

Tourism/SARS Link.

Prior to the outbreak of SARS, Cambodia was rapidly becoming a favorite destination for foreign tourists.

- 1.1 million tourists visited Cambodia in 2004 and 2.2 million foreigners were expected to visit Cambodia by 2006.
- Before the outbreak of SARS, the tourism industry was expected to bring in revenues of $1 billion in just 3 years, a staggering figure for impoverished Cambodia, whose total GDP is worth around $ 3.5 billion.

Good News. If SARS is contained in Asia, tourism could decisively drive stronger economic growth and help to reduce poverty in Cambodia.

- Families and group tours can already visit the ancient Angkor Wat temple complex in the northwest, flying directly to the nearby town of Siem Reap and bypassing the lawless capital, Phnom Penh.
- New hotels and restaurants are springing up almost daily in and around Siem Reap.

Bad News. That said, the flow of tourists is also bringing in thousands of Western pedophiles, who take advantage of Cambodia's weak law-enforcement machinery.

- Prostitution and drug abuse have also led to the highest HIV/Aids infection rate in Asia.
- "New Killing Fields." 160,000 Cambodians aged between 15 and 49 have HIV, or 2.6% of a population of just 12 million.
  - AIDS has so far killed about 90,000 people since it was discovered in Cambodia in 1991.
  - Another 200,000 people are expected to develop Aids within the next 10 years.
  - This human-made disaster will overwhelm the country's grossly inadequate health care system and seriously affect economic growth as many young people succumb to the disease.

Corruption/Economic Reform Link.

Rampant corruption and inadequate courts will also hinder growth.

- Corruption prevents money from reaching the people who need it.
- In addition, corruption is providing opportunities for people-trafficking, money-laundering, prostitution and trade in small arms and illegal drugs.
- International donors have criticized the government for its sluggish pace in reforming the judiciary and curbing corruption.
- As a result, Belgium and the Netherlands suspended foreign aid due to Cambodia's chronic lack of "transparency and accountability" (code words for corruption).

Political Instability.

Ever since the 27 July 2003 election, Cambodia has struggled with political instability.

- The problem goes beyond the obvious frustration with the government's inability to develop a sustainable economic strategy.
- Political instability could make international donors think twice before extending more foreign aid to a country that can't get its act together.
- That could cause the economy to go from bad to worse.

If the economy is dealt a serious blow due to political instability, Cambodia's troubles could have negative consequences for the whole region.

CONCLUSION

Cambodia remains one of the poorest countries in the region. Foreign aid is propping up the economy. The economy is plagued by serious economic mismanagement. In particular, the government is dangerously over-borrowed. Foreign investors find the business climate unattractive. Potential investors complain about high levels of corruption.

The economy is driven by two volatile industries – tourism and garments. The overdependence of the economy on these two sectors makes the country vulnerable to economic shocks. To dig itself out of its hole, Cambodia must diversify its economy.

In many ways Cambodia's near term economic outlook will depend on four factors: Cambodia's entry into WTO, a tourism/SARS link, a corruption/economic reform link and political instability.

ENDNOTES

[1] Cambodia's national debt is about $ 3 billion. It owes over $ 500million to IMF, World Bank and ADB. It owes the former Soviet Union $ 1.6 billion. Cambodia owes the U.S. $ 500 million and China $ 210 million.

[2] Although the SARS outbreak did not hit Cambodia directly, wealthy tourists decided to avoid Asia entirely during this period in 2003.

[3] Cambodia's revenue collection amounts to only about 11% of GDP, one of the lowest figures in Asia.

Executive Summary.

In 2005, Indonesia's economy is clearly back on track.

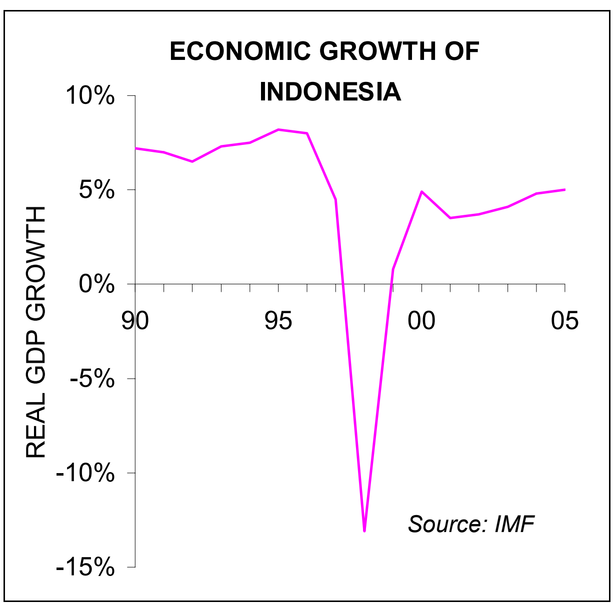
- It grew as much as 6.7% in the 4th Quarter of 2004 (its fastest quarterly pace in four years).
- Overall growth for 2004 was 5.1% (its strongest yearly performance since 1996), and investment grew 15.7% (the highest growth since 1997).
- The Indonesian stock market recently set new highs, and macroeconomic strategy and performance over the past year were impressive.
- Exports also performed well.

Figure A. Selected Historical Data

Indonesia	2001	2002	2003	2004
Purchasing Power $B	669	705	747	801
GDP $B (Nominal)	164	201	239	258
GDP Growth (Real)	3.8%	4.4%	4.9%	5.1%
Inflation	11.5%	11.8%	6.8%	6.1%
Exports $B	56.3	57.2	61.1	69.7
To U.S. $B	2.5	2.6	2.5	3
Imports $B	31.0	31.3	32.6	46.2
From U.S. $B	10.1	9.6	9.5	11
FDI held by U.S. $B	10.5	10.3	10.4	...
held in U.S. $B	0.1	0.0	0.0	...
Gross Intl Reserves $B	28.0	31.6	36.2	36.3
Savings /GDP	25.5%	21.1%	20.1%	19.7%
Fiscal Balance /GDP	-2.0%	-1.4%	-1.7%	-1.3%
External Debt /GDP	81.0%	65.5%	56.8%	...
Current account/GDP	4.2%	3.9%	3.0%	2.8%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



For the long-term.

The objective is to further boost growth, reduce poverty and create more jobs:

- Indonesia needs to attract more foreign direct investment (FDI).
- Options to do so include making progress in the areas of internal security, structural economic reforms and long-term competitiveness.

OPEC.

Indonesia also is struggling to boost oil production and hopes to avoid a forced exit from OPEC.

The tsunami.

The biggest human tragedy was the December 2004 tsunami disaster in Aceh.

- Thankfully, the macroeconomic impact to Indonesia as a whole was relatively small.
- However, the impact of the tsunami on Aceh was significant.

Changes in the Political Landscape.

The landslide victory of General Susilo Bambang Yudhoyono (or SBY) in the 2004 Indonesian presidential election is promising.

- SBY has extensive background in economics.
- He will arguably be more decisive than President Megawati in creating a better business climate for investment.

That said, the Megawati government deserves credit for fostering economic progress in a number of areas.

- In fact, after hitting rock bottom after the Asian economic crisis, Indonesia’s economy is indeed back on track and moving in the right direction.
  - Indonesia’s macroeconomic strategy and performance has been first rate.
  - Jakarta has generated solid growth in the face of a stagnant global economy, the SARS epidemic and the terrorist bombing in Bali.
  - This impressive economic turn-around caught the eye of foreign investors who are returning to the country.

ECONOMIC BACKGROUND

Looking Back at Crisis.

Prior to the economic crisis, Indonesia was growing at a **7.2 %** annual clip from 1990 -1996. Then the economic crisis devastated the country.

- The country went into a depression in 1998, with GDP falling by 14 %.
- In contrast to over $1 billion in portfolio inflow prior to the crisis, during 1997-1998 Indonesia hemorrhaged financially and experienced an outflow of $9 billion in portfolio investment.
- Poverty worsened, unemployment soared and debt skyrocketed.

- The government was forced to go to IMF for a costly rescue package.

Skeptics Wrong.

The skeptics glibly argued that Jakarta would fail to stay the course with a responsible macroeconomic strategy. The skeptics were wrong.

- Facing a stagnant global economy, the SARS epidemic and a negative post-Bali bombing investment climate, Indonesia is on track to grow at an almost 4 % clip in 2003.

Positive Indicators.

This healthy macro-economic picture created lots of demand for Indonesian stocks and bonds.

- Indonesia's stock market was Asia's top performer in 2003, and set new highs in 2004.
- The rupiah has consistently strengthened against the U.S. dollar.
- The current account in its balance of payments is in a strong surplus position.
- In fact, its foreign exchange reserves have risen to a robust $33.7 billion.
- Inflation and interest rates have fallen.

Fiscal Discipline.

This impressive economic performance is especially remarkable since it was not the result of an unsustainable fiscal stimulus, as is the case in many other Asian countries. Quite the contrary.

- Thanks to Indonesia's fiscal discipline and tough political will, the country actually reduced its budget deficit (as a % of GDP) from 2.5 % in 2002 to an estimated 1.8 % in 2003 during this period of weak global demand.
- That's well under the Maastricht budget deficit criterion of 3 % of GDP (that the EU uses for its Growth and Stability Pact) and a far cry better than Japan's financially unstable 7% figure.

Falling Debt.

Jakarta has made reducing its government debt a national priority. In this regard, the country has also made dramatic progress in reducing its official government debt.

- Following the government's bailout of the commercial banks in 2000, the government's official debt burden was about 100 % of GDP.
- Indonesia reduced this Debt/GDP ratio in 2001 for the first time since the Asian economic crisis.
- In 2002 its Debt/GDP ration fell further to an estimated 75 % of GDP.
- IMF says Indonesia can reduce its Debt/GDP ratio below 50 % by 2007 if it can maintain its demonstrated fiscal discipline.

Rating Upgrades.

Jakarta's impressive fiscal discipline and economic turn-around has won plaudits around the world. In fact, several international rating agencies upgraded Indonesian sovereign ratings in August and Sept 2002.

- Fitch upgraded Indonesia's rating in August 2002, and again in 2004.
- Standard & Poor's upgraded Indonesia's rating in September 2002, and again in 2004.

- Moody's upgraded Indonesia's rating in 2003.

Responsible Debt Management.

Jakarta's financial diplomacy and debt management have also been impressive.

- Indonesia's improved economic performance gave Jakarta the confidence to amicably conclude its IMF lending program at the end of 2003.
  - Indonesia has also successfully concluded 3 consecutive debt-rescheduling agreements with official bilateral creditors in 2005.

Rising FDI.

Indonesia's economic comeback story caught the eye of foreign investors in 2003.

- Foreign direct investment (FDI) rose in the first half of 2003 to nearly $ 4.4 billion from $3 billion in 2002.
- Foreign investors have bought banks and telecommunications industries.
- One of the biggest investors is Singapore, with $ 2 billion in new FDI.

Still Not Enough FDI.

That said, even the $ 4.4 billion in FDI in the first half of 2003 is a far cry from the $ 30 billion in investments that flowed into Indonesia annually in the mid-1990s.

- Unfortunately, two issues will likely keep many potential investors on the sidelines for the next year or so, according to U.S. Embassy Jakarta.
- Jakarta will have to send a clear message to the markets that it will maintain fiscal discipline after IMF's departure in December 2003.

Fostering Investment.

Jakarta's key challenge in boosting FDI remains how to enact effective policies and attract more foreign investment.

- Indonesia's progress in the following core areas would greatly increase the prospects for sustained and robust new investment in Indonesia:

STRUCTURAL ECONOMIC REFORMS

Strengthening the Rule of Law.

Foreign investors cite Indonesia's inefficient and obscure legal system as a major obstacle to attracting foreign investment. In this regard, official corruption remains a pervasive problem.

- In addition, Indonesian courts routinely rule against foreign defendants in contract cases and refuse to recognize international arbitration awards.
- Jakarta has repeatedly acknowledged the importance of this issue but has been reluctant to take decisive action to solve the problem.

Reforming the Banking System.

Despite Jakarta's re-capitalization of its banks in October 2000, the banking sector remains fragile.

- The Indonesian Bank Reconstruction Agency (IBRA) is scheduled to close in early 2004. Yet 6 of 11 banks owned by IBRA are near insolvency.
- Before significant commercial lending resumes to the real economy and before the risk to Indonesian finances from potential bank failures is reduced, Indonesia must --
  - Strengthen bank supervision,
  - Establish a credit rating system and
  - End the blanket government guarantee of bank liabilities.

Long-Term Competitiveness.

Hefty wage hikes in 2001 and 2002 reduced Indonesia's competitiveness for labor-intensive manufacturing.

- If Indonesia were indeed moving up the value-added chain, higher wages would not be a problem. Unfortunately, Indonesia lacks the cognitive skills to "move uptown," e.g., from the garment industry to the fashion industry.
- In a nutshell, Indonesia is simply not doing enough to strengthen its human capacities to compete effectively in world markets.
- In particular, the quality of Indonesia's education and health care lags far behind that of most other developing countries.

Rebuilding the Infrastructure.

Indonesia's physical infrastructure, once adequate, has significantly deteriorated and will limit future growth.

- Jakarta has not developed a strategy for boosting infrastructure investment to pre-crisis levels.

Reducing Uncertainty from Decentralization.

Indonesia's ambitious fiscal decentralization program, implemented back in January 2001, continues to create uncertainty for foreign investors, particularly in the mining and petroleum sectors.

- On the positive side, local governments now have the authority to approve investments in all areas except for the financial and oil sectors, which remain the preserve of the central government.
- In theory, this should expedite investment and remove unnecessary layers of central government, red tape and corruption.
- Unfortunately, too many local governments don't have their act together.
  - Local investment rules and procedures -- approval criteria for new investments, licensing arrangements, etc. -- remain unclear.
  - Worse still, many local governments have enacted taxes that discriminate against foreign investors.

Oil Production.

Indonesia is struggling to boost oil production and hopes to avoid a forced exit from OPEC.

- Falling oil output made Indonesia a net importer of oil for several months in 2004.

- Indonesia is struggling to meet its OPEC output quota of around 1.4 million barrels a day.
- Indonesia only produced 942,000 barrels a day in February 2005, and only 961,200 barrels a day in March – a 30-year low point.

Conclusions from a recent internal Indonesian study recommended three options regarding Indonesia's faltering OPEC status: (a) maintain OPEC status until declared a net oil importer and disqualified as an OPEC member, (b) withdraw voluntarily from OPEC, or (c) downgrade to a new "observer status" in OPEC.

President Susilo Bambang Yudhoyono's (SBY) desire is to stay in OPEC. He helped to restart the state-owned oil company Pertamina's talks with Exxon-Mobil in April 2005, in hopes of resolving a long-running commercial dispute over a massive oil field in Cebu.

- Bringing the Cebu field on line would add up to 165,000 barrels a day of oil output, and help Indonesia avoid a forced exit from OPEC.
- A deal with Exxon-Mobil would also boost confidence in President SBY's government, and attract badly needed foreign investment, as well as new oil exploration.
- In November 2004, U.S. President Bush brought up the contentious Exxon-Mobil dispute at the APEC meeting in Chile.
- SBY is anxious to see concrete progress in the Pertamina-Exxon/Mobil talks to ensure the dispute did not detract from his talks with POTU.S. in Washington in May 2005.

DECEMBER 2004 TSUNAMI

As the SBY Administration settled into its first year of governance and wrestled with the multitude of challenges, a most devastating natural disaster struck Indonesia in December 2004. The tsunami inflicted devastating human and economic costs in Aceh.

- Almost 170,000 people died and over 1,000 villages and urban communities were razed.
- Economically, the damage is estimated as equivalent to 97% of Aceh's annual GDP before the disaster.
- Jobs of more than 500,000 people were lost.
- And the environmental damage in Aceh was valued at $664.6 million.

The "Paris Club."

The "Paris Club" is an informal group of 19 predominantly wealthy creditor nations -- including the U.S., Western Europe and Australia – who came to agreement in January 2005 to suspend all tsunami-hit Asian state debt payments to the Paris Club, and to instead use the money to cover costs of reconstruction. This debt moratorium extends to a maximum of one year.

- However, Jakarta was – and remains --not enthusiastic about freezing repayment of its $3.2 billion debt, correctly perceiving that it would send the wrong signal to financial markets, raise borrowing costs and likely reduce desperately needed foreign investment.
- Recently, Sri Lanka has also expressed similar sentiments.
- Indonesia's position today remains that it wants to keep repaying its debt.
- Most importantly, Jakarta sees the tsunami crisis as an opportunity to get what it really wants – trade concessions to give Indonesia wider access to U.S. markets.

Jakarta's "Trade, not Aid" mantra underscores broader economic pressures in the region.

- It highlights the difficulties that lie ahead as relief efforts turn from emergency aid to broader recovery plans.
- Indonesia, along with several other tsunami-hit nations, would prefer grants and concessionary loans, rather than a Paris Club debt moratorium.

Jakarta now plans to make the rescheduling of debt payments, and even debt forgiveness, the centerpiece of negotiations worldwide.

- This debt relief will ease the pain of servicing the $80 billion debt that Indonesia owes foreign creditors, of which 60% is owed to the Paris Club.
- The negotiations are expected to take months -- even to begin -- as the IMF and World Bank assess Jakarta's needs on behalf of the Paris Club.

In March 2005, Jakarta published its "Master Plan" for reconstruction of Aceh, which was hit hard by the December tsunami.

- The plan outlines priorities for the next five years, addressing issues ranging from culture and religion to roads and jobs.
- However, the actual implementation of this plan remains problematic.
- Jakarta does not desire the UN High Commissioner for Refugees (UNHCR) to have a role, due to longstanding restricted access to Aceh (because of the long-running separatist conflict and sensitivities regarding alleged human rights abuses by the Indonesian military).
- Initially, in January 2005, Jakarta lifted those restrictions. However, as the focus in Aceh turned from emergency response to reconstruction, Indonesia reimposed additional restrictions.
- Due to pressure from Jakarta, the UNHCR announced in March 2005 that it was closing its Aceh office, putting into question the fate of the $33 million raised by the UN to fund reconstruction projects.

Jakarta's "master plan" currently continues to remain unclear regarding implementation, and as to which other foreign aid agencies will be allowed to participate in the reconstruction of Aceh.

CONCLUSION

In the past, Indonesian consumer spending was the main economic driver, while investment was too low. In 2005, the rising investment spending indicates that economic fundamentals are improving.

- Jakarta's success in safeguarding security and social stability during the 2004 elections, and henceforth, helped to improve the investment climate.
- Credit rating agencies have rewarded Jakarta. Fitch upgraded Indonesia's foreign and local currency ratings, citing Jakarta's success in cutting the budget deficit and its government debt.
- Standard & Poor's also upgraded Indonesia.
- These higher ratings lower borrowing costs for Indonesian companies, as well as for the government.
- Thus, Indonesia is in a much-improved position to woo the foreign investors needed to fund $150 billion of investments in infrastructure, i.e., roads, power plants and other projects during next five years.

As the 2005 relief effort on the tsunami devastation in Aceh moves from emergency aid to reconstruction and recovery, almost all of the tsunami-hit Asian nations will join in with Jakarta's "Trade, not Aid" mantra.

- For its part, the U.S. should support Indonesia's determination to keep repaying its Paris Club debt.

- Jakarta is proving itself to be financially responsible and market savvy, and clearly wants to create a favorable business climate to further attract desperately needed foreign investment.
- The Paris Club should reward this behavior, not discourage it.

SUBSEQUENT ECONOMIC UPDATES

25 January 2005

Indonesian Economic Minister Aburizal Bakrie publicly stated yesterday that Indonesia does not need the Paris Club offer of a debt moratorium. This statement is consistent with a similar statement made on 13 January by Indonesian Foreign Minister Hassan Wirajuda. That said, Mahendra Siregar, one of Mr. Bakrie's deputies, says that Indonesia is still considering the Paris Club offer of a debt freeze. So the issue is not settled.

Economic Advisor's Comment:

Why isn't Jakarta more enthusiastic about a debt moratorium?

- A debt freeze would hurt Indonesia's credit rating and send the wrong signal to financial markets.
- A debt freeze would raise borrowing costs and discourage desperately needed foreign investment.
- Instead, Indonesia would understandably prefer grants and concessionary loans.

Most of all, Jakarta wants trade concessions that would give Indonesia wider access to U.S. markets. Jakarta's push for trade concessions underscores the broader commercial pressures in the region and highlights the diplomatic challenges that lie ahead with the transition from emergency aid to broader reconstruction and recovery issues.

17 February 2005

Indonesia grew 6.7% in 4Q 2005 - its fastest quarterly pace in 4 years.

- Indonesia's growth for 2004 was 5.1% -- its strongest yearly performance since 1996.
- Why is the economy improving?
  - Investment grew 15.7% in 2004 -- the highest growth since 1997.
  - Lowest interest rates since 1998 spurred consumers to boost spending.
  - Exports also performed well in 2004.

Economic Advisor's Comment:

In the past consumer spending was the main economic driver and investment was too low.

- The rising investment spending indicates that economic fundamentals are improving.
- Jakarta's success in safeguarding security and social stability during the elections and henceforth helped to improve the investment climate.
- Credit rating agencies have rewarded Jakarta. Fitch upgraded Indonesia's foreign and local currency ratings, citing Jakarta's success in cutting the budget deficit and its government debt. S & P also upgraded Indonesia.
  - These higher ratings lower borrowing costs for Indonesian companies and the government.

- o That helps Indonesia woo foreign investors needed to fund $150 billion of investments in roads, power plants and other infrastructure projects planned in the next 5 years.

11 March 2005

Tsunami-hit countries were offered a debt repayment freeze through 2005.

- The Paris Club of the world's top 19 creditor nations says the grace period should help tsunami-hit countries devote more resources to humanitarian and reconstruction efforts.
- This offer lets the tsunami-hit countries spread their repayment over 5 years (2006- 2010).

Economic Advisor's Comment:

The Paris Club offer was a compromise between two competing positions:

- On 24 Jan, Indonesian Economic Minister Aburizal Bakrie said Indonesia did not need a debt moratorium because it might hurt Indonesia's credit rating.
- On 8 Feb, Sri Lankan Finance Minister Sarath Amunugama said Sri Lanka wanted at least a 3-year moratorium on debt repayment because the recovery would take 3 to 5 years.

21 April 2005

Indonesia is struggling to boost oil production and hopes to avoid a forced exit from OPEC.

- Falling oil output made Indonesia a net importer of oil for several months in 2004.
- Indonesia is struggling to meet its OPEC output quota of around 1.4 million barrels a day.
- Indonesia only produced 961,200 barrels a day in March and only 942,000 barrels a day in February – a 30 year low point.

An Indonesian study came up with 3 options regarding Indonesia's faltering OPEC status: a) maintain OPEC status until declared a net oil importer and disqualified as an OPEC member, b) withdraw from OPEC, or c) downgrade to a new "observer status" in OPEC.

Economic Advisor's Comment:

President Yudhoyono wants to stay in OPEC and he helped to restart state oil company Pertamina's talks with Exxon-Mobil on 20 April in hopes of resolving a long running commercial dispute over a massive oil field in Cebu.

- Bringing the Cebu field on line would add up to 165,000 barrels a day of oil output and help Indonesia avoid a forced exit from OPEC.
- A deal with Exxon-Mobil would also boost confidence in President Yudhoyono's government and attract badly needed foreign investment and new oil exploration.
- POTUS brought up the contentious Exxon-Mobil dispute at the APEC meeting in Chile in November.

President Yudhoyono is anxious to see concrete progress in these talks so that the dispute doesn't detract from President Yudhoyono's talks with POTUS in Washington in May.

26 April 2005

Chinese President Hu Jintao and Indonesian President Yudhoyono concluded a successful summit in Jakarta and agreed to boost bilateral trade by more than 40%.

- This trade target would raise two-way trade from the current baseline of $ 14 billion to $ 20 billion over a 3-year period.
- 9 deals were signed including a new $300 million PRC concessionary loan to Indonesia in addition to a $400 million PRC concessionary loans already negotiated before the summit.
- China has also provided $500,000 of relief goods and $1.5 million in cash to the tsunami-hit Indonesian province of Aceh.
- In addition, China has agreed to invest $ 10 billion in agriculture and infrastructure projects in Indonesia.

Economic Advisor's Comment:

China is making a strategic comeback in Indonesia.

- Diplomatic ties were cut off in 1967 after Jakarta accused Beijing of backing an attempted coup by the Communist Party of Indonesia.
- In an anti-Communist crackdown that followed the coup, hundreds of thousands of people, many of them ethnic Chinese, were slaughtered. Relations were not restored until 1990.
- China and Indonesia have moved on and now see the potential for shared prosperity.
- China sees Indonesia as a politically reliable source of petroleum and mineral resources to fuel its booming industrial growth.
- Indonesia sees China as a valuable export market for its commodities as well as a source of desperately needed foreign investment to modernize its economy.

07 June 2005

Indonesia grew 6.35%, a faster rate than expected, in 1 Q 2005.

- That's well above the prevalent 5.5% growth forecast for 1 Q 2005.
- Transport and communication sectors continued to be the fastest growing sectors.
- The mobile phone section grew 12.3% and vehicle sales also rose strongly.

Economic Advisor's Comments:

Indonesia is emerging from years of too much consumer driven growth.

- Investors simply found the business climate unattractive in Indonesia.
- The first four months of 2005 foreign direct investment (FDI) doubled over the same period in 2004
- Investors are optimistic that President Yudhoyono is combating corruption and improving the overall business climate for foreign and domestic investment spending.
- Jakarta shows progress in settling and environmental dispute with Newmont, the world's largest gold miner and a longstanding contract dispute with ExxonMobil.
- Jakarta is anxious to remove such issues before President Yudhoyono meets with POTUS in Washington next week.

05 August 2005

High oil prices are threatening Indonesia's economic and financial security.

- Though Indonesia continues to export lots of oil, the country now imports more than it exports.
- As a net oil importer, the high imported oil prices are undermining Indonesia's efforts to cut domestic fuel subsidies.
- Paying for imports is soaking up scarce foreign reserves and offsetting recent cuts in the politically sensitive government oil subsidies.

Economic Advisor's Comment:

At the current rate of subsidies, Indonesia could be facing an oil shock as early as October 2005.

- Outlays for energy subsidies could reach more than $12 billion in 2005, 40% more than the government had budgeted.
- The $7.8 billion allocated for fuel subsidies in the 2005 budget will be used up by the end of September 2005.
- Indonesia will need to allocate $4.5 billion more to maintain domestic fuel prices at current levels.
- Otherwise, the country won't have sufficient funds to import oil in 4Q 2005.

But if Jakarta spends more on politically attractive oil subsidies it would mean:

- Increasing its budget deficit (and alarming foreign investors over financial instability).
- Curbing infrastructure spending that is a critical foundation for stronger economic growth.

The core problem reflects decades of oil mismanagement - especially too little investment in exploration and refining.

- Indonesian state controlled oil companies have a limited ability to increase oil and gas production.
- Jakarta estimates crude-oil production in 2005 will decrease about 6% from last year's 968,000 barrels a day.

One option might be for US oil companies that have superior drilling technology to buy Indonesia's oil assets and boost exploration and production.

- However, US oil companies are now finding it difficult to make a case for buying foreign oil assets after China's CNOOC was frustrated in its bid to buy the assets of Unocal, a US oil company.

17 August 2005

Indonesia's economic performance is faltering.

- Annualized GDP growth slowed from a revised 6.2% in 1 Q 2005 to 5.5% in 2 Q 2005.
- The government's official 6% economic growth target is now in doubt.

A number of negative factors are now slowing down economic growth:

- Weak oil production now makes the country a net oil importer for 2005.
- Heavy demand for US dollars to fund costly oil imports has driven the rupiah's 5% fall against the dollar, with the currency now at a 41-month low against the dollar.

- The central bank has spent $5 billion to support the currency in 2005.
- The rupiah's fall makes imports more costly and has weakened consumer spending.
- The central bank action to raise interest rates to fight rising inflation has also slowed growth.

Economic Advisor's Comments:

The current economic problems Jakarta faces are largely due to the government's politically popular (but economically distortionary) fuel subsidies.

- Indonesia still has among the cheapest oil in the world, with gasoline costing the Indonesian motorist just 27 cents a liter at the pump.
- The government makes up the difference between the fixed 27 cents a liter at the pump and surging global energy prices. That difference is huge.

Due to high global oil prices the government now faces a fuel subsidy bill of more than $14 billion in 2005.

- That's a big opportunity cost that equates to 1/3 of the central government's expenditures in 2005 and 13 times what it plans to spend on health and education.

On 1 March Jakarta raised the government-set fuel prices by about 29% without any major disturbances. They pledged not to raise prices again in 2005.

- In his state of the nation address on 16 August, President Yudhoyono said the fuel subsidies were "missing the target and unjust."
- A better approach would be for President Yudhoyono to follow the advice of his economic minister and pay subsidies directly to the poor rather than via price controls.

26 August 2005

The Indonesian Rupiah has now fallen to a 3½-year low against the US dollar.

- The currency's 3-month decline of 8.5% is the world's 2nd worst after the Zimbabwe dollar.
- In response, Jakarta announced on 26 August that it was preparing to cut its fuel-price subsidies and raise fuel prices for the second time this year.

These 2nd fuel price hikes should occur before January 2006.

- Jakarta raised the government-set fuel prices the first time by about 29% on 1 March.
- To curb capital flight, the central bank has spent $5 billion to defend the currency in 2005.

Economic Advisor's Comment:

Weak oil production now makes the country a net oil importer for 2005.

- Indonesia's oil production fell 4.5% in 2004 while oil consumption rose 1.4%.
- Fuel consumption may rise 7% from the first half of 2005 to the second half of 2005.
- Local oil companies are on track to only produce about 1.06 million barrels of oil in 2005, thus falling short of the 1.125 million barrels of oil target.
- Heavy demand for US dollars to fund costly oil imports has put downward pressure on the Rupiah.

The current financial turmoil is largely due to the government's fuel subsidies.

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31 August 2005

Jakarta finally took actions intended to defend its embattled currency, stabilize stocks and boost investor confidence in the nation's economy and government.

- In the face of soaring oil prices, a falling currency and a sliding stock market, on 30 August the central bank raised its one-month interest rate by 75 basis points (bps) to 9.5% and the 7-day interest rate by 100 bps to 8.5%.
- The central bank also increased bank reserve requirements (less money to for capital flight).
- The central bank also said on 29 August that it was seeking to expand to a total of $ 10 billion its bilateral swap currency-swap arrangements with Japan, China and South Korea.

Economic Advisor's Comment:

The currency's decline was triggered by a surge in oil prices, which –

- Increased the demand for dollars to import fuel and raised the cost of oil subsidies.
- The higher interest rates are long overdue and helped to --
- Curb the 8-day slide in the rupiah – the longest losing streak in more than 4 years,
- Increase investor earnings in Indonesia as opposed to countries offering lower rates of return,
- Boost overall confidence and curb inflation by discouraging borrowing.

The problem is the 9.5% one-month interest rate falls short of the 10% to 12% range needed to meet market expectations and sustain financial stability.

- Jakarta reportedly felt that higher interest rates would slow down economic growth.

Worst of all, President Yudhoyono's stated on 31 August that his government would not increase fuel prices to tackle ballooning fuel subsidies until at least November.

- Jakarta could slash fuel subsidies and still avoid riots with a compensation program for the poor to offset higher fuel prices.

But dithering undermines investor confidence and raises fears of a 1997 financial crisis.

- Credit Sights -- which measures the probability of a country seeking an IMF rescue -- says Indonesia moved closer to a financial crisis than any other country in the world in August.
- CreditSights index says only Croatia, Brazil and South Africa are more likely to have a financial crisis within 30 days than Indonesia.

To avoid a financial crisis, Indonesia needs to slash fuel subsidies, raise interest rates over 10% and remove obstacles to FDI to help strengthen the currency against the dollar.

Executive Summary.

Poverty-plagued Laos has been struggling in recent years.

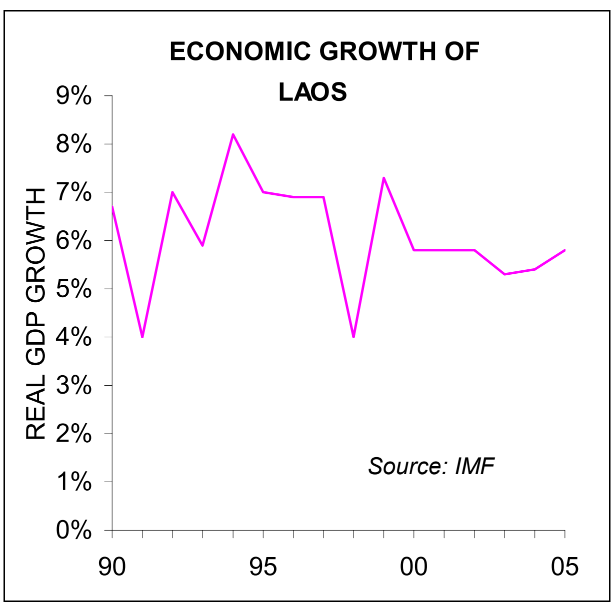
- Heightened security concerns have scared off any upsurge in tourism.
- An unattractive business climate and instability also discourage FDI.
- Foreign aid and remittances prop up this struggling economy.
- Thankfully, a booming Thai economy is coming to the rescue.
- The Lao future is looking brighter since Thailand has agreed to buy electricity from Laos.

Figure A. Selected Historical Data

Laos	2001	2002	2003	2004
Purchasing Power $B	9	10	10	11
GDP $B (Nominal)	2	2	2	2
GDP Growth (Real)	5.8%	5.8%	5.3%	5.4%
Inflation	7.8%	10.6%	15.5%	11.0%
Exports $B	0.3	0.3	0.4	...
To U.S. $B	0.0	0.0	0.0	0
Imports $B	0.5	0.4	0.5	...
From U.S. $B	0.0	0.0	0.0	0
FDI from U.S. $B	(*)	(*)	(*)	...
In U.S. $B	0.0	0.0	0.0	...
Intl Reserves $B	0.1	0.2	0.2	...
Savings /GDP	…	16.4%	19.6%	18.3%
Fiscal Balance /GDP	-7.6%	-8.3%	-7.8%	-9.2%
External Debt /GDP	150.0%	165%	...	...
Current account/GDP	-3.3%	-5.5%	-4.5%	-3.7%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization

Figure B. Historical Economic Growth



Introduction.

Over ¼ century after independence, Laos is the second poorest country (after Cambodia) in East Asia, with a GNP per capita of about $330.

- In fact, Laos remains one of the poorest nations in the world.
- More than ¾ of the 5.3 million population lives on less than $ 2 a day.
- Lao social indicators are among the lowest in the region and closer to the average for Sub-Saharan Africa.
- Subsistence agriculture is 53% of GDP and employs 80% of the workforce.

Economics/Security Link.

Whatever development Laos has seen over the past decades has been concentrated in Vientiane and other towns in the Mekong River plain, adjacent to Thailand

- Even worse, inequality between various parts of the country is increasing.
- Remote provinces in the mountainous north have seen little or no change.
- The “natives are getting restless” and demanding their fair share of the pie.
- Therefore, a successful counterinsurgency initiative must include a socio-economic component to address perceptions of social and economic injustice.

Unfulfilled Potential.

That said, Laos has abundant natural resources of forestry, minerals and vast hydropower potential.

- Unfortunately, only 3% of that potential has been exploited.

Structural Woes.

Laos faces a number of structural economic difficulties.

- Laos is a landlocked country with a primitive infrastructure.
- Laos has no railroads, a rudimentary road system and limited external and internal telecommunications.
- Electricity is only available in a few urban areas.
- Laos has a small industrial base.

Macroeconomic Mistakes.

In addition to its structural problems, Vientiane made a number of serious macroeconomic mistakes in response to the Asian economic crisis.

- Vientiane unwisely pursued loose monetary and fiscal policies that multiplied the negative effects of the crisis on domestic macroeconomic stability.

Current Economic Woes.

Due to past mistakes, Laos faces a grim economic reality today:

- Laos suffers from an inadequate regulatory framework, corruption, a large trade deficit and weak financial management.
- High non-performing loans also undermine banking.

GDP Improving.

That said, Lao economic growth improved in 2004 despite the effects of the drought and Severe Acute Respiratory Syndrome (SARS) in the region.

- A strong global economy boosted GDP growth to 5.4% in 2004 according to the IMF preliminary data. However, to make a dent in poverty, Laos must boost GDP close to 8% a year.
- The growth is supported by a recovery in agriculture, hydro-electricity output and rebound in tourism.
- Incremental improvement in macroeconomic policies in the past year has been the primary driver for this improved performance.
- Provided that sound macroeconomic policy implementation is sustained, macroeconomic performance is expected to remain favorable in 2005.
- Growth in 2005 is projected to rise to 7 %, driven by:
  - An expansion in mining exports and export growth
  - Low inflation in single digits.

Rise and Fall of Tourism.

For a while tourism looked promising. In fact, tourism was one of the few sectors that once made a solid contribution to –

- GDP growth
- Balance of payments.

Economics/Security Link.

Unfortunately, heightened security concerns have dampened hopes that tourism would be a silver bullet for the economy.

- The instability generally scares off potential foreign investors.

Weak FDI.

Even if security improves, foreign investors have found the business climate in Laos unattractive for a number of other reasons. These include:

- Macroeconomic instability
- High inflation,
- Expectations of devaluation.

Two Saving Graces.

If the economy has so many problems, what's keeping it afloat?

1. "Gifts from Heaven."

   For now, many Lao rely on remittances from overseas.

- In 1975, some 350,000 Lao, almost 10% of the population at the time, left the country after the communists took power.
- Over half the population in Vientiane has relatives overseas and almost half the population in the city receives money from them.
  - Remittances from abroad are reportedly the single most important source of income in the Vientiane valley.

Unfortunately these "gifts from heaven" are more likely to strengthen Laos' new role as an economic basket case than to lead to the kind of sustainable development that Laos needs to fight poverty effectively.

2. Donor Aid.

- For the foreseeable future, Laos will depend on foreign aid.
- Foreign aid -- mainly from Japan, Australia and Sweden -- covers trade and fiscal deficits.
- Aid provides 80% of the capital budget.
- But this international funding stopgap won't last forever.
- International donors from Japan, Sweden and Australia are increasing the pressure for progress on economic reforms before making new disbursements, which are over 16% of the country's GDP.

Donor fatigue may increase if the donors perceive that the government's commitment to economic reform is mostly rhetorical.

IMF Plan.

Laos is also a recipient of multilateral aid.

- For instance, in April 2001, the IMF approved a three-year arrangement (which has been extended by an additional year to April 2005) to 31.7M ($40.7M) Special Drawing Rights (SDR) to lift Laos out of poverty.
- The plan aims to restructure Laos' insolvent state banks, to increase revenue collection to fund development projects and to promote the private sector.

Hooked on Foreign Aid.

The government has become totally dependent on foreign aid.

- Foreign aid finances public investment.
- Foreign aid also covers the severe current-account deficit in balance of payments.
- In 1985-86, foreign aid was 6.25% of Laos' meager GDP. By 1988, it had increased to 10%. Now it is over 16% — or at a point where self-sufficiency is difficult.

Failure of Foreign Aid.

This trend toward increasing dependence on foreign assistance fits a disturbing pattern of failing economic development programs.

- Poverty reduction—in the form of several decades of huge disbursements of development aid—simply hasn't worked.

Thailand to the Rescue.

Thankfully, a booming Thai economy may rescue it.

- The future is looking brighter for Laos since Thailand has agreed to buy more electricity from Laos.

Promising New Dam.

The Electricity Generating Authority of Thailand finally signed an agreement with developer Nam Theun-II Power Company in Vientiane on 8 Nov 2003 to buy 995 megawatts of electricity worth $5 billion over 25 years.

- Once the power-generating dam on the Nam Theun River is operational it could enable Laos to achieve GDP growth of 6.4%.
- Currently, the sale of electricity to Thailand from existing dams accounts for almost 30% of total exports and constitutes 15% of government revenues.
- Experts say the construction of the Nam Theun-II power station could increase government revenues by more than 5%.

Environmental Concerns.

Construction of the dam was delayed 8 years due to the Asian economic crisis and more recently opposition from conservationists.

- The dam will be built in the once forested Nakai Plateau in Khammouane province, and there's concern about the impact on the biodiversity of the area.
- The World Bank, which is providing bank guarantees for the project, is determined to ensure that environmental safeguards will be followed.

Why not power at home?

The Swedes say that while Laos generates lots of electric power for export, under 20% of rural Laotians have access to electricity.

- This electric shortfall in rural Laos is one of the main factors that limits commercialization and diversification of the economy.

Financial Concerns.

That said, donors say income from the sale must be spent in a sound manner to reduce the Lao heavy dependence on foreign aid.

- The Swedes cite the project's lack of administrative accountability, inefficient systems for public-service management and under-qualified staff.
- All of these shortcomings provide ample opportunity for corruption.
- With this in mind, the World Bank is watching closely to make sure the project really contributes to macroeconomic stability and poverty reduction.

CONCLUSIONS

What's the Laotian economy like?

- One of the poorest economies in region.

Can tourism help the economy?

- Bombings have scared off any upsurge in tourism.

What's keeping the economy afloat?

- Remittances from abroad and foreign aid.
- Is Laos getting any foreign direct investment?
- Not much.
- Foreign investors find the business climate in Laos unattractive.
- The government's economic mismanagement and recent bombings deter FDI.

Is there any hope for the economy?

- Yes. A booming Thai economy is coming to the rescue.
- The Lao future is looking brighter now that Thailand is buying Lao electricity.
- The sustained government's efforts in incrementally improving the macroeconomic policies can drive the economic growth and improve performance.

MALAYSIA

• CHAPTER 9 •

Executive Summary.

Malaysia is back on track and moving in the right direction.

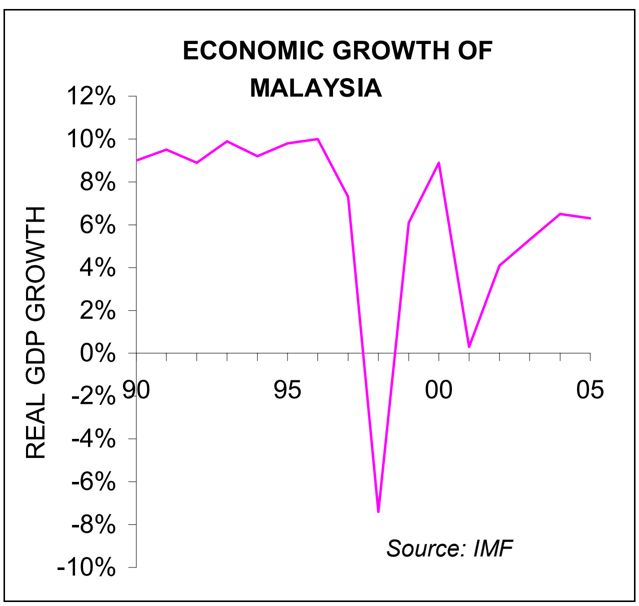
- Its economy is on a roll.
- New PM Abdullah has stabilized things politically.
- He is decisively reducing the budget deficit.
- His resounding victory in the March elections gives him a clear mandate to push through even tougher economic reforms.

Figure A. Selected Historical Data

Malaysia	2001	2002	2003	2004
Purchasing Power $B	214	227	244	265
GDP $B (Nominal)	88	95	104	118
GDP Growth (Real)	0.3%	4.1%	5.3%	7.1%
Inflation	1.4%	1.8%	1.1%	1.4%
Exports $B	88.0	94.1	105.0	126.5
To U.S. $B	9.4	10.3	10.9	11
Imports $B	73.9	79.8	83.6	105.2
From U.S. $B	22.3	24.0	25.4	27
FDI held by U.S. $B	7.5	7.0	7.6	...
held in U.S. $B	0.3	0.3	0.2	...
Gross Intl Reserves $B	30.8	34.6	44.9	66.7
Savings /GDP	42.5%	41.8%	42.1%	43.0%
Fiscal Balance /GDP	-5.5%	-5.6%	-5.3%	-4.5%
External Debt /GDP	51.9%	51.3%	47.3%	43.4%
Current account/GDP	8.3%	8.4%	12.9%	13.3%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



From Bears.

Investors were bearish on Malaysia until recently.

- In fact, the Malaysian stock market under-performed its Asian peers for 6 years.
- The stock index was the worst performing major Asian market during 2003.
- Not anymore

To Bulls.

Malaysia is now SE Asia's strongest performer.

- From January to March the stock index rose 10% (818 to 902).
- JP Morgan predicted it would surpass 1,000 before the end of 2004.
- U.S. pension fund CalPERS recently moved back into Malaysia.
- Fitch Credit Agency upgraded Malaysia's currency outlook.

Why the Optimism?

Three reasons.

- Growth.
- Political stability.
- Economic reform.

Virtuous Circle.

These three key drivers (growth, stability and reform) are creating a virtuous circle:

- Confidence generated by the strong economy makes it easier for the government to introduce reforms.
- Reforms are supporting and sustaining the economic rebound.

Growth: On a Roll.

Malaysia is the third fastest growing economy in Asia, after Thailand and China.

- Malaysia's GDP grew at a 5.3% in 2003 and 7.1% in 2004.

Drivers.

A number of factors are moving Malaysia in the right direction:

- Consumer spending is up.
- Exports remained strong through 2004.
- Global highs are occurring in commodity prices for products Malaysia exports.
- Crude oil prices are set at about $ 37 a barrel.
  - Palm oil prices have risen 50% in 6 months.

  - Timber and plywood prices are up 10%-25% since January 2004.
- Inflation is a tame 1.4% and unemployment is relatively low at 3.4%.
- FDI increased 35% in 2003 after contracting in 2001 and 2002, and remained strong through 2004.
- Local private investment expanded by 7% during 2004, after growing by less than 2% in 2003.
- A continuing trade surplus since 1998 has swollen international reserves, which reached $ 67 billion at the end of 2004. That's more than double pre-Asian financial crisis levels.

Political Stability.

The political transition that replaced Prime Minister Mahathir with new PM Abdullah Badawi was smooth.

- Abdullah's resounding victory in March elections removes uncertainty.
- Fitch Credit Agency says that Abdullah's victory removes "diminishing political transition risks."

Reform.

Abdullah has utilized the resounding election victory as a clear mandate to push through reforms that he began before the elections. The PM is --

- Cracking down on corruption.
- Abandoning Mahathir's crony capitalism by making government contract awards procedures more transparent.
- Opening an inquiry into abuses in the police.

Economic Reforms.

Abdullah is also pushing through budget, trade and financial reforms to improve long term economic growth:

Cutting Budget Deficit.

Back in 2003 Malaysia's budget deficit was an alarming 5.4% of GDP.

- This 5.4% figure is well above the 3% figure that rings alarm bells of possible financial turmoil.
- Abdullah (wearing a second hat as Finance Minister) is sharply reducing the budget deficit by canceling or postponing costly government mega-projects.
- As a result, the budget deficit should drop to 4.5% of GDP in 2004 and 3.5% of GDP by end of 2005.

Movement Toward Free Trade Agreement (FTA).

On 10 May Malaysia signed a Trade and Investment Framework Agreement with the U.S.

- The agreement opens the way for progress towards a bilateral FTA as a long-term boost to the economy.
- Movement towards an FTA with the U.S. is the clearest sign of Abdullah's new openness.
  - That's a welcome change from Mahathir's financial protectionism and hostility toward U.S. investors since the Asian financial crisis.

Greater Financial Openness.

In addition, there are other significant signs of greater openness:

- Abdullah recently floated the possibility that the 30% foreign ownership ceiling in most of Malaysia's service sectors may be dropped.
  - If implemented, this could be his most significant reform, allowing more foreign money into the protected banking sector.
- Foreign money would also be given greater access to the booming telecommunications market.
  - Under Mahathir, Singaporean state-controlled SingTel was repeatedly rebuffed in its attempts to establish a strategic stake in Malaysia's telecoms sector.
- Bursa Malaysia (formerly Kuala Lumpur Stock Exchange) and the Singapore Stock Exchange recently announced plans to promote cross-listings.
  - That's a welcome change from Mahathir's controversial decision to unilaterally close Singapore trading in Malaysia stocks in Sept 1998, at the height of the economic crisis.

Unfinished Agenda.

These high-profile reforms are signs that Malaysia has liberalized its overall economic policy approach and is making up lost ground after past protectionism.

- That said, the initiatives are yet to be implemented, and have not been tested against the strong local vested interests benefiting from existing policies.
- The early signs in the post-Mahathir period are good for the international investment community and Malaysian firms seeking foreign capital and expertise.

Litmus Test.

The test will lie in how comprehensively and quickly the new government team pushes these reforms.

- The lifting of the foreign equity ceiling in the service sector will act as the litmus test, as this is a unilateral policy that cannot be held up by negotiations with other governments.

CONCLUSIONS

The Malaysian economy is on a Roll.

- It's the third fastest growing economy in Asia.
- Stock market has gone from worst to best performing index in Asia.
- Strengthened confidence.

Why all the economic optimism in the stock market?

- Three reasons: Growth, Political Stability and Economic Reform.

What's driving the growth? Three factors:

- Consumer spending
- Exports and
- High commodity prices.

What do the results of the March elections mean for the economy?

- New PM Abdullah's resounding victory in the March 2004 elections –
  - Removes uncertainty and political risk and
  - Gives the new PM a clear mandate for economic reform.

What kind of economic reforms is the new PM pushing?

- Cutting the budget deficit
- FTA with U.S.
- Greater financial openness.

SUBSEQUENT ECONOMIC UPDATES

28 April 2005

The World Bank warned China and Malaysia that their fixed exchange rate systems (pegged to the US dollar) are attracting the kind of currency speculation that ignited the Asian financial crisis in the late 1990s.

- When fixed exchange-rate systems were common in the region in the 1990s, economies in the Asian-Pacific region boomed as foreign capital poured in.
- The boom became a bust in 1997, when the currency systems in many nations collapsed in the face of attacks from speculators.
- Drawing from these lessons learned in the 1990s, the World Bank argues that greater exchange-rate flexibility and currency appreciation in China and Malaysia are required to discourage speculative inflows.
- While Homi Kharas, the bank's chief Asian economist, says the bank isn't warning of an imminent crisis, he underscores that "very large volumes of money" flowing into China and Malaysia greatly increases the risk of a crisis.

Economic Advisor's Comment:

At first glance the World Bank makes a persuasive case that China looks a lot like East Asia before the onset of the Asian financial crisis.

- These similarities include a PRC investment boom that is excessive in housing and the industrial sector, a rotten financial system, poor corporate governance, poor transparency of data and policies, an asset bubble that continues unabated and large capital inflows that hide underlying problems.

However, there are also substantial and important differences:

- China is running a current account surplus rather than a deficit, capital controls rather than an open capital account, massive foreign exchange reserves and low short-term foreign currency debt rather than low reserves and massive short-term debt.

While a financial crisis in China (and Malaysia) could occur today, it would play out quite differently from the balance of payments crisis that took place in East Asia back in 1997

02 May 2005

Socio-economic instability is rising in the Muslim world and is challenging U.S. interests.

- Recent trends in social and economic activity in numerous Muslim-majority countries – including Bangladesh, Indonesia and Malaysia -- paint a grim picture and point to significant challenges ahead.
- Socioeconomic woes are creating environments in which discontent is growing and in which activist or radical Islamic messages have increasing resonance.
- Islamic activism often finds strong support among populations buffeted by poor economic conditions and young people whose aspirations for a better life have been thwarted.
- Though not the only factor, socioeconomic frustrations are among the key drivers of alienation and radicalism.

Economic Advisor's Comment:

These adverse trends provide conceptual justification for the following:

- National Strategy for Combating Terrorism Goal # 3 -- Diminish the Underlying Conditions that Terrorists Seek to Exploit;
- 9/11 Commission Report Recommendation # 7 – Provide Hope and Socio-economic Opportunity;
- National Military Strategy Plan for the War on Terrorism (NMSP-WOT) Pillar on Environment Development;

In addition, these trends provide new impetus for the PACOM J5/Joint Interagency Coordination Group for Combating Terrorism (JIACG-CT) and National Intelligence Council (NIC)/CIA co-sponsored Conference at the US Army War College (USAWC) on Addressing Socio-economic Conditions that Foster Terrorism, 8-10 June 2005.

- This PACOM/CIA/USAWC conference discussed the US inter-agency process that is trying to drain the swamp (or reverse these grim socio-economic conditions), identify gaps in the process and recommend creative and decisive new ways to overcome them.

19 July 2005

Malaysia's macroeconomic performance continues to be impressive.

- Malaysia's GDP growth is on track to expand 5% - 6% in 2005 - one of the highest growth rates in Asia.

On the external front, Malaysia is on a roll.

- For the first 5 months of 2005 total exports grew 12.3% from a year earlier.
- Strong exports reflect foreign demand for oil and gas and semiconductors. .
- Crude oil, liquefied natural gas and refined oil products accounted for 12% of total export earnings.

- Exports of semiconductors, hard disks and other electronic products rose 8.2% in May from a year earlier.

Economic Advisor's Comment:

In addition, Prime Minister Abdullah is replacing former Prime Minister Mahathir's state-led growth strategy with a market led growth strategy.

- He is freezing several extravagant state funded construction projects.
- The government decided in May to raise the fuel prices - the 3rd such increase since October in a bid to ease its fiscal burden from oil subsidies.
- These two policy changes have initially hurt earnings at local businesses and accelerated inflation.
- Abdullah's strategy will eventually help to reduce a large budget deficit (that's 4% of GDP).

Long - term gain is short - term pain, with the domestic economy presently struggling.

- Consumers now facing higher costs and are reducing spending, which is hurting retail sales.
- PM Abdullah is also under fire from the politically powerful construction sector.
- Mr. Abdullah shows every indication that he is willing to stay the course.

25 July 2005

On 24 July Malaysia announced it would drop its 7 year foreign exchange peg (3.80 Ringgit/Dollar) and allow the Ringgit to float.

- Malaysia's move to abandon its fixed exchange rate regime marks a total break from a set of capital-control measures announced in September 1998 by former Prime Minister Mahathir.
- Mahathir had put capital controls in place to stem capital flight and stabilize an economy shaken by the Asian economic crisis of 1997.
- Over the past year, PM Abdullah, who took over from Mahathir in November of 2003, has moved to dismantle the package of capital controls to slowly reintegrate Malaysia, the world's 17th largest trading nation, with the global financial system.

Economic Advisor's Comment:

The Ringgit will initially appreciate to around 3.72/Dollar, in line with the roughly 2.11% appreciation of the Yuan after China also abandoned its peg to the dollar last week.

- But unlike China, Malaysia will rely more on market forces to maintain the stability of its managed float.
- Malaysia will rely on occasional central bank intervention rather than a currency-trading band, which Singapore and now China use.
- The Kuala Lumpur stock market celebrated the managed float by rising to a 5-year high on 22 July.
- The market sees the Malaysian economy benefiting from greater import purchasing power of a stronger currency and as well as increased foreign investment.
- Malaysia's record $75 billion in foreign reserves and a strong trade surplus will probably help drive the undervalued Ringgit 5% to 10% higher against the dollar over the next 3 months.

PHILIPPINES

• CHAPTER 10 •

Executive Summary.

During much of Philippine President Gloria Macapagal Arroyo's time in office, the economy seemed to drift.

- Poverty and high unemployment seemed intractable.
- Credit agencies kept downgrading Philippine government debt.
- President Arroyo and her government dithered.

But in 2004 and early 2005 things began to improve.

- The Philippines enjoyed its strongest economic performance in 15 years.
- The government finally raised taxes.
- That helped reduce the budget deficit and move the country away from the brink of an Argentine-style default on repayment of its government debt.
- Financial markets reacted positively.

But is the strong Philippine economic performance in 2004 sustainable?

- On balance, the economy will likely not perform as well as in 2004.
- In fact, the economy was almost flat in 4Q 2004 due to typhoons and storms.
- The economy will recover.
- But a number of domestic and global factors will likely slow down the economy in 2005.

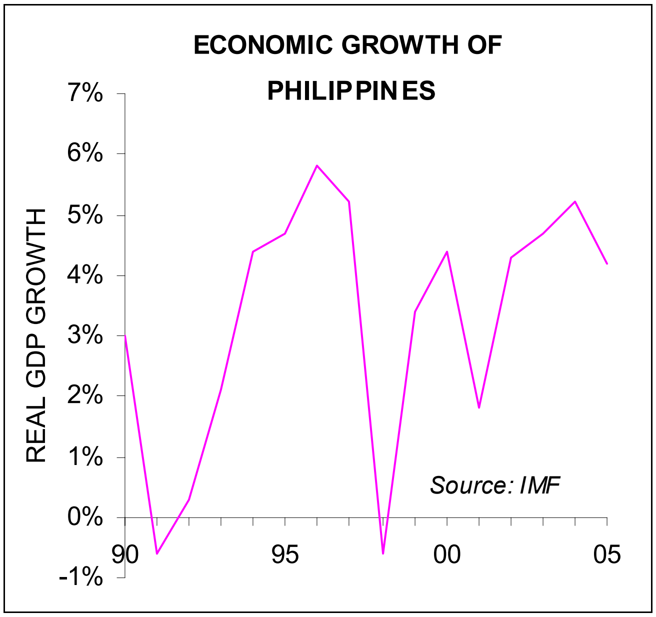
To make the economy more resilient in the future, the government must redouble its efforts to attack the structural problems.

Figure A. Selected Historical Data

Philippines	2001	2002	2003	2004
Purchasing Power $B	314	334	356	383
GDP $B (Nominal)	70	76	78	85
GDP Growth (Real)	1.8%	4.3%	4.7%	6.1%
Inflation	6.1%	2.9%	3.0%	5.5%
Exports $B	32.7	36.5	37.0	39.6
To U.S. $B	7.7	7.3	8.0	7
Imports $B	34.9	37.2	39.5	42.6
From U.S. $B	11.3	11.0	10.1	9
FDI held by U.S. $B	5.4	4.6	4.7	...
held in U.S. $B	0.0	0.0	0.0	...
Gross Intl Reserves $B	15.7	16.2	16.9	16.0
Savings /GDP	16.8%	17.3%	19.5%	21.0%
Fiscal Balance /GDP	-4.0%	-5.3%	-4.6%	-3.8%
External Debt /GDP	74.0%	71.0%	73.4%	64.4%
Current account/GDP	1.9%	5.8%	4.3%	4.6%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization

Figure B. Historical Economic Growth



STRUCTURAL CHALLENGES

Introduction.

During Philippine President Gloria Macapagal Arroyo's time in office, she has struggled with persistent weaknesses in the Philippine economy:

- The Philippines is plagued with some of Asia's highest rates of poverty and unemployment.
- 1/3 of the country's 84 million people live on less than $1 a day.

Overseas Filipinos.

Since jobs are so scarce in the Philippines, too many Filipinos are forced to work abroad.

- More than 1 million people leave each year to work abroad and send money (remittances) home to their families, including increasing numbers of middle class professionals.
- About 8 million Filipinos – almost 10% of the population – are working overseas.

Structural Unemployment.

While some university graduates find jobs in calls centers and other businesses outsourced to the Philippines, the number of unemployed Filipinos is far too high.

- The unemployment rate was 11.8% in 2004 and is expected to reach 12.2% by the end of 2005.

Constraints on Growth.

Although the economy has recorded strong growth of 6% in 2004, structural problems forestall any end to the boom-bust cycle that's afflicted it for 20 years and prevented it from moving to higher and sustained levels of growth.

The most important constraints on Philippine long-term economic growth are:

- Shortages of financial capital and technology.
- High rates of population growth (that keeps per capita growth at only 2.5%).
- Corruption.

Low Private Investment.

To increase capital and technology, the Philippines needs to attract more foreign direct investment (FDI). Unfortunately, too many potential foreign investors find the business climate to be unattractive in the Philippines.

- FDI, which averaged $1.5 billion between 1998 to 2002, fell to $161 million in 2003 and did not pick up significantly in 2004.
- As a result, the Philippines is not attracting the financial capital and technology needed for stronger economic growth.
- Why can't the Philippines attract more investment?

Poor Investment Climate.

Foreign investors are holding back on investment to the Philippines because they don't regard the country as competitive.

- They point to a weak infrastructure.
  - Companies complain that they lose 8% of their production because of power blackouts.
  - FDI in infrastructure is inadequate in part because of populist regulatory and judicial decisions such as those that prevented Manila Electric from raising its rates.
- They also point to an unpredictable legal system and relatively high minimum wages.
- Most of all, they point to serious financial mismanagement of the government.

Massive Borrowing.

The Philippines continues to live dangerously beyond its means.

- The Philippines is Asia's largest sovereign-debt issuer after Japan.
- The country's public-sector debt is 110% of GDP – or almost twice the 60% figure that the EU uses as a sign of financial instability.
- The government interest expense is nearly 40% of revenue,
- In 2005 the Philippines plans to borrow a total $4 billion from the international debt market to fund its budget deficit.
- The funding plan includes $1 billion for its beleaguered state utility National Power Corp., or Napocor, which has been able to borrow only at exorbitant rates of interest.

What was Needed.

To defuse this financial time bomb the government desperately needed to tighten fiscal policy and cut its over-borrowing.

- Manila needed to front-load a consolidation plan in order to ease the market's concern about the government's commitment.
- Additionally, the government needed to make permanent a provisional increase in the power rates of Napocor and further raise its tariff to put the state utility back in the black.
- In short, prompt passage of the government's fiscal plan was necessary to avert a potential financial disaster.

GOVERNMENT DITHERING

Government Inaction.

During most of 2004 the government was unable to take decisive action.

- Of the 8 revenue measures proposed by the government last year, only 1 -- a boost in tobacco and alcohol taxes -- had been passed in watered-down form by the end of the December legislative session.

Credit Rating Worsens.

Given Manila's weak performance on the eight tax measures. S&P said it has lowered its expectations that the government will be able to raise tax receipts materially from their current low level of 12% of GDP.

- Skeptical that Manila will be able to raise 80 billion pesos in revenue a year through new fiscal measures, S & P cut –
- Philippines' long-term foreign-currency rating from double-B to double-B-minus.
  - Philippine long-term local-currency sovereign credit rating from triple-B-minus to double-B-plus,
  - Philippine short-term local-currency rating from A-3 to single-B.
- S & P also warned of a further downgrade if the government falters in its effort to revamp the economy.
- Moody's also threatened to downgrade the country's ratings by one notch unless Manila took decisive action to reduce its budget deficit.

Impact.

These downgrades made it even costlier for the Philippines to finance its growing budget deficit.

Government Dithering.

For most of 2004, the government's weak fiscal position raised the specter of an Argentine style default on government debt.

- Instead of taking decisive action, the government dithered.

S & P Downgrade.

Then Standard and Poor's (S&P) downgraded Philippines debt.

- It also warned that further downgrades would be forthcoming if the government kept dithering.

THE TURNAROUND

Strong Growth.

Notwithstanding its problems on the debt front, the Philippines' economy began to improve in 2004 and early 2005.

- The Philippines enjoyed its strongest economic performance in 15 years.
- GDP grew 6.1% in 2004.

Drivers.

This impressive economic growth reflects –

- A steadily growing service sector.
- Robust consumer spending at home.
- Rising exports.
  - Exports in 2004 rose 14% compared to just 4.4% in 2003.

Rising Economic Ties with China.

A key economic driver of this growth the past few years has been rising exports to the PRC market.

- China is the fastest growing market for Philippine exports and the country's fifth biggest trading partner.
- In 2003, bilateral trade volume reached U.S.$9.4 billion, representing a growth rate of 79 % over the figure of U.S.$5.2 billion in 2002.
- Several Chinese companies pledged in late January to invest at least $1.3 billion in Philippine mining ventures.
- A Philippine trade delegation said it had won PRC commitments to gold, copper and other mining projects.
- Foreign investment in mining was opened up in December 2004 when the Supreme Court upheld a 1995 law allowing foreign companies to control up to 100% of big mining projects.

Decisive Action.

In response to S & P's wake-up call, the government finally took decisive action to reduce the budget deficit.

- The legislature approved a bill on 27 January 2005, raising value added taxes from 10% to 12%, and expanding their scope.
- The government is also implementing higher power and water rates.
- New cabinet appointments to the finance, trade and energy departments have also fueled optimism.

Away from the Brink.

Thanks to strong economic growth in 2004 the budget deficit actually fell below market expectations and far below the target for 2004.

- The budget deficit fell from 4.6% of GDP to 3.9% of GDP.
- That helped the country away from the brink of an Argentine-style default on repayment of its government debt.

Market Bullish.

Financial markets responded favorably to the government's new resolve:

- The Philippine stock market hit a 5-year high the last week of January 2005.
- In late January 2005 the peso climbed to its highest point in 8 months.

SLOWDOWN AHEAD?

Bad News.

Unfortunately, market optimism could be short-lived. Why?

- The economy is rapidly slowing down.
- Due to devastating typhoons, the Philippine economy experienced almost no growth in 4Q 2004 -- the worst quarterly economic performance in 3 years.
- This slowdown is a threat to short-term financial stability and long-term political and economic stability.

Time Bomb Defused.

While government actions to boost taxes have thankfully defused the fiscal time bomb, it could be reignited if Manila softens its line.

- For instance, an ill-advised government decision to cave into protesters 'demand for a roll-back of the rise in the value-added tax (VAT) could reignite the time-bomb.

Good News.

Thankfully, there are a number of economic drivers that will likely help the Philippines recover from a virtually flat 4Q 2004:

- The growing service sector – about ½ of the GDP – will remain strong especially in the telecommunications and fast-growing call-center industry.
- The central bank is projecting remittances to grow by 10% in 2005.
- Thanks to Chinese FDI in the mining sector, investment flows should be stronger.

Bad News.

But a strong growth rate in 2004 of 6% that helped the country avoid a default on government debt will be difficult to achieve in 2005 for a variety of reasons:

- Global consumption should fall as interest rates rise in the U.S. and elsewhere.
- Weaker global growth will likely reduce Philippine exports, which in turn would cut manufacturing production.
- Higher taxes will also hurt consumer spending.
- High oil prices and rising inflation will likely dampen consumer spending.
- El Nino will likely mean a dry spell and a relatively low yield in the farm sector, which accounts for 20% of GDP and employs 40% of the work force.
- Increasing JI and other terrorist attacks in Filipino commerce centers will undoubtedly make domestic and foreign investors more cautious, and will reduce the flow of FDI.

(*Footnote: Jemaah Islamiya (JI) is the primary terrorist threat in the Philippines -- a Southeast Asian–based terrorist network with links to al-Qaida. The network recruited and trained extremists in the late 1990s, following the stated goal of creating an Islamic state comprising Brunei, Indonesia, Malaysia, Singapore, the southern Philippines and southern Thailand*.)

Unfinished Agenda.

To make the economy more resilient in the future, the government must redouble its efforts to attack structural problems.

To boost long-term economic growth the government needs to --

- Modernize the physical infrastructure
- Upgrade technological capabilities.
- Stand up an appropriate population management program, of which better education is the pillar.

CONCLUSIONS

How would you assess Philippine President Arroyo's economic leadership?

- It was a policy of drift until the last year or so.

What are some of the structural challenges?

- Structural unemployment and poverty
- High population growth
- Poor infrastructure
- Shortages of financial capital and technology
- Low FDI
- Corruption.

Is the country going to have an Argentine style default on government debt?

- Not as likely now, as compared to previous years.
- The government finally raised taxes.
- That action – along with stronger growth -- helped reduce the budget deficit as a % of GDP.

How have the financial markets reacted in early 2005?

- Stock market hit a 5-year high.
- The peso hit its highest point in 8 months.

Is the strong economic growth we saw in 2004 sustainable?

- No.
- The economy slowed down in 4 Q 2004 – with almost flat growth.
- That was the worst quarterly performance in 3 years.

How will the economy perform in 2005?

- We expect a slowdown.

Why will the economy slowdown in 2005?

- High oil prices and rising inflation will likely dampen consumer spending.
- Weaker global growth will reduce Philippine exports.
- Higher taxes will reduce consumer spending.

How could the economy be more resilient and have higher long-term growth?

- To make the economy more resilient in the future, the government must redouble its efforts to attack the structural problems.
- The government needs to:
  - Modernize infrastructure
  - Upgrade technology
  - Reduce population growth.

SUBSEQUENT ECONOMIC UPDATES

11 February 2005

The Philippine government disagrees with the International Monetary Fund (IMF) over the pace of proposed economic reforms to avert a potential Argentine style default on repaying its debt.

- In 2004, the Philippine government debt was 104% of GDP or nearly double the 60% upper limit for financial stability.

- A 7 February IMF report says Manila must front-load new taxes and budget cuts in 2005 and 2006 to mitigate risks from higher global interest rates and negative investor sentiment.
- Manila says that the IMF is overly pessimistic and that the IMF austerity plan is a political non-starter.

Economic Advisor's Comment:

The IMF representative in Manila now concedes that the 7 February IMF report was based on talks a visiting IMF team had with the Philippine government back in July. Since then, a shaky Philippine financial situation has improved.

- Philippine economy grew 6.1% in 2004 -- its strongest performance in 15 years.
- As a result, the budget deficit fell from 4.6% of GDP to 3.9% of GDP. That made debt servicing easier.
- The government finally raised taxes and financial markets responded favorably.
- The Philippine stock market hit a 5-year high the last week of January 2005.
- On 4 February the peso strengthened to 54 pesos to the U.S. dollar, its highest point in 8 months.
- Finally Manila hopes reduce the budget deficit by cutting the military budget once it reaches an agreement with the Moro Islamic Liberation Front (MILF).

25 February 2005

President Arroyo warns that the Philippines is close to an Argentine style default on government debt.

- She's trying to scare lawmakers into action to put public finances in order.
- Unresponsive lawmakers are holding up Arroyo's proposals for badly needed tax reforms.

Economic Advisor's Comment:

Arroyo's alarmism may seem overdone. Growth is fastest in 15 years. The stock market is strong.

- Alcohol and tobacco taxes are up. Unlike Argentina, less debt is short term and foreign.
- Yet Manila has at best only slowed the sharp deterioration in public finances.
- Public debt is 130% of GDP - or over twice the 60% upper limit for financial stability.
- The economy remains vulnerable to higher U.S. interest rates, a falling dollar and higher oil prices.

27 April 2005

Chinese President Hu Jintao and Philippine President Arroyo concluded a successful summit and boosted Sino-Philippine economic ties.

- Deals valued at over $ 1.5 billion include a $500 million PRC loan for a railway linking Manila and northern provinces and a $950 million PRC investment in a nickel mining project in the southern Philippines.
- China is now the fastest growing market for Philippine exports, with China now ranking as the Philippines' 4th-biggest trade partner, up from 12th-largest in 2001.
- Bilateral trade has been growing about 55% annually since 2002 and the two countries are targeting $20 billion in annual trade by 2009.
- The increase in trade is largely because of expanding Philippine exports of electronics components for assembly in China and rising Chinese textile exports to the Philippines.

Economic Advisor's Comment:

Sino-Philippine shared prosperity can be a mixed bag for US national interests:

- On the negative side, cross cutting loyalties are deepening between Manila's valuable commercial ties with China and its long-standing economic and security ties with the US.
- Manila will not want to do anything with the US to antagonize Beijing and jeopardize this shared prosperity with China.
- On the positive side, the Sino-Philippine railway project will create at least 17,000 new jobs and indirectly supports:
  - The environment development pillar of the new US National Military Strategy Plan for the War on Terrorism (NMSP-WOT) and
  - The 9/11 Commission Report's recommendation calling for tangible actions to provide hope and economic opportunity to unemployed people.
- In addition, China's capital inflow will ultimately strengthen Manila's ability to resist an Argentine style default on its huge government debt.

05 May 2005

Rising socio-economic problems are weakening Philippine President Gloria Macapagal Arroyo's political strength.

- Philippine consumer prices remained at 6-year highs in April for the sixth straight month.
- On 4 May, Manila said that GDP growth in 1Q 2005 may have slowed down from 5.4 % in 4Q 2004 to between 4 % and 5 % in 2005.
- Higher prices, which reduced consumer spending, were mainly to blame for the slowdown. In addition, poor farm output growth and weak exports hurt growth.
- These rising socio-economic problems contributed to the Philippine president's approval rating falling to 38 % in March -- the lowest since she became president in January 2001.

Economic Advisor's Comment:

Over the weekend a former Philippine defense secretary called for the ouster of the Philippine president.

- Similar political challenges will continue to mount as her government imposes new taxes and raises utility rates to stem the rapid growth in government debt, which is one of Asia's highest.

Manila was able to resist an Argentine style default on government debt because of 6.1% economic growth in 2004 -- the fastest pace in 15 years. But economic growth in 2005 is slowing down.

- Standard Chartered Bank has said that the government's shaky finances could trigger a financial crisis similar to Argentina's 2001 default.
- The Philippine president has made similar warnings herself and Moody's, Fitch and Standard and Poor's all have low credit ratings for Philippine government debt.

If the Philippines were to default on its debt payments, it would seriously weaken the government's ability to fight and win the war on terrorism.

09 May 2005

A joint panel of Philippine Senators and House members broke a two-week deadlock and pushed a decision on a higher value added tax (VAT) back to President Arroyo.

- The compromise on the VAT legislation gives President Arroyo the prerogative to raise the VAT from 10% to 12 % after 2005.
- The compromise bill also calls for raising the corporate income taxes from 32% to 35%.
- The tax plan is aimed at providing vital revenues for the heavily indebted government to help cut the government's financially destabilizing $3.4bn budget deficit.
- The tax plan may be approved formally this week unless President Arroyo decides to veto it.

Economic Advisor's Comment:

The VAT compromise reflects Philippine lawmakers' reluctance to enact tough laws to reduce the budget deficit and reduce Manila's dependence on foreign borrowing to finance the budget gap.

- The VAT compromise means the VAT hike can't even be collected until 2006 at the earliest.
- Lawmakers are wary of taking political heat for increasing VAT at a time when so many impoverished Filipinos are struggling with sharp price rises.
- Therefore, increasing the VAT will be a painful task for President Arroyo and could provoke a public backlash against an already unpopular president.

Meanwhile, boosting the corporate tax rate, already among the highest in Asia, from 32% to 35% probably won't yield much in new revenue, and could deter new foreign and local investment.

- Finally, Philippine stock prices fell on 10 May as investors worried over the extent to which higher corporate taxes and weaker consumer spending in the face of higher VAT could combine to damage corporate bottom lines.

12 May 2005

Philippines finances are worse than Argentina before it defaulted on government debt in December 2001, according to Moody's Investors Service.

- Moody's says, "If you compare all the key fiscal ratios that we look at, the Philippines is much worse than Argentina was in 2001."
- Three months ago Moody's cut Philippine government debt ratings to B1 -- that's 4 levels lower than investment grade and the lowest since Moody's assessed Philippine creditworthiness in July 1993.
- Moody's rating is a step below that assigned by Standard & Poor's, which cut its rating by one level in January 2005.

Economic Advisor's Comment:

Moody's argument is basically on target.

- The Philippine budget deficit --almost 4% of GDP -- is larger than Argentina's 3.2% budget deficit in 2001.
- The Philippine government's $75 billion debt -- at 77% of GDP in 2004 -- is bigger than Argentina's debt/GDP ratio of 54% in 2001.

- The Philippine government debt/ revenue ratio is 525% in 2004 -- almost double Argentina's debt/revenue ratio in 2001 before it defaulted on its $95 billion government debt.

While lawmakers recently agreed to raise the value added and corporate taxes, the new taxes are small and incremental, and won't amount to a significant improvement.

- The government's payment of $22.3 billion of foreign-currency bonds will hinge on its ability to maintain a current account surplus.
- Back in 2004, the current account surplus was a healthy $ 2.08 billion due to the fastest Philippine economic growth in 15 years. But that growth spurt wasn't sustainable.
- In 2005, the current account surplus is decelerating to $1.2 billion due to import growth outpacing export growth as the global economy slows down.

05 July 2005

On 4 July the Philippine Supreme Court suspended the government's new sales tax legislation designed to boost revenue and stabilize the country's precarious finances.

- Financial markets reacted negatively, with the PESO falling to a 6 month low.
- Stock prices fell 4.2% -- its steepest one-day slide since September 2001.

Economic Advisor's Comment:

Manila is struggling to avoid defaulting on a huge government debt.

- Credit agencies downgraded Philippine credit ratings, in part, because of tax collection problems.

Back in May, President Arroyo strengthened finances with new tax legislation that expands the existing 10% value added tax, or VAT, to businesses that were previously exempt.

- It also grants President Arroyo the authority to raise the VAT to 12% next year.
- The tax would automatically raise the maximum corporate tax rate from 32% to 35% in 2006.

Standard and Poor's (S & P) says the court's freeze adds to financial vulnerability.

- Manila had anticipated increased annual revenue of $502 million from the expanded VAT.

Embattled President Arroyo says she will contest the court's freeze.

- The court's freeze says it's illegal for the president to raise taxes because this is the sole control of Congress.
- Ironically, it was Congress that granted Arroyo the tax-raising power, allowing her to increase the VAT to 12% in 2005, because lawmakers were concerned about a public backlash if they did it themselves.

12 July 2005

On 11 July Fitch and Standard and Poor's (S&P) revised their outlook on Philippines' sovereign credit ratings from stable to negative.

- A downward revision of ratings agencies' outlook often equates to financial indication and warning of a full-blown downgrade, which would make it more expensive for the Philippines to borrow to service its $70 billion foreign debt.

- S&P says " the combination of delayed fiscal consolidation, protracted political stalemate and a possible change in economic policy has shifted the balance of risks onto the downside, making a stable outlook no longer justified."

Economic Advisor's Comment:

Even in the best of times, it would take extraordinary presidential leadership to move the Philippines away from the financial brink of defaulting on government debt.

- But these are not the best of times. On 8 July Morgan Stanley said Philippine economic growth is on track to slow from 6.1% in 2004 to 4% this year due to higher oil prices, higher inflation and slower global growth.
- Slower growth means lower tax revenue, which in turn forces the government to keep over-borrowing.
- To make matters worse, the Supreme Court has temporarily frozen new value added taxes (VAT), the centerpiece of President Arroyo's push to raise tax revenues and cut the debt.

The accusations that President Arroyo attempted to rig the vote count in the May 2004 presidential election make this bad financial situation far worse.

- Former President Cory Aquino has called for Arroyo's resignation and 10 cabinet secretaries and officials (including the finance secretary, budget secretary, trade secretary, and head of two revenue agencies) resigned in protest last week.
- As a result, President Arroyo has lost the moral high ground to orchestrate a politically unpopular fiscal overhaul that is desperately needed to stabilize the country's dismal public finances.

Executive Summary.

In 2004, Singapore had a spectacular economic yearly performance -- growing 8.4%, its best in four years -- de facto making Singapore Asia's best economic performer after China. However, in 2005, Singapore's economy has been struggling.

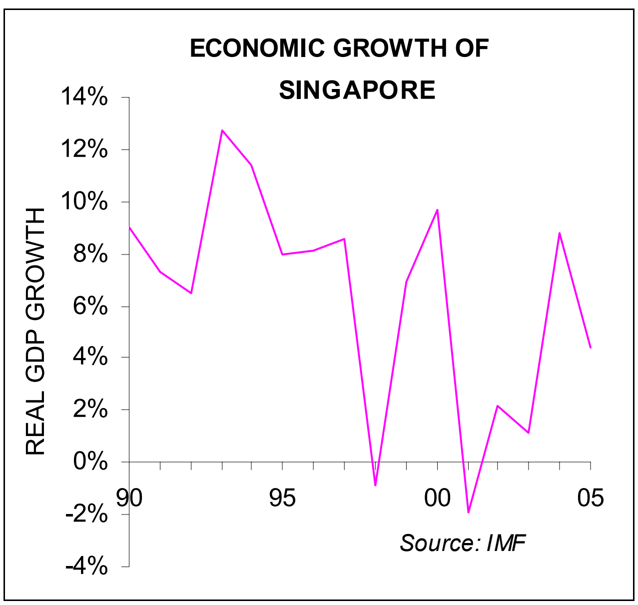
- In fact, in 1Q 2005, Singapore's economy suffered its first quarter-on-quarter contraction in nearly two years.
- Singapore's economic problems in 2005 are both structural and cyclical in nature.

Figure A. Selected Historical Data

Singapore	2001	2002	2003	2004
Purchasing Power $B	97	101	104	116
GDP $B (Nominal)	86	88	92	107
GDP Growth (Real)	-2.0%	3.2%	1.4%	8.4%
Inflation	1.0%	-0.4%	0.5%	1.7%
Exports $B	121.8	125.2	144.2	179.5
To U.S. $B	17.7	16.2	16.6	20
Imports $B	116.0	116.4	127.9	163.8
From U.S. $B	15.0	14.8	15.1	15
FDI held by U.S. $B	40.8	52.4	57.6	...
held in U.S. $B	1.2	0.7	-0.2	...
Gross Intl Reserves $B	75.8	82.3	96.3	112.8
Savings /GDP	45.8%	44.2%	47.1%	47.3%
Fiscal Balance /GDP	4.8%	4.3%	6.5%	3.4%
External Debt /GDP	189.2%	183.3%	188.4%	175.3%
Current account/GDP	16.8%	17.8%	29.2%	26.1%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Introduction.

Why did the economy do so well in 2004?

- High tech and biomedical manufacturers - Singapore's biggest export industries - enjoyed strong performances.

But Singapore's robust GDP growth in 2004 was abnormally high.

- Because growth in 2003 was abnormally low (1.1%) due to the SARS epidemic and the Iraq war.
- As a result, there was a lot of pent-up GDP in 2003 that spilled over into 2004.

Contraction.

In 4Q 2004 and 1Q 2005, Singapore's economy entered a period of contraction. To some extent, the sharpness of Singapore's economic contraction in 1Q 2005 reflects the cyclical volatility of the pharmaceutical industry and an especially strong performance of this industry in 4Q 2004.

- GDP fell on an annualized basis 5.8% from 4Q 2004 to 1Q 2005.
- GDP expanded by a sluggish 2.4% from 1Q 2004 to 1Q 2005.Rising oil prices and higher interest rates will likely hurt export demand for the rest of 2005.
- Not surprisingly, manufacturer optimism for the next 6 months has deteriorated; leading economic indicators are negative for the next 3 quarters.
- Based on Singapore's poor industrial performance for January and February 2005, its GDP growth in 2005 may come in closer to the lower end of the government's 3% to 5% growth forecast for 2005.
- This would make Singapore one of the worst economic performers in Southeast Asia in 2005.

Negative Economic Drivers in 2005.

A number of additional factors will likely weigh down Singapore's growth potential in 2005.

- Electronics production has already peaked and global demand for semiconductors is slowing down as part of a cyclical cycle.
- Higher interest rates will weaken global demand for Singapore's goods and services.
- The business confidence index shows a deterioration of optimism among manufacturers over the next 6 months.
- Similarly, the government's composite leader indicator is negative for economic activity over the remaining 3 quarters of 2005.

Rising Jobless Numbers.

In 1Q 2005, unemployment rose to 3.9% -- or about double the 1.9% rate before the Asian economic crisis.

- Prime Minister Lee currently predicts a jobless rate rising to 5% during 2005.
- Fortunately, the unemployment rate is not expected to reach the 17-year high of 5.7% that occurred in 3Q 2003 during the last Singapore recession.

Structural Layoffs.

PM Lee states that many of these layofffs are structural.

- The U.S. company Maxtor -- a producer of U.S. hard disk drives -- recently announced it was cutting 5,500 jobs in Singapore and shifting production to China.
- Other jobs are also being outsourced to China.

Roller Coaster Ride.

Singapore's economy has been on a roller coaster ride.

Volatile Economy.

The economy has been volatile in recent years.

- In 1997 the economy enjoyed a robust annual growth rate of 8.5%.
- Asia's economic crisis dragged it down in 1998 (0.1% growth).
- The economy bounced back with relatively strong growth of 5.9% in 1999.
- Then in 2000, Singapore once again bounced back with 9.9% growth.

Recession.

After this remarkable growth in 2000, Singapore suffered through its worst recession since its independence.

- The subsequent 9/11 terrorist attack on the United States and its impact on the global economy worsened the existing negative trend.
- Much of the recession can be traced to the plunge in exports.

Electronic Vulnerability.

Singapore, which was the first Asian nation to go into a recession after 9/11, has been highly vulnerable to the U.S. economic downturn and the slowdown in global demand for electronics.

- Electronics make up about 2/3 of the country's non-oil domestic exports.
- Singapore has a small domestic market, which means it has few buffers left against a downturn.

Economic Stagnation.

Economic growth continued to be uninspiring in 2002.

- The economy grew 2.2% in 2002 – far lower than what Singaporeans expected.
- Then in 2003, things went from bad to worse.
- The economy went almost flat again (0.8% growth) in 2003.

Rising Jobless Numbers in Recent Years.

Starting in 3Q 2001, the number of Singaporean people without jobs rose for 8 consecutive quarters.

- The unemployment rate increased from 4.5% at the end of June 2003 to 5.9% at the end of September 2003 – a 17 year high.
- Why was the richest country in SE Asia performing so poorly?

2 Reasons --

Reason # 1: Cyclical: Shortfall in U.S. Aggregate Demand.

- The U.S. recession during much of the Bush administration meant that the U.S. appetite for Singapore's electronic exports was low.

Reason # 2: Structural: Low Cost Rivals Threaten Singapore's Market Shares.

- China, India and Malaysia have started to chip away at Singapore's previous competitive edge in manufacturing.
- While SARS and the War in Iraq were negative factors in the downturn, a key reason for Singapore's economic stagnation is also structural.

Lower Expectations.

Singaporeans, the richest population in Southeast Asia, have been conditioned to expect a rising standard of living. Not anymore.

- In Aug 2003, the government made deep cuts in the state-run pension system, effectively reducing workers' pay.
- Acting Minister for Manpower Ng Eng Hen noted in Dec 2003 that the boom years of near full employment would not return.
- Government officials have also told Singaporeans to –
  - Be less choosy about job prospects
  - Lower their salary expectations
  - Upgrade skills to compete with foreign labor.

Value Added Goods Up.

Singapore is trying to make the transition to a higher-value added economy.

- In this regard, Singapore is trying to put a greater emphasis on such value added sectors as pharmaceuticals and petrochemicals.
- On the positive side, Singapore's non-electronic exports, which include pharmaceuticals and petrochemicals continued to show solid growth in 3Q 2003.

Job Creation Shortfall.

Unfortunately, the loss of jobs in the electronics sector is not being offset by the job creation in the chemicals and petrochemical sectors.

- 40,000 jobs were lost in the electronics sector between 1996 and 2002.
- Only 3,000 jobs were added in chemicals and pharmaceuticals during this same time period.

Entrepreneurial Shortfall.

While Singapore's top-down economic model still appears to have some life left in it, the government is fretting that its people lack the entrepreneurial urges needed to exploit opportunities in the new economy.

- That explains the government's fervent desire to recruit international managerial talent.
- The government says that it wants to move away from rote learning and towards creative thinking and critical thinking skills.
- But it remains to be seen whether the government will relax its authoritarian social norms in order to attract the top creative thinkers from the U.S.

U.S. Recovery to the Rescue.

If the U.S. economy had remained down and out in 2004, Singapore's economy would have been in big trouble in 2004 as well.

- Thankfully, the U.S. recession -- which contributed to a weak U.S. appetite for Singaporean electronic exports – is over.
- A strong U.S. recovery (which started in 4Q 2003 and galloped along in 2004) acted like an expanding dry sponge – sucking in more and more Singapore goods.

FDI Up.

Singapore is also attracting more foreign direct investment.

- Singapore managed to attract $ 4.4 billion in fixed asset investment commitments in the manufacturing sector in 2003.
- It also nailed down a little over $ 1 billion in service investments in 2003.

CONCLUSIONS

Singapore's economy has been on a roller coaster ride in recent years. How's the economy doing at the moment?

- The U.S. recovery came to its rescue in 2004.
- U.S. is importing more Singapore goods – and thus drove Singapore's GDP up in 2004.
- Unfortunately, a downturn is underway in 2005.
- Singapore's economy has structural problems.
- Low cost Asian rivals threaten Singapore's market shares.

Although Singapore grew 8.4% in 2004, its growth is decelerating to about 4.7% in 2005 -- one of the slower growth rates in Asia.

- Business confidence is falling and leading indicators are negative for the remaining three quarters of 2005.

Will Singapore's recovery in 2004 solve its 2005 unemployment problem?

- Unfortunately, we don't think the 2004 recovery created or will create enough new jobs.
- This weak job creation will continue until the society becomes less rigid and moves to a more value added, service economy.

Ultimately, based on Singapore's poor industrial performance for January and February 2005, its GDP growth in 2005 may come in closer to the lower end of the government's 3% to 5% growth forecast for 2005.

- Not surprisingly, Singapore is bracing for a sharp slowdown.
- The government expects GDP to drop closser to 3% (into the 3%-5% range) in 2005.
- This would make Singapore one of the worst economic performers in Southeast Asia in 2005.

The contraction of the Singapore economy in 1Q 2005 makes it less affordable for Singapore to sustain otherwise robust maritime security cooperation with the U.S. military.

SUBSEQUENT ECONOMIC UPDATES

3 June 2005

Most of the countries in SE Asia are experiencing a painful economic slowdown in 2005.

- Singapore's economy contracted 5.5% in 1Q 2005.
- After 6% growth in 2004, Thai growth may fall to as low as 4% in 2005.
- The Philippine and Malaysian economies are also growing less rapidly in 2005.
- One exception is Indonesia, which has attracted higher levels of foreign and domestic investment and has generated higher growth rates since President Yudhoyono took the helm.

Economic Advisor's Comments:

To some extent, the SE Asian slowdown reflects the challenges the region has faced.

- For instance, Thailand has had to cope with the after-effects of December's tsunami and a recent drought, in addition to waning demand for its manufactured goods.
- Most importantly, the SE Asian slowdown reflects the region's high vulnerability to stiff oil prices
- SE Asia's heavy reliance on fuel-guzzling factories makes it especially vulnerable to oil-price swings.

20 June 2005

Singapore's economy continues to struggle.

- Singapore's non-oil exports fell 5.6% from a year earlier in May.
- This was the first fall in non-oil exports in 35 months.
- Smaller shipments of semi-conductors and pharmaceuticals help to explain the fall in exports.
- This poor export performance follows a 5.5% contraction of the economy in 1 Q 2005.

Economic Advisor's Comment:

If exports continue to be weak in June, Singapore's GDP may shrink in 2 Q 2005 for the 2nd consecutive quarter, thus creating a recession.

- If so, security cooperation with the US may become less affordable and Singapore may consider scaling back some of its military activities.
- While Singapore continues to be a major oil refining country, it is falling behind in head to head competition with its more entrepreneurial Asian rivals.
- Singapore needs to reinvent itself and move away from the old top-down economic model.
- Singapore's people are too repressed and now lack confidence and entrepreneurial skill-sets.
- Singapore's educational system needs to move away from rote learning and toward a curriculum that rewards creative thinking and critical thinking skills.

10 August 2005

After a 4.6% contraction in 1Q 2005, Singapore's economy grew at an annual pace of 18% in 2Q 2005 - its fastest pace in almost two years.

- Electronic and drug companies drove this economic surge in growth in 2Q 2005 and indications from major IT companies are pointing to strong orders from a rising global economy in the 2nd half of 2005.
- The 1 August Singapore survey shows manufacturers more optimistic about the outlook for the six months ending in December 2005 than they were in a previous survey for six months ending in September 2005.
- Based on these trends, Prime Minister Lee said in his National Day message on 8 August that the Singapore economy is expected to grow 3.5% to 4.5% in 2005.
- However, Singapore's economic growth figures fluctuate more than in most countries because of large swings in pharmaceutical production. For instance, drug production surged 49% in June.

Economic Advisor's Comments:

On 9 August the Asia Development Bank (ADB) released a study arguing that record-high oil prices, lower export levels and slower growth in Singapore (and China) would reduce East Asia's economic growth rate from 7.6% in 2004 to 6.8% in 2005.

- The 9 August ADB study, however, has been overtaken by events and needs to be revised.
- Improved global demand for electronics will likely boost growth in Singapore as cited above as well as in export-led Asian economies including South Korea, Taiwan and Malaysia.
- Rising chip sales helped boost South Korean exports 11.4% in July, the biggest increase in four months.

- Taiwan's export orders rose a more-than-expected 16.7% in June, fueled by demand for laptop computers, chips and flat-screen displays.
- Malaysia's exports unexpectedly accelerated in June, rising 11.7% from a year earlier.
- In short, the rising global demand for electronics means that the ADB forecast for a sizeable Asian economic slowdown is arguably too pessimistic.

30 August 2005

Hurricane Katrina threatens to close energy production in the Gulf of Mexico and Louisiana refining systems for an extended period and deal a blow to some Asian economies.

- Katrina sent oil prices soaring above $70 a barrel on 29 August and the US dollar initially sagged before rebounding.
- US bond prices rose as investors sought a haven from the surge in oil prices.

Most Asian currencies and stocks tumbled following the latest oil-price jump.

- The Singapore dollar slipped to a new one-month low against the US dollar, while the Taiwan dollar plunged to a fresh 8-month low. The Yen also was weaker.
- Asian stock markets fell across the board, especially in South Korea, where stocks dropped 2.2% and Taiwan stocks fell 1.4% -- its lowest settlement level since 2 June.
- Tokyo's stocks fell 1%, while Hong Kong's stocks fell 0.97%.

Economic Advisor's Comment:

Before Katrina hammered this chunk of the world's energy supply, Asia's prospects for the rest of the year appeared promising.

- A pickup in growth was expected for the second half of 2005 after a slow start in the first half of 2005.

But the global energy supply was extremely vulnerable to disruption, with virtually no spare capacity.

- Katrina has shut down 12% of US crude oil production and 10% of US refining capacity.
- While it's too early to sound an alarm for Asia's major economies, Katrina could send oil prices to $80 a barrel and natural gas to $15 per million British thermal unit.
- A jump in prices could hurt the US economy, and by extension, the economies in Asia that export to the US

Soaring oil prices could deal a blow to Asia's weakest links - Indonesia and the Philippines.

- To a lesser extent, Thailand is sensitive to elevated oil prices because of its high inflation.
- However, the region's biggest economies -- Japan, China and India - should remain relatively resilient after the initial shock.

Introduction.

Thai Prime Minister Thaksin's first economic strategy depended on cheap credit to pump up consumer spending. While the economy boomed, household debt grew unacceptably high.

In Thaksin's second economic strategy, the government is boosting infrastructure spending. This fiscal stimulus should offset the economic drag from bird flu and the insurgency in the south.

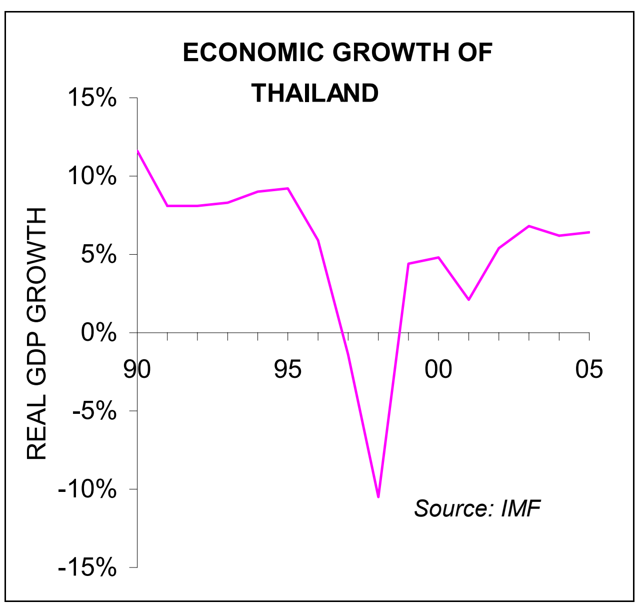
The biggest economic concerns are the high level of off-budget government debt and over-borrowed consumers. As a result, neither of Thaksin's economic strategies is sustainable. In many ways, Thaksin is sacrificing medium term financial health for politically popular, short-term economic gains. What's needed is a more durable market driven strategy.

Figure A. Selected Historical Data

Thailand	2001	2002	2003	2004
Purchasing Power $B	405	434	471	512
GDP $B (Nominal)	116	127	143	163
GDP Growth (Real)	2.2%	5.3%	6.9%	6.1%
Inflation	1.7%	0.6%	1.8%	2.7%
Exports $B	65.0	68.1	80.3	97.7
To U.S. $B	6.0	4.9	5.8	6
Imports $B	62.0	64.6	75.8	95.4
From U.S. $B	14.7	14.8	15.2	17
FDI held by U.S. $B	6.2	7.6	7.4	...
held in U.S. $B	0.1	0.1	0.2	...
Gross Intl Reserves $B	33.0	38.9	42.1	49.8
Savings /GDP	31.4%	30.5%	28.7%	25.8%
Fiscal Balance /GDP	-2.1%	-2.2%	0.6%	0.3%
External Debt /GDP	58.4%	46.9%	36.2%	30.9%
Current account/GDP	5.4%	5.5%	5.6%	4.5%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Thaksin's 1st Economic Strategy.

Since taking office in early 2001, Thai PM Thaksin Shinawatra wanted to generate more domestic driven economic activity in order to mitigate Thailand's historic reliance on exports and foreign investment.

Thaksin's aggressive state-led economics relied primarily on policies that sparked a consumer-led recovery in Thailand. These policies included --

- Monetary easing and aggressive state-bank lending.
- State-backed, easy-credit schemes for mostly poor rural residents.
- Generous incentives for homebuyers.

As a result consumer confidence hit a post-1997-crisis high in December as Thais spent lavishly on consumer durables.[1]

- For instance, new car sales were up around 37% in 2003, even after rapid sales growth in 2002.

Initial Success.

At first glance, the Thai economy appears invincible.

- Thailand enjoyed the fastest economic growth rate in Southeast Asia.
- Thailand's economy expanded 6.7% in 2003.
- In fact, Thai GDP surged by over 7.8% in the fourth quarter of 2003, the fastest quarterly economic growth since the 1997-98 Asian financial crisis.

Economic Problems.

Thailand's consumer-led growth strategy reached its limit after 3 years of government pump-priming and easy credit.

- Thaksin's first strategy dangerously raised household debt.
- Household debt levels have climbed to 19 times average annual income, marking a historic high.[2]
- Both consumer and business confidence fell in January 2004.
- The property market and stock market started to overheat.
  - The Thai Stock Exchange recently dipped around 20% from its January 2004 peak, marking a notable retreat from the market's torrid 125% gain in 2003.

Thaksin's 2nd Strategy.

To his credit, Thaksin was flexible enough to change his first strategy that depended on consumers who were now over-borrowed.

- But Thaksin was still committed to domestic driven economic activity in order to mitigate Thailand's historic reliance on exports and foreign investment.
- If Thaksin were going to rely on the private sector, business investment would have to drive the economy.
- But how?

Weak Investment Spending.

New domestic and foreign private sector investment notably lagged behind economic recovery.

- Many industrial companies remained cautious about committing capital for plants or equipment to meet the demands of what could prove to be a short-lived consumption boom.
- Even with faster economic growth, Thailand's producers were only using about 65% of total capacity, far below the 80%-85% most companies require to justify new investment.
- Who would close this investment gap?

Keynes to the Rescue. [3]

Thaksin reasoned that if the private sector lacked the ability or confidence to close the investment gap, the Thai government would have to play an even more interventionist role in filling the shortfall in spending and steering the country's economic development.

- But what would the government spend money on?
- Thaksin decided that infrastructure spending would help bridge the investment gap.
- Thaksin hopes such fiscal pump-priming will add momentum to current growth while allowing him to stick to domestic demand-led growth.

Massive Infrastructure Spending.

Problem -- Infrastructure spending had been anemic in Thailand since the financial crisis that began in 1997, when bad loans crushed banks and limited the government's fiscal flexibility.

- Armed with fast growth and strong tax revenues, Thaksin opted for a $37 billion government-run plan to build infrastructure projects the next 5 years.
- Those outlays include a plan to build new roads and modernize and upgrade the country's decrepit railway system.
- There are also plans to build a new city approximately 60 kilometers outside Bangkok in Nakorn Nayok province.

More Problems.

Unfortunately, changing his economic strategy and evidence of strong economic growth is not enough for Thaksin. His aura of invincibility is gone.

- The rot started in January when allegations that cabinet ministers initially tried to cover up a bird-flu epidemic rocked his government. The health scare ravaged the poultry industry.
- That was followed by an outbreak of an insurgency in Thailand's predominantly southern regions.
- Bird flu and the insurgency have recently hit business and investor confidence and hurt tourism.

Offsetting Factors.

That said, the combination of recovering private investment and heavy fiscal pump-priming should be more than enough to offset the risks of bird flu and the insurgency in the southern provinces.

- Even in a worst-case scenario, a bird-flu epidemic would shave only 0.6% off GDP, while Bangkok's 130 billion baht ($3.28 billion) supplementary spending budget for 2004 accounts for nearly 2% of GDP.[4]

- Bangkok's fiscal capacity to offset surprise economic risks looks impressive.
- For instance, the government revenues were 40% over target in the fourth quarter of 2003, due to higher consumption and income-tax collections.[5]

Still on Target.

In this regard, hefty infrastructure spending may enable Thaksin to achieve his ambitious growth targets.

- A recent report by Merrill Lynch estimates that an extra 300 billion baht a year in state spending, which is what Thaksin envisions, could increase GDP growth by as much as 4.5% annually.
- Thailand's GDP was on track and expanded at the rate of a respectable 6.1% in 2004, and Thaksin predicts the economy will grow at 8% in 2005.

Investment in 2004.

Most importantly, private investment is finally starting to kick in. That's good news because it was the one laggard sector holding the economy back.

- Private investment expanded almost 20% year-on-year in the fourth quarter of 2003, mostly in export-oriented industries such as electronics.
- Average industrial-usage rates touched a post-1997 high in January of 74.6% of factory capacity, near the 80% threshold most manufacturers require to make new capital outlays in plant and equipment.
- That's sparking government hopes that new investments will create more jobs and boost wages, critical for sustaining domestic consumption growth.

Concern # 1: Crony Capitalism.

That said, the new state-spending spree could just as likely create new risks -- particularly if contracts are doled out for political reasons rather than sound economic considerations.

- That's what has happened in Japan, where more than a decade of infrastructure spending has failed to spur growth.
- Historically, Thailand, too, has suffered from ill-conceived and corruption-tainted infrastructure outlays, leading to the Asian economic crisis in 1997.
- Too much spending on infrastructure could lead to over-investment in the economy and produce a mini-bubble.
- The Thai economy is already showing signs of overheating in property and equity markets, and rapid infrastructure spending could aggravate the situation.

Concern # 2: Government Debt.

There's also the question of government debt.

- Thailand's public debt is officially estimated at about 50% of GDP.
- At first glance, that 50% figure is well the 60% figure that would trigger alarm bells of possible financial turmoil.
- Unfortunately, sovereign-debt analysts at rating agencies estimate that the actual ratio is much higher than the 50% figure if off-budget spending by state-controlled agencies and banks is taken into account.

- In addition, many of the proposed projects -- particularly the high-speed train system -- will require substantial imports. That could undermine Thailand's large trade surplus, which has underpinned the country's recently restored economic stability and has been an important contributor to growth.

While the Thai economy is on a roll, appearances can be deceiving.

- Thai economic growth was initially the result of cheap consumer credit.
- Current growth is due to massive government infrastructure spending.
- Neither driver is sustainable over the long term.
- Large off-budget debt and over-borrowed consumers are big concerns.
- In many ways, Thaksin is sacrificing medium term financial health for politically popular, short-term economic gains.

CONCLUSIONS

The Thai economy has enjoyed a respectable 6.1% growth.

What's driving the economy?

- At first, consumer spending.
- Now, it's government infrastructure spending.

Are the bird flu and the insurgency in the south hurting the economy?

- Well, they're reducing consumer and business confidence and could hurt tourism.
- But strong government spending should offset most of the drag on the economy.

What are the concerns?

- The biggest economic concerns are the high level of off-budget government debt and over-borrowed consumers.
- As a result, neither of Thaksin's economic strategies is sustainable.
- In many ways, Thaksin is sacrificing medium term financial health for politically popular, short-term economic gains.

SUBSEQUENT ECONOMIC UPDATES

25 February 2005

Bangkok just approved a $100 million advertising campaign to revive the embattled tourism industry.

- Media images of "widespread disaster and disease" have inaccurately portrayed the Thai resort areas.
- Damage was limited to a small area. The World Health Organization says disease is not a problem.
- Clean up has mostly been completed. Most of the resorts hit by the tsunami are back in business.

Economic Advisor's Comment:

Media calls for foreign aid relief have been counterproductive. Thailand's economy, especially in the South, is dependent on a strong tourist industry.

- Drop-off in tourist arrivals in January and February alone on Thailand's Andaman coast will cost $500 million; almost double the property costs inflicted by the tsunami in that area. Hotel occupancy has plummeted from the usual 90% to just 10-15%.
- In Sri Lanka and the Maldives, tourists have also disappeared and dollars have dried up.
- Even in Bali -- 4,300 km away from tsunami hit Aceh -- bookings have been cancelled.

16 March 2005

A severe drought is taking its toll in Thailand and much of Southeast Asia.

- The drought has hit almost all the Thai provinces, with water at hydroelectric dams falling close to the bare minimum needed to produce electricity.
- Water levels at Cambodia's Mekong River are also dangerously low.
- Vietnam's 8 Central Highlands provinces are suffering their worst drought in 28 years.

Economic Advisor's Comment:

The negative impact of the draught on these Southeast Asian economies is already significant.

- Millions of pounds of Vietnamese crops are withering in the fields. The draught is threatening Vietnam's coffee industry, the second largest in the world.
- On 11 March 2005, parts of Thailand's Chiang Mai province were declared disaster zones.

Cambodia's government has requested an international humanitarian response.

- Emergency aid is needed to help Thai and Cambodian farmers.
- The Thai military is on standby to cloud-seed in hopes of stimulating rain in the worst hit areas Civil Affair units might be helpful to guide the drilling of 6,000 new Thai wells in rural areas.

06 June 2005

Thailand's economic growth fell 0.6% in 1Q 2005 quarter-on-quarter and grew just 3.3% year-on-year in 1Q 2005.

- That's the first economic contraction Thailand has experienced since 2001.
- The drought took an especially heavy toll on agricultural output, which dropped by 8.3%.
- The tsunami also took a heavy toll, with a 8.2% drop in hotel services and a 2.3% fall in air transportation.
- In addition, rising oil prices and weaker global demand also contributed to Thailand's widest monthly trade and current account deficits in 9 years in April 2005.

Economic Advisor's Comment:

- The rest of the year doesn't look much better, with high oil prices, including a recent cut in diesel subsidies, and unrest in the Muslim-dominated south likely to dampen positive sentiment and keep spending down.
- To offset these negative drivers, the Thai government plans to reignite growth by spending about 1.7 trillion baht, or roughly $42 billion, on infrastructure projects over the next four years.
- In a broader sense, Thailand's first-quarter slowdown tracks with that of other Asian economies, notably exporters like Singapore, Taiwan and South Korea, all of which are particularly vulnerable to the price of fuel for factories.
- While low real interest rates, undervalued currencies, and improved fundamentals have helped Asian markets stand up to slack demand for exports and high oil prices, any further slowdown in the U.S. and China could prevent recovery in the second half of 2005.

28 June 2005

Rising oil prices are starting to strain Asian economies.

- High oil prices may have the following effects:
  - Threaten Japanese economic growth.
  - Slow down the South Korean economy.
  - Raise concerns in Thailand and India about widening deficits in their current account (which measures goods and services in their balance of payments).
- Thai PM Thaksin urged state enterprises to find ways to cut non-essential imports.
- In response, Thai Airways is taking a second look at taking delivery of 5 new Airbus aircraft this year.

Economic Advisor's Comment:

While China's bid for Unocal highlights Asian efforts to secure new energy supplies, what's needed is a better strategy to reduce Asia's appetite for energy.

- Asia accounts for 40% of this year's rise in oil demand.
- India, China and Thailand burn 2 to 3 times more oil per unit of output than the US and Europe.
- Indonesia spent $7 billion on energy subsidies in 2004 and oil subsidies were also high in India, Malaysia and Thailand in 2004.
- Energy subsidies reduce incentives to curb oil use and needlessly increase budget deficits.
- On the positive side, China, India, Malaysia, Indonesia and Thailand have recently increased fuel prices, although not to market levels.

What's needed in Asia is a concerted effort to a) further cut fuel subsidies and b) use energy more efficiently in order to ease pressure on global oil prices and improve Asian economic growth.

06 September 2005

The Thai economy bounced back in 2 Q 2005.

- After 0.7% quarterly contraction in 1 Q 2005 the quarterly economic performance was up 1.9% in 2 Q 2005 – the fastest pace in 6 quarters.

- Year on year, the economy grew 4.4% in 2 Q 2005 from 3.3% in 1 Q 2005.

Key economic drivers in 2 Q 2005 were:

- Revival in tourism (that was initially down after the tsunami),
- Expanding domestic consumption and
- Robust investment, which offset a sharp slump in exports.

Economic Advisor's Comment:

Until mid-July, free spending Thai consumers were shielded from the full effect of high oil prices.

- During this period, the Thaksin government spent more than $2.2 billion on fuel subsidies, which in turn put pressure on the budget.

The elimination of the Thai subsidy on retail and diesel prices in July is long overdue and will be positive for the Thai budget.

- But higher energy prices will initially have a negative impact on consumer spending in the second half of 2005. In fact, consumer sentiment is already deteriorating.
- In addition, two other factors will reduce aggregate demand in the second half of 2005:
  - PM Thaksin's government is scrapping some transportation projects
  - Private investment will likely falter after a big buildup in inventories during 2 Q 2005.

As a result, the strong Thai economic performance in 2 Q 2005 may not be sustained in the 2nd half of 2005.

ENDNOTES

[1] Source: Thai Chamber of Commerce.
[2] Source: A recent nationwide study by the Thailand Development Research Institute, a Bangkok-based independent think-tank.
[3] This government interventionist role partially reflects the ideas of John Maynard Keynes.
[4] Source: JP Morgan.
[5] Ibid.

VIETNAM

· CHAPTER 13 ·

Executive Summary.

At first glance, Vietnam's economic strategy appears successful.

- Economic growth is booming.
- Donors are happy and are increasing their aid.

But below the surface danger signals are flashing.

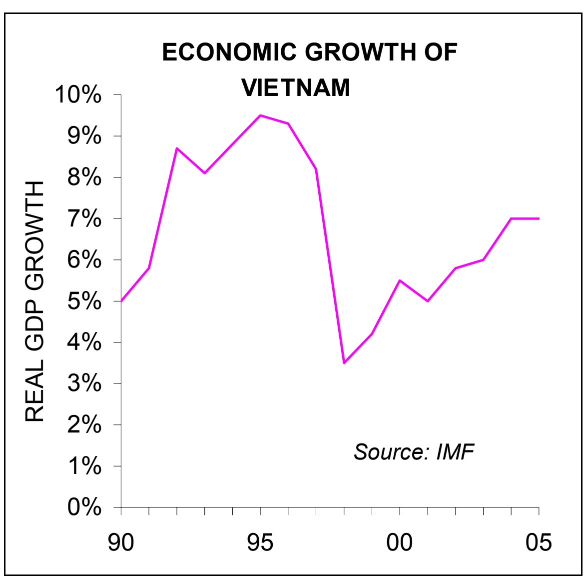
- Industrial overexpansion far exceeds market demand, fosters financial problems and could well lead to a boom and bust scenario down the road.
- Therefore, Vietnam is jeopardizing its economic future without a more serious effort at economic reform.
- Vietnamese are scrambling to contain the Avian flu.

Figure A. Selected Historical Data

Vietnam	2001	2002	2003	2004
Purchasing Power $B	166	178	193	211
GDP $B (Nominal)	33	35	40	44
GDP Growth (Real)	6.9%	7.1%	7.3%	7.7%
Inflation	-0.4%	4.0%	3.2%	7.7%
Exports $B	15.0	16.7	20.2	26.2
To U.S. $B	0.5	0.6	1.3	1
Imports $B	16.2	19.7	25.2	31.0
From U.S. $B	1.1	2.4	4.6	5
FDI held by U.S. $B	0.2	0.2	0.2	...
held in U.S. $B	0.0	0.0	0.0	...
Gross Intl Reserves $B	3.5	3.8	5.6	6.0
Savings /GDP	27.0%	29.2%	28.3%	25.8%
Fiscal Balance /GDP	-3.0%	-3.8%	-4.6%	-3.8%
External Debt /GDP	40.7%	37.3%	35.7%	32.8%
Current account/GDP	2.1%	-1.2%	-4.7%	-4.6%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Good News.

Vietnam's GDP has doubled over the last 10 years.

- Following a downturn due to the Asian economic crisis of 1997, the economy rebounded in 2000 with a growth rate of 6.7%.
- The economy grew at 7% in 2001 and 2002.
- The economy grew 7.3% during 2003 and 7.7% in 2004.

Economic Drivers.

In 2003, this strong economic growth was fueled by –

- Domestic investment, consumer spending and export earnings.

Rising Donor Support.

At the Consultative Group Meeting of Donors in Dec 2003, Hanoi received praise for high growth rates and reducing poverty.

- As a reward, donors pledged about $ 2.8 billion in Overseas Development Assistance (ODA) for 2004, 15% more than was pledged for 2003.
- Hanoi hopes that continued economic progress on donor support will pave the way for WTO entry in 2005.

U.S. Link: Mixed Bag.

Hanoi is pleased the U.S. is its largest trading partner, but unhappy that the U.S. ranks only 11th or 12th among foreign investors in Vietnam.

- Why don't more U.S. businessmen invest in Vietnam?
  - They find the business climate relatively unattractive.
  - Case in point: Vietnam's ill-advised industrialization strategy.

Industrial Overexpansion.

Vietnam's national frenzy to build industrial parks has far exceeded market demand from investors.

- 86 industrial parks (IPs) & export-processing zones were built by 9 Oct 2003.
- And if dozens of smaller provincial IPs are counted, the number is much higher.
- Hanoi concedes that IP occupancy rate is only 45% on a national average.
- Many IPs are saddled with only 15% to 20% occupancy.
- Only about 20% of these IPs are making a profit.
- Despite this overexpansion Hanoi keeps building new IPs.
- Hanoi plans to have 133 IPs by 2010.

Costly Dreams.

The failure to fill these IP parks comes at a steep price.

- Domestic investment in IPs totals more than $ 1 billion.
- Like Kevin Costner in the movie Fields of Dreams, Hanoi seems to think, "If we build fields of dreams, they will come."
- Unfortunately, hope is not a strategy. Sound international marketing doesn't work this way.
- In fact, the current rate of FDI won't come close to sustaining this IP boom.

Inefficient SOEs.

Why are the state run IPs not more successful?

- The state owned enterprises at these IPs are inefficient.

Graft.

If market demand is not driving the supply of IPs, what else is driving this construction boom?

- Government officials get fat commissions from the construction contracts on IPs, even if there are no occupancies.

Private Business Crowded Out.

The crowning irony is that most Vietnamese private businessmen at small and medium sized firms say their biggest problem is getting their hands on affordable, strategically located commercial land.

- The government IPs are too pricey for the fledgling small and medium sized private enterprises, the real engines of job creation.
- High interest rates are also squeezing these private enterprises.

Danger Signals: Flashing.

Hanoi is pumping way too much credit into inefficient SOEs and massive infrastructure projects.

- In its pact with IMF, Hanoi agreed to a 20% credit- growth cap for all of 2003.
- But at the 6-month point in 2003, credit had already grown by 16%. So the 20% cap was almost certainly exceeded by a wide margin.
- Out of control credit growth is earmarked for pork barrel SOE projects.

WTO Entry in 2005?

Despite these problems Hanoi is hopeful that it can gain entry into the WTO in 2005.

- Hanoi thinks WTO entry is a silver bullet – and will help attract more FDI.
- To be blunt, Hanoi simply doesn't get it.
  - Flaws in Hanoi's economic strategy make entry into WTO difficult if based on market principles.
  - Even if Vietnam gains entry based on politics, foreign investors will not invest much in Vietnam unless it changes its socialist mind-set.

Socialist Mind-Set.

To sum up the flaws in the Vietnamese economic strategy:

- The core problem boils down to Vietnam's state owned commercial banks recklessly allocating money to the IPs.
- The Vietnamese banks make soft loans to their favorite SOE losers with little or no expectation the SOE borrowers will ever repay the loans.
- Funding surplus IPs and inefficient SOEs also means huge opportunity costs, with potential Vietnamese private entrepreneurs who have a fighting chance of making money, getting elbowed out of the picture.
- The sharp and relentless rise in poor quality loans eventually leads to a financial crisis.

Avina Flu.

Vietnamese are also scrambling to contain the Avian flu.

- After claiming 5 lives in northern Vietnam, bird flu infection among humans has spread to southern Vietnam.
- Experts worry that the bird flu may extend throughout Asia.
- The region's multi-billion poultry industry could be at risk.
- The World Health Organization (WHO) urges a global effort to develop a vaccine and halt the spread of the bird flu.

Action Recommendations.

To decisively solve this problem, there must be a fundamental overhaul in the core philosophy that's used to allocate capital.

- In a nutshell, market demand must drive the supply of IPs.
- Credit must be driven by the commercial potential of IPs and industrial projects rather than politics.

CONCLUSIONS

How's the Vietnam economy doing?

- It's enjoying strong short-term growth.

What's driving this growth?

- Investment, consumption and exports.

Are the donors happy with Vietnam's economic performance?

- Yes. In fact, they're increasing the aid by 15% in 2004.

How's the U.S.-Vietnam economic relationship?

- Mixed bag.
- U.S. is Vietnam's top trading partner.

- But U.S. ranks only 11th or 12th in terms of FDI in Vietnam.

Why don't U.S. companies invest more in Vietnam?

- Vietnam's business climate is relatively unattractive.

What makes Vietnam's business climate so unattractive to U.S. investors?

- Industrial overexpansion.
- Credit growth out of control.
- Socialist mindset.

SUBSEQUENT ECONOMIC UPDATES

03 May 2005

Vietnam's GDP rose 7.7 % in 2004 -- the fastest pace in 7 years -- and growth could even accelerate if Vietnam joins the WTO by the end of 2005.

- Vietnam now has one of Asia's fastest-growing economies and is one of the world's biggest exporters of coffee and rice.
- Vietnam's poverty rate has been cut at least in half since 1993 and its per capita income has doubled in the past decade.
- In 2004 Vietnam granted foreign companies licenses to invest $4.2 billion in the country – which as a % of GDP, puts Vietnam on a par with China in foreign direct investment.
- Exports to the U.S. have quadrupled to nearly $7 billion a year since the bilateral trade agreement took effect in 2001.

Economic Advisor's Comment:

A note of caution, however, is in order. We've seen this economic revival before in Vietnam.

- Back in the mid 1990s, investors were also bullish and billions of dollars poured into Vietnam.
- When the Asian financial crisis hit in 1997, Vietnam had already begun to lose its luster.
- Its labyrinthine bureaucracy, shoddy legal system and rampant corruption proved to be major obstacles, and projects were halted or abandoned altogether.

Investors say things are different this time around.

- The government has removed the shackles from the private sector, streamlined some regulations, and is moving ahead with privatization.

But bureaucratic problems, an opaque legal system and corruption still hold back long-term economic growth.

- Moreover, Vietnam is suffering from its worst drought in 28 years. The drought coupled with polluted water, has hurt an estimated 2 million people in Vietnam's shrimp industry as well as numerous farmers in the coffee and rice industries.

If Vietnam can overcome the drought and sustain the economic revival in the rest of the economy this time around, Vietnam's prosperity will enhance JIATF-West's prospects to sustain its counter-drug training -- which it started with the Vietnamese in February 2005.

21 June 2005

Vietnam's Prime Minister Phan Van Khai - the first Vietnamese PM to visit the US in 3 decades -- achieved his economic objective in talks with POTUS on 21 June.

- Mr. Khai's top priority was to secure POTUS support for Hanoi's bid to join the WTO by the end of 2005, a crucial part of Hanoi's efforts to keep Vietnam's economic reforms on track.
- POTUS enthusiastically supported Vietnam's WTO entry, which would arguably result in a flood of new foreign direct investment (FDI).
- Vietnam is already off to a good start, with $ 4.2 billion in FDI in Vietnam in 2004 and $ 4.5 billion in FDI likely in 2005.
- Finally, POTUS said he looked forward to a visit to Vietnam to participate in the Asia Pacific Economic Cooperation (APEC) forum in late 2006.

Economic Advisor's Comment:

Vietnam has come a long way since the US and Vietnam normalized relations in July 1995.

- Today, Vietnam is one of Asia's fastest-growing economies, growing at about 7% a year since 2000.
- The US is crucial to Vietnam's success story and is now Vietnam's top trading partner.
- US-Vietnam trade was $ 6.4 billion in 2004, up from $ 1.5 billion in 2001, with Vietnam's exports to the US worth nearly $ 5 billion in 2004.
- Affluence is also rising in Vietnam, with less than 30% of Vietnam's estimated 82 million people living in poverty today, down from 60% on 1993.
- Finally, Vietnam's shared prosperity with the US creates a solid foundation for the overall relationship and strengthens Hanoi's confidence in dealing with the US on security issues.

22 June 2005

Vietnam's bid to join the World Trade Organization (WTO) by December 2005 received a shot in the arm when POTUS gave his personal support to Vietnam.

- Hanoi has also completed successful bilateral talks with the EU late last year and with Japan earlier this month, both of which are prerequisites for WTO entry.
- However, Vietnam still needs to complete bilateral trade negotiations with the US before September.
- The US and Vietnam made progress in trade talks that ended on 17 June.
- More work is needed to lower Vietnam's tariffs on imports; cutting its non-tariff barriers and opening telecom and financial service sectors would allow this happen.
- In addition, Vietnam's legislature still needs to overhaul 60 laws and decrees before it will be eligible for WTO entry.

Economic Advisor's Comment:

Even if Vietnam clears these trade hurdles with the executive branch, Hanoi still faces formidable political hurdles on Capital Hill.

- Congress would need to pass a bill granting Vietnam permanent normal trade relations.
  - This will prompt protests from US lawmakers about violations of human rights in Vietnam, particularly Hanoi's religious oppression and repression of ethnic groups.
- Vietnam is designated as a country of "particular concern" to the USG for its violations of religious freedom.
- In addition, the US textile industry is expected to raise concerns about Vietnamese textile exports to the US marketplace.
- Therefore, POTUS made it clear to Hanoi that its chances of joining the WTO at the trade group's ministerial meeting in Hong Kong in December are somewhat conditional.
- Vietnam's chances of WTO entry would rise if Vietnam could do more to a) protect intellectual property rights, b) bolster legal transparency and c) grant foreign companies access to the Vietnamese market and d) improve human rights in Vietnam.

Executive Summary.

At first glance the Australian economy looks solid.

- Australia's economy has done well since the launch of deregulation and reform in the 1980s.
- Liberalization of the Australian economy has generated 14 years of strong, uninterrupted economic growth.
- The economy is back on the growth track with GDP at 3.6% in 2004.
- Consumer and business confidence are both picking up. Grain prices are rising, export earnings are improving and housing is on the rebound.

But economic upswings do not last forever.

- Too much of the economy is now driven by wealth effects for consumers of an overheated housing market.
- In addition, the high current account deficit is worrisome.
- Australia is also becoming complacent and losing its enthusiasm for further economic reform.
- The Australian dollar is at a new low of 52 U.S. cents.
- Stagnation and recession in the United States, Japan and the rest of Asia are still causes for concern.

Finally, Australia is increasingly dependent on its robust commodity and service exports to China.

- That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.

Australia now faces a dilemma:

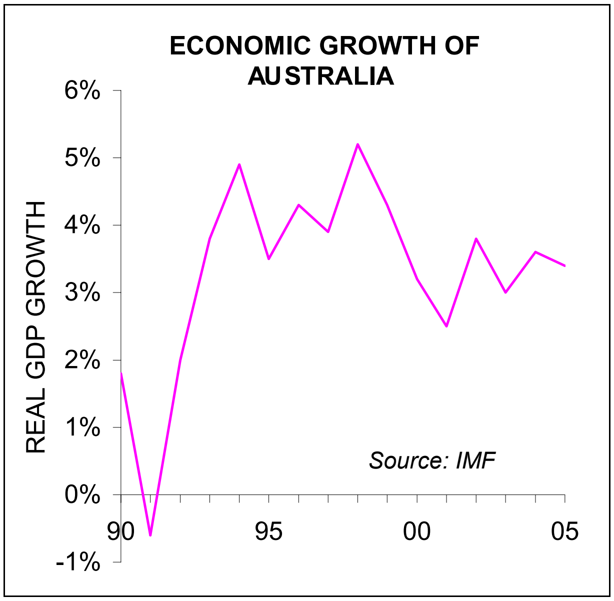
- How to balance China and the U.S.?

Figure A. Selected Historical Data

Australia	2001	2002	2003	2004
Purchasing Power $B	513	541	568	602
GDP $B (Nominal)	357	401	512	618
GDP Growth (Real)	2.5%	4.0%	3.4%	3.2%
Inflation	4.4%	3.0%	2.8%	2.3%
Exports $B	63.4	65.0	71.5	86.6
To U.S. $B	10.9	13.1	13.1	13.9
Imports $B	63.9	72.7	89.1	107.8
From U.S. $B	6.5	6.5	6.4	7.2
FDI held by U.S. $B	27.8	34.4	41.0	...
held in U.S. $B	19.5	23.1	24.7	...
Intl Reserves $B	21.2	21.2	30.9	35.4
Savings /GDP	...	18.7%	18.9%	...
Fiscal Balance /GDP	0.9%	1.0%	1.2%	0.7%
External Debt /GDP	...	132%	104%	...
Current account/GDP	-2.3%	-4.1%	-5.9%	-6.4%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



That creates security concerns:

- How will Australia accommodate China in a crisis over Taiwan?

Government's Performance in Managing the Economy.

- Over the last decade or so, the Australian government's management of the economy has been generally positive.
- Its economic reforms establish a strong foundation for long-term economic growth.
- Of course, the economic contraction and the fall in the Australian dollar could make things politically difficult for the government. (Note: In 2001, popular support for the government coalition was at its lowest level since 1994)

14-Year Streak.

At first glance, the economy appears to be on a roll.

- Australia's economy looked set to expand for the 14th year in a row.
- The economy grew at 3.2% in 2004.

Good News.

Australia also enjoys the following:

- Unemployment hit a 28 year low of 5.1% in April 2005.
- The budget surplus is double what the government estimated.
- Inflation remains a low 2.4% in 1Q 2005.

Stocks Up.

Stocks have risen more than a 1/3 over the past 18 months.

Rising Farm Production.

Australian dollar grain and oilseeds prices are soaring.

- Australian wheat prices are trading at record levels. Barley prices are at records and canola (cooking oil) is near its all-time highs.
- Livestock prices are also high.
- The net value of farm production is expected to increase.

Property Boom.

Australia is also enjoying a massive property boom. Lower interest rates and an expanded first-home owner's scheme have lit the fuse under housing construction.

- Housing prices have more than doubled since 1997.
- This housing boom has left Australians feeling richer than ever before.

However, as of March 2005:

- Economic growth in Australia is slowing down.
- Evidence showed that manpower and capacity constraints at ports and in rail and mining industries hurt the economy in two ways: (a) by increasing wages and inflation and (b) by reducing exports and slowing growth.
- The Central Bank was fighting inflation with the second highest interest rates in the developed world.
- Higher interest rates are controversial because they will worsen the slowdown and will discourage the borrowing needed for capacity expansion.

Bust?

But economic upswings do not last forever.

- In fact, Australia's boom is starting to show parallels with the final stages of the U.S. technology bubble of the 1990s.
- In March 2005, Australian consumer confidence had its biggest drop since surveys began in 1974. Consumer sentiment fell 16.6% to 85.8%, below 100 where pessimists outnumber optimists. Business confidence fell in February 2005, while the March 2005 economic outlook index for the next twelve months fell 25.9% and the economic outlook index for the next five years fell 15.6%.
- As in the U.S., consumer spending has been the main motor of the economy.
    - Finally domestic demand has been rising at an unsustainable 5-6 % over the past few years – or faster than overall GDP.
- Real estate (rather than stock market gains, as was the case in the U.S.) has been driving a temporary splurge in household spending.
- That said, the wealth effect has been the same.

Aussie Gamblers.

Australians are even out-doing Americans in their willingness to gamble with their financial health.

- The U.S. household savings rate is still marginally positive, while Australia's stands at minus 3%.

- Australian debt levels are skyrocketing.
- Equity withdrawals from property are running at twice the U.S. level, and household debt averages 150% of household incomes, compared to 120% in the U.S.
- Housing now represents 85% of household borrowing.

Slower Spending Ahead.

Aussie consumers, like their American counterparts, will almost certainly have to start de-leveraging their over-borrowed positions at some point.

- That will hit their ability to spend and hence, reduce Australia's overall growth rate.
- Housing prices (which were largely pumped up this boom) probably peaked at the end of 2003.
- Already, car sales are falling and retailers are increasing their discounting to keep volumes up.

Lower Stocks Ahead.

This will have a disproportionate effect on stocks.

- Although Australia is still perceived internationally as "a mine with a farm attached," it is actually a modern service economy.
- While mining and farming each contribute just 5 % to GDP, and resource companies make up 15 % of the stock market, financial stocks represent the lion's share of the stock market (at 42%).
- Financial stocks have been growing, with their earnings at more or less double-digit rates for the past decade.
- A slowing down of financial stocks will far outweigh the positive effects of China's demand for commodity imports and a weaker Australian dollar.

More Bad News.

There are also a number of other challenges for the Australian economy.

High Current Account.

The current account deficit is a source of serious concern. [1]

- The current account deficit rose 6% in December 2004.[2]
- A strong Australian dollar flattened out exports and contributed to high current account deficits.
- These current account deficits leave exporters increasingly dependent on uncertain Chinese demand.

Complacency.

In addition, Australia is becoming complacent about its economic performance over the past 14 years.

- Canberra is losing its enthusiasm for more comprehensive reforms.
- Budget surpluses are largely the result of a temporary and exceptionally favorable demographic situation.
- Demographics have boosted the number of taxpayers relative to dependent children and pensioners.

Good News: Terms of Trade.

The recent success of the Australian economy is underpinned by the best terms of trade in 30 years.

- Australia is now the world's best supplier of industrial inputs to developing Asia and will remain so for decades to come.
- More than 50% of Australia's exports go to Asia, while China's share of Asian exports is 18%.
- Australian commodities exported to China have earned high prices, while the cost of imported Chinese manufactured goods has fallen sharply.

Critical Services.

China is important for Australian service industries as well, especially tourism and education.

- Some 50,000 Chinese are studying at Australian universities.

Shared Prosperity.

China's emergence in the northern hemisphere as the world's manufacturing center has a counterpart in the south:

- Australia is supplying much of the iron ore, non-ferrous metals, coal and the higher education that fuel China's industrial revolution.
- That said, the interdependence of the Chinese and Australian economies makes Australia's balancing act particularly difficult.

Competing Perceptions of China.

Australia's role in Chinese trade inevitably affects its view of Beijing.

- In the U.S., China is often seen as a dangerous competitive threat.
- In Australia, China is generally seen as an irresistible opportunity.

Two-Edged Sword.

Australia's booming exports to China therefore represent a two-edged sword:

- These exports to the PRC have driven strong economic growth.
- But these exports have also left Australia economically dependent on China.

Difficult Dilemma.

As a result, Australia's economic relationship now leaves Australia with a dilemma:

- How does Canberra balance its increasingly important economic relationship with China with its longstanding the friendship with the U.S.?

Accommodating China.

Australia is not alone in this balancing act.

- Several U.S. allies in the region face the same difficulties in accommodating the rise of China.

Implications for ANZUS.

The implications of China's growing influence in Australia are clear.

- The U.S. alliance is going to become less important to Australia as time goes by.
- That means the Aussies are going to have much harder choices.
- Australia is going to need a much more agile foreign policy.

Downer's Flap.

Unfortunately, Alexander Downer, Australia's foreign minister, is anything but agile.

- Downer stumbled into a diplomatic minefield in August 2004 when he said, during an official visit to China, that Australia was not bound to help the U.S. defend Taiwan in a China-Taiwan war.

PM Howard's Correction.

An embarrassed Mr Howard was obliged to reaffirm Australia's alliance with the U.S. and its commitment to the ANZUS treaty.[3]

Prospects for ANZUS.

What does the Downer flap mean for the future of ANZUS?

- At a minimum, Australia arguably feels it can't afford to have ANZUS unless it has more flexibility.
- Notwithstanding Mr. Downer's clumsiness, he was making the obvious point –
  - Australia would not blindly support the U.S. in any circumstances.
- Mr. Downer's comments also showed the lengths to which Australia will now go to avoid offending Beijing.

Look Back.

The Downer flap also shows how things have changed.

- Back in 1996 (just after Mr. Howard first became Prime Minister) China prompted a crisis by threatening Taiwan.
- Australia was steadfast and sent a warship to the area in a token show of support for the U.S.
- At that time, Australia's economic stake with the Chinese was minor.
- Even so, Chinese leaders put Australia in a 12-month diplomatic deep freeze to show their displeasure.

Crisis in Taiwan Strait.

Today, Australia has a much stronger stake in its relationship with China.

- That changes Canberra's calculus.
- So, what if a conflict erupts today in the Taiwan Strait?
- Australia will struggle to strike a balance between U.S. and Chinese interests in the crisis.

- Canberra knows that any PRC retaliation for Australian support for Taiwan could seriously damage the Australian economy.

Striking a Balance.

How does Australia's balancing act play out in a broader sense?

- Prime Minister Howard is anxious to finalize the free trade agreement (FTA) between Australia and the U.S.
- Conscious of the need for balance, Australia is now embarking on the difficult task of preparing for FTA negotiations with China.
- It also wants a trade deal with ASEAN.
- In this sense, Prime Minister Howard is intensifying its diplomacy in Asia in recognition of Chinese power and Australia's interests in the region.

Critics of Howard.

Some people question the wisdom of bilateral deals with China.

- They argue it would be safer for a medium-sized power such as Australia to engage Beijing in multilateral forums, whether the issue is trade or security.
- But no one disputes that China and Asia generally are returning to prominence in Australian policy debates.
- Overall, Australia needs to find security "in Asia and not from Asia."

CONCLUSIONS

How's the Australian economy doing?

- Overall, it's doing well.
- It has enjoyed 14 years of strong, uninterrupted growth.

Can Australia sustain this economic upswing?

- Not at the same pace.
- Economic upswings do not last forever

Are there problems that could slow down the economy? Yes.

- The economy is relying too much on the wealth effects for consumers of an overheated housing market.
- The high current account deficit is worrisome.
- Australia is becoming complacent and losing its enthusiasm for further economic reform.

How does China fit into the economic/security picture?

Australia is increasingly dependent on its robust commodity and service exports to China.

- That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.

- Australia now faces a dilemma: How to balance China and the U.S.?
- That creates security concerns: How will Australia accommodate China in a crisis over Taiwan?

SUBSEQUENT ECONOMIC UPDATES

03 March 2005

Economic growth in Australia is rapidly slowing down.

- Growth slumped to just 1.5% in 4Q 2004 – just half the growth rate in 3Q 2004.

Economic Advisor's Comment:

Manpower and capacity constraints at ports and in rail and mining industries hurt the economy in two ways: a) by increasing wages and inflation and b) by reducing exports and slowing growth.

- Central Bank is fighting inflation with second highest interest rates in the developed world.
- Higher interest rates are controversial because they will worsen the slowdown and will discourage borrowing needed for capacity expansion.

09 March 2005

Aussie consumer confidence in Mar had its biggest monthly drop since series began in 1974.

- Consumer sentiment fell 16.6 points from 102.4 points (optimists outnumbering pessimists over 100 figure) to 85.8 points (where pessimists outnumber optimists).
- 8 Mar report says business confidence fell in February. March economic outlook index for next 12 months fell 25.9% and the economic outlook index for the next 5 years fell 15.6%

Economic Advisor's Comment.

Fall in consumer confidence occurred after the central bank raised interest rates the same day the government said economy had expanded just 0.1% in 4Q 2004, the slowest pace in four years.

- PM John Howard and Treasurer Peter Costello publicly questioned the need for the rate hike since cutting interest rates is normally what central banks do to simulate a sluggish economy.
- Flat growth over time puts downward pressure on the Australian budget and could possibly delay or even reduce Australian activities with the U.S. military down the road.

09 September 2005

Australia's economic expansion is accelerating.

- Australia's economy grew from 0.5% in 1 Q 2005 to 1.3% in 2 Q 2005.
- The economic performance in 2 Q 2005 was the best performance in 18 months.
- The economy is now 2.6% larger than a year ago.

Economic Advisor's Comment:

A record surge in domestic business investment, construction and mining is driving this impressive economic acceleration in 2 Q 2005.

- China's insatiable appetite for raw materials has resulted in booming Aussie commodity exports to the PRC.
- China's rising demand for Aussie commodities has caused commodity prices to soar, with corporate profits up more than 10%.
- BHP Billiton, Australia's largest company, just recorded the biggest annual net profit in Australian corporate history.

On the job front, the pace of annual jobs growth reached a 10-year high of 4.2% in August, more than enough to keep downward pressure on the jobless rate in coming months.

- Unemployment hit at a 30-year low of 5% in August, is likely to fall below 5% soon.

The biggest concern lies in its current account deficit in the balance of payments.

- The bad news is that at 5.8 % of GDP, the current account deficit is close to the 6.5 % level that preceded Australia's 1986 currency crisis, when Paul Keating, then treasurer, warned the country was in danger of becoming a "banana republic."
- The good news is that China's demand for Aussie raw materials has helped to raise contract prices for key commodities such as coal and iron ore and drive up exports values.
- Higher exports values have in turn reduced the current account deficit in 2Q 2005 to A$12.6bn -- its lowest level in a year.

At the same time, the country's net foreign liabilities rose A$3.3bn to a worrying level of A$430bn in 2Q 2005.

- The cost of servicing these foreign liabilities now amounts to roughly 4 % GDP and is Australia's big challenge in the next decade.

ENDNOTES

[1] Australia's deficit in the current account of its balance of payments is the trade deficit in goods and services.
[2] As a rule of thumb, any current account deficit over 3% of GDP is a financially unstable.
[3] The ANZUS Treaty signed in 1951 requires each side to help the other in a conflict.

COMMONWEALTH OF NORTHERN MARIANA ISLANDS (CNMI)

• CHAPTER 15 •

Executive Summary.

The two main CNMI economic growth engines -- tourism and garment industries -- are on two different tracks.

Threat to Garment-Makers. Until recently, the garment industry had been a remarkable success story.

- But with the end of the Multi-fiber Agreement (MFA) in January 2005, Saipan lost its export quotas.
- Garment makers in China are now arguably cornering the garment market.
- The Chinese threaten to drive Saipan garment-makers out of business and trigger rising unemployment and social unrest on the island, unless Saipan can reinvent itself in a hurry.

Comeback in Tourism. Thankfully, tourism is rebounding in Tinian and will soften the economic blow to CNMI.

- Japan's recovery is driving much of the current rise in tourism.
- And while the number of Chinese tourists visiting CNMI is currently tiny, prospects are rosy for Chinese tourism in the future.

Remarkable Evolution.

The CNMI has successfully evolved economically, financially, and socially since its establishment.

- Most remarkable has been how a small and isolated market has been able to control its own labor and immigration laws.
- It showed a remarkable ability to sell its manufactured goods, produced by workers paid less than U.S. minimum wage, as if they were produced in U.S.
- Under CNMI rules, low-cost Asian labor can be paid less than the U.S. minimum wage and is exempt from U.S. visa and immigration regulations.

No Dependency on U.S.

CNMI embarked on a program that a generation later has created one of the most self-sufficient economies in the U.S.-affiliated Pacific.

- CNMI politicians who did not see the comparative economic advantages of garment making were pushed to the sidelines.
- CNMI statesmen who prevailed persuasively argued that CNMI could be financially more stable and predictable if they were supported by more than one dominant industry such as tourism.

Globalization Model.

CNMI is a gateway to dynamic East Asia and home to Asian investors as well as workers.

- CNMI is a manifestation of the new global economy where political and geographic boundaries become obsolete.
- Unlike other Pacific island economies, CNMI relies mostly on the private sector, which is largely supported by foreign capital and foreign labor.

- CNMI shows that economic and financial interdependence among economies works, regardless of their size and scale.

Different Rule-Set.

CNMI took a totally different route from its neighbors.

- They allowed Asian manufacturers to set up shop in the islands, hire Asian temporary workers, manufacture garments, and sell them in the U.S. domestic market as if they were produced anywhere else in the U.S.

Beyond Tourism.

CNMI leaders concluded that tourism alone was not the best path to economic prosperity and stability.

- CNMI leaders wanted to avoid unpredictable market swings in addition to cyclical changes in the regional and global markets.

Rise and Fall of CNMI Garment Industry.

Saipan's garment industry grew rapidly in the 1990s.

- The industry expanded from 21 factories with $300 million in sales 1992 and peaked at 34 factories with sales of $1.06 billion in 1999.
- Sales began to decline in 2000 and continued to be weak through 2002 when they totaled $831 million.
- The 29 factories that were still in business in 2003 were expected to sell garments valued at about $765 million.

Sweatshop?

Along the way the same factors that underlie the remarkable degree of economic self-sufficiency and financial independence from Washington also triggered accusations in the mid-1990s that Saipan was a sweatshop.

- Workplace conditions and treatment of foreign workers, especially those making garments, made headlines in national and regional media.

Clinton's Federalization Proposal.

In response to adverse publicity, President Bill Clinton proposed to the U.S. Congress in the spring of 1997 that U.S. immigration and labor laws be extended to the commonwealth (i.e. federalization).

- The U.S. Senate embraced federalization for CNMI, but House did not consider it.
- Meanwhile, Congress asked GAO for an on-site study in 1999.

GAO Study.

GAO found that CNMI's economic self-sufficiency and its ability to generate most of its revenue from within were important considerations.

- The GAO neither endorsed nor criticized the CNMI is unique labor market situation.

Special Subsidy?

Critics argued that the U.S. –

- Allowed Saipan's garment manufacturers to pay less than the U.S. minimum wage to temporary foreign workers and --
- Labeled and sold their products as if they were made in the United States, and --
- Extended a de facto special subsidy to them.

U.S. Hypocrisy?

Critics say U.S. was hypocritical and had a double-standard with regard to international trade and free market principles --

- The U.S. allowed a peculiar labor market to exist within its national boundaries
- But the U.S. but advocated free trade and efficient market mechanisms (meaning no subsidies) to the rest of the world.

No Congressional Action.

Despite intense and widespread publicity over CNMI workplace conditions, the Congress did not take action.

Lawsuit.

In April 2003 workers filed a $1-billion class-action suit against garment makers and retailers over allegations of sweatshop conditions.

- The lawsuit was settled under terms approved by a federal court.

Win-Win Settlement.

Although the settlement involved a much smaller amount of compensation for workers than they had sought, both sides claimed victory.

- Garment making enterprises felt they won because they admitted no wrongdoing.
- Workers felt they won because they received some compensation.

Quotas End.

Under WTO's MFA, which took effect in January 2005, quotas disappeared for textiles products.

- Lifting quotas makes it possible for producers of labor-intensive goods such as garments to sell more of their products in markets such as the United States, Europe, and Japan, even with import duties.

Now let's explore whether or not tourism can offset the fall in garment-making industry.

Vulnerability of Tourism.

From 1988 to 1996, tourism was CNMI's largest income source and most dynamic industry.

- Its sharp decline in 1997-98 and then in 2001, and only modest recovery since then, has shown the fragile and vulnerable nature tourism in CNMI.

Good News: Tourism.

The CNMI tourism industry had a 20% rise in total tourist traffic in 2004, which raised total arrivals to about 570,000.

- Japan's recovery is driving much of this rise in tourism.
- While better than 2003's total, even that level of tourists in 2004 was far short of the 736,000 CNMI received in 1996.

Culture Clash.

Separating the industrial economy of garment manufacturing from leisurely tropical tourist pursuits on the island of Saipan presents the commonwealth with yet another obstacle to revitalizing tourism.

- The mixing of an industrial city peopled by foreign workers and a vacation paradise trying to attract more visitors is a new experiment in itself.

Eye on the Future: China.

Meanwhile, a tourist market that holds both immediate and long-term potential is China.

- Tourists from China were such a small number in 1996 that they were lumped together with "other" markets.
- They increased haphazardly in the next few years, but averaged just over 2,200 per year from 1997 to 2001.
- In 2002, they increased nearly five-fold to 10,471.
- Although they made up just over 2% of the market share in 2002, Chinese tourists are likely to increase in the years ahead, perhaps at rates greater than either Japanese or Korean tourists in the past decade.

Rosy Prospects for Chinese Tourism.

It may be some time before Tinian becomes a mini-Macao, but it certainly has the potential.

- Demand: Chinese tourists are increasing in the years ahead, simply because per capita income is rising in China at the rate that occurred in Japan in the 1950s and 1960s and Korea during the 1970s and 1980s.
  - Outbound tourist traffic from China is expected to increase substantially in the years ahead.
- Access. In addition, Tinian is a relatively short flight from either Hong Kong or Guangzhou (Canton), the main city in southern China.
  - And since CNMI-bound tourists do not need U.S. visas (as they do to enter Guam) –
  - CNMI has the added advantage of receiving Chinese tourists at any time, once China places the Commonwealth on the list of "approved destinations" and allows Chinese citizens to travel there.
- Capacity. While the hotel and casino on Tinian has been struggling to stay open since they started business in 1996, Tinian has the capacity to receive and entertain large numbers of Chinese tourists.
  - CNMI's comparative advantage is in the presence of tourist facilities already on the ground that cater to Chinese tourists.
  - In fact, there is already a plan for expansion of the hotel and casino on Tinian should circumstances call for an increase in capacity.

- Cultural Link. CNMI has the cultural and linguistic advantages to receive Chinese tourists.
- Ownership. Chinese interests from Hong Kong own and operate Tinian facilities.
- Skill-Set. These Chinese operators know the Chinese gambling market and how to attract tourists from that market to CNMI.
- Outreach. Admittedly, Tinian's infrastructure is currently geared mainly toward Chinese tourists, and possibly Korean tourists as well, especially gamblers.
  - But other tourists and local residents are just as welcome to the casino and hotel as anyone else.
  - With the mix of tourists and tourist facilities on-island, CNMI is in an advantageous position to benefit from economic recovery in Japan and increased outbound travel from China.

CONCLUSIONS

The two main CNMI economic growth engines -- <u>tourism</u> and <u>garment industries</u> -- are on two different tracks. On the one hand, garment-makers are commercially threatened. Why?

- With the end of the Multi-fiber Arrangement (MFA) in January 2004, Saipan lost its export quotas.
- Garment makers in China have arguably now cornered the garment market.
- The Chinese threaten to drive Saipan garment-makers out of business and trigger rising unemployment and social unrest on the island unless Saipan can reinvent itself in a hurry.

On the other hand, tourism in CNMI is rising. Why?

- Japan's recovery is driving much of the current rise in tourism.
- And while the number of Chinese tourists visiting CNMI is currently tiny, prospects are rosy for Chinese tourism in the future.

GUAM

• CHAPTER 16 •

Executive Summary.

Following several years of stagnation and decline, Guam's economy is headed for recovery and growth.

- In 2004, most of the economic, financial and security factors affecting Guam's tourism were moving in directions favorable to the U.S. territory's economy.
- The two main engines of growth -- tourism and national defense spending -- are rising.
- Japan's recovery is driving the rise in tourism.
- That said, Guam's financial mismanagement is a formidable obstacle.

Positive Trends.

The prospects for recovery in Guam's economy are better than in several years.

- Defense outlays are rising.
- Tourism is up.
- It is too early to decipher the depth and breadth of this recovery.
- But if both tourism and defense spending rise consistently for 4-6 months, it will be possible to make a more quantitative assessment of gains in business, the tax base, public finances, employment and, eventually, total output.

Difficult Journey.

Before we explore factors driving the economic turnaround, it's important to understand the difficulty of Guam's economic journey.

- Guam is small and isolated.
- Its fragile ecosystem limits new industries, even under the best economic and financial conditions.
- Most of Guam's commercial infrastructure is aging and requires large sums to maintain.

Grim Economic Legacy.

Until recently, Guam was suffering through a substantial and continued erosion of its economic base since the mid-1990s.

- Guam's GDP fell as much as 25-35 % in the past decade.
- Guam lost nearly 20% of its payroll employment within a decade.
- It was clear that Guam's economy needed to be rebuilt, at least to the more recent prosperity levels of 1996-97.

Defense Cuts.

In the same period, national defense spending decreased from $506.9 million to $461.3 million.

- The drop in national defense spending may appear small, but the total impact of federal dollars on Guam is larger than the dollars Japanese tourists spend.
- Generally, federal employees, whether in uniform or civilians, receive more in wages, salaries and benefits than those employed in tourism and other civilian services on the island.

Stagnant Japan.

In the late 1980s and 1990s, Guam became increasingly dependent on Japanese tourists and less on defense and non-defense federal outlays.

- Economically, Guam seemed more like a part of Japan than a U.S. territory.
- Guam's reliance on the Japanese economy is due to market factors.
- Guam's economic exposure to Japan was a destabilizing factor as the Japanese economy entered its long phase of decline and stagnation.
- Japan's weak economy exacerbated Guam's problems.
- A large majority of tourists to Guam have been Japanese.
- Nearly 75% of well over a million tourists in 2004 came from Japan.
- But in recent months, Japanese tourists arrived in fewer numbers and spent less money on the island.

Other Negative Factors.

In addition, a number of other negative factors contributed to a contraction in Guam's economy that began in the mid 1990s.

- Economic woes dating back to the Asian financial crisis of 1997-98 plagued Guam's recovery from the burst of the Japanese asset price bubble of the early 1990s.
- The 9/11 terrorist attacks set in motion a chain of events that would ultimately cut monthly tourist traffic by as much as 50-60%.
- The Dec 2002 Pongsona typhoon was the strongest storm to hit Guam in more than a century. That followed a series of other natural disasters.
- During 2003, the Iraq War and the SARS epidemic contributed to yet another fall in tourism from Japan.

Rise in DOD Spending.

The recent rise in defense spending during 2003-2004 reflects substantial repair and rehabilitation work on Guam's military bases and housing complexes.

- Workers have been rebuilding the aging infrastructure and refurbishing facilities damaged by a series of destructive typhoons in the last few years.
- The rise in contracts put out for bid or awarded is much more favorable to Guam than has been the case in the last few years.
- Hopefully, this rising defense spending will act as a catalyst to attract foreign capital and skills to launch the next stage of business and economic recovery.

Defense Spending: Immediate Impact.

Increases in defense spending tend to have a perceptible and immediate impact on the economy.

- This is especially true in the areas of force and personnel, refurbishment of base facilities and new construction projects.
- In fact, some of these areas of defense spending create immediate work opportunities.

Defense Spending: High Multiplier Effect.

The trend of rising defense outlays on the island actually adds more momentum to economic and financial recovery than tourism.

- Why?
- Defense spending has a higher multiplier effect, as more of defense dollars tend to stay in the local economy.

Look Back at Tourism.

Tourist arrivals to Guam peaked at 1.382 million in 1997, the onset of the Asian financial crisis, and then dropped 17.1% in 1998.

- A modest recovery followed in 1999-2000, but was derailed by the aftermath of 9/11 terrorist attacks.
- In 2002-2003, air traffic concerns, the weak Japanese economy, severe typhoons and the SARS epidemic all combined to keep Japanese tourists away from many destinations.
- Since Guam did not play a direct role in the post-September 11 military buildup related to the war on terror, it did not benefit directly from spending emanating from the war.
- In 2003, Guam received 909,506 tourists. – 14.1 % below the previous year and the first time in a decade that Guam had fewer than one million tourists.

Tourism Up.

In January 2004, tourist arrivals increased 76 % to 101,515 from 57,826 in January of 2003.

- With tourist traffic in January 2004 returning to what may be considered normal, Guam had, once again, one million tourists in 2004.
- Higher levels of tourist traffic and subsequent increases in hotel and other taxes would contribute to improving the financial condition of the territory.

Driver: Japanese Recovery.

Japan’s recovery is boosting tourism.

- The U.S. recovery is also boosting and strengthening the Japanese economy.
- The rise of China may also mean more Chinese tourists in the years ahead.

Bad News: Financial Mess.

Unfortunately, the government of Guam (GovGuam) still has formidable financial obstacles to overcome.

- Guam has a long-held local tradition to avoid public employee layoffs.
- As long as the economy generated revenues to pay for existing obligations, GovGuam balanced its books by borrowing in financial markets to pay employees.
- Years of cumulative budget deficits for operational expenses like government salaries have created large government debt.

Opportunity Cost: Education.

This financial mess has created painful opportunity costs in the form of cutbacks on educational programs.

- Major efforts must be made to improve education.
- As other U.S. states have shown, world-class educational institutions are often the essential building blocks for economic growth and development, regardless of the phases of business cycles.
- With more funds and more efficiency, the University of Guam and Guam Community College can be the leaders for the entire West Pacific region.

CONCLUSIONS

Guam's economy is on the road to recovery. Why?

- National defense spending is rising with more repair work on Guam's military bases and housing complexes.

Tourism is also rising. Why?

- The Japanese economy is recovering.

That said, are there significant economic problems?

- Yes. Government debt is too high.
- That's an opportunity cost in the form of cutbacks in education.