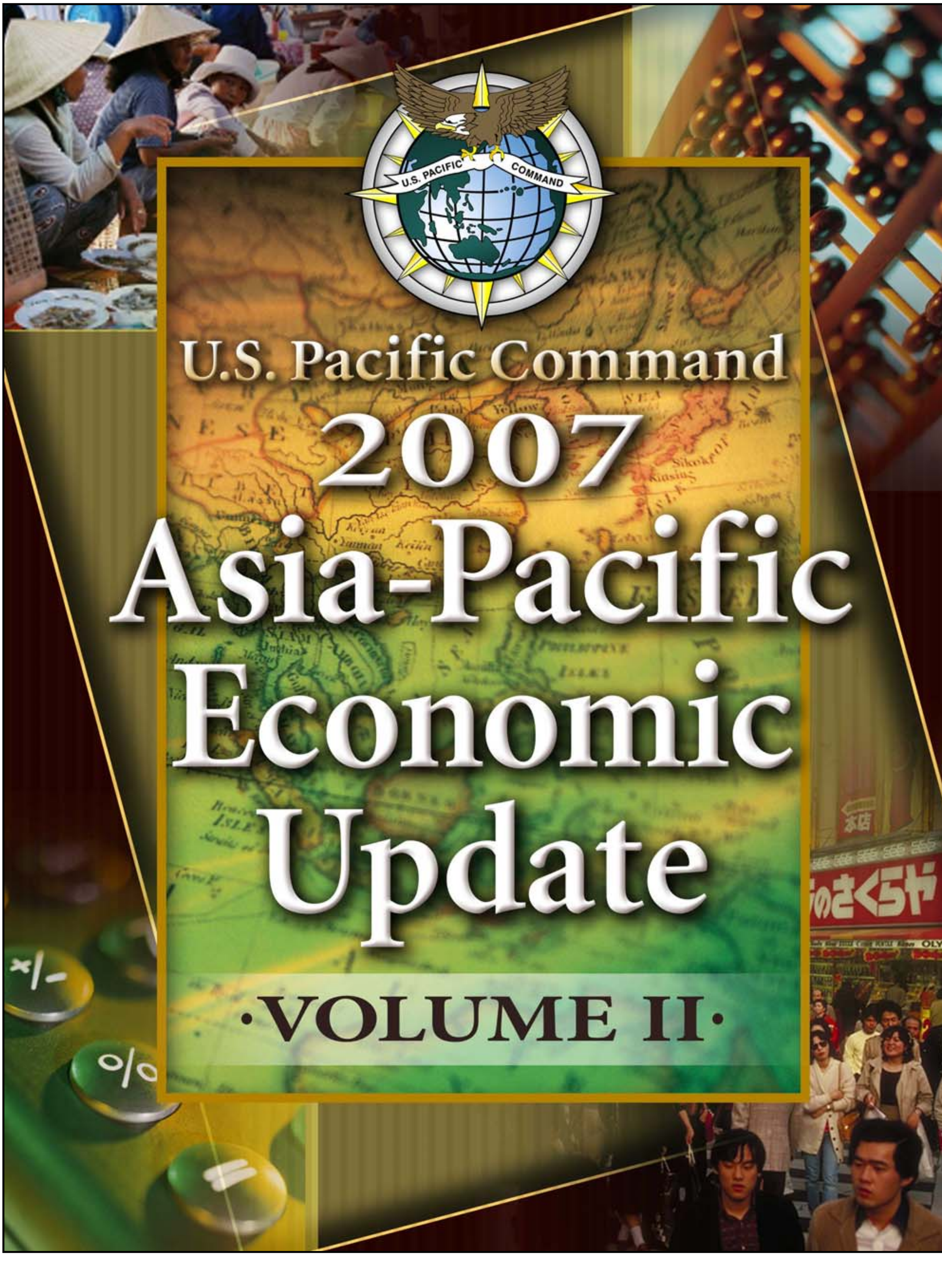


U.S. Pacific Command

2007 Asia-Pacific Economic Update

·VOLUME II·

U.S. PACIFIC COMMAND
ASIA PACIFIC ECONOMIC UPDATE

• 2007 EDITION •

FOREWORD

I'm pleased to announce the launch of the 2007 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.

The purpose of this product is to stimulate informed debate and challenge our readers to think creatively and critically about the vital economic challenges in the region and their implications for security. Therefore, the views, opinions and findings contained in this publication should not be construed as representing the official position or policy of the U.S. Pacific Command, the U.S. Department of Defense or the U.S. Government.

In the country chapters you will usually find a baseline economic assessment for each economy. Following this baseline assessment, Dr. Leif Rosenberger (our economic advisor) selects daily economic developments and discusses their importance.

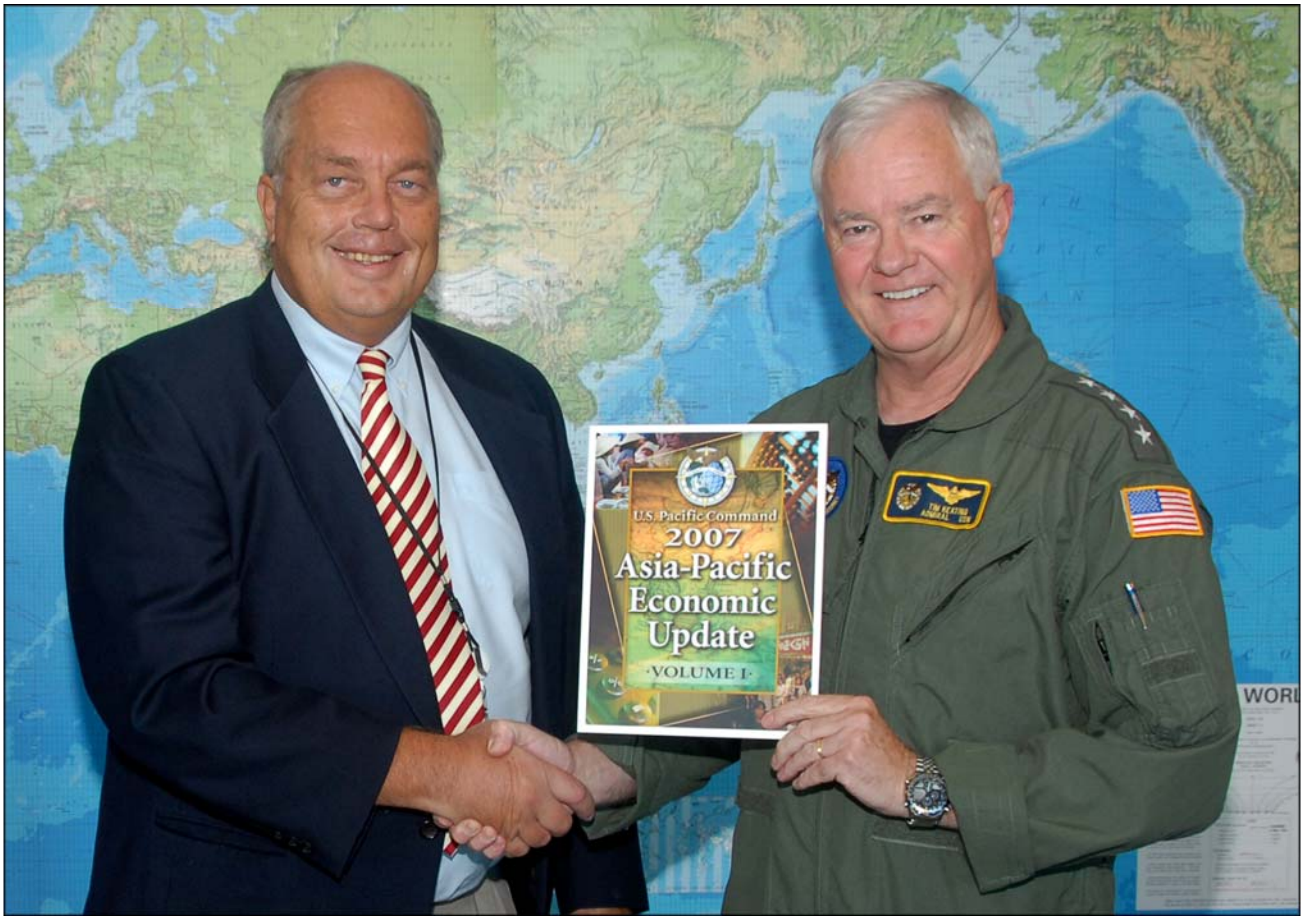
In Volume I, you will find historical case studies on financial turmoil followed by more recent financial trends of concern to us all. While we highlight the economic rise of China once again, there are important new developments in Russia and North Korea that will be of interest to our readers.

In Volume II, we continue to look closely at the dynamic economic developments in South and Southeast Asia. While poverty is still a problem in the region, many economies that were struggling in the past are enjoying accelerating economic growth. In addition, we have put more emphasis on the South Pacific, an area of increasing importance to the command.

In Volume III we continue to look at transnational issues. We discuss the socio-economic strategy to counter terrorism and how to implement it via creative partnerships with the private sector. We expand 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.

We are pleased to publish the 2007 edition of the U.S. Pacific Command Asia Pacific Economic Update as a military perspective on the seamless web of economic and security interdependence.

TIMOTHY J. KEATING
Admiral, U.S. Navy



Dr. Leif Rosenberger, Economic Advisor
and
Admiral Timothy Keating
Commander of U.S. Pacific Command

ACKNOWLEDGEMENT

I was fortunate the past two and half years to have Major Miemie Byrd, my able deputy, at my side throughout this APEU "intellectual marathon." Thank you, Miemie, for your infectious enthusiasm, collegial contributions and tireless research support and coordination. Without your diehard efforts, there would be no product line. I also want to wish her well in her new position as a professor of economics and international business at the Asia Pacific Center for Security Studies in Honolulu.

I also want to take this opportunity to thank Ms Sharon Strickland, our tireless research assistant. Sharon never complained about pouring though endless amounts of articles and books and providing us with pithy suggestions and comments about them. We wish her well as she pursues her masters in economics in the years ahead. We also want to thank Mrs. Laura Emanovsky for her contribution with formatting and editing the publication, Ms. Faith Goodwin for her graphic support at PACOM and Mr. Mark Harstad from Asia Pacific Center for Security Studies for his superb graphic support and data collection and organization in all the chapters.

Intellectual Burden Sharing

This three volume publication is a monumental enterprise. While the bulk of the writing once again rested on my shoulders, I was blessed this year with additional authors who wrote chapters for us. A big mahalo to the following contributing authors for the following:

- Major Miemie Byrd for Mongolia in Volume 1 and Brunei, Fiji, Guam, Tonga, and co-authored Nepal in Volume 2. She also authored two chapters in Volume 3 and edited the entire volume.
- Ms. Sharon Strickland contributed three chapters, Burma, Laos, and Sri Lanka and co-authored on Nepal in Volume 2.
- Mrs. Laura Emanovsky, our Vietnam expert, wrote the Vietnam chapter in Volume 2 and for formatting and editing the three volumes.
- Mr. Mark Harstad of Asia-Pacific Center for Security Studies for his two chapters on Asian economic trends.
- Finally, Mr. Brad Babson once again gave us an excellent chapter on North Korea in Volume 1.

Thank you all for sharing the burden. We hope the following economic discussion stimulates interest and debate.

In addition, we were fortunate to have strong senior leadership in our corner throughout the process. The ringing endorsement from former PACOM Commander William Fallon opened crucial doors for us in the early going. And Admiral Timothy Keating thankfully kept those doors wide open for us and helped us reach the finish line. Thank you both for your votes of confidence. I also want to thank Rear Admiral Michael Tracy and Major General Thomas Conant for their continuous encouragement and support along the way. It was a privilege and an honor working with all of you. Godspeed.

Once again I dedicate this Asia Pacific Economic Update to my wife Regina, the love of my life. Without her patience, emotional support and encouragement, none of this would have been possible.

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

Dr. Leif Rosenberger, Economic Advisor
and
Admiral William Fallon
Former Commander of U.S. Pacific Command
(February 2004-February 2007)

United States Pacific Command
BIOGRAPHY

Dr. Leif Rosenberger
Economic Advisor, U.S. Pacific Command
(808) 477-6174, leif.rosenberger@pacom.mil

Dr. Leif Rosenberger has been the Economic Advisor at the U.S. Pacific Command (PACOM) since 1998 and worked for five Commanders-in Chief. He has a dual reporting chain to a) J5 (Rear Admiral Michael Tracy and recently Major General Thomas Conant) and b) Admiral Timothy Keating, PACOM Commander. Dr. Rosenberger was chosen as PACOM Professional Federal Employee of the Year for 2006 and 2007. Access Asia of the National Bureau of Asian Research ranks Dr. Rosenberger as its #1 expert out of 145 specialists on Asian economies. Admiral Fallon -- Commander at the U.S. Central Command (or CENTCOM) and previously PACOM Commander -- recently picked Dr. Rosenberger to be his Economic Advisor. Dr. Rosenberger starts work at CENTCOM on 04 September 2007.

Dr. Rosenberger is the main author for volumes 1 and 2 of the Asia Pacific Economic Update (APEU) 2007. He is the author of all but one chapter in Volume 1 and each chapter in Volume 2 of APEU 2005, which received the highest 5-star rating from the Australian National University (ANU). Admiral Fallon, former Commander at PACOM, made his APEU publication mandatory reading for all new employees reporting to PACOM. His economic home page at PACOM has over 10,000 external visits since 31 October 2005.

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 at the Army War College. He won four faculty U.S. Army War College 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.

Dr. Rosenberger taught International Finance and Trade in the Executive MBA Program at the University of Hawaii in 2006 and received the highest student evaluation. 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 taught Economics and Political Science at Dickinson College.

In recent years he has published, "The United States and Australia: Competing Economic Perspectives," in *The Other Special Relationship: The United States and Australia at the Start of the 21st Century.* U.S. Army War College, February 2007; "China's Economic Rise" in *Economics and Maritime Strategy: Implications for the 21st Century.* The U.S. Naval War College, 2006; "Towards a Socio-Economic Struggle against Violent Extremism" in *The Struggle Against Extremist Ideology: Addressing the Conditions That Foster Terrorism.* U.S. Army War College, 2005; "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. In addition, former Drug Czar General (Ret) Barry R. McCaffrey favorably reviewed his book, *America's Drug War Debacle*, Avebury, 1996.

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. He can be contacted at leif.rosenberger@pacom.mil or leifrosy@yahoo.com and at 808-477-6174.

Mark Harstad, Leif Rosenberger,
Miemie Byrd, and Laura Emanovsky

Major Miemie Winn Byrd, Deputy Economic Advisor

Miemie had served as the Deputy Economic Advisor for U.S. Pacific Command since 2004. She holds an M.B.A with emphasis in Asia Pacific Economics and Business from University of Hawaii and received her B.A. in Economics and Accounting from Claremont McKenna College. She is a native Burmese speaker and served as a Burmese linguist and cultural advisor for the U.S. Government. Prior to the mobilization, Miemie held a range of diverse financial positions in the private sector, to include fortune 500 companies and accounting firm, Ernst and Young. Her current research area is in exploring ways to leverage the private sector to address the underlying negative socio-economic conditions in the Asia Pacific region.

Mrs. Laura Emanovsky, Research Analyst

Laura holds a B.A. in International Business from Hawaii Pacific University and is currently completing her M.A. in Economics from University of Oklahoma. She is fluent in Vietnamese and serves as a Vietnamese linguist for the U.S. Government. Laura has worked extensively in Vietnam.

Mr. Mark Harstad, Operations Research Analyst, Asia Pacific Center for Security Studies

Mark holds an M.S. in Operations Research from the University of California-Berkeley, an M.S. in Strategic Studies from the U.S. Army War College, and a B.S. in Industrial Engineering from the University of Wisconsin-Madison. His professional interests include the application of modern systems theory to complex problem areas.

Ms. Sharon L. Strickland, Research Analyst

Sharon served as the Research Analyst for U.S. Pacific Command (October 2006 - February 2007). Sharon was selected for the Navy Acquisition Internship program at Naval Air Systems Command HQ located at Patuxent River NAS, Maryland. She is currently a Business Financial Analyst for Department of Navy's Maritime Patrol and Reconnaissance Aircraft division. Sharon is also a veteran. She served four years in the Marine Corps as an Aircraft Rescue Firefighter. Sharon received her B.A. in Economics from Saint Mary's College of Maryland.

· VOLUME II ·

CHAPTER TITLE PG

Electronic version of APEU 2007 can be downloaded at U.S. PACOM official website: http://www.pacom.mil/publications/apeu07/index.shtml

EXECUTIVE SUMMARY

· ASIA PACIFIC ECONOMIC UPDATE 2007 ·

Leif R. Rosenberger

SOUTH ASIA

Bangledesh.

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

- Poverty and adult illiteracy still hold the country back.
- The country is over-populated and desperately short of electrical power.

However, Bangladesh has made significant progress in recent years.

- The country is now largely self-sufficient in food production.
- Dhaka has implemented a number of important economic reforms.

On the energy front, Bangladesh is blessed with virtual oceans of natural gas.

- What it lacks is capital and technology to efficiently extract the energy.
- With a little political common sense, the Bangladesh people would be prosperous.

But Bangladesh has a fatal flaw.

- Bangladesh political leaders never miss an opportunity to choose the path that destroys wealth and reduces optimum economic growth.

Bangladesh shoots itself in the foot in a variety of ways. These include: Political violence, economic nationalism, corruption and political red tape.

India.

India's economy is growing at fastest pace in 18 years.

- Credit rating agencies have upgraded India's financial standing.

However, India's high growth rate is unsustainable.

- Economy is overheating, with aggregate demand outpacing aggregate supply.
- Inflation is over central bank limit and actually understates over-heating.
- Excessive demand is showing up in current account deficit.

One option to curb inflation is to raise interest rates and slow down growth.

- But higher interest rates would simply attract capital inflow.
- Capital inflow has already made rupee too strong and is hurting exports.

A better idea would be to increase aggregate supply (potential GDP).

- A shortfall of aggregate supply is visible in bottlenecks throughout the country.
- India desperately needs to upgrade its infrastructure, and to speed up economic reforms.
- India needs better public services, education, health, job skills and labor laws.

Reforms would help half of India's 1.1 billion who live on less than $1 a day.

- However, India faces significant fiscal constraints that will limit what it can do.

Nepal.

Nepal is one of the poorest countries in the world, with 2.7% of GDP growth for 2005-06.

- Strikes and political strife in 2006 hit Nepal's tourism sector hard.
- Nepal's garment and textile industry is on the decline as the result of the expiration of Multi-Fibre Arrangement (MFA) at the end of 2004.
- Another contributor to its feeble economic performance was the agriculture sector which was affected by unforgiving weather and prolonged drought.
- Luckily, increased overseas workers' remittances have kept Nepal's economy afloat.
- There is untapped potential for hydropower, however, the huge capital start-up cost required to develop hydropower has prevented the Nepalese from realizing this potential.
- Opening and restructuring of the petroleum sector could bring in needed FDI.
- The rapid economic development of its two large neighbors—China and India—can offer significant opportunities for Nepal to emerge as a transit point for their trade as well as a place for increased investment.

Sri Lanka.

- For a country that embraced globalization for centuries, the past few decades have been economically difficult for Sri Lanka.
- In the 1970s Sri Lanka's closed door economic strategy failed miserably.
- A civil war that killed 40,000 people frustrated its return to globalization.
- A 2002 ceasefire helped spur accelerating economic growth.
- But a tsunami hit in December of 2005, killing another 31,000 people.
- Thankfully, international support was robust for reconstruction.
- Reconstruction helped spur GDP growth to 5% in 2005 and over 6% in 2006.
- But solid growth and falling unemployment created a false sense of security.
- Sri Lankans became complacent and stopped pushing for a durable peace.
- Sri Lanka needs to double its efforts at a durable peace for sustained economic growth.

SOUTH-EAST ASIA

Brunei.

Brunei remains on solid economic footing thanks to the high price of oil in 2006.

- But before long, Brunei will be running short of oil.
- So Brunei needs to change its ways in the future.

To its credit, Brunei has made some progress with its economic reforms.

- The government has made significant progress in sustaining its commitment to open up and free the economy of tariff and non-tariff barriers.

But Brunei must do far more to reinvent itself.

- The Sultan has an E-Commerce vision for Brunei and IT spending is on the rise.
- Also trying to remake itself as an international finance/trade and tourism hub in the region.
- Brunei is also trying to strengthen its economy by integrating its economy with other SE Asian economies.

Unfortunately, Brunei faces numerous obstacles that will make it difficult to reinvent the economy.

Burma.

- Burma's economy is in shambles and the future is bleak.

- Since 1990, the Burmese have been locked away from the rest of the world by theirs and Western governments.
- They are caught in a quagmire between the idealistic Western governments' zeal and the military junta's subjugation.
- Burma's richness in natural resources and its strategically significant geographic location at the mouth of the Straits of Malacca are irresistible to these emerging economic giants.
- Burma's "Roadmap" towards democracy is at a dead-end at this point.
- Ultimately, it is the majority of ordinary Burmese citizens that have suffered from extreme poverty, stagnation and isolation.
- A nation that was once one of the wealthiest nations in South-east Asia (under British administration in the 1940s) is now one of the poorest countries in the world.

Cambodia.

For years Cambodia's economy struggled. Then in 2005, everything went right.

- Cambodia's GDP growth soared, with agriculture, tourism, and construction all performing well while FDI doubled in 1985.
- But the biggest driver was the garment industry, which soared in 2005-06.

Unfortunately, declining prices for garments have left Cambodia's garment factories operating on declining profit margins despite rising productivity.

- Worse still, real wages of garment factory workers have been falling for three years.
- So it's unclear whether or not this economic success story in 2005 can be sustained.

Despite economic success in 2005, Cambodia remains a poor country and leans heavily on the crutch of foreign aid.

- Investors find the business climate unappealing due to high levels of corruption and volatility.

The economy is driven by two unpredictable 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.

Maybe the energy windfall over the horizon will be what it takes for Cambodia to get over the hump. Cambodia expects to receive $1 billion dollars a year in oil revenue by 2010.

Indonesia.

- Indonesian economy is on a roll, with strong 6% GDP growth.
- The country struggled to regain its growth they enjoyed prior to the Asian economic crisis.
- Jakarta decisively cut energy subsidies and curbed subsequent inflation. That enabled Jakarta to responsibly cut interest rates.
- Lower interest rates stimulated consumption and investment.
- Enthusiastic investors cite healthy macroeconomics and political stability as encouraging.
- Stocks hit all time high and rupiah became best performer in region.
- Fixed investment is also up from 2.9% in 2006 to estimated 10.6% in 2007.
- Recently passed new investment law, helps in making Indonesia more foreign investor friendly.

Laos

Enough positives counter the negatives, when taking a snapshot of Laos' economy.

- Laos has made tremendous progress towards a market economy, through the help of the mining and hydropower sector, private sector development, and tourism.
- Laos' economy grew at a record 7.6%. Strong growth and relatively low inflation continues to reduce poverty in both rural and urban areas.
- Positive outlook lies ahead for the economy as investments and exports continue to increase.
- Further expansion is anticipated to continue due to the government's accomplishment of major milestones in recent years; however its commitment to reforms remains vital in obtaining future economic gains for Laos.
- Meanwhile, Laos is still considered a Least Developed Country (LDC) with an average income of $570 per capita for 2006 and it continues to rely heavily on international donor assistance.

Malaysia.

Malaysia remains on track and moving in right direction. Three reasons for optimism: political stability, economic reform and solid growth.

- Under Prime Minister Abdullah, Malaysia is cracking down on corruption.
- Budget austerity in the past provides a foundation for improving infrastructure. Modern infrastructure will increase Malaysia's potential GDP without inflation.
- Malaysia enjoyed solid 5.9% GDP growth in 2006; expect the same in 2007.
- The country is running a large surplus in its current account (goods and services).
- Malaysia's capital controls during the Asian financial crisis made it a pariah.
- Malaysia's de-pegging currency to U.S. dollar is winning back investor confidence.

Philippines

The Philippine economy is on a roll while enjoying their fastest growth in 17 years.

- GDP is up 6.9% in 1Q 2007; stock market recently hit 10-year high.
- Peso is at 6-year high against U.S. dollar; inflation is at a 7-year low.

Business sentiment is also rising.

- Texas Instruments is about to build a $ 1 billion plant in the country.

Remittances from overseas Filipinos are rising.

- Rising remittances is stimulating more consumer spending.

Kudos should go to President Arroyo for boosting business confidence.

- Raised taxes in 2006 to cut budget deficit.
- Built more roads, bridges, ports and other infrastructure
- Improved infrastructure is attracting more foreign investment.

Singapore.

Rote learning and hard work used to be enough for Singapore's success, but its boom and bust economy revealed cyclical and structural weaknesses.

- Overdependence on electronics made it vulnerable to volatile global economy.

Singapore needed to diversify its economy to cushion electronic down cycles.

- Risk adverse Singapore also faced an entrepreneurial shortfall.
- Entrepreneurs that Singapore needed to attract found old Singapore too staid.

Singapore reinvented itself with a casino economy and other reforms.

- In 2006, GDP was up 7.7%, making it one of fastest growing Asian economies.
- More diversified economy can now weather storm of electronics down cycle.
- GDP is on track to grow at least 5% in 2007 despite the slowdown in the U.S. economy.

Thailand.

Back in 2006 Thailand enjoyed relatively strong export-led economic growth (5%).

- Investors hoped economy would do even better without Thaksin's cronyism.
- When tanks rolled into Thai streets, foreign investors were still optimistic.

But then post-coup Thai government opted for capital controls.

- Thai stock market crashed, investor confidence fell in new government.
- Capital controls were partially removed, but the damage was done.
- Economy is slowing down; much needed foreign investment is drying up.
- Muslim insurgents' economic targets in the South worsen slowdown.

Vietnam.

Vietnam is one of the top performing developing countries in the world. Year 2006 and the first quarter of 2007 have proven to be prosperous for the country. After 11 years of work, and eight years of negotiations, Vietnam became the World Trade Organization's (WTO) 150th member in January, 2007. Even with these successes, Vietnam is looking towards what can be done to prosper in years to come.

- Currently working towards Middle Income Country Status.
- Exploring its fruitful cooperation between the U.S. and Vietnam.
- Striving to protect its environment and strengthen its education system.

OCEANIA

Australia.

Australia's economy is on a roll. In 1Q 2007, Australia enjoyed its fastest growth in over 3 years.

- China's rising demand for Aussie goods and services is the strategic driver.
- China is like a huge vacuum cleaner sucking up all the energy and other raw materials it can find from every corner of Australia.

Despite close security ties, U.S. and Aussies see PRC economic rise differently.

- The economic rise of China divides the U.S. and Australia.
- Australia's commodity and service exports to China are booming.
- In contrast, the U.S. is losing the economic high ground with Australia.
- Sino-Australian merchandise trade rose 248% between 2000 and 2005.
- U.S.-Aussie trade was flat -- only growing 13% between 2000 and 2005.

Six years ago Australia traded twice as much with U.S. than with China.

- Today the situation has reversed itself; Australia now trades twice as much with China than with U.S.

China is far more important trade partner to Australia than U.S.

- In fact, China just eclipsed Japan as the #1 Aussie trade partner.

Aussie dilemma: How to strike balance between U.S. and China.

- Aug 2004: Aussie Foreign Minister Downer said Aussies are not bound to help U.S. defend Taiwan in war with Taiwan.
- Today – almost 3 years later – Aussie trade with PRC dwarfs trade with U.S.
- Aussies will try hard to placate U.S. while bending over backwards not to antagonize China and jeopardize close and strong economic ties to PRC.

Closely related to economic rise of China is how U.S. and Aussies look at energy.

- U.S. economic nationalism/ideological problems with "Red China" mindset stands in contrast to Australia's shared prosperity with China.

Fiji.

- Fiji's economy has struggled through much of 2006.
- The December 2006 military coup in Fiji made a bad situation worse.
- This coup was a painful reminder of three other recent coups in Fiji.
- A political crisis has ensued; receiving mostly negative responses form Asia, the Pacific, as well as the rest of the world.
- By March 2007, Fiji was running a current account deficit of 17% of GDP – twice the 8% figure of Thailand and Mexico before their financial crises.
- On 19 March 2007, Standard and Poors (S&P) downgraded Fiji's credit rating and gave it a negative outlook.
- Fiji may well have to go the International Monetary Fund (IMF) for an emergency loan to avoid or manage a financial crisis.
- That said, it's important to note that the situation could be even worse.
- The EU and other important countries doing business with Fiji actually showed considerable restraint in terms of the nature and extent of their sanctions.

Guam.

Following several years of stagnation and decline, Guam's economic outlook is brighter than it has been in recent years.

- The recent announcement by the Pentagon to relocate forces from Okinawa to Guam is expected to inject $15 billion into Guam's economy over next 10 years.
- The real estate sector has been recovering from a recession. Real estate prices are rising in anticipation of the U.S. military build up.
- The tourism industry had experienced encouraging growth in last three years. The Japanese accounted for nearly 80% of Guam's total visitor arrivals in 2006. Japan's recovery is driving the rise in tourism.
- That said, Guam's financial mismanagement remains a formidable obstacle.

Tonga.

- Tonga's economy was already struggling before the riots.
- Business confidence had dwindled as the result of the riots.
- Overseas remittances are increasingly important to Tonga's economy.
- Tourism is recovering.
- The new king and the parliament have a difficult task of balancing political reforms, responsible fiscal policy, the need to provide social programs, and recovery/reconstruction efforts.

New Zealand. – **See Volume I, Chapter 2.**

BANGLADESH

• CHAPTER 1 •

Leif R. Rosenberger

Executive Summary.

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

- Poverty and adult illiteracy still hold the country back.
- The country is over-populated and desperately short of electrical power.

However, Bangladesh has made significant progress in recent years.

- The country is now largely self-sufficient in food production.
- Dhaka has implemented a number of important economic reforms.

On the energy front, Bangladesh is blessed with virtual oceans of natural gas.

- What it lacks is capital and technology to efficiently extract the energy.
- With a little political common sense, the Bangladesh people would be prosperous.

But Bangladesh has a fatal flaw.

- Bangladesh political leaders never miss an opportunity to choose the path that destroys wealth and reduces optimum economic growth.

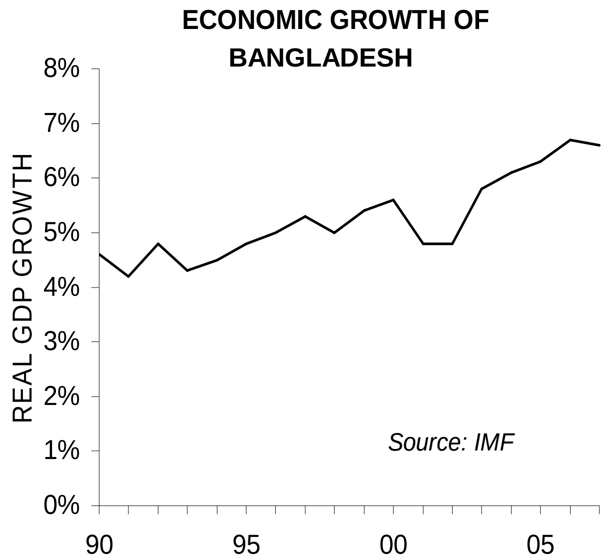
Bangladesh shoots itself in the foot in a variety of ways. These include:

- Political violence, economic nationalism, corruption and political red tape.

Selected Historical Data

Bangladesh	2001	2002	2003	2004	2005	2006
Purchasing Power $B	219	234	253	276	302	330
GDP $B (Nominal)	119	124	130	136	143	151
GDP Growth (Real)	4.8%	4.8%	5.8%	6.1%	6.3%	6.7%
Inflation	1.9%	3.7%	5.4%	6.1%	7.0%	6.3%
Exports $B	6.1	6.1	7.0	8.3	9.3	...
To U.S. $B	0.3	0.3	0.2	0.3	0.3	0.3
Imports $B	9.0	8.6	10.4	12.0	13.8	...
From U.S. $B	2.4	2.1	2.1	2.3	2.7	3.3
FDI held by U.S. $B	-	-	-	-	-	...
held in U.S. $B	0.004	0.001	0.001	0.001	0.001	...
Gross Intl Reserves $B	1.3	1.6	2.5	2.7	2.9	3.5
Savings /GDP	17.2%	23.6%	22.7%	23.0%	20.2%	…
Fiscal Balance /GDP	-5.0%	-4.6%	-3.4%	-3.2%	-4.7%	-4.6%
External Debt /GDP	12.5%	12.8%	13.1%	12.7%	...	...
Current account/GDP	-0.8%	0.3%	-0.4%	-1.2%	-0.3%	0.9%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



The First Impressions.

If you landed in Bangladesh on Monday 13 November 2006, the first impressions one gets is that of another violent, third world basket case.

- Initially at least, the negative factors seem to outweigh the positive elements of the business environment.

Political Unrest.

Take the periodic outbreaks of violence and social unrest at election time. At such times, Bangladesh gives democracy a bad name.

- Politicians regard an election campaign as a chance to set up blockades and resort to violence.
- Trade is paralyzed and large chunks of the economy are brought to a standstill.

Economic Paralysis.

Political parties created a countrywide blockade that inflicted telling blows on the economy.

- Amidst gunfire in the streets, commerce was paralyzed.
- Transports could not move to or from ocean ports.
- 30 ships remained anchored at the outer anchorage of Chittagong port.
- Land, river and ocean ports were all inoperative.
- Exporters of garments, frozen fish and leather goods watched their profits disappear.

Infrastructure Problems.

Eventually commerce returned to normal.

- But one wonders why Bangladesh politicians insist on playing violent games that undermine the business climate.
- But even when there's relative political stability, transport facilities and infrastructure remain a major, structural obstacle to economic development.

Over-Population.

Bangladesh is also overpopulated.

- Some 144 million people, equivalent to about half of the U.S. population, live in an area the size of New York State.

Poverty.

Little wonder that poverty and adult illiteracy still hold the country back.

- Bangladesh per capita income is only U.S. $470 – extremely poor in comparison to South Asia's U.S. $684 average per capita income.
- Adult illiteracy remains at 43% and is slow to fall.

Corruption.

Corruption gnaws away at Bangladesh every day. Too many people in Bangladesh truly believe they have a license to steal.

- In 2005 Berlin-based research organization Transparency International has announced that Bangladesh was the most corrupt nation continuously for the past 5 years.
- Two out of five instances, parents must bribe officials to enroll their children in state schools.
- Every second person needing an X-ray scan in a public hospital must make an illegal payment.

Economic Nationalism.

And at a time when most developing countries are bending over backwards to attract foreign direct investment (FDI), Bangladesh leaders turn their back on over U.S. $4 billion of FDI to develop their largely untapped energy sector.

- Dhaka would rather keep the country poor and self-reliant than share prosperity with another country.

Red Tape.

Commercial red tape is also a big problem in Bangladesh.

- In this regard, Bangladesh is paying a price for not being open to trade.
- It takes 38 official signatures and 57 days to import anything into the country, compared with 24 days for China, 39 days for Pakistan and 43 days for India.

Natural Disasters.

And if man-made disasters were not enough, nature has seen fit to punish the country.

- Floods ravage the Bangladeshi economy once a year.
- But here again, if Dhaka better prepared for likely natural disasters, it could minimize the damage to people and property.

Masking Reality.

Unfortunately, these negative outward impressions of Bangladesh mask some significant progress that Bangladesh has made in recent years.

- However, many potential investors can't see beyond the violence, corruption, shoddy infrastructure, etc.

Upside: Growth.

With so much going wrong, why should investors even consider risking their money in Bangladesh?

- For starters, no matter how bad things get, Bangladesh almost always manages to produce a decent economic growth rate of about 5%.

Goldman's Vote of Confidence.

Goldman Sachs (the world's premier investment bank -- with more money than god) saw this upside and gave Bangladesh a big vote of confidence.

- In December of 2005 Goldman Sachs Group Inc. included Bangladesh in a list of 11 developing countries that have the greatest potential to emulate the long-term economic success expected from China, India, Brazil and Russia.
- In addition, Bangladesh is the 10th most rapidly growing economy among 31 large developing countries with populations above 20 million.
- In a sample of 151 countries studied by the World Bank, Bangladesh's GDP expanded with the least volatility.

Positive Developments.

Goldman's vote of confidence is not just wishful thinking. Bangladesh has done a lot of good things to boost investor confidence and offset some of the negative factors cited above. For instance:

- The World Bank notes 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. The need for food aid has declined.

Nobel Peace Prize for Yunus.

In addition, Muhammad Yunus – the Bangladesh social engineer -- won the Nobel Peace Prize for proving that the poor can be bankable.

- Yunus' Grameen Bank pioneered micro-credits.
- A flourishing micro-credit movement has reached over 15 million families.
- Micro-credit has empowered women through income-generation and decision-making in the family and the community as part of a 3-year poverty reduction program.

Recent Progress.

In recent years Dhaka has implemented 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 and improvement in tax revenue collection.
- The international financial institutions (IFIs) were impressed and responded favorably by boosting foreign aid.

Demographics.

Demographic factors also shine on Bangladesh.

- Population growth has slowed (from 1.6% in 1994/1995 to 1.3% in 2004/2005).

Women are now better educated and are having fewer children.

- Compared with three decades ago, when women, on average, produced six children, fertility rates have dropped below three children. Almost 35% of Bangladeshis are now aged 15 years or younger.
- They will soon enter the workforce. New workers will have fewer dependents to feed than older ones.
- Household incomes and savings will rise, provided there's enough capital to employ the labor productively. (See Bloomberg-on-line, 24 January 2006).

British Law.

While the Bangladesh legal system is rightly criticized for allowing corruption and entrenched special interest groups to undermine the economy, the glass is half full.

- Bangladesh is blessed with a British common law tradition dating back to 1862, when it was part of British-ruled India.
- With some cleaning up, the Bangladeshi judiciary can be made to support a modern economy if only politicians would agree to create one. (See Bloomberg-on-line, 24 January 2006).

Sanctity of Contracts.

The World Bank notes that enforcing a contract is 4% cheaper in Bangladesh than in China, where a creditor ends up losing 25% of the value of the debt in the process of trying to collect it legally.

- In addition, Bangladesh's investor protection standards are far superior to China's.
- The World Bank notes that they're also better than what's available, on average, in rich countries.

Overall Assessment.

An in-depth study of Bangladesh reveals that positive factors more than offset the negative factors. The economic prospects in Bangladesh look promising.

- That said, Bangladesh could do much better. The following case study on the Bangladesh garment industry shows positive as well as negative factors at work.
- An understanding of external factors — especially the China factor – as well as internal factors are crucial to understanding this turbulent industry.
- But in the end, the positive factors outweigh the negative ones.

A CASE STUDY: BANGLADESH GARMENT INDUSTRY

Introduction.

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.

Port of Chittagong.

This is Bangladesh's main port for trade and commerce.

- The port is continually racked by delays and strikes, forcing exporters to hire expensive air-cargo space to get orders to the 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 Fibre Arrangement (MFA), which guaranteed quotas for $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. and 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 Price.

Bangladesh garment makers were afraid they couldn't compete against China.

- Why?
- For a 6 year period – 1998 to 2004 – China had price deflation in textiles and other low-end manufacturing.
- The China price was more and more unbeatable.

China's Overnight Success.

Some people said, "Don't worry, it will take China a long time to capture new market shares after MFA expires on 01 January 2005.

- Well, guess again.
- In the first quarter of 2005, China's cotton shirt sales in the U.S. market rose 1,250% from the same period in 2004.
- China's cotton trouser sales in the U.S. market rose 1,500% from the same period in 2004.

Bangladesh on the Brink.

Bangladesh appeared to be on the verge of losing a key industry.

- The garment industry in Bangladesh accounted for 80% of its exports and had lifted 13% of the country's poor households out of poverty.

China Corners the Global Textile 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.

Fertile Ground for Extremism.

Bangladesh – a poor, overpopulated, corrupt country with rising income disparity -- is always fertile ground for extremism.

- But now the extremists had an issue they could exploit.
- Violent extremists in Bangladesh were blaming the U.S. for globalization and the end of MFA.
- Violent extremists in Bangladesh were planning to exploit this ill-advised but pervasive perception of social and economic injustice.
- Lack of jobs in country forces the young men to go abroad to earn a living. Where are these young men going? Middle Eastern countries such as Saudi Arabia. These young men could

import the extreme version of the Islam as they return home. Overtime, this could tip the scale of the relatively moderate Muslim country to an extreme one.

Great Debate.

Would terrorism break out in Bangladesh?

- One “supply” school of thought said the Bangladesh government had beefed up its “capacity” – (or supply of intelligence and counter-violence) to combat terrorism.
- A competing “demand” school of thought said capacity building – while necessary – was not sufficient. This school said the socio-economic demand for violence was rising. Frustrated people were at risk of buying the propaganda line of violent extremists. If capacity building was a silver bullet, there’d be no terrorism in Israel. God knows, the Israeli military doesn’t have a shortfall in its capacity to combat terrorism. Grievances were rising.

Rising Terrorism.

Who was right? Was the terrorist threat up or down?

- In August of 2005, the worst fears of the demand school were played out.
- 500 bombings occurred in Bangladesh in just one month.

China to the Rescue.

But at a time when things looked especially bleak, things were changing in the Chinese countryside that would reverberate in every nook and cranny in the international garment industry.

- These developments would also reduce the demand for violent extremism in Bangladesh.

Rural Unrest in China.

Social unrest was rising in the Chinese countryside.

- In 2005 there were 87,000 public disturbances in China.
- That’s a 13% rise over 2004.

Urban Migration.

Frustrated Chinese farmers were pouring into Chinese coastal cities looking for work in the garment factories.

- An oversupply of Chinese workers in the cities pushed Chinese wages below Bangladesh wages.
- Most of these ex-farm workers stayed in the cities.
- How’re you going to keep them down on the farm after they’ve seen Shanghai?

Beijing’s Response.

In September 2005 – one month after 500 bombings in Bangladesh – Beijing announced that the agricultural tax – that dates back over 2,000 years – would be eliminated.

- What was the impact of abolishing the agricultural tax?
- At first glance, eliminating the agricultural tax seemed like a good idea to Beijing.
- It was now more affordable for Chinese farmers to stay on the farm now that their taxes were gone.
- That also reduced at least some of the social unrest in the countryside.

Be Careful what you Wish for.

But there were unintended consequences for Beijing.

- Improving life in the rural areas of China meant fewer migrant workers leaving the countryside looking for work in urban garment factories along the PRC coast.

Falling Supply, Rising Demand.

So imagine you're running a garment factory in Shanghai.

- You now have a shortfall of workers knocking on your door.

Rising PRC Wages.

How are you going to attract more workers?

- You have to boost wages.
- And in 2005 there was a double-digit rise in Chinese wages.
- That just didn't happen in the textile industry.
- It happened across the board in Chinese low-end manufacturing.
- As a result, China's manufacturing competitiveness fell in 2005.
- China was no longer the low cost producer.

Godsend for Bangladesh.

Who benefited from rising prices in China?

- Garment factories in Bangladesh.
- Garment workers in Dhaka earn 39 U.S. cents an hour, while the hourly wage for sewing and stitching in coastal China is 88 cents.
- In Bangladesh orders started to soar at its garment factories.
- Thanks to China's rising prices, Bangladesh garment exports rose by $500 million in 2005 over 2004.
- UN fears of a million Bangladesh garment workers being laid off never happened.

Falling Demand for Violence.

Now imagine you're a recruiter for a violent extremist group in Bangladesh.

- Bashing the U.S. and globalization has lost its punch.
- Jobs and incomes at Bangladesh textile factories are rising.
- Globalization is wonderful.
- The free market has marginalized you.
- The demand for violent extremism has therefore fallen.
- Nobody believes your propaganda.

Final Word.

That is not in any way meant to minimize the terrorist threat in Bangladesh.

- In fact, the U.S. State Department continues to stress the threat posed to American citizens and organizations by Jama'atul Mujahedeen Bangladesh (JMB), blamed by the government in Dhaka, the capital, for a spate of suicide bombings since Nov. 29 that have killed at least 17 people.
- The group, known as JMB, has called for the establishment of an Islamic state in Bangladesh, where 83% of the population is Muslim and 16% Hindu.
- The point is that the terrorist threat in Bangladesh would be far worse if a million garment factory jobs were lost, as was once feared.

CHRONICLES OF ECONOMIC HIGHLIGHTS

10 July 2006

Indian attempt to increase energy security by diversifying energy imports has fallen hostage to Bangladeshi economic nationalism.

- Tata Group (India) halting attempts to persuade Dhaka to co-develop/co-produce mineral and energy reserves in neighboring Bangladesh.

Economic Advisor's Comment:

Oct 2004: Tata Group more optimistic, announced U.S. $3bn investment proposal to meet Bangladeshi concerns.

- Integrated development included an open-cut coal mine, fertilizer plan, steel facility and two thermal power stations.
- Electricity production would have been shared between Bangladesh and India.

Dhaka failed to respond to an improved 30 June offer, so Tata began looking for business elsewhere.

- Decades of bickering rendered bilateral cooperation in industry and energy impossible.
- In particular, proposals to export Bangladeshi gas via pipeline to India have foundered on Bangladeshi economic nationalism.
- Dhaka fears India is stealing "crown jewels."

01 November 2006

Violence is giving way to more normal economic activity.

- Chittagong (SE port): Economic lifeline and main gateway for exporting/importing; now back in operation.
- Stock market operational and private cars and buses back on roads.
- Millions stranded in countryside returning to cities.

Economic Advisor's Comment:

Before crisis: Bangladesh starting to turn economy around.

- Replacing China as low cost textile producer.

During crisis: Serious distribution bottlenecks.

- Chittagong operations at standstill.
  - Overloaded ports: 19K containers stockpiled at port with 13K container capacity.
- Textile exporters unable to produce or deliver goods.
  - Imported raw materials not available.
  - Highways closed from Dhaka to Chittagong.

Way Ahead: Bangladesh global garment suppliers must win back foreign buyers who:

- Demand just in time inventory.
- Dislike political unreliability of Bangladesh supply chain.

INDIA

· CHAPTER 2 ·

Leif R. Rosenberger

Executive Summary.

India's economy is growing at its fastest pace in 18 years.

- Credit rating agencies have upgraded India's financial standing.

However, India's high growth rate is unsustainable.

- Economy is overheating, with aggregate demand outpacing aggregate supply.
- Inflation is over central bank limit and actually understates over-heating.
- Excessive demand is showing up in current account deficit.

One option to curb inflation is to raise interest rates and slow down growth.

- But higher interest rates would simply attract capital inflow.
- Capital inflow has already made rupee too strong and is hurting exports.

A better idea would be to increase aggregate supply (potential GDP).

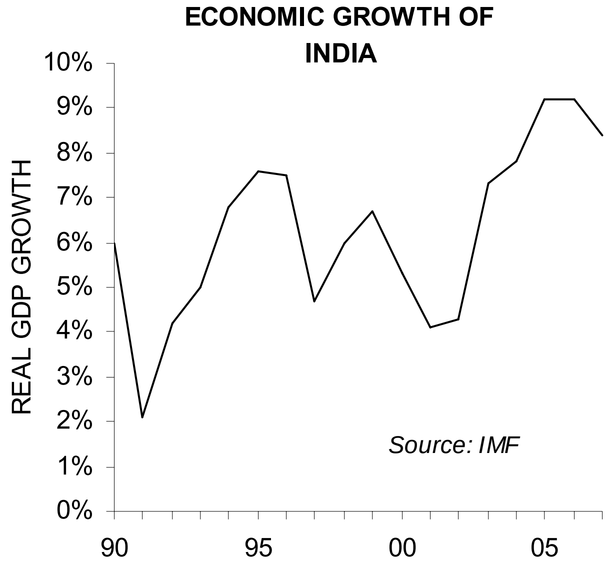
- A shortfall of aggregate supply is visible in bottlenecks throughout the country.
- India desperately needs to upgrade its infrastructure.
- It also needs to speed up economic reforms.
- India needs better public services, education, health, job skills and labor laws.
- Reforms would help half of India's 1.1 billion who live on less than $1 a day.

However, India faces significant fiscal constraints that will limit what it can do.

Selected Historical Data

India	2001	2002	2003	2004	2005	2006
Purchasing Power $B	2,587	2,744	3,004	3,337	3,730	4,159
GDP $B (Nominal)	106	110	114	119	124	131
GDP Growth (Real)	4.1%	4.3%	7.3%	7.8%	9.2%	9.2%
Inflation	3.8%	4.3%	3.8%	3.8%	4.2%	6.1%
Exports $B	43.4	49.3	57.1	75.6	95.1	...
To U.S. $B	3.8	4.1	5.0	5.8	8.0	10.1
Imports $B	50.4	56.5	71.2	97.3	134.8	...
From U.S. $B	9.7	11.8	13.1	15.4	18.8	21.8
FDI held by U.S. $B	1.030	1.105	1.344	1.563	1.592	...
held in U.S. $B	0.258	0.227	0.352	0.630	1.355	...
Gross Intl Reserves $B	49.0	76.1	113.0	141.5	151.6	194.6
Savings /GDP	23.4%	24.5%	24.1%	25.2%	29.1%	...
Fiscal Balance /GDP	-10.0%	-9.5%	-9.4%	-9.1%	-8.8%	-8.5%
External Debt /GDP	93.0%	96.2%	98.1%	110.8%	...	...
Current account/GDP	0.3%	1.4%	1.5%	0.1%	-0.9%	-2.2%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



O n a R o l l .

- India's economy is growing at its fastest pace in 18 years.
- Government expects the economy to grow 9.2% this FY (ends 31 March).
- India is 2nd fastest growing Asian economy, 2nd only to PRC.

D r i v e r s .

While drought hurt agricultural production, the service sector and manufacturing were major engines of growth in 2006.

- While India is now an increasingly important player in the IT sector of the global economy, India's economy as a whole is less reliant than many others on exports for growth.

Domestic demand is important for promoting economic growth in India.

- Private consumption is by far the largest contributor, with a stable share over the last 25 years and a large contribution to GDP growth.

M a n u f a c t u r i n g H u b .

In 2Q 2006 India's manufacturing enjoyed its fastest growth since Delhi started collating quarterly data in June 2000.

- That's promising since New Delhi needs manufacturing firms to soak up workers from country's inefficient, and sprawling, agricultural sector.
- Finance Minister Chidambaram says "the key" to making India a strong economy is to make India a "manufacturing hub."

F i n a n c i a l U p g r a d e .

India's financial status is also improving.

- 30 Jan: Standard & Poor's (S & P) upgraded India's government credit rating.
- India finally regained full investment-grade status after over 15-year hiatus.

- S & P followed lead of Moody's and Fitch in removing speculative stigma.
  - Fitch raised India's rating to investment grade in August 2006.
  - Moody did so for its foreign currency borrowings in January 2004.

Vindication for Reformers.

- Upgrade is symbolic for government reformers:
  - May 1991 balance of payments crisis: S&P downgraded debt rating to junk.
- This S & P upgrade:
  - Reflects India's improving macroeconomic stability and strength.
  - Opens country's capital market to wider investor base.
  - Makes it easier for Indian firms to borrow more cheaply across world.

Trade Liberalization.

Credit rating agencies also applaud how much India has opened up its trading system.

- Tariffs fell from 50% in 1990 to 20% in 2003.
- However, current average is still high when compared to ASEAN-5 average.

Mixed Bag.

Despite the upgrade, India is still a financial mixed bag:

- Good News: Growth & foreign reserves soaring and external debt is low.
  - On the home front, the budget deficit – while still high – is moving in the right direction.
  - Budget deficit has fallen from 10.1% in 2001-02 to 7.5% of GDP in 2005-06.
- Bad News: India's public finances are still shaky.
  - Public debt to GDP ratio is 85% -- over 3 times higher than China's.
  - Maastricht criterion for fiscal stability is public debt under 60% of GDP (and 3% for budget deficits).
  - India also remains vulnerable to fiscal backsliding.
  - The fiscal improvement reflects high cyclical growth rather than structural changes.

Overheating.

In addition, the strong economic growth that India is experiencing is unsustainable without policy changes.

- The economy is overheating.
- Rising aggregate demand outpacing inelastic aggregate supply.
- Over-heated economy is performing above non-inflationary growth potential (capacity).
- 6.6% inflation is over 5.5% (upper limit of central bank tolerance).
- High asset prices and persistently high current account deficit.

Rising Current Account Deficit.

Worse still, the central bank target actually understates over-heating.

- Excessive demand is showing up in current account (trade in goods & services).
- 1st half of 2004, surplus almost 4% of GDP.
- 3Q 2006: Excessive demand pushed deficit over 3% of GDP.
- Excluding remittances, current account deficit running close to 5% of GDP.

- That's a larger current account deficit minus remittances than during balance of payments crisis in early 1990s.

Bottlenecks.

Supply shortages limit economical capacity to create goods/services.

- Bottlenecks are occurring due to poor infrastructure (roads, ports, power).
- The banking system is inadequate (over-priced credit).
- The labor market is too tight.
- India has too many poor schools and not enough educated, skilled workers.

Needs for Infrastructure Upgrade:

India has estimated that it will take U.S. $320 billion over the next five years to expand and upgrade physical infrastructure. For instance India needs:

- $75bn in the power sector.
- $25 bn in telecommunications.
- $50 bn in airports, seaports and roads.

Infrastructure.

Delhi is responding, with 25% increase in infrastructure spending, which is boosting economy.

- Infrastructure spending is aimed at attracting more foreign direct investment (FDI) and lifting manufacturing to 25% of economy from current 17%.
- Infrastructure spending spurs demand for steel, cement and electricity.
- India spends 1/7 of China's $150 billion investment in public works each year.
- If India is growing at 8% with poor infrastructure, then with great infrastructure it can grow at 12%.

Poverty Reduction.[1]

In addition, rural physical infrastructure is necessary for rapid poverty reduction.

- Rural physical infrastructure covers roads, electricity, irrigation, telecommunications and much more.
- The impact of various types of infrastructure on rural economies and poverty reduction is maximized when provided in unison.

UN Study.

A UN study says that in South Asia, only 65% of the rural population lives within two kilometers of an all-weather road, far less than the 95% in East Asia.

- Only 43% of the population has access to electricity, far less than the 88% in East Asia. The situation in rural areas is much worse.
- The study concluded that rural roads and electricity improvements had a significant impact on poverty reduction.
- In India, a million rupees spent on roads led to 7 times the poverty reduction as a million rupees spent on specific anti-poverty programs.

The logic is simple:

- Roads are the arteries that go where poor people live, improving their lives in concrete, immediate ways.

Rising Rupee.[2]

Another challenge for the government is the Indian rupee, which has risen against the U.S. dollar by nearly 10% since late 2006.

- The rupee is now worth about 40 rupee to the dollar.
- This strong rupee is over-pricing India's exports and worsening the current account deficit cited above.
- This poses a dilemma for Indian policymakers.

Why is Rupee Rising?

Main reason for rising rupee's since late 2006 has been a flood of capital inflow.

- Foreign companies are attracted to India's strong economic growth and large domestic market.

Rising FDI.

Incoming foreign direct investment (FDI) in 2006-2007 FDI rose to $16 billion -- almost three times the previous year's figure.

- More than half of these inflows arrived in the final four months of the fiscal year (December 2006-March 2007).[3]

Rising Stock Market.

Foreign investors are also pouring money into India's booming stock market.

- Between 2003-2004 and 2006-2007, the net annual inflow of funds by foreign institutional investors (FIIs) averaged U.S. $8.1bn.
- Trends during the first five months of 2007 indicate that this flood is continuing, with net FII inflows amounting to U.S. $4.6bn.
- Another large source of foreign-exchange inflows has been remittances from the huge number of Indians working overseas temporarily.
- Such remittances amounted to a colossal U.S. $19.6bn in April-December 2006, a 15% year-on-year increase.

Robust Reserves.

Buoyant export growth has also built up India's foreign-exchange reserves.

- India now has about $180 billion in foreign exchange reserves.
- That provides a nice financial cushion to cover 11 months of import cover.
- India's relatively small foreign debt also cushions any blow that may come its way.

Dutch Disease.[4]

India's central bank deputy governor, Rakesh Mohan, recently referred to the effects of the rupee's appreciation as a case of "Dutch disease."

- The "Dutch disease" refers to episodes where large inflows of foreign exchange leads to appreciation of the currency, undermining a country's traditional export industries.

Export Downturn.

There is already evidence in India of an export downturn in a number of sub-sectors.[5]

- In the apparel sector -- one of India's major export industries -- the strong currency has eaten into the value of exports to the U.S., which declined by 3.5% year on year in January-April 2007.

- During the same period, apparel exports to the U.S. by China, India's most important competitor, rose by 57%.
- Moreover, for India the decline marks the reversal of a positive trend--apparel exports to the U.S. rose at an average rate of 21% a year after import quotas were phased out at the beginning of 2005.

Tighten Monetary Policy?

Policymakers often opt for higher interest rates to dampen inflation.

- But in the Indian context, higher interest rates would only worsen matters by attracting even more portfolio capital inflow, thus strengthening the exchange rate and hurt exports.

Increase Aggregate Supply.

A better approach to dampen inflation is to boost aggregate supply by speeding up reforms. In this regard, India desperately needs:

- Better infrastructure, public services, education, health, skills, labor laws.
- Reforms help half of India's 1.1 billion who live on less than $1 a day.

CONCLUSION

India's economy is on a roll. It is growing at its fastest pace in 18 years. Credit rating agencies have upgraded India's financial standing. However, India's high growth rate is unsustainable. The economy is overheating, with aggregate demand outpacing aggregate supply. Inflation is over central bank limit and actually understates over-heating. Excessive demand is showing up in current account deficit. One option to curb inflation is to raise interest rates and slow down growth. But higher interest rates would simply attract capital inflow. Capital inflow has already made rupee too strong and is hurting exports.

A better idea would be to increase aggregate supply (potential GDP). A shortfall of aggregate supply is visible in bottlenecks throughout the country. India desperately needs to upgrade its infrastructure. First rate physical infrastructure reduces poverty in two ways. It promotes growth, which generally benefits the poor. And it directly benefits the poor by improving their incomes and the quality of their lives. Since most of the poor in countries of South Asia still live in the rural areas, rural infrastructure is the key to rapidly reducing poverty.

CHRONICLES OF ECONOMIC HIGHLIGHTS

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.

26 September 2005

On 26 September Indian Finance Minister P. Chiadambaram told the IMF that India's economy expanded 7.1% in 2Q 2005.

- That's the fastest Indian growth in 4 quarters.
- India is now the 2nd fastest growing major economy after China.
- Corporate profits are rising, particularly in IT sector.
- The stock market is buoyant with foreign capital continuing to flow into the country.
- However, this benign economic climate is fostering complacency in Delhi.

Economic Advisor's Comment:

Despite this impressive short-term economic performance, a left-leaning political coalition undermines India's economic strategy.

- Prime Minister Singh's government would collapse without the support of the communists.

Not surprisingly, the communists have tied Singh's hands by making him adhere to their outdated agenda:

- Efforts to privatize state owned enterprises have been killed.
- Legislation that would partially relax India's crippling rigid labor laws have been gutted.
- Proposals to tackle chronic electricity supply shortages and increase much-needed investment in roads and airports are in limbo.
- Efforts to cut subsidies have been shelved.
- Plans to raise foreign ownership limits in insurance and telecommunication are failing to gain traction.
- Action to reduce India's bloated budget deficit (which is 9% of GDP) is on hold.

In short, economic complacency and left-leaning political realities prevent Indian Prime Minister Singh from creating a solid foundation to sustain even stronger economic growth over the long term.

09 November 2005

As Sec Treasury Snow completes his 4-day visit to India, his message to New Delhi is clear – India needs to accelerate the pace of its economic reforms.

- Mr. Snow cited the need for financial reforms as well as legal reforms.

On the financial front, Mr. Snow addressed India’s pressing need to upgrade its shoddy infrastructure.

- Liberalization of the financial sector would help mobilize foreign capital.
- More foreign capital would help finance the $150 billion in upgrades for ports, airports, roads and railway networks.
- On the legal front, Mr. Snow argued that India’s backward system repels foreign investors.
- India’s courts are clogged, presenting a risk to investors who face delays of several years on earning a return on their investment if they face a legal challenge.
- Mr. Snow raised the idea of an arbitration system to speed up the process of dispute-settlement.

Economic Advisor’s Comment:

At first glance, India’s economy is on a roll.

- India enjoys an 8.1% growth rate, positive business sentiment, balanced domestic versus foreign demand, healthy foreign exchange reserves, and a buoyant stock market.

However, this economic success has created complacency.

- Sec Treasury Snow is correct in his concern that India is losing the will to reform.
- In addition, the oil for food scandal is undermining the Congress Party’s credibility.

The Congress Party’s left-leaning coalition has also tied Prime Minister Singh's hands and made him adhere to an outdated agenda:

- In August the government resisted privatization of 13 state owned companies.
- New Delhi also failed to relax India's crippling rigid labor laws.
- Decisive action to reduce India's bloated fiscal deficit (which is 7.7% of GDP) is on hold.

To sum up, complacency, corruption and a left-leaning coalition weaken the foundation to sustain long term economic growth.

21 November 2005

India’s Communist-backed government presented a plan on 17 November for a sweeping liberalization of India’s rules for foreign direct investment (FDI).

- This is the first time that New Delhi has ever seriously undertaken such a specific sector review of FDI.
- If implemented, the plan would kick-start long-stalled economic reforms.

If the new rules get approved, they would allow FDI to come in by the so-called “automatic route.”

- New FDI in this plan would circumvent a cumbersome approvals process overseen by Ministry of Finance’s Foreign Investment Promotion Board.

Economic Advisor’s Comment:

This FDI plan would allow 100% FDI in a range of sectors where fresh capital is desperately needed.

- These sectors include airport construction, the exploration and mining of coal and diamonds and the cultivation of coffee, tea and rubber.

- Plans to open up the retail sector should be ready in 3 months.

Energy infrastructure is also one of the new strategically important sectors being considered for FDI.

- FDI in the energy sector would harness international capital for the proposed gas pipeline from Iran to India via Pakistan.

Minister of Commerce and Industry Kamal Nath proposed the plan and Prime Minister Singh backed it.

- However, the FDI plan was sent back to a panel of ministers for further consideration.

The FDI plan will trigger lively debate in the cabinet, with no guarantee of approval.

28 November 2005

The India Economic Summit – a 3-day gathering of high-level foreign investors exploring business opportunities in India -- opened on 27 November in New Delhi.

- Attendees are addressing how India can emulate China's success and expand its economic growth faster.

Finance Minister P. Chidambaram argues that the Indian economy is capable of generating economic growth larger than its 7% pace for 2005.

- Mr. Chidambaram stressed that India must open up its economy to more foreign competition.

Economic Advisor's Comment:

At first glance, India's economy looks impressive.

- India enjoys strong economic growth, favorable demographic trends and vibrant, innovative, high-quality investment opportunities.

India attracted $5.5 billion in foreign direct investment (FDI) in 2004-5, an increase of 18% over the previous two years.

- However, this $5.5 billion figure is less than 10% of the inflows into China.

Foreign investors find the Indian infrastructure unattractive.

- To boost economic growth, India needs $150 billion over the next 10 years to invest in better roads, ports and electricity generation.

To make matters worse, India's combined central/state budget deficit of over 8% of GDP limits Delhi's ability to spend on this much needed infrastructure development.

- Key economic reforms (such as better tax collection, privatization and lower subsidies) are needed to alleviate the fiscal burden.
- The high budget deficit also crowds out spending on health care and education, which worsens the prospects for 25% of the Indians who live below the poverty line.

Finally, foreign investors still face massive amounts of red tape, notwithstanding Delhi's plans to open new sectors of the economy to FDI.

- Not surprisingly, the World Bank's International Finance Corporation ranks India 116 out of 155 countries (between Indonesia and Albania) in terms of the ease of doing business.

12 January 2006

China and India signed an energy agreement in Beijing on 12 January.

- The deal was signed by Mani Shankar Aiyar, India's petroleum minister, and Ma Kai, the head of the National Reform and Development Commission, China's chief economic planning and energy ministry.

The world's two fastest growing energy consumers set aside long-standing rivalries and agreed to co-operate in securing crude oil resources overseas.

- The agreement, aimed at preventing the two nations' competition for oil assets pushing up prices, symbolizes their increasingly assertive role in global energy politics.

Economic Advisor's Comment:

India is more dependent on oil imports than China.

- While China only imports about 50% of its oil, India imports 70% of its oil.
- India's import dependency will increase to about 85% in 15 years.

New 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.

Skeptics argue that Chinese companies are unlikely to share their real business plans with Indian rivals, especially as they have been able to outbid them in the past.

- The Sino-Indian bidding war over PetroKazakhstan showed that India and China can be fierce competitors.
- In addition, India's Oil and Natural Gas Corp (ONGC) recently lost out to Chinese rivals in the race to acquire fields in Angola, Nigeria and Ecuador.

However, Chinese and Indian energy companies have started to cooperate as well.

- In fact, a recent joint Sino-Indian purchase of a stake in a Syrian oil field by ONGC and the state-owned China National Petroleum Corp could set a pattern for future cooperation.

India's Aiyar hails this agreement as a model that will help end the "mindless rivalry" that characterized many competitive bids.

- Oil executives said co-operation between China and India could benefit international energy companies by reducing the ferocity of the bidding.

Under the agreement, Chinese and Indian oil companies will establish a formal procedure to exchange information about a possible bid target, before agreeing to co-operate formally.

- Their memorandum of understanding also covers possible co-operation across the energy industry, from exploration to marketing.

06 February 2006

India has launched its ambitious program to tackle rural poverty.

- National Rural Guarantee Scheme (scheme) promises some 60 million rural households a level of financial protection through guaranteed work or unemployment benefits.
- One member from each rural household is guaranteed 100 days of work each year.
- First phase of program will cover 200 of country's poorest and least developed districts.

Economic Advisor's Comment:

At first glance, India's economy is shining.

- At recent World Economic Forum, Indian officials touted India as 2nd fastest growing economy in the world.

However, India's economy is not shining for everyone in India.

- In fact India's poor – especially in rural areas – are making little progress.
- More than a third of India's one billion people live on less than $1 a day.

Scheme does not resolve many underlying reasons for that poverty.

- Scheme provides little access to decent education and health care.
- New Delhi is trying to address those separately.

Scheme will not lift people out of poverty.

- Work will be manual labor, not anything that develops new, marketable skills.

However, scheme could potentially ease burden of India's poorest sector by helping them survive crises.

- If it works, guarantee of work should act as a safety net for India's most vulnerable—they would have a basic safeguard when a humanitarian disaster hits.

Implementation of scheme is another big concern.

- India has a long-standing struggle with corruption and bad governance.
- Scheme will tap into India's network of local councils to decide who is eligible.
- It's unclear how transparent it will be and how much of the money will really reach the poor.
- Some of India's poorest states are also those with the worst reputation for governance.
- Precisely where there is greatest need is where scheme's effectiveness is most in danger.

20 March 2006

Indian PM Singh is promoting plans to open up India's capital markets.

- India is drawing up an ambitious plan to remove all remaining capital controls on the partially convertible rupee.
- Singh says India is ready to loosen restrictions on capital-account convertibility -- flow of money in and out of country for investments.
- At present, India allows its currency to be convertible only on trade or current account.

Economic Advisor's Comment:

PM Singh's plan is latest signal of rising confidence in the economy.

- PM Singh says India's economic position internally and externally is far more comfortable.
- India has more than $140 billion in foreign-exchange reserves and 8% GDP growth.
- India is stable enough economically to absorb the sudden outflows of money that can occur when a country relaxes foreign-exchange restrictions.

PM Singh is trying to free up the international flows of capital in order to increase foreign investment in the subcontinent.

- India needs around $70 billion in foreign direct investment over next five years to lift its economic expansion rate to a target of more than 9% a year.

New plan would give international investors, foreign companies and expatriates more confidence that they will be able to get proceeds from Indian investments.

- When a country is partly closed there is always fear about getting money out.

New plan would send a clear message to ratings agencies that economic reforms are moving forward and tough decisions will be taken.

- Allowing full convertibility of the rupee would eliminate an important obstacle to India's integration with global economy.

19 April 2006

Standard & Poor (S&P) raised India economic rating outlook from stable to positive.

- Change to a positive outlook signals that S&P may raise India to BB+ rating (the highest non-investment grade) to an investment grade.

In addition, S&P raised outlook on Export Import Bank of India, Indian Railway Finance Corp and Power Finance Corp to positive from stable.

- State Bank of India and Industrial Credit and Investment Corporation of India (ICICI) Bank Ltd., the two top national banks, also had their rating outlook revised to positive, along with Industrial Development Bank of India, Bank of India and Indian Overseas Bank.

Economic Advisor's Comment:

India economic rating outlook was raised because of government efforts to reduce its debt burden and prospects of higher economic growth.

- S&P change follows renewed government pledges to narrow budget deficit and debt and plans to allow rupee to trade more freely against other currencies.

Combined state and central governments deficit is expected to fall to 8% of GDP in 2006 from 10% in 2002.

- Efforts to improving tax collection should result in higher revenue.
- Growth at highly taxed industries and services companies will help boost revenue, rating company said.

S&P upgrade is a vote of confidence on Indian economy with overseas investors noticing things are moving in the right direction.

- Upgrade is a reaffirmation of India growth prospects.
- Pace of economic growth may have accelerated to 8.1% in 4Q 2006 from a 7.5% in 2005.
- Prime Minister Singh is aiming for as much as 10% growth in next two to three years.

S&P upgrade will also help India reduce borrowing costs for Indian companies.

- This in turn will make economy more attractive for overseas investors.
- However, India still needs to further open up economy and improve infrastructure such as roads, ports, irrigation networks, power generation and drinking water facilities.
- Further liberalization of economy and infrastructure improvements will help economy sustain an upward trajectory.

Such reforms coupled with continued fiscal consolidation will help India achieve investment grade over time.

- On the other hand, if fiscal consolidation stalls or reform agenda derails, outlook could be revised back to stable.

28 April 2006

Asia Development Bank (ADB) warns that Asia is facing an unemployment crisis that could lead to social instability, political strife, policy making paralysis, and capital flight.

- ADB Chief Economist Ifzal Ali says problem is slow pace of job creation even in countries with relatively high growth rates like India.
- Almost 1.9 billion Asians still survive on less than $2 a day - they are either unable to find work or earning too little when they do.
- Ali says Indian economic growth could fall 7% - 8% to 3% - 4% very easily within five to six years if unemployment and underemployment are not addressed.

Economic Advisor's Comment:

ADB report resonates with Indian Prime Minister Singh who says rising Maoist insurgency in India is "directly related to underdevelopment."

- Singh now identifies Maoists as the single greatest threat to Indian national security.

His counter-insurgency combines zero tolerance of terrorism with a robust socio-economic strategy that reduces demand for violence.

- Aim is to curb pervasive perceptions of social and economic injustice and address legitimate grievances which violent Maoists exploit.
- Singh's National Rural Employment Guarantee Scheme offers one member of each household a number of days of paid work a year.

Singh says Indian companies that fail to compensate communities displaced by their industrial activities are a main cause of Maoist militancy.

- Made it clear to the business community that it must do more to create opportunities for at risk social groups most likely to be recruited by Maoists.
- Indian government is considering whether it should require private sector companies to reserve jobs for disadvantaged groups.

01 June 2006

Economic growth accelerated to robust 9.3% in 1Q 2006 with Gross Domestic Product (GDP) up 8.4% in fiscal year (FY) ending March 2006.

- Strong farm production and vibrant consumer spending drove 1Q 2006 economic expansion.

Strong economic performance is keeping pace with rapidly growing Chinese economy.

- Like China, commodity markets in India are showing strain of accelerating growth.
- India is importing more crude oil, which is pushing up prices.

India needs strong and sustained economic growth to lift underclass out of poverty.

- Over 1/3 live below poverty line, making India home to over 1/3 of world's poor population.

Economic Advisor's Comment:

Despite strong growth, investor concerns rising over large Indian trade deficits.

- Soaring fuel prices and increasing frequency of capital good and industrial raw material imports continue to increase trade deficit.

Deficit reached record-breaking $39.6 billion in last 12 months (as of 31 March).

- April deficit ($4.2 billion) suggests trade gap will continue to widen in 2006-07.

JP Morgan analysts expect deficit to hit all-time high of almost $70 billion (8.3% of GDP) in current FY.

- India has large foreign reserves to cover trade gap (temporarily).

Fear of high trade deficit contributed to 5% drop in Indian stock market on 31 May.

- Sharp sell-off on 31 May a continuation of mini-market meltdown that began 12 May.

Rupee (Indian currency) fell to 3-year low against U.S. dollar on 31 May.

- JP Morgan analysts predict rupee will fall to 47.5 (compared to U.S. dollar) by end of 2006.

Poor quality of physical infrastructure undermines New Delhi efforts to sustain strong economic growth.

- Dilapidated roads, seaports and airports constrict transport of goods, depriving needy areas of business activity and new investment.

High budget deficit limits New Delhi ability to spend on critical infrastructure development and social services.

- Combined central/state budget deficit is over 8% of GDP.
- Budget deficits over 3% of GDP fail to meet EU Maastricht criterion for financial stability.

Several industries remain partially closed, shielding from foreign competition, but also preventing fresh capital.

- To sustain strong economic growth, India needs to hasten market reform.

26 June 2006

India is rebuffing Chinese commercial efforts to penetrate Indian markets.

- Huawei, PRC telecom firm, is stalled in efforts to spend $164 million on new Indian facilities.
- New Delhi has rejected Huawei's application to obtain a trading license (to sell in PRC domestic market) at least 9 times since early 2003.

Other Chinese companies that are frustrated in efforts to invest in India include:

- China's ZTE Corp.'s drive to expand its telecom business in India has run into security roadblocks.
- Hong Kong port-operating unit of Hutchison Whampoa Ltd. also has been unable to win security clearance for investments.
- Shenzhen CIMC-Tianda Airport Support was turned away from installing air bridges in several Indian airports because of security concerns -- despite an offer that was at least 40% lower than only other bid.

Economic Advisor's Comment:

At first glance, Sino-Indian economic ties are on upswing, with two-way trade expected to hit $20 billion in 2007, a year ahead of the original target date.

- Ironically, Indian firms are expanding aggressively in China and apparently encountering few roadblocks. Initially, Chinese telecom firm Huawei also enjoyed a warm market reception in India.
- In 2005, it recorded $120 million in local sales, up about 80% from the year before.
- But then a sharp debate developed within India's bureaucracy -- one group embraced.
- PRC firms have run smack into Indian national-security concerns.
- Indian fears tripped up Chinese forays in telecommunications and infrastructure – sectors where India generally welcomes foreign capital and expertise.

Rival companies are squeezing Huawei and other PRC firms out of lucrative Indian markets.

- In October, U.S. based-Cisco announced it was investing more than $1 billion in India.
- The same month, Cisco broke ground for a new research lab here just 10 kilometers from where Huawei wants to build its facility.

India's concerns mirror fears in the U.S. and Europe about China's corporate ambitions in the West and Africa, and its growing influence overseas.

- A year ago, an $18.5 billion bid for Unocal Corp. by China National Offshore Oil Corp., or Cnooc, stoked a political backlash in the U.S. that helped prompt the Chinese to back down.

Moreover, after decades of relative separation, India is experiencing China's economic might firsthand.

- Chinese goods from refrigerators to Hindu statues flood Indian domestic markets.

07 July 2006

Chinese and Indian officials re-open Nathu La Pass.

- Has been closed since Sino-Indian border war (44 years ago).
- Links Indian NE state of Sikkim and Chinese Tibet.

Pawan Chamling, chief minister of Indian Sikkim state said:

- This is a “historic day…re-establishing contact…that started centuries back between our two civilizations.” Additionally, this is “a win-win situation for both countries."

Economic Advisor’s Comment:

Sino-Indian economic ties were dogged by suspicion until surging trade and economic ties pushed political disputes into backseat.

- While trade through Nathu La will be duty free, Indian exports are limited to mostly food items (29 commodities approved).
- Chinese traders restricted to bringing in 15 types of goods, including goat and sheep skins, wool and herbs.
- Pass was thoroughly modernized with customs facilities, bank, Internet café and ATM.

This is the latest in a string of measures to improve ties and end over 4 decades of mutual suspicion.

- Last week, Beijing linked Tibet capital, Lhasa, with railway - another Chinese move to modernize the isolated region.

However, Sino-Indian relations are not totally tension-free.

07 July 2006

More Sino-Indian economic strains: India rebuffs Chinese commercial efforts to penetrate markets.

- Huawei (PRC telecom firm) efforts to spend $164 million on new Indian facilities stalled.
- New Delhi rejected Huawei application for trading license (to sell in PRC domestic market) at least 9 times since early 2003.

Other Chinese companies frustrated in efforts to invest in India include:

- Security roadblocks hinder ZTE Corp in the drive to expand telecom business in India.
- Hong Kong port-operating unit of Hutchison Whampoa unable to win security clearance for investments.
- Shenzhen CIMC-Tianda Airport Support turned away from installing air bridges in several Indian airports because of security concerns -- despite an offer that was 40% lower than any competition.

Economic Advisor’s Comment:

Sharp debate developed within Indian bureaucracy--one group embraced China and one remained wary of PRC firms in Indian strategic industries.

- Indian national-security concerns become an obstacle for PRC firms.
- Indian fears tripped up Chinese forays in telecommunications and infrastructure -- sectors where India generally welcomes foreign capital and expertise.

After decades of relative separation, India is experiencing Chinese economic might firsthand.

- Various Chinese goods now flood Indian domestic markets.

Initially, Chinese telecom firm Huawei also enjoyed a warm market reception in India.

- 2005: $120 million recorded in local sales (up approximately 80% from previous year).

However, rival companies squeezing Huawei and other PRC firms out of lucrative Indian markets.

- October 2006: U.S. based-Cisco announced Indian investments top $1bn.
- Cisco building a new research lab 10 kilometers from where Huawei plans to build a facility.

Additionally, Indian concerns over Chinese corporate ambition in the West and Africa.

- Delhi concerns over PRC growing influence overseas are similar to those seen in the U.S. and European markets.

On the other hand, Sino-Indian economic ties are on upswing; two-way trade expected to hit $20bn in 2007.

- In China, Indian firms seem to be encountering very few roadblocks in an aggressive Chinese expansion.

10 July 2006

New Delhi gave Scottish oil explorer Cairn Energy green light for up-stream exploration and development in NW desert state of Rajasthan.

- Proceeding with exploration in Northern Fields Development Project.
- Recently increased oil reserves estimate from 2.5bn to 3.5bn barrels.
- These reserves contribute to Indian energy security by offsetting soaring dependency on Mid-East oil.

Economic Advisor's Comment:

India is in a bind over energy. As economy grows, so do shortfalls.

- Domestic oil production -- largely a preserve of state-owned companies -- is stagnant while imports soar.

Rajasthan discovery highlights that full extent of Indian oil deposits has yet to be determined.

- U.S. Department of Energy reports only one quarter of 26 sedimentary basins already explored.
- Cairns project is an encouraging and rare example of foreign involvement in energy sector (closed to outsiders for decades).

If India wants more foreign investment to strengthen energy security, i.e. Cairn project, must create more attractive business climates.

- Won't be easy given strong political and worker opposition from left.
- Tamil Nadu has been in grip of power shortages since 4 July, when workers from state-owned Neyveli Lignite (produces coal for electricity generation) went on indefinite strike.
- Strike is over plans to sell a 10% stake in Neyveli Lignite to private sector.
- Indian communists and Union oppose sales of minority stakes in energy companies -- they insist all stock remain entirely in public hands.

10 July 2006

Indian attempt to increase energy security by diversifying energy imports has fallen hostage to Bangladeshi economic nationalism.

- Tata Group (India) halting attempts to persuade Dhaka to co-develop/co-produce mineral and energy reserves in neighboring Bangladesh.

Economic Advisor's Comment:

Oct 2004: Tata Group is more optimistic, announced U.S. $3bn investment proposal to meet Bangladeshi concerns.

- Integrated development included an open-cut coal mine, fertilizer plan, steel facility and two thermal power stations.
- Electricity production would have been shared between Bangladesh and India.

Dhaka failed to respond to an improved 30 June offer, so Tata began looking for business elsewhere.

- Decades of bickering rendered bilateral cooperation in industry and energy impossible.
- In particular, proposals to export Bangladeshi gas via pipeline to India have foundered on Bangladeshi economic nationalism.
- Dhaka fears India is stealing “crown jewels.”

25 July 2006

On 25 July India’s central bank raised short term interest rate by ¼ point to 6%-- a 4 year high.

- Indian central bank action is 3rd interest rate hike in 4 months.

Central bank described move as pre-emptive action.

- Central bank fears rising global oil prices threatens financial stability.
- Goal is to make sure high fuel costs do not stoke inflation/over-heat economy.

Economic Advisor’s Comment:

India’s tighter monetary policy is consistent with tighter monetary policies across much of the world.

- 17 central banks, including those of the U.S. and India, raised borrowing costs in June.
- 8 central banks besides India’s increased rates in July.

India’s tighter monetary policy has been a blow to business confidence in India.

- India’s business confidence has been shaken by market turbulence since early May.
- On 21 July India’s business confidence index (BCI) fell for 1st time in 4 years.

Falling business confidence in India reflects:

- Rising cost of capital, higher input costs, higher oil prices and lack of progress in structural reforms.

India's benchmark stock index has slumped 17% from a record high on 10 May.

- Rising U.S. interest rates has prompted investors to sell emerging market stocks.

That said, India’s economy remains fundamentally strong and resilient and should ultimately benefit from non-inflationary growth track.

- India’s economy grew at robust annual rate of 9.3% in 2Q 2006.

28 July 2006

Nearly 500,000 Indian bank workers walked off their jobs on 28 July.

- Strikers protesting against planned outsourcing of their work to private domestic companies.

Unions claim 1-day strike in response to continuing attacks on banking industry and bank employees’ jobs and job security.

- Unions argue outsourcing would threaten 250,000 jobs.

Economic Advisor's Comment:

Rally is ironic given the fact that:

- India is home to one of the world's most robust outsourcing industries.
- Indian software and business process outsourcing is key engine of growth for economy.
- Companies such as Infosys, Tata Consultancy Services and Wipro together generate billions of dollars annually from multinational companies shifting work overseas to cut costs.

However, labor unions don't see hypocrisy - they claim their outcry is different from that of workers in rich countries who have lost jobs to India.

- Unions see themselves living in "an impoverished nation."
- Unions argue that India is a labor-oriented country that needs greater job security.
    - In contrast, (unions argue), developed countries have fewer hands for work.

Central bank has proposed letting banks use outside agencies in India for certain tasks:

- Processing loan and credit card applications, supervision of loans and data processing.

Central bank says global banks are increasingly using outsourcing as a means of both reducing cost and accessing subject matter experts (SMEs).

- Central bank provided guidelines on outsourcing financial services in a recent circular.

Unions disagree with central bank assertion that outsourcing leads to more efficiency.

- Unions claim outsourcing creates complications in rendering good customer service.
- Unions charge banks outsource jobs to offset low-cost lending to corporate sectors.

Strike organizers (including All India Bank Employees Association [AIBOA], and Bank Employees Federation of India) are also demanding the government:

- Stop selling off larger stakes in state-run banks.
- Put limits on foreign direct investment.
- Provide broader pension coverage for bank employees.

03 August 2006

Fitch credit rating agency gives Indian economy vote of confidence with financial upgrade - but Fitch glosses over serious fiscal problem.

- Fitch upgraded New Delhi domestic and foreign currency ratings to investment grade.

While other credit ratings evaluate differently, all see Indian economy improving.

- Moodys in May raised Indian local currency debt outlook from negative to stable.
- Standard and Poors raised Indian local currency debt outlook from stable to positive.

Economic Advisor's Comment:

While India enjoys strong external balance sheet, Fitchs takes a leap of faith and is inexplicably upbeat about Indian fiscal situation.

- Fitch says for 1st time since it started rating India in March 2000, "there appears to be near universal commitment among the centre and the states to fiscal consolidation."
- Nobody else can discover basis for such optimism.

In contrast, World Bank last week described Indian weak fiscal position as "serious."

- World Bank notes that its public debt/GDP ratio is over 80%.
- That is over 20% above Maastricht alarm bell for debt/GDP ratio of 60% for financial turmoil.
- 80% figure is also 3 times higher than that of China.

Admittedly, India has made fiscal progress since 2001-2002.

- Combined state/central government deficit fell from 10.1% of GDP in FY 2001-02 to 7.5% in FY 2005-06.
- Faster growth also cut central budget deficit to 4.1% of GDP in 1Q 2006, compared with 4.3% target.

However, this fiscal consolidation is largely cyclical, driven by buoyant government revenues in a booming economy rather than a structural reduction in spending.

- Prime Minister Singh's government is banking on faster growth to increase tax revenue.
- Singh has to abide by a law that requires India to cut central budget deficit from 4.1% in 1Q 2006 to Maastricht criterion of 3% of GDP by 31 March 2009.

Uncertainty is growing over government achieving its full-year deficit target of 3.8% of GDP for 2006-07.

- JP Morgan correctly argues that India's sharply higher fiscal deficit is cause for concern.

Lavish government spending commitments on programs such as the National Rural Employment Guarantee Scheme have raised fears of renewed fiscal slippage.

- Indian fiscal deficit in the first 3 months of the year starting April 1, 2006 has jumped to rupee 777.4bn, or 52.3% of the government full-year target.

15 August 2006

Chinese and Indian oil firms teamed to buy part of oil company in South America.

- Sino-Indian energy collaboration involves India's state-owned Oil & Natural Gas Corp. and PRC state-owned Sinopec Group, China's 2nd biggest oil firm by output.
- 15 Aug: Purchased half an oil company in Columbia called Omimex de Columbi, owned by U.S.-based Omimex Resources Inc.

Economic Advisor's Comment:

Sino-Indian economic ties reflect competition as well as cooperation.

- On competition side, they've tried to outbid each other in the past for oil supplies.
- Chinese firms have outbid India in places like Africa and Central Asia.
- Aug 2005: Chinese oil company outbid an Indian oil company in Kazakhstan.
- India's Oil and Natural Gas Corp (ONGC) also lost out to Chinese rivals in the race to acquire fields in Angola, Nigeria and Ecuador.

More recently, India and China have set aside long-standing rivalries and agreed to co-operate in securing crude oil resources overseas.

- 20 Dec 2005: 1st time Chinese and Indian state owned energy companies teamed and took a stake in a Syrian oil field previously owned by Canadian firm.
- 12 Jan 2005: China and India signed energy agreement in Beijing.
- 15 Aug 2006: 2nd time Chinese and Indian oil firms teamed--purchased oil company in Colombia cited above.
- 06 Jun: Chinese and Indian officials re-opened Nathu La Pass - closed since Sino-Indian border war (44 years ago) -- that links Indian NE state of Sikkim and Chinese Tibet.

However, India's cooperation with China in the energy sector does not carry across the board.

- Indian national security fears tripped up Chinese forays in telecommunications and infrastructure -- sectors where India generally welcomes foreign capital and expertise.

30 August 2006

Embattled Indian Prime Minister Singh between rock and hard place:

- Maintain fiscal discipline and jeopardize support from left-leaning coalition government.
- Keep political coalition solid but lose support from financial community.

Credit Rating Agencies warn India to hold firm on pledge to cut budget deficit.

- Warning comes amid tensions over funding costly social spending programs.

Indian finance ministry and central bank are onboard with credit rating agencies.

- They reject option of placating communists in coalition by shifting fiscal deficit goalposts.

Fiscal credibility depends on hitting Fiscal Responsibility and Budget Management Act (FRBM) targets:

- Central government must cut budget deficit from 4.1% of GDP (2005-2006) to:
  - 3.8% of GDP by 2006-2007 deadline.
  - 3% of GDP (Maastricht criterion for financial stability) by 2008-2009 deadline.
- But left-leaning planning chief Ahluwalia says FRBM targets unrealistic and should be relaxed.

Economic Advisor's Comment:

India combined state and central government deficits declined from 10.1% of GDP in 2001-2002 to 7.5% of GDP in 2005-2006.

- However, buoyant government revenues, rather than structural spending cuts, drove decline.

Fitch this month joined Moody's in assigning Indian investment grade rating.

- It cited commitment budget deficit cuts, strong growth and robust foreign reserves.

Fitch was arguably over-generous in rewarding India for small cuts in fiscal deficit.

- World Bank last month called Indian fiscal position "remains serious."

Public debt to GDP ratio (more than 80%) more than 3 times higher than Chinese.

- Interest payments absorb 35% of government revenues.

Fitch rating agency says Singh must hold fiscal line.

- India has moved goalposts once - doing so again undermines fiscal credibility.

However, New Delhi determination to hold fiscal line appears to be weakening.

- Could delay sovereign rating upgrade expected from Standard & Poor's in early 2007.

Delhi leftist coalition partners vigorously oppose any attempt to rein in social programs.

- But National Rural Employment Guarantee Scheme is budget buster.
- Impasse presents Prime Minister Singh with test of his commitment to economic reform.

Finance Minister P. Chidambaram wrote letter to left-leaning Ahluwalia.

- Chidambaram questions boosting social spending without better delivery of public services:
  - "You do not repair a leaking supply pipe by simultaneously stepping up the water pressure."

19 October 2006

Prime Minister Singh warns Indian farm crisis could lead to political and social instability.

- 40% of India's farmers want to move out of farming.
- Rural discontent contributed to Bharatiya Janata Party being knocked out of power.

Economic Advisor's Comment:

In clamor to industrialize, Indian governments have neglected agriculture.

- Has led to poor maintenance of irrigation systems, rural roads, and food storage facilities.
- Complicated drought and crop-withering heat waves have led to major Indian crop losses.
- Agricultural growth rates have fallen from 4.7% between 1992-97 to just 1.5% in the past 4 years.

India's food stocks have fallen from 60 million tons to 18 million tons.

- Now importing rising amounts of grain from extremely tight global food market.

2006 world grain harvest projected to fall short of consumption by 61 million tons.

- As a result, world carryover stocks are at their lowest in 34 years.
- Projected to drop to 57 days of consumption - shortest buffer since 1972.
- Historically when stocks drop below 60 days of consumption, prices rise.

21 November 2006

Indian PM Singh hosted Summit for PRC President Hu Jintao.

- 1st Chinese head of state to visit India in 10 years.

12 agreements signed, including:

- Joint exploration projects for energy firms.

Plan is to double trade to $40bn by 2010.

- Up from $250 million in 1990 to $20bn by 2007.

Economic Advisor's Comment:

Rising trade is improving bilateral relations.

- Few land routes between nations limit trade expansion.
- However, land routes opening up.
- 2005: Himalayan border crossing opened after 44 years.

Economic relationship largely complementary:

- Indian raw materials satisfy growing Chinese appetite.
- China exports manufactured goods and computer hardware.
- Indian firms provide business/IT services and computer software.

India is wary of PRC trade deal.

- Fearful of flood of cheap PRC imports.
- Concerned over lack of transparency.
- Hidden subsidies allow PRC goods to under-price Indian competition.

China also has concerns.

- Complains India blocking investment in ports and telecommunication.
- PRC firm Huawei says Delhi blocking visa request for PRC engineers.

11 December 2006

U.S. Congress approves civilian nuclear deal for India.

- Ends U.S. technology denial regime against India since 1974 nuclear test.

Strategically important for the U.S. and India:

- Helps meet India's rising energy demand.
- Helps U.S. offset China's economic and military rise.
- Provides partial alternative to Indian Iranian energy ties.

U.S. Under Sec State Burns stresses deal:

- Breaks with conventional wisdom of sanctions to punish India.
- Creates symbolic center of new U.S. strategic partnership with India.

Economic Advisor's Comment:

Opens the door to a wide range of U.S. high tech commercial opportunities.

- 25 nuclear-oriented firms (GE, Bechtel, Westinghouse) traveled this week to New Delhi to explore booming new market.

Way ahead: U.S. firms must wait about 6 months before they can begin selling nuclear technologies.

- Both sides still need to agree on parameters for types of nuclear technologies.

India must:

- Reach new safeguards agreement with International Atomic Energy Agency (IAEA).
- Deal with Nuclear Suppliers Group (global body controlling the trade of nuclear technologies).

Critics of deal (i.e. Senator Markey) say deal is "huge mistake."

- Rewards India's nuclear weapons program.
- Loses moral high ground on sanctions against Iran and North Korea.
- Encourages spread of nuclear technology.

26 January 2007

25 Jan: President Putin and Prime Minister Singh pave way for closer economic ties at summit in New Delhi.

- Plan to strengthen energy, technology and trade ties.
- Plan to boost bilateral trade from $3.8bn to target $10bn by 2010.
- Indian Oil and Natural Gas Corporation (ONGC) and Russian oil giant Rosneft announced joint exploration and refining operations.
- 200 Russian firms attending Indo-Russian investment summit (India) next month.

Economic Advisor's Comment:

1991: Soviet collapse; bilateral trade and investment went flat.

- Indian exports to Russia fell from $850 million in 1994-95 to $740 million in 2005-06.
- Rekindling relations based on energy security.
- Singh: Russia "indispensable" to energy-starved India and energy security is centerpiece of "strategic partnership."
- Russia building two nuclear power plants in Kundankulam.
- Agreed to build more in Southern Tamil Nadu.
- Dec 2006: 1st shipment of oil to India from Sakhalin I offshore facility.
- Russia facing competition from U.S. (and France) for Indian nuclear power.
- Dec 2006: President Bush signed legislation ending U.S. ban on civilian nuclear trade with India.

- Conditions before bill can take effect: final bilateral agreement be sealed.
- India signs safeguards agreement with International Atomic Energy Agency.
- Nuclear Suppliers Group of 45 civil nuclear countries lifts restrictions on India.

01 March 2007

28 February: Indian government unveiled budget for year beginning 01 April. Social and infrastructure spending up:

- 40% increase for ports, power, roads; 34.2% on education.

In order to cut inflation, import tariffs were cut on manufactured goods from 12.5% to 10%.

Economic Advisor's Comment:

Problem: Rising aggregate demand outpacing inelastic aggregate supply.

- Over-heated economy: performing above non-inflationary potential (capacity). Indicators (of overheating):
  - 6.6% inflation over 5.5% (upper limit of central bank tolerance).
  - High asset prices and persistently high current account deficit.

Problem: Supply shortages limit economical capacity to create goods/services.

- Bottlenecks due to poor infrastructure (roads, ports, power).
- Inadequate banking system (over-priced credit).
- Tight labor market (poor schools; not enough educated, skilled workers).

Budget: Bad News: Includes too many populist giveaways:

- Rural job guarantee scheme: 100 days of paid "work" a year.
- India needs 5 times more infrastructure ($150bn/year) than budgeted.

27 Feb: Singh's United Part Alliance (UPA) coalition lost 2 state elections.

- Defeat reflects anger over rising prices; inflation highest in 2 years.

Way Ahead: Singh wants to curb inflation before April election in Uttar Pradesh.

- Outcome in Uttar Pradesh sets tone for next general elections (2009).

18 June 2007

China and India: Rising bilateral trade outpaces expectations.

- Bilateral trade expected to hit $20 billion in 2007 (year ahead of original target date).
- Actual trade hit $25 billion in 2006 -- 25% higher than original target for 2008.
- Trade has almost doubled in 2 years (from $13.6bn in 2004).
- China's rising consumption, demand for raw materials and investments should boost trade.
- India's new open door (lowering tariffs in Feb 07 budget) should also increase future trade.

Economic Advisor's Comment:

India's fears of China are starting to give way to a pervasive sense of shared prosperity with PRC.

- China and India re-opened Nathu La Pass (Himalaya border) in July 06 (closed for 44 years).
- Economic relationship is largely complementary:
  - China exports computer hardware; India provides IT services and computer software.
  - Indian exports iron ore for steel, processed cotton, plastic, precious stones and minerals.

- o China takes these raw materials and sends back manufactured goods, machinery, steel and fuel.

India and Pakistan close to deal to pipe natural gas from Iran. Indian Oil Secretary met with Pak and Iranian counterparts since 27 June.

- Pipeline would run 1,625 miles from Iran towards India via Pakistan.
- $7bn pipeline on track for completion by 2011.
- Three oil secretaries confident of resolving issues in Islamabad and Iran by August.

Economic Advisor's Comment:

Controversial pipeline is at odds with U.S. policy to Iran.

- But India sees Iranian nuclear status as secondary to Indian vital energy needs.
- Indian energy shortfall drives it on global quest to lock in energy supplies wherever it can get it, even with pariah states like Iran.
- India and Pakistan also see this “peace pipeline” as confidence building measure (CBM) to avoid a third war and give peace a chance.
- But pipeline depends on Iranian credibility as energy supplier, which does not inspire confidence.
  - o Iran historically unreliable as supplier to Turkey.
  - o Iranian energy production stagnant while domestic demand soared.
  - o Iran will be net energy importer in a few years unless reduces domestic demand.
  - o Response of Iranian people to energy rationing: panic and rioting.

ENDNOTES

[1] This section draws from UN, *Indian Briefing Notes*, April 2007.
[2] This section draws from Economist.com, India’s Strong Rupee, 27 June 2007.
[3] In recent years, incoming foreign direct investment (FDI) has been low. That said, FDI inflows are only 0.8% of GDP. That’s just 9% of what China gets for incoming FDI.
[4] "Dutch disease" originally referred to the adverse impact of the discovery of natural-gas deposits in the Netherlands on that country's manufacturing exports.
[5] Economist.com, *op.cit.*

NEPAL

• CHAPTER 3 •

Sharon Strickland and Miemie Winn Byrd

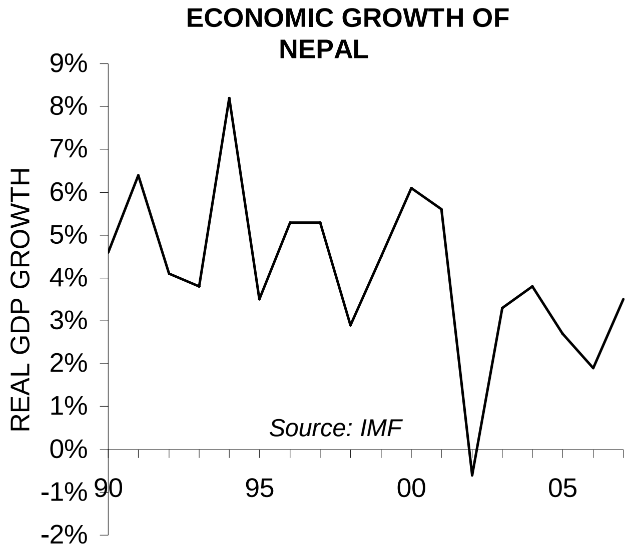
Executive Summary.

- Nepal remains one of the poorest countries in the world, with barely 2.7% (at producer prices) of GDP growth for 2005-06.
- Strikes and political strife in 2006 hit Nepal's tourism sector hard.
- Nepal's garment and textile industry is on the decline as the result of the expiration of Multi-Fibre Arrangement (MFA) at the end of 2004.
- Another contributor to its feeble economic performance was the agriculture sector which was affected by unforgiving weather -- prolonged drought in the South plains and floods in the mid- and far- Western regions of Nepal.
- Luckily, increased overseas workers' remittances have kept Nepal's economy afloat.
- There is untapped potential for hydropower, however, the huge capital start-up cost required to develop hydropower has prevented the Nepalese from realizing this potential.
- Opening and restructuring of the petroleum sector, currently monopolized by Nepal Oil Corporation (NOC) -- a state-owned enterprise, could bring in needed foreign direct investment (FDI).
- The rapid economic development of its two large neighbors—China and India—can offer significant opportunities for Nepal to emerge as a transit point for their trade as well as a place for increased investment.

Selected Historical Data

Nepal	2001	2002	2003	2004	2005	2006
Purchasing Power $B	35	35	37	40	42	44
GDP $B (Nominal)	140	145	152	159	166	178
GDP Growth (Real)	5.6%	-0.6%	3.3%	3.8%	2.7%	1.9%
Inflation	2.9%	4.7%	4.0%	4.0%	4.5%	8.0%
Exports $B	0.7	0.6	0.7	0.8	0.9	...
To U.S. $B	0.0	0.0	0.0	0.0	0.0	0.0
Imports $B	1.5	1.4	1.8	1.9	1.8	...
From U.S. $B	0.2	0.2	0.2	0.1	0.1	0.1
FDI held by U.S. $B	-	-	-	-	-	...
held in U.S. $B	…	…	…	…	…	...
Gross Intl Reserves $B	1.1	1.0	1.2	1.4	1.5	1.8
Savings /GDP	14.2%	17.4%	17.0%	17.0%	12.5%	…
Fiscal Balance /GDP	-4.5%	-3.9%	-1.5%	-1.5%	-1.7%	-3.0%
External Debt /GDP	1.9%	1.9%	2.0%	2.0%	...	...
Current account/GDP	4.8%	4.5%	2.6%	3.0%	2.2%	2.4%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

Nepal has been plagued with a decade of insurgency, strikes, blockades, extortion and intimidation by the Maoist rebels. Industries and manufacturing units have been disrupted by riots and protests, off and on throughout the year – causing many business owners to go elsewhere. This uncertainty scares off badly needed foreign direct investments (FDI), a key factor for Nepal's future development and economic growth.

The United Nations brokered a peace agreement between the Maoists and government in late 2006. The Maoists, in compliance with the United Nations peace accord, laid down their arms and became part of the interim government. The Maoists now have been allotted 83 seats out of the 330 seats in Parliament.

They hold the second-largest group in legislature, and obtained the following five ministry positions within the government:

- Information and Communication.
- Local Development.
- Works and Physical Planning.
- Forest and Soil Preservation.
- Women, Children, and Social Welfare.

What do the Maoists Want?

Prachanda, the Maoist leader, in his 'first' address to the public, pledged to push for a 'Republican Nepal,' with a mixed economy and radical land reform.

- The Maoist party is promoting nationalistic capitalism and planning on keeping the country less dependent on foreign capital.
- Traditionally in the past, the Maoists have utilized the leftist-status approach.
- They believe the rich should pay higher taxes, with an emphasis on managed trade, government subsidies and land reform.
- Although the Maoists now have representation in the government, there are reports of Maoists continuing to conduct extortion, attacks, kidnapping, etc.
    - The government is unable and unwilling to crack down on the Maoists in fear of stopping the peace process and interrupting the Maoist incorporation into the government.

- o In a way, the Maoists are currently operating with impunity.

Maintaining law and order during the transition to democracy is a key ingredient and critical for economic revival.

One of the Poorest Countries in South Asia.

Nepal ranks as the 12th poorest nation in the world, with $260 per capita. However, recent human development indicators for Nepal have shown some improvement.

Improvements.

- Urban poverty has been reduced from 22% to 10%, while rural poverty has been reduced from 43% to 35% from 1995-96 to 2003-04 per the World Bank.
- Standards of living improved in areas such as increased agricultural wages, ownership of durables, and self-assessments of adequacy in improvements of housing, clothing, health care and children's schooling.
- Child mortality fell from 40 to 29 deaths per 1,000 live births, while infant mortality decreased from 79% to 64%. Despite these facts, Nepal remains high compared to all of South Asia.
- Sadly, conflict induced migration was the primary contributing factor to the reduction of poverty.
- Other factors that have contributed to unexpected strong development and reduction in poverty are the reduction in the fertility rate, increased farm wages, and urbanization (low-paying rural jobs to higher-paid urban jobs).

Increased Overseas Remittances.

Between 1996 and 2004, remittances soared from 3% of GDP to 12% of GDP, mainly driven by those migrating to the Persian Gulf and East Asia, where wages are much higher than Nepal and the neighboring countries.

- If it wasn't for the strong inflows of remittances, growth would have been stunted even further.
- The remittances boosted money supply; experienced a 15.6% year-on-year expansion to NRs 347.2bn in 2005-06.

Robust Foreign Reserves.

Thanks to these remittances, foreign reserves are strong.

- Total foreign reserves rose by 27% year on year to NRs 165bn (U.S. $2.2bn) by mid-July 2006, sufficient for approximately 11 months of import cover.

Himalayan Nation Still Attracts Tourists.

While there were some fluctuations in the percentages over the year, tourists are still drawn to the majestic view of the Himalayan mountain range.

- However, strikes and political strife in August 2006 hit hard on the tourism sector.
- The Maoist rebels are charging extortion "tax" on the average of U.S. $3 - $20 to the trekkers, although in some cases higher amounts are demanded.
- Indian visitors declined by 22.9% in August and by 17.4% in September. U.K. visitors declined by 14.5%, Italy by 9.9% and the Netherlands by 5.5%.
- Meanwhile, U.S. and Australian visitors increased by 22.6% and 38.9% respectively in September, the beginning of the tourist peak season.

The tourism sector in Nepal has been on a rollercoaster ride for nearly a decade. Hopefully, the political stability on the horizon will bring steady growth in this sector.

Garment and Textile Industry in Decline.

In the past, the only sector that has generated noteworthy export earnings in 2006 is the garment and textile industry.

- Carpets and readymade garments historically dominated exports; however, this dominance is on the wane.
- These commodities amounted to 21% of total exports in 2004-05. As other countries have felt the reverberation from the end of global export quotas (Multi-Fibre Arrangement ended in December 2004), Nepal was not any different.
    - Nepal's higher transport costs associated with importing raw materials and exporting the finished products contributed to its lack of competitiveness in a now highly competitive global market.
    - Wage hikes have negatively impacted the textile industries.
    - Maoist extortion and affiliated trade unions conducting strong-arm tactics for hiring contributed to decline in productivity.
    - Therefore, Nepali producers could not compete with China, India and Bangladesh.

Agriculture Sector's Poor Performance.

Agriculture has been one of Nepal's most important sectors, making up 38% of GDP. However:

- Agriculture has been in the slumps due to the prolonged drought, poor performance of irrigation projects and a feudal land tenure system characterized by concentrated ownership and extremely high rent.
- As cash crops, sugarcane, potatoes, oilseeds, jute and tobacco production increases, food production has declined in paddy output.
- Commodity imports of rice rose by 380% in 2005-06 and fertilizer imports by 157%.
- Nepal has also failed to realize its potential as a tea-growing nation with its favorable terrain and climate.

Growing Trade Deficit.

Sluggish agricultural output and poor business climate contributed largely to widening of the trade deficit.

- Many investors have deferred investing in their industries and a significant number of businesses have left or failed within the past three years due to Maoist threats and extortion.
- Additionally, India's introduction of a countervailing duty in March 2006 had a significantly negative impact on Nepal's exports.
- Exports to India grew just 5.4% year on year in 2005-06, down from 26% in 2004-05, while imports from India rose by 23.3% to NRs 109.3bn, much faster than the 12.3% increase in 2004-05.
- Overall import growth in 2005-06 increased by 17.1%, compared with 9.7% in 2004-2005.
- Total imports reached NRs 175.1bn, almost three times the level of exports, and led to a further increasing trade deficit, to NRs 113.9bn in 2005-06, up from NRs 90.7bn in 2004-05 (EIU).

Dependency on India.

Nepal's number one trade partner is India, with imports at 47.5% and exports at 53.7%. Since Nepal shares the border with India, strong cultural ties exist between residents of the heavily populated Southern strip of Nepal and Northern India. These ties contribute to Nepal's heavy reliance on India for its economic growth.

India and Nepal have developed a symbiotic relationship, where both parties benefit. While Nepal has benefited from East – West roads in the South plains region, they both have benefited from the rail operation agreement, allowing transport of cargo directly to the port of Calcutta, India. Meanwhile, India is looking to Nepal for the possibilities of future hydropower generation to fuel its current explosive economic growth. However, a long history of distrust between these two nations continues to fester and strain the bilateral relationship.

What about China?

Although Nepal's trade with China, the Northern neighbor, increased by 78% from 2002 to 2006, it remains minimal. A significant physical barrier imposed by the Himalayas has hindered bilateral trade between the two countries.

However politically, Nepal views China as the counterweight to India's sphere of influence. In November 2005, China provided military supplies to Nepal, after U.S., Britain and India stopped such support. China has been a substantial aid donor and in return, Nepal has supported the "One China" policy regarding the China-Taiwan issue.

Hydropower Potential.

Hydropower is the main source of electricity for Nepal. It has been a largely untapped resource with the potential of generating 83,000 mw.

- Currently, Nepal is harnessing less than 1% of its potential hydropower energy and the country depends on biofuels (mainly wood) to meet its energy needs.
  - This has serious consequences for Nepal's environment as the consumption of wood for fuel accelerates deforestation and soil erosion.
- In 1996, Nepal and India agreed on the joint development of the Mahakali River for a hydropower project but there has not been any movement towards the construction.
  - And controversy remains over the use of rivers that flow into India to generate hydropower.
- Capital-intensive nature of developing hydropower has been one of the greatest obstacles for Nepal in realizing it hydropower potential.

Petroleum Sector Potential.

Petroleum sector in Nepal has been monopolized by Nepal Oil Corporation, a state-owned enterprise to manage the import, storage and distribution of various petroleum products in the country. Nepal, being one of the land locked countries of the South-Asia, is solely dependent on India for the supply and distribution of various petroleum products. The prospect of crude oil exploration in Nepal has not yet been proved a feasible one. So the entire national demand is met by import alone.

On October 20, 2006 the cabinet presented the parliament with a draft bill, regulating trade in petroleum products, for approval.

- Upon approval, the law would allow private-sector participation in oil imports and sales, an area in which the NOC currently enjoys a monopoly.
- Under the new legislation, petroleum product prices would be determined by international rates rather than government policy.
- Meanwhile, in August 2007, NOC had to borrow NR 1bn from the government to cover its payables to the supplier, Indian Oil Corporation (IOC).
- Due to huge operating losses, NOC was unable to meet the committed payment to the IOC.
- NOC draws a significant chunk of the government's budget.

CONCLUSION

Although the United Nations human indicators showed that the incident of poverty has declined in recent years, Nepal has a very long way to go. The economy has been stunted as a result of continuous conflicts over the last decade between the Maoists and the government.

The recent cease fire agreement between the government and the Maoists is an encouraging step towards stability in Nepal. However, the Maoists and the government need to move swiftly beyond the peace process and start the process of critical reforms to move the country and its economy forward.

- To achieve reasonable growth rates, the government must convert its economy from an agriculture-based economy to an economy that is based primarily on services and industry, while increasing productivity in agriculture.
- Nepal's infrastructure and institutions are in need of significant improvement and investments to make the business environment competitive and attractive to investors.
- Opening and restructuring of the petroleum sector could bring in the badly needed FDI into Nepal.
- Nepal's comparative advantages lies in processing agro-based and herbal products, tourism, and hydropower, and these have yet to be fully exploited.
- The rapid economic development of its two large neighbors—China and India—can offer significant opportunities for Nepal to emerge as a transit point for their trade as well as a place for increased investment.

CHRONICLES OF ECONOMIC HIGHLIGHTS

20 March 2007

Business groups called for "indefinite" general strike to protest against extortion by Maoist trade unions.

- 19 March: Shops, factories, schools and transport networks shut down across Nepal.
- Over 10,000 people took to streets of Kathmandu to protest against Maoists.
- Protest was largest against former rebels since November peace deal.

Kidnapping and beating of hotel owner triggered strike.

- He was briefly abducted and beaten after refusing to make "donation" of about $140,000.

Economic Advisor's Comment:

70 business groups orchestrated the general strike.

- They want government to guarantee their security and put an end to Maoist extortion and violence.
- Businesses would reopen only after they received such an assurance.

SRI LANKA

• CHAPTER 4 •

Leif R. Rosenberger

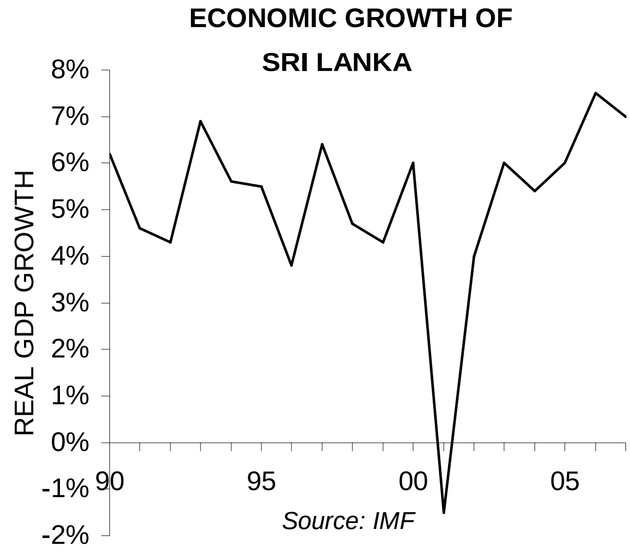
Executive Summary.

- For a country that embraced globalization for centuries, the past few decades have been economically difficult for Sri Lanka.
- In the 1970s Sri Lanka's closed door economic strategy failed miserably.
- A civil war that killed 40,000 people frustrated its return to globalization.
- A 2002 ceasefire helped spur accelerating economic growth.
- But a tsunami hit in December of 2005, killing another 31,000 people.
- Thankfully, international support was robust for reconstruction.
- Reconstruction helped spur GDP growth to 5% in 2005 and over 6% in 2006.
- But solid growth and falling unemployment created a false sense of security.
- Sri Lankans became complacent and stopped pushing for a durable peace.
- Sri Lanka needs to redouble its efforts at a durable peace in order to sustain strong economic growth.

Selected Historical Data

Sri Lanka	2001	2002	2003	2004	2005
Purchasing Power $B	71	75	81	88	96
GDP $B (Nominal)	151	163	172	188	206
GDP Growth (Real)	-1.5%	4.0%	6.0%	5.4%	6.0%
Inflation	12.1%	10.2%	2.6%	7.9%	10.6%
Exports $B	4.8	4.7	5.1	5.8	6.3
To U.S. $B	0.2	0.2	0.2	0.2	0.2
Imports $B	6.0	6.1	6.7	8.0	8.8
From U.S. $B	2.0	1.8	1.8	1.9	2.1
FDI held by U.S. $B	-	-	-	-	-
held in U.S. $B	0.007	...	...	...	...
Gross Intl Reserves $B	1.4	1.7	2.3	2.2	2.5
Savings /GDP	15.3%	15.8%	16.5%	17.0%	17.2%
Fiscal Balance /GDP	-10.4%	-8.3%	-7.5%	-7.6%	-8.0%
External Debt /GDP	5.5%	5.7%	6.2%	6.3%	...
Current account/GDP	-1.1%	-1.4%	-0.4%	-3.2%	-2.8%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

For centuries Sri Lanka was a country that embraced globalization.

- The economy thrived thanks to international trade between East and West.
- The past and present are reminders of its rich commercial heritage.
- As recently in the 1960s, Sri Lanka's per capita income rivaled South Korea's.
- Many saw Sri Lanka becoming the Hong Kong of India.
- Just as Hong Kong is a gateway to China, many hoped Sri Lanka would be one to India.[1]

Protectionism.

But Sri Lanka took a different economic strategy to the Asian tigers in the 1970s.

- At a time when East Asia was opening its doors to the rest of the world, Sri Lanka closed its doors.
- While East Asian economies enjoyed an economic boom with their export led strategy, Sri Lanka’s economic socialism was a dismal failure.
- In 1978 Sri Lanka ended its experiment with inward looking economic development and protectionism. Its GDP growth jumped 8.2% in 1978.
- Unfortunately, Sri Lanka was unable to sustain this kind of economic growth.
- Sri Lankan living standards stagnated.
- It never did become a robust destination for foreign investment, nor did it evolve into an Asian hub for airlines, tourism or shipping.[2]

Civil War.

Sri Lanka’s strongest economic headwinds have come from its two-decade civil war, which has killed 40,000 people.

- Longstanding ethnic tensions between the majority Sinhalese and the minority Tamils erupted into civil war in 1983.
- The Liberation Tigers of Tamil Eelam (LTTE) or Tamil Tigers want a separate homeland in the island's North and East.

Growth Despite Conflict.

For the past 10 years, Sri Lanka's economic growth has averaged 4.5%.

- Not half good, not half bad.
- However, in 2001 Sri Lanka experienced a painful recession.
- That may have prompted the government to redouble its efforts to curb the fighting.

2002 Ceasefire.

The following year (2002) Norway brokered a ceasefire.

- The government and the LTTE met in Thailand for the first round of peace negotiations 16-18 September without success.
- The two sides met again 18-21 March in Japan without any real progress.

Foreign Assistance.

Sri Lanka has been highly dependent on foreign assistance.

- In June of 2003 the IMF, the World Bank, the Asian Development Bank, Japan, the EU, and the U.S. convened for a conference in Tokyo.
- Sri Lanka received $4.5 billion in aid from this poverty reduction conference.
- At the time, this seemed like an ample amount of money for Sri Lanka's economic development needs.

Tsunami.

But then in late December 2004, a major tsunami hit the island.

- The tsunami was devastating for the economy.
- 31,000 people were killed, 4,000 were missing, and 418,000 people were displaced.
- It also destroyed an estimated $1.5 billion worth of property.
- 65% of the country's fishing fleet of 29,700 boats was either damaged or destroyed.
- Other economic sectors affected included fishing, hotels and restaurants, banking, small industry, domestic trade and transport.
- The Sri Lankan government estimates total recovery costs to be $2.2 billion.

U.S. Response.

U.S. forces (along with India) reacted quickly to the tsunami and sent relief and units to Sri Lanka.

- The U.S. led the international efforts for tsunami relief and reconstruction.
- In addition to pledging $350 million to tsunami-affected countries, more than 15,000 U.S. military personnel were involved in providing relief support in the affected area.
- 25 ships and 94 aircraft participated in the effort.
- The U.S. military delivered about 2.2 million pounds of relief supplies to affected nations, including 16,000 gallons of water, 113,000 pounds of food and 140,500 pounds of relief supplies.[3]

Economic Growth.

Initial estimates said the economic damage form the 2004 tsunami would cause the GDP to contract by 3% of GDP.

- But the robust external support from the U.S. and others actually helped the economy grow by 5% in 2005 and over 6% in 2006.

- Sri Lanka's most dynamic sectors have been food processing, textiles and apparel, food, beverages, port construction, telecommunications and insurance and banking.
- In addition, about 800,000 Sri Lankans work abroad and send home over $1 billion in the form of remittances to family and friends.

Initial Impact on Civil War.

At first, the tsunami appeared to take the fight out of the LTTE.

- Sri Lankan President Kumaratunga and the Tamil Tigers reached a deal in June 2005 to share about $4.5 billion in international aid to rebuild the country.
- Many hoped this collaboration in reconstruction could lead to a permanent reconciliation between the government and the LTTE.

False Dawn.

But hopes for peace turned into a false dawn.

- By May of 2006 the ceasefire agreed to in 2002 had collapsed.
- Nearly 300 people were killed in May 2006.
- In August of 2005, Foreign Minister Lakshman Kadirgamar was assassinated and the government declared a state of emergency.

Economic/Security Disconnect.

Despite the return to civil war, Sri Lanka's GDP growth soared to 7.4% in 2006 – the fastest economic growth in 30 years.

- Why isn't the civil war hurting growth?
- The conflict is localized.
- The fighting is taking place far from industries driving the $26 billion economy.
- The worst fighting is taking place in the North and the East.

Regional Prosperity.

In contrast, the Western province, the home of the textile and garment industries, the biggest export earners, grew 10% in 2006.

- In addition, agriculture performed better with higher output of major crops and fisheries, confirming its recovery from the tsunami.
- The island also attracted a record overseas investment of $600 million, mostly from garment makers and telecommunications companies in Colombo (the capital), which is located in Western province.

Economic Complacency.

Unfortunately, this very economic resilience in the Sri Lankan economy is making peace even more elusive.

- Solid growth and falling unemployment are creating a false sense of security.
- That 2002 truce is now in tatters.
- But since Sri Lankans in the South and West enjoy regional prosperity, they don't really push very hard for peace. [4]
- This disconnect between a booming economy, surging asset prices, and a worsening security situation isn't exactly ideal for forging a peace accord.
- Strong growth amid a resurgence of violence in the North and the East shows the increasing economic marginalization of the conflict-affected provinces.

Tide Turns?

While Colombo has been about to shrug off settling the civil war and still maintain relatively strong economic growth, William Pesek from Bloomberg makes the point that Sri Lanka's economic growth would be even better with a durable peace.

- He argues that the answer today is the same as it was centuries ago: Sri Lanka needs to go back to its rich economic heritage and once again embrace globalization.
- It's up to the new leadership to prod Sri Lanka toward peace so that it can participate more fully in the world's marketplace.

Recommendations.[5]

To win back foreign investors in larger numbers, Pesek recommends that the government do the following:

- Get serious about securing and keeping the peace. That means moving toward a social, economic and political reconciliation with the Tamils. Attempts in the past to achieve a military victory will fail in the future.
- Create a more market-based economy. Sri Lanka needs to open up its economy even more to international trade and investment.
- Build a genuine national economy. Move toward social and economic justice. That means closing the gap between the haves and have-nots. Immediate attention should go toward equalizing opportunities for those in Tamil-dominated areas. Address Tamil legitimate grievances and ensure they are not discriminated against by the majority Sinhalese.
- Trim the Debt. The nation's budget deficit is forecast to widen from 8.5% of GDP to 9% of GDP. That's too big and moving in the wrong direction. Reverse this adverse trend. Reducing the deficit is vital to lowering bond yields so more businesses and consumers can afford to borrow.

CONCLUSION

For centuries Sri Lanka embraced globalization. More recently, people used to talk about Sri Lanka becoming the Hong Kong of India. Just as Hong Kong is gateway to China, Sri Lanka was to become a gateway to a globalizing India. But that never happened. Sri Lanka wasted valuable time pursuing a closed door economic policy in the 1970s that failed miserably. Then a two decade old civil war erupted in the 1980s. 40,000 people were killed. A 2002 ceasefire helped spur accelerating economic growth. But a tsunami hit in December of 2005, killing another 31,000 people.

Thankfully, international support was robust for reconstruction. Reconstruction helped spur GDP growth to 5% in 2005 and over 6% in 2006. At first, the tsunami appeared to take the fight out of the LTTE. The government and the LTTE agreed to share reconstruction aid. But hopes for peace turned into a false dawn. The 2002 ceasefire collapsed in 2006.

Despite the return to civil war, Sri Lanka's GDP growth soared to 7.4% in 2006 – the fastest growth in 30 years. The civil war is not hurting growth because the conflict is localized. The fighting is taking place in the North and the East -- far from industries that drive the economy. But solid growth and falling unemployment created a false sense of security. Sri Lankans have become complacent and have stopped pushing for a durable peace. Sri Lanka needs to redouble its efforts at a durable peace in order to sustain strong economic growth.

ENDNOTES

---

[1] William Pesek Jr., "Sri Lanka Needs Peace Before It Can Prosper", Bloomberg on-line.) Nov. 23 2006.
[2] *Pesek, Ibid.*
[3] Discussions with Wayne Swan, from J52 at U.S. Pacific Command, April and May 2007.
[4] Andy Mukherjee, "Sri Lanka's Peace Is Stymied by Strong Economy," *Bloomberg On-line*, 25 October 2006.
[5] Pesek, *op. cit.*

BRUNEI

• CHAPTER 5 •

Miemie Winn Byrd

Executive Summary.

Brunei remains on solid economic footing thanks to the high price of oil in 2006.

- But before long, Brunei will be running short of oil.
- So Brunei needs to change its ways in the future.

To its credit, Brunei has made some progress with its economic reforms.

- The government has made significant progress in sustaining its commitment to open up and free the economy of tariff and non-tariff barriers.

But Brunei must do far more to reinvent itself.

- Toward that end, the Sultan has an E-Commerce vision for Brunei.
- IT spending is on the rise.
- Brunei is trying to remake itself as an international finance center and a trade and tourism hub in the region.
- Brunei is also trying to strengthen its economy by integrating its economy with other SE Asian economies.

Unfortunately, Brunei faces numerous obstacles that will make it difficult to reinvent the economy.

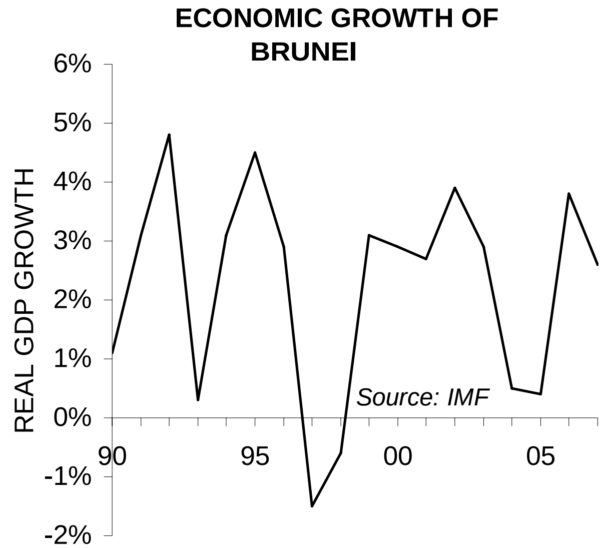
Selected Historical Data

Brunei Darussalam	2001	2002	2003	2004	2005	2006
Purchasing Power $B	8	8	8	9	9	10
GDP $B (Nominal)	94	95	101	117	138	153
GDP Growth (Real)	2.7%	3.9%	2.9%	0.5%	0.4%	3.8%
Inflation	0.6%	-2.3%	0.3%	0.9%	1.1%	0.5%
Exports $B	3.6	3.7	4.4	5.1	6.6	...
To U.S. $B	0.1	0.0	0.0	0.1	0.0	0.0
Imports $B	1.2	1.6	1.3	1.4	1.4	...
From U.S. $B	0.4	0.3	0.4	0.4	0.6	0.6
FDI held by U.S. $B	-	-	-	-	-	...
held in U.S. $B	...	...	...	...	...	...
Intl Reserves $B	0.4	...	...	...	...	...
Savings /GDP	...	...	...	...	...	...
Fiscal Balance /GDP	...	...	...	...	29.8%	...
External Debt /GDP	...	...	...	...	...	...
Current account/GDP	51.5%	42.5%	49.6%	47.9%	56.0%	58.7%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO

Introduction.

There is a little in the way of real politics in Brunei. The political process is managed closely by the sultan of Brunei, Hassanal Bolkiah. He has announced previously to introduce partly democratically elected Legislative Council. Progress on this effort is likely to be very slow. There is currently no popular pressure on the sultan to move towards democracy since the oil-rich sultanate is able to provide most of its citizes with jobs and healthcare without imposing an income tax.



Strong Performance.

The oil rich country of Brunei remains on solid economic footing thanks to the high price of oil in 2006.

- The economy grew at 3.7% in 2006.
- Brunei’s current account surplus is running at a huge 68% of GDP.
- While Brunei’s real foreign reserve figure is unknown, Economist Intelligence Unit cites an estimate of a healthy $20 billion.

More Good News.

Other economic indicators also look positive:

- Inflation is benign. Unemployment is relatively low.

Economic Reform.

Brunei has made steady progress with economic reforms.

- Brunei is reducing trade barriers and privatizing state-run companies.
- Brunei wants to spur private sector with low-interest loan incentives.
- Government seeks to attract foreign investors with corporate tax exemptions.
- Government has cut back government spending and subsidies.
- To be less dependent on oil companies such as Shell, the government created a national oil company to explore for oil and refine it.
- Oil sector accounts for 66% of GDP and Japan remains key consumer of Brunei’s oil exports.

Toward E-Commerce Vision.

Before long, Brunei will be running short of oil. The oil and gas reserves are expected to run out within next 10-20 years. So Brunei's Sultan, Hassanal Bolkiah, is trying to reinvent Brunei.

- In September 2005 the Sultan outlined his vision of creating an "e-Brunei" by developing information technology (IT).
- He called for greater study of IT in the school curriculum, and said that IT-enabled business would be complemented by e-government and the development of e-commerce.

Rising IT Spending.

Brunei's IT spending will rise by 34.9% in 2005 and will grow by a compound average of 18% a year from 2004 to 2009.

- In 2004 IT spending represented 1.7% of GDP, but this figure is estimated to rise to 2.1% of GDP in 2005. (Source: International Data Corporation).

Regional Hub?

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

- However, that will be a difficult makeover. 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.

Regional Economic Integration.

Brunei is trying to strengthen itself by integrating its economy with other SE Asian economies.

- In October 2005 the countries participating in the Brunei, Indonesia, Malaysia, Philippines, East Asian Growth Area (BIMP-EAGA) agreed to a five-year plan to boost economic co-operation and security.
- The BIMP-EAGA Roadmap to Development 2006-10 envisages a 10% increase in trade and investment between member states.
- Infrastructure spending is to be used to support a 20% increase in tourist flows within the region over the same period.

Ambitious Plans.

That said, Brunei has been unable to attract much foreign direct investment (FDI) in the past.

- A government plan seeks to attract $4.5 billion in foreign direct investment between 2003 and 2008.
- That would create 6,000 new jobs.

But this scenario is more dream than reality and is unlikely to materialize.

- Luring non-oil related FDI will not be easy given the fact that most other Asian locations appear more attractive.

Poor Business Climate.

To become a more attractive business location, Brunei would somehow have to diversify its economy. But diversifying its 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. In addition, the Sultan runs everything. Therefore, most decisions are 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, this all bottlenecks development.

Frustrated Investors.

Investors get frustrated with the long approval process.

- Investors turn their back on Brunei and invest elsewhere -- which hampers Brunei's economic progress.

Wanted: Decentralization.

What is needed is a healthier free market economy.

- Economic decision-making needs to be 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.

Unfinished Agenda.

Brunei still has a long way to go in reinventing itself. 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 and reduce government labor.
- Encourage the investment climate and lure foreign direct investment.

CONCLUSION

How's the economy doing?

- Economy is on solid economic footing.

How are the economic reforms going?

- Good progress in reducing trade barriers and in privatizing state companies.

Can oil revenue sustain economy?

- No. Before long, Brunei will run out of oil.

Can Brunei reinvent itself?

- Well, Sultan is trying to do that with his E-Commerce vision.
- IT spending is up.
- Another vision is Brunei as a regional hub for finance, tourism and trade.

Any obstacles to Brunei reinventing itself?

- Yes. Investors find business climate unattractive.
- Brunei is small, costly and over-centralized.
- So Brunei will struggle with makeover.

BURMA (MYANMAR)

• CHAPTER 6 •

Sharon Strickland

Executive Summary.

Burma's economy is in shambles and the future is bleak. The military junta's oppression and mismanagement has broken what was once a prosperous nation with a wealth of natural resources and a lot of potential for growth. The U.S., Canada, European Union (EU) and Australia punished the Government of Burma through sanctions and embargoes, in the name of promoting human rights and democracy.

Since 1990, the Burmese have been locked away from the rest of the world by theirs and Western governments. They are caught in a quagmire between the idealistic Western governments' zeal and the military junta's subjugation. The sanctions had assisted the military junta's goal to isolate and cut off its citizens from the Western influences. Who is actually being hurt? The ordinary Burmese are the ones that are being penalized for their government's wrongdoings.

The military regime is not really being affected by these measures, especially when neighboring countries such as China, Russia, Thailand, Singapore and India continue to engage and trade with Burma. Burma's richness in natural resources and its strategically significant geographic location at the mouth of the Straits of Malacca (a vital waterway for global seaborne trade) are irresistible to these emerging economic giants.

Burma's "Roadmap" towards democracy is at a dead-end at this point. The Western nations need a different tactic to influence the military junta to make progress towards democracy and national reconciliation. The solution may be difficult to cultivate, however, change in strategy and approach is now needed to break the current state of stagnation.

Ultimately, it is the majority of ordinary Burmese citizens that have suffered from extreme poverty, stagnation and isolation. When thinking of a solution, the best interest of the people must be kept in focus. A nation that was once one of the wealthiest nations in South-east Asia (under British administration in the 1940s) is now one of the poorest countries in the world.

Political Background.

- Burma has been under the military dictatorship since the coup lead by General Ne Win in 1962.
- In 1988, Burmese Army violently repressed protests against economic mismanagement and political oppression, which led to the 1990's People's Assembly elections.
- National League for Democracy (NLD), led by Aung San Suu Kyi, won over 60% of votes and over 80% of parliamentary seats in the 1990 election, the first held in 30 years.
- The election results were subsequently invalidated by Senior General Saw Maung's regime. Aung San Suu Kyi has been repeatedly placed under house arrest for years.
- Recently, on 27 May 2006 she was extended on house arrest for another year.
- Burma's political system remains under the tight control of the State Peace and Development Council (SPDC), the military junta led by Senior General Than Shwe since 1992.
- The regime, rife with corruption, has a poor human rights record and has been charged with forced labor, child labor, drug trafficking, and human trafficking.
- The paranoid leadership abruptly relocated the capital from Rangoon (Yangon) to a remote area outside of Pyinmana in late 2005 for what is seemingly irrational.

Whose Side Are You On?

- U.S. submitted a draft security council resolution, backed by Great Britain, in effort to end political repression and human rights violations to United Nation Security Council in January 2007.
- Belgium, France, Ghana, Italy, Panama, Peru, Slovakia, the UK and the U.S. voted in favor of the resolution.
- China and Russia vetoed against the resolution.
- Indonesia, Qatar and the Republic of Congo abstained from voting on either side.
- Some state that the human rights issues are domestic affairs, while the others believe it is an international issue.

ASEAN's Thoughts.

- During the January 2007 ASEAN summit in Cebu, Philippines, the member countries failed to come up with a common solution on the issue of Burma's lack of political reform.
- The Ministers in attendance called for Burma to make greater progress on its "Roadmap" towards democracy and national reconciliation.
- Burma was forced to withdraw from the consideration for ASEAN Chairmanship in 2005 by other ASEAN members due to lack of progress towards political reforms.
- Some ASEAN members, notably Malaysia and Indonesia, kept up pressure on the junta since 2006, calling for the release of Aung San Suu Kyi and for faster progress on political reform.

Others Continue to Support Burma's Economy.

- Export revenue remains buoyant because of oil and gas sector, the only area of significant growth for the economy.
- Natural gas to Thailand supports Burma's sales in the energy industry. Thailand is the top export destination for trade.
- China and India has a strong demand for Burma's mining, energy, agricultural and forestry products.
- Burma's principal import sources (2005) are China (29.3%), Thailand (22.2%), Singapore (18.7%) and Australia (1%).
- Foreign investment comes primarily from China, Singapore, South Korea, India, and Thailand.

The Black Economy.

- Burma is the second largest opium producer in the world, following behind Afghanistan, accounting for 8% of entire world production.
- Data for imports and exports may be overstated or understated due to unrecorded military imports from China. Legal export invoices may be vastly exaggerated as a result of money-laundering in association with the illegal drug industry.

Commodities Help Exports.

- Natural gas has risen to become the top exporter, overtaking more traditionally important commodities such as timber and pulses.
- In the last five years, garments also emerged as another top export-earner; however U.S. sanctions have slowed development of the sector.
- India is the major market for Burma's pulses, consuming about 80% of exports.
- Hardwood exports have also risen, owing to strong demand from China.

Fiscal & Monetary Policy.

- Fiscal policy is dire, with the junta set to continue to borrow from the central bank to finance high fiscal deficits, particularly now that the salary outlay for the public sector has expanded sharply.

- The SPDC recently managed to sell stakes in 11 state-owned enterprises, and tax revenue continues to rise at a fairly rapid pace in nominal terms.
- The central bank is not expected to make any effort to tighten monetary policy in the next few years, despite the likelihood of high inflation.
- In April 2006, the central bank raised its leading indicator rate by 2 percentage points to 12%, the first change in around five years. This coincided with the government's decision to raise public-sector salaries, aimed at containing inflationary pressures.

Inflation.

- Consumer price inflation has been rising sharply, particularly commodity prices that have soared in the wake of the government's decision to raise public-sector salaries in March. Rice and fuel prices remain high as well.
- Economist Intelligence Unit (EIU) estimates that annual inflation at an average of around 18% this year, although prices for most commodities are likely to be rising at a much faster pace.
- Junta will attempt to contain inflation by implementing ad hoc (and potentially ill-devised) remedies, but these will be of a short-term nature and will fail to resolve the structural weaknesses in the economy.

Labor Force is Weak.

- Estimated that Burma's labor force reached 26.4 million people, according to Asian Development Bank (ADB) in 2003-2004, however statistics are unreliable.
- Agricultural sector accounts for over 60% of all employment.
- Lack of investment in education and repeated closures of the universities in recent years have reduced the number of skilled workers.
- Political repression and a stagnant economy have driven a huge number of nationals overseas in search of work; there may be up to one million illegal migrant workers from Burma based in Thailand, with other large populations based elsewhere in South-East Asia and the Middle East.

Education System Suffers.

- Lack of funding is a chronic problem, according to World Bank, spending by SPDC on education totaled a measly 1.3% in 2002.
- According to World Bank data, the adult literacy rate (rudimentary reading and writing) was close to 90% in 2004, despite poorly paid teachers and quality of teaching, due to monastic education traditions. Monastic schools have played an important role in education, but it cannot make up for the shortfall left by junta's lack of investment in education.
- In 2005, only around 40% of all children were enrolled in secondary schools, compared with an average of 71% for East Asia and the Pacific.
- The overall standard of education in Burma is believed to have declined sharply in recent years.

Bleak Healthcare Looms Ahead.

- International Monetary Fund (IMF) figures reveal that health spending was equivalent to just 0.1% of GDP in the second half of the 1990s. Most of Burmese populace does not have access to basic healthcare.
- Life expectancy was 60.8 years in 2004 compared with an average of 70.3 in East Asia and the Pacific.
- Borders suffer the worst, with higher incidence of diseases such as HIV/AIDS, tuberculosis and malaria. Avian flu and cholera are other threats.
- Migrant workers, human trafficking, and refugees play a role in exporting and spreading the diseases to neighboring countries.

- Pandemic diseases such as the Avian Flu could quickly spread without much detection within the country.

Foreign Direct Investments (FDI).

- FDI inflows averaged U.S. $217.1 million a year in 2000-04. Aside from gas and oil, few sectors are now attracting any fresh FDI approvals.
- FDI approvals totaled U.S. $35.7 million in the first 11 months of 2005-06, down from U.S. $158.3 million for the whole of 2004-05.
- These estimates could be underestimated, as they may not capture smaller foreign-invested projects funded by China and Thailand.
- FDI could rise in the future if offshore gas finds are developed.

A Choke Hold on Foreign Investment.

- Poor business climate and erratic policy environment has dampened FDI.
- Coordinated global consumer boycott campaigns have targeted international investors in many sectors such as tourism, energy and garments.
- Sanctions banning new U.S. investment imposed in April 1997, and the ban on all U.S. imports from Burma which has affected export-oriented sectors has made foreign investment difficult.
- Discouragement of investing by a number of governments and the investor's concern over political instability has constrained the growth of Burma.

Rich, Fertile Ground.

- Burma has rich natural resources, including fertile agricultural land, a range of minerals and extensive forests.
- The agricultural sector has great potential. Some of the most important crops are rice, pulses, oilseeds, timber, rubber, cotton and many fruits and spices.
- Lack of investment holds this industry back, along with the low area of land cultivated for these crops.
- Teak and other hardwoods are most important economically – accounts for 75% of the world's remaining teak.

Infrastructure is Insufficient.

- Highways are normally unpaved, except in major cities.
- Energy shortages are common throughout the country.
- Railroad system is decrepit, with few repairs since the 1800s.
- Poor transport and communication infrastructure is under funded and unreliable.

CONCLUSION

The Westerners' attempts to asphyxiate Burma (Myanmar) through government sanctions and embargoes, has proven to be questionable. Has the Burmese government suffered from these efforts? Who has been hurt more - the government or the citizens of Burma?

- The U.S., Canada, Australia and the E.U. have imposed government sanctions, coupled with boycotts and direct pressure on Western corporations for protection of human rights after the military crackdown in 1988.

- Burma is now one of the poorest nations in the world, suffering from decades of stagnation, mismanagement and isolation. GDP is estimated to be 2.9%, the lowest rate of economic growth in the Greater Mekong sub region. The Burmese are falling further behind as the forces of globalization speeds forward in the rest of the region.
- Dramatic changes are unlikely, due to continued support from major regional powers such as India, Russia, and China in particular.

CHRONICLES OF ECONOMIC HIGHLIGHTS

16 May 2007

Russia is to build 10-megawat nuclear reactor with low-enriched uranium for Burma.

- Under International Atomic Energy Agency (IAEA) control.
- Up to 350 Burmese students to be trained in Russia.
- Revives stalled 2001 plans to help Burma with nuclear energy program.

Economic Advisor's Comment:

Burmese people endure chronic power shortages – if they even live in the few areas that get any state power at all.

- Burma only had 1,775 megawatts of power for 53 million people in 2006.
- In contrast, Thailand had 26,000 megawatts for 63 million people in 2006.

U.S. concern: Moral hazard.

- Russian nuclear reactor rewards Burma's bad behavior.
- Burma can get what it wants without reform.
- Burma could someday transform nuclear power into nuclear weapons.
- However, nuclear weapons takes high tech skills/massive investment.
- That's far beyond the current financial and technical capacity of Burma.

23 May 2007

Burma's widening economic gap between Junta and the people. Gap is widening between:

- Fortunes of the junta, which is reveling in unprecedented inflows of natural gas revenues and warming relations with key neighbors.
- Wider population face deteriorating living conditions.

Economic Advisor's Comment:

Burma's natural gas sales are filling the junta's coffers.

- Burma's global trade rose to $7.9bn in 2006, up from $5.5bn in 2005.
- That produced a healthy trade surplus of $2.1 billion.

Junta is using its energy wealth to cement its ties with powerful, energy-hungry neighbors:

- China and India are courting Junta as they vie for access to its vast natural gas supplies.
- Russia has just announced it will help the regime build a 10 megawatt nuclear research reactor.

In contrast, the Burmese people struggle with high inflation, higher fuel costs, and power cuts.

- Mounting public frustration prompted protests.

Burma’s natural gas boom is reinforcing the Junta’s defiance.

- Junta has cracked down on several civil society organizations.
- Junta moved to shut down a popular group that provided free funerals to the poor and business groups such as the Myanmar Chinese Chamber of Commerce.

CAMBODIA

• CHAPTER 7 •

Leif R. Rosenberger

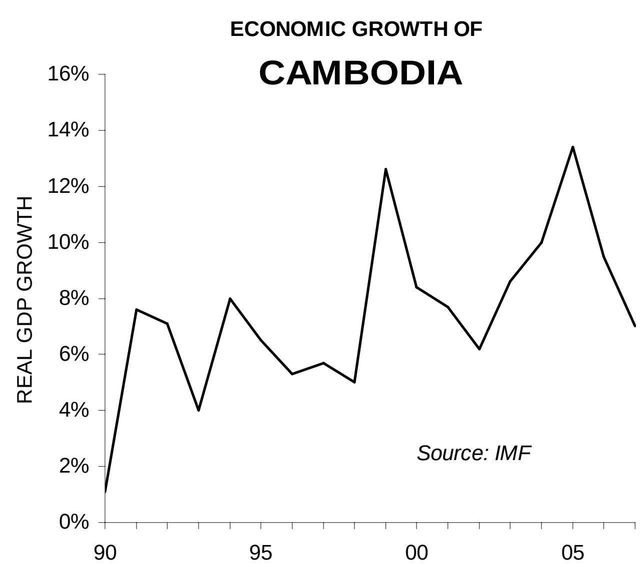
Introduction.

For years Cambodia has been one of the poorest countries in the world. Cambodia's economic growth has been unspectacular – with GDP growth actually slowing down from 5.2% in 2003 to 4.3% in 2004. Analysts were focusing on why economic growth was so sluggish and what could be done to turn the tide.

Selected Historical Data

Cambodia	2001	2002	2003	2004	2005	2006
Purchasing Power $B	26	28	31	35	41	45
GDP $B (Nominal)	103	104	104	111	117	122
GDP Growth (Real)	7.7%	6.2%	8.6%	10.0%	13.4%	9.5%
Inflation	0.2%	3.3%	1.2%	3.9%	5.8%	4.8%
Exports $B	1.5	1.9	2.1	2.8	3.1	...
To U.S. $B	0.0	0.0	0.1	0.1	0.1	0.1
Imports $B	2.1	2.3	2.6	3.2	3.7	...
From U.S. $B	1.0	1.1	1.3	1.5	1.8	2.2
FDI held by U.S. $B	-	-	-	-	-	...
held in U.S. $B	-	…	…	…	…	...
Gross Intl Reserves $B	0.7	0.7	0.7	0.8	0.9	1.1
Savings /GDP	11.4%	10.0%	9.7%	9.4%	13.9%	…
Fiscal Balance /GDP	-5.6%	-6.7%	-7.0%	-6.4%	-6.3%	-6.0%
External Debt /GDP	2.4%	2.6%	2.9%	2.8%	...	...
Current account/GDP	-1.2%	-2.4%	-3.7%	-2.3%	-4.3%	-4.8%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



All's Well in 2005.

Then in 2005 everything went right.

- Cambodia's real GDP growth soared an unprecedented 13.4%.

Drivers.

This impressive economic performance was due to a number of factors.

- Agriculture remained a crucial sector for the economy, accounting for 38% of GDP growth and some 60% of total employment in 2005.
- Tourism receipts rose 44% in 2005.
- FDI more than doubled in 2005.
- Construction also boomed.

Garment World.

But of all the drivers of this spectacular growth, the strong performance of garment exports was most unexpected. For years the Multi-fiber Arrangement (MFA) guaranteed Cambodian garment exporters access to U.S. and EU markets. Then on 01 January 2005 that guaranteed access ended for Cambodia. Skeptics argued that Cambodian garment makers couldn't compete against China, which for years had the lowest garment prices in the world. They would also have a hard time competing against many other developing countries that had tariff free access via the Central America Free Trade Agreement (CAFTA) or the African Growth and Opportunity Act (AGOA). After all, Cambodian garments are saddled with an average 18% U.S. tariff.

Primacy of Garments.

If Cambodian garment makers lost head to head competition for markets it would devastate Cambodia's economy. The garment industry has been critical to its economy:

- In 2004 garment exports accounted for 96% of total exports.
- In 2004, textiles and garments (and footwear) accounted for 72% of total manufacturing GDP and 15% of total GDP.

Good News: Growth.

Could Cambodia withstand greater international competition in 2005? Yes. Cambodia's garment industry stunned skeptics. It grew rapidly since the end of Multi-fiber Agreement in January 2005.

- The value of Cambodia's garment exports grew by 13% in 2005.
- In the first 8 months of 2006 they grew 21%.

While some small and medium-sized factories (i.e., up to 1,500 employees) have closed, there has been a net gain of 15 factories in 2006.

There's no silver bullet explanation for the success of the Cambodian garment industry. But the U.S. Embassy cites a number of contributing factors:

- Safeguards against China played a large role. Garment orders were largely flat in early 2005 and only took off once U.S. and EU safeguards were imposed.
- Cambodia's unique factory monitoring organization (Better Factories Cambodia) shows that the program was also an important factor. Cambodia's strong reputation for worker rights, and the commitment of major buyers -- like the Gap -- to supporting Cambodia's labor rights experiment as impetus for the increase.
- Chinese garment factories raised their low garment prices. (See Bangladesh chapter for the reasons why).
- Cambodian prices remain 15% below world market average, spurring growth.

As a result, existing buyers are placing larger orders with Cambodian factories and a few new buyers have begun to source from Cambodia.

Bad News: Weak Profits.

Unfortunately, declining prices for garments have left Cambodia's garment factories operating on declining profit margins despite rising productivity.

- The price of Cambodian garments declined by 20% from January to December 2005.
- Since January 2006, prices have increased slightly in the U.S. market but are still decreasing in the EU market.
- However, garment factory productivity rose 50% from 2001 to 2006.
- The U.S. Embassy reports that Cambodia's garment factory profit margins, which were 10-11% net in 2003 and 2004, have now fallen to 5-6%.
- Private sector experts say Cambodia's garment makers were only making 2-3% profit.

Bad News: Lower Wages.

To make matters worse, real wages of garment factory workers have been falling for three years:

- 3.1% decline from 2003 to 2004.
- 8.7% decline from 2004 to 2005.
- A further 0.3% decline through February 2006.

Not surprisingly, there was a dramatic increase in garment sector strikes from February to June 2006.

In retrospect, Cambodia's garment industry grew impressively since the Multi-fiber Agreement (MFA) ended.

- This growth has translated into a growing number of factories and workers.
- However, neither factory owners nor workers have truly reaped the benefits of this growth.
- That's because dramatically lower prices for Cambodian garments hurt factory profits and contributed to declining wages and increasing labor unrest.

Uncertain Future.

Thankfully, Cambodia's government and private industry have made some efforts to improve the country's competitiveness. But there is no consensus on how Cambodia will fare once the U.S. and EU safeguards expire in 2008.

- Some experts say Cambodia's garment sector will grow 10-20% after U.S. and EU safeguards expire in 2008.
- Other experts say it will decline of up to 30%, followed by a partial rebound.

There are, however, two areas where there is broad agreement.

- First, Cambodia's garment sector will not collapse due to the end of safeguards or increased Chinese competition, though it may contract significantly in the worst case scenario.
- Second, a protracted labor dispute is the one thing that could do swift and extremely serious damage to the garment industry.

However, there is broad agreement that unstable labor relations, not the 2008 deadline, are the biggest threat to the industry.

Oil to the Rescue?

All agree that 2005 was an extraordinary year in the garment industry as well as in other sectors of the economy. But can this economic success story in 2005 be sustained? Well, 2010 and beyond looks great. Why? Impoverished Cambodia is bursting with excitement about a recent oil discovery by Chevron off the South-Western coast. The government hopes to use oil money to gradually rid the country of its "beggar state" status. Exactly what lies beneath the seabed is still uncertain. But energy experts estimate that oil production could generate well over $1 billion a year in revenue. That's an extraordinary jump for a country that heavily relies on some $500 million a year from donors. 35% of Cambodia's 14 million people live below the national poverty line of 50 U.S. cents a day.

Once energy windfall kicks in, will Cambodia get complacent? Will chronic corruption turn energy into the black curse? Will energy enrich the privileged few and ignore the rest? For instance, Nigeria exemplifies the so-called oil curse. Nigeria is wracked by massive corruption fueled in part by its vast oil revenues. Although its oil sector contributes 95% of its export revenue, some 37% of its 131 million people live in extreme poverty. That fans underlying conditions for violent extremism. Prosperity is like horse manure. We need to spread it around for shared prosperity.

Bridging the Gap.

Moreover, windfall profits from Cambodia's new found energy bonanza probably will not appear until at least 2010. How will Cambodia make it between now and then? Can Cambodia sustain this spectacular economic performance that we saw back in 2005 in the near future? While the official numbers are still not in for 2006, leading economic indicators point to a slowdown from unusually strong economic growth in 2005.

- The World Bank expects Cambodia to grow at an estimated 8.9% in 2006.
- 8.9% growth is only slightly better than the 8% growth needed to reduce the pervasive poverty and rapidly growing labor force.

Time to Rebuild.

Given the ambiguity in the garment industry and the outlook of energy in the future, Cambodia still needs to hedge its bets and broaden its economic base. Regrettably, many of the foundations for growth and development in other economic areas have been shattered and are in desperate need of restoration.

- Roads need to be paved.
- Cambodia only has one deepwater port Sihanoukville and one small port for small vessels.
  - Both suffer from antiquated cargo-handling equipment and silting.
- Majority of population have no access to electricity.
  - Only about 20% of households have electricity connections.

Human Capital Development.

Cambodia needs to invest more in human capital to broaden its economic base.

- Educational opportunities are unsatisfactory at the tertiary level which directly impinges on shortages of skilled labor.
- Half of the population does not have access to the public healthcare system, making Cambodia's health care systems one of the worst in the world.

Poverty.

Cambodia is also one of the poorest countries in the world, with GDP per capita for 2006 of only $459.

- Infant death rate is 68.78 deaths/1,000 births.
- Life expectancy is 59.29 years, lower than Vietnam and Thailand.
- Adult literacy rate stood at 73.6% in 2003, up from 62% in 1990.
  - Women literacy was at 64.1% compared to men's 84.7%.

Cambodia is making strides to better their situation but is still falling short in alleviating poverty and corruption.

Donors Support.

UN and Western governments continue to deliver generous pledges of aid, despite the tensions over the human rights record.

- In support of the "One China" policy, China offered a generous soft loan of U.S. $200 million for road and bridge construction projects, with no associated calls for improvements in governance and human rights.
- Cambodia continues to co-operate closely with Vietnam, Laos and Thailand.
- Bilateral trade between Australia and Cambodia is integral to the efforts of reducing poverty and expanding economic growth.

Dependency Issues.

Cambodia remains highly dependent on imports, mainly petroleum products and construction materials.

- Imports totaled U.S. $3.2bn in 2004 according to IMF, while customs data indicates a total of U.S. $2.1bn.
- Thailand is its number one source of imports, providing Cambodia with refined oil, cement, in addition to foodstuffs, chemicals, motorbikes and electrical components.

Foreign Debt.

To make matters worse, the majority of capital inflows are foreign loans.

- External debt has increased steadily from approximately U.S. $2.5bn (end 1999) to U.S. $3.1bn at the end of 2003.
- Nearly all of debt stock is medium and long-term owed to 72% bilateral creditors.

Volatile FDI.

Foreign direct investment flowing into Cambodia has been on a roller coaster ride.

- FDI inflows fell from an average of nearly U.S. $150 million in 2000-02, to only U.S. $84 million in 2003.
- FDI rose to U.S. $131 million in 2004.
- Textiles and garment sector have received the biggest proportion of FDI.
- China (including Hong Kong) is Cambodia's biggest investor, followed by Thailand and the U.S.

CONCLUSION

Despite a surprising spurt of economic growth in 2005, Cambodia remains one of the poorest countries in the region. It leans too heavily on the crutch of foreign aid. The economy is plagued by serious economic mismanagement. In particular, the government is severely over-borrowed. Foreign investors find the business climate unappealing because of the high levels of corruption and volatility. The economy is driven by two unpredictable 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. Maybe the energy bonanza over the horizon is the be-all-end-all of what Cambodia needs to get over the hump. Cambodia expects to receive $1 billion dollars a year in oil revenue by 2010. Let's hope this previously impoverished nation will embark on a peaceful, prosperous future that includes all the citizens of Cambodia, not just the privileged few.

CHRONICLES OF ECONOMIC HIGHLIGHTS

22 March 2007

Cambodia's fast track economy soared 10.5% in 2006.

- Drivers were rises in garment, tourism, construction and agricultural production.

Economic Advisor's Comment:

Just 3 years ago IMF predicted Cambodia's "fragile" economy would collapse:

- Cambodia faced cut-throat competition from China's garment makers.

Feared exodus of garment factories from Cambodia to China did not occur.

- Today 320,000 Cambodians work in 290 active garment factories.
- That's up from 250,000 in 220 factories before 2005.
- Garment exports hit $2.5bn in 2006, up 17% from 2005.

Cambodia's off-shore oil is also expected to provide a boom in years ahead.

- Chevron discovered oil reserves off the coast in 2005.
- $1 billion a year in revenues is expected to flow into state coffers by 2010.

INDONESIA

• CHAPTER 8 •

Leif R. Rosenberger

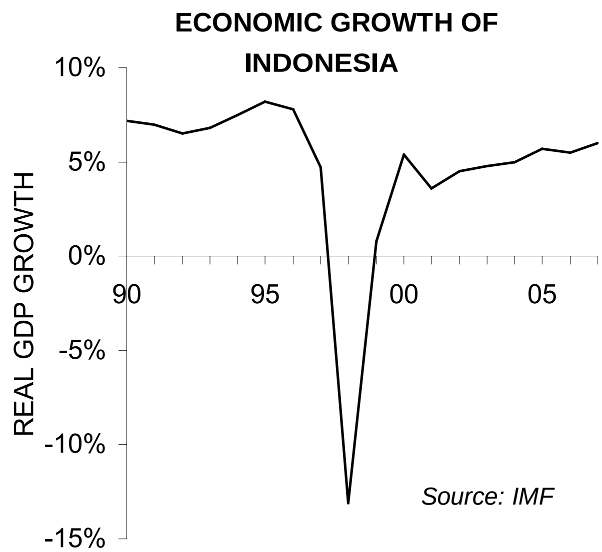
Executive Summary.

- Indonesian economy is on a roll, with strong 6% GDP growth.
- The country has struggled to regain its strong economic growth they enjoyed prior to the Asian economic crisis.
- Jakarta decisively cut energy subsidies and curbed subsequent inflation.
- That enabled Jakarta to responsibly cut interest rates.
- Lower interest rates stimulated consumption and investment.
- Enthusiastic investors also cite healthy macroeconomics and political stability as encouraging to foreign investors.
- Stocks hit all time high and rupiah became best performer in region.
- Fixed investment is also up from 2.9% in 2006 to estimated 10.6% in 2007.
- Recently passed new investment law, helps in making Indonesia more foreign investor friendly.

Selected Historical Data

Indonesia	2001	2002	2003	2004	2005	2006
Purchasing Power $B	663	705	754	815	886	960
GDP $B (Nominal)	114	121	128	139	159	181
GDP Growth (Real)	3.6%	4.5%	4.8%	5.0%	5.7%	5.5%
Inflation	11.5%	11.8%	6.8%	6.1%	10.5%	13.1%
Exports $B	57.4	59.2	64.1	70.8	86.2	...
To U.S. $B	2.5	2.6	2.5	2.6	3.0	3.1
Imports $B	37.5	38.3	42.2	54.9	69.5	...
From U.S. $B	10.1	9.6	9.5	11.0	12.0	13.4
FDI held by U.S. $B	6.355	…	…	…	8.104	...
held in U.S. $B	0.057	0.040	0.058	0.046	0.050	...
Gross Intl Reserves $B	28.1	32.0	36.3	36.3	34.7	42.6
Savings /GDP	25.5%	21.1%	20.1%	19.7%	26.3%	…
Fiscal Balance /GDP	-2.0%	-1.4%	-1.7%	-1.3%	-0.8%	-1.0%
External Debt /GDP	116.4%	108.5%	106.1%	...	...	...
Current account/GDP	4.3%	4.0%	3.5%	0.6%	0.1%	2.7%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



O n a R o l l .

Indonesian GDP rose 6% year on year in 1Q 2007– near fastest pace in 2 years.

- Economic growth is accelerating, with 2Q 2007 growing faster than 1Q 2007.
- Indonesia is one of only two countries (Philippines is the other) on track to grow faster in 2007 than 2006.
- But economic growth has not come easily in recent years.

E c o n o m i c R o l l e r C o a s t e r .

Prior to the Asian economic crisis Indonesia enjoyed strong economic growth.

- The Asian economic crisis sent the country into an economic depression.
- Indonesia eventually recovered from the depression.
- But Indonesia has been unable to generate the same kind of economic growth in recent years that it generated before the Asian economic crisis.

R i s e a n d F a l l o f O i l E x p o r t s .

- Not long ago, Indonesia was an oil exporter.
- But due to a foreign direct investment shortfall in energy sector, Indonesia's oil output has fallen.
- Indonesia is now a net oil importer, with high oil prices a financial loser for it.

B i g P r o b l e m : S u b s i d i e s .

High cost oil imports initially raised cost of its energy subsidies by 40% in 2005.

- In the face of this budget buster, jittery investors opted for capital flight.
- Rupiah fell to 3½-year low against dollar in August 2005.
- 29% cut in energy subsidies on 01 March 2005 had failed to placate financial markets.

G o o d N e w s .

Then the big event -- Jakarta raised fuel prices 126% on 01 October 2005.

- Investors celebrated Jakarta's new fiscal discipline (on fuel prices) and high interest rates.
- Rupiah touched 11-month-highs in late January 2006.
- New inflow of foreign portfolio investment also caused the stock market to surge to new records in late January 2006.

Bad News: Inflation.

Higher fuel prices caused inflation to soar over 18%.

- Jakarta raised interest rates six times from August to January 2006 to fight inflation.
- Higher borrowing costs caused consumer spending to fall.
- GDP growth slowed down.

Inflation Under Control.

- Jakarta kept raising interest rates until May of 2006.
- Jakarta's persistence paid off -- inflation was finally under control.

Looser Monetary Policy.

- In the past year Indonesia cut interest rates 11 times.
- Interest rates have fallen from 12.75% a year ago to 8.75% on 08 May 2007 – lowest since August of 2005.

Rising Consumption.

Lowering borrowing costs encouraged companies to borrow to fund expansion.

- Investment spending started to pick up.
- Lower interest rates boosted consumer demand for new homes, motorcycles and cell phones.
- In fact, consumption rose 4.5% in 1Q 2007 from a year earlier – fastest pace in 10 quarters.

Other Positive Indicators.

Indonesia's economic performance is improving almost across the board.

- Unemployment fell from 10.3% in August 2006 to 9.7% in February 2007.
- Consumer confidence hit a four month high in April 2007.
- Foreign exchange reserves rose to a record $49.2 billion in May 2007.

Bullish Financial Markets.

Faster growth attracted foreign investors to invest in financial markets.

- On 17 April the Indonesian stock market closed at 1,965.
  - That was an all-time high and a rise of 69% since the end of 2005.
  - At last glance (17 May 2007), the stock market was at 2063.
- Rupiah rose 3.1% in May 2007 – best performance among 15 Asia Pacific currencies.
- Rupiah's gain is also helping to stem inflation.

Rising Fixed Investment.

But it was not just portfolio investment (stocks and bonds) that were rising.

- Indonesia's gross fixed investment has risen from just 2.9% in 2006 to an estimated 10.6% in 2007 and a similar rise expected in 2008.

Positive Drivers.

Investors are responding to a confluence of positive economic indicators:

- Healthy macroeconomics, with strong GDP growth and low inflation.
- Falling interest rates.
- Political stability.

New Investment Law.

Frosting on the cake is the new investment law, finally passed on 29 March 2007.

- While not a panacea, it is a big step in the right direction in terms of making Indonesia more foreign investor friendly.
- The law reduces the number of sectors closed to foreign investors and includes provisions for tax breaks and other incentives.

Despite this optimistic picture, there are grounds for caution.

- New law is short on all-important implementation details.
- Reforms to tax regime and labor markets need to follow.

CONCLUSION

How's the economy doing?

- On a roll, with strong 6% GDP growth.

How did SBY turn economy around?

- He cut subsidies and curbed subsequent inflation.
- He then cut interest rates, which stimulated consumption and investment.

How did financial markets react?

- Stocks hit all time high and rupiah became best performer in Asia Pacific.

How is fixed investment doing?

- Up from 2.9% in 2006 to estimated 10.6% in 2007 and 2008.

Why are investors so bullish?

- Healthy macroeconomics; strong GDP growth and low inflation.
- Falling interest rates.
- Political stability.
- New investment law passed in late March.

What's so good about the new investment law?

- Friendlier to foreign investors.

CHRONICLES OF ECONOMIC HIGHLIGHTS

02 June 2006

Jakarta began creating broad elements of reconstruction strategy.

- Focus: Small-scale initiatives -- cash grants to victims of up to $3,300 to fund individual reconstruction efforts.

Small-scale cash grants stand in contrast to large scale projects seen in tsunami-devastated Aceh province.

- Lesson learned from tsunami - relying on large-scale projects made reconstruction too laborious.

Aim to accelerate reconstruction process in affected areas.

- Asian Development Bank (ADB) President, Haruhiko Kuroda, praised Jakarta for quick start.
- ADB experience shows better reconstruction results with early planning.

Economic Advisor's Comment:

Jakarta expected to present breakdown of reconstruction needs to donors at 14 June meeting.

- Jakarta working with ADB and World Bank on detailed assessment.
- ADB pledged $60 million in grants/soft loans; World Bank offered $50 million to $60 million.

Based on level of destruction, Jakarta estimated $100 million as reconstruction cost.

- However, ADB president claims cost likely much higher than $100 million.

Aid workers unsure of how many are left homeless (unsure how to calculate).

- Jakarta estimates as many as 650,000 left homeless based on estimated 135,000 homes destroyed (assuming each house held 5 people).

UN children's agency (UNICEF) thinks Jakarta estimates are inflated.

- Recent UNICEF estimates far fewer left homeless (130,000).
- Accurate estimate of destroyed homes could help determine how much aid actually necessary.

21 June 2006

Indonesia scaling back plans to force military to unload business interests.

- Deflated reform efforts only seven months after U.S. restored full military ties with Jakarta.
- Per Defense Minister, Juwono Sudarsono in London *FINANCIAL TIMES* interview; Jakarta able to force Indonesian military (TNI) to divest only "6 or 7" of 1,500 profitable businesses within its control.

Economic Advisor's Comment:

2004: Parliament required TNI to unload businesses within 5 years.

- Reform advocates accuse TNI business network of contributing to corruption, illegal logging and other crimes, as well as complicating new investments for foreign companies.

Sudarsono: Main reason for continued TNI business is "meager Indonesian defense budget."

- Civilian government provides 48% - or $2.8 billion - of supposed "minimum defense budget required."
- Continued TNI business based on "economics and affordability."
- Conclusion: "You cannot expect us to reach your [Western] standards of reform, accountability, and propriety because socio-economic underpinnings are just not there."

Release by Human Rights Watch criticized efforts to reform military businesses. Report said:

- Leaders recognize need to address question of financing.

- Ending military economic activities is part of a "wider agenda" to bring TNI under civilian control.
- Claims have not been met with actions.

Sudarsono insists Indonesia remains committed to military reform.

- Glitches in reform process exist because of vested interests at all levels.

18 August 2006

16 August: Indonesian President Susilo Bambang Yudhoyono (SBY) unveiled big plans for 2007 government spending increase in annual state of nation speech:

- 16% rise in central government spending in 2007.
- 13.8% increase in Jakarta's grants to provincial governments.
- 23% rise in salaries for 4 million poorly paid civil servants to reduce incentives for corruption.

SBY says 2007 budget retains significant subsidies.

- Jakarta plans to spend $7.5bn on fuel subsidies in 2007.
- Opportunity cost --- subsidies (on fuel, etc) in budget is 1/3 more than education budget even after 18.5% increase in education budget.

Economic Advisor's Comment:

Historically, budget problem results from weak implementation or under-spending.

- In 1st 6 months of 2006, less than 23% of budget had been disbursed.

SBY celebrates 1st favorable economic news since he took office 22 months ago.

- SBY still not delivering on economic promises.

Good news - 18 month slowdown in growth is over, with annual GDP up 5.2% in 2Q 2006.

- Public debt under control and inflation, though high at 15%, is falling.
- Prospect of lower interest rates helps recovery in consumer demand.
- Stronger consumer demand should propel growth to more than 5.5% for 2006.

Bad news - growth rate likely to stay below 6 to 7% needed to create jobs and dent poverty.

- Recent pick-up in growth due to higher commodity prices and government spending.
- Economy desperately needs more private investment.

Investment has been way too low since country's 1997 economic crisis.

- Without solid rebound in job-creating investment, economy will struggle to tread water.

Domestic and foreign investors remain reluctant to invest.

- Investors want better business conditions before they will commit.

Why is business climate unattractive and a turn-off for investors?

- Anti-corruption drive is bogged down in weak, disorganized court system, resulting in few convictions so far.
- Proposals to overhaul Indonesia's ramshackle tax system and rigid labor laws are marooned in an unruly parliament.
- Parliament has yet to pass a single substantive item of economic legislation apart from budget.
- Policy execution is held hostage by inflexible, inefficient bureaucracy that regards economic reforms as a threat to its own livelihood.

14 March 2006

Exxon – Mobil reached a $2 billion oil deal with Pertamina, Indonesia's state-owned oil and gas company, thus resolving a longstanding dispute.

- Pertamina and Exxon now have a joint organization to operate the Cepu oil field on Java.
- Exxon will appoint general manager, while Pertamina will appoint a deputy general manager.
- Pertamina and Exxon will each hold 45% of Cepu; other 10% to be held by local governments.

Economic Advisor's Comment:

Tapping Cepu oil field, which holds 250 to 500 million barrels of oil reserves, is important.

- Pertamina has been struggling to stem falling oil output and exports.

Jakarta recorded a $7.3 billion oil trade deficit in 2005 owing to faltering energy investment.

- That forced Jakarta to slash costly domestic fuel subsidy programs last year, causing inflation to hit double-digit levels and squeezing tens of millions of poor Indonesians.

Indonesia is banking on the Cepu -- expected to begin some production by 2008 -- to stem a 15% decline in output to less than one million barrels a day.

- Cepu could produce 170,000 barrels a day, or 18% of Indonesia's output.

Overcoming Cepu impasse with Exxon is positive for President Yudhoyono (SBY).

- Deal enhanced atmospherics for a successful Sec State visit to Indonesia.

However, Exxon deal is unlikely to be watershed event for Indonesia's investment climate.

- SBY has been slow to deliver on more business-friendly tax and investment laws.

Foreign investors still see Indonesia as an unattractive place to invest.

- It has too much risk, too much red tape and too little ability to compete in manufacturing with the likes of China.
- Investors have left industrial zones because of the headaches of doing business there.

In addition, several key initiatives SBY billed as priorities are languishing.

- Tax overhaul legislation is bogged down and investment plan only has timetables to draft or revise regulations.

29 Jan 2007

Indonesia's financial situation is improving.

29 Jan: Fitch credit rating agency raised Indonesia's debt rating outlook from "stable" to "positive."

- Positive outlook means company more inclined to raise BB- currency debt rating.
- Higher debt ranking would help Indonesia reduce its borrowing costs.
- Fitch says government's efforts to tackle investors' concerns about corruption and bureaucratic hindrances starting to pay off.

Economic Advisor's Comment:

Positive change in Fitch outlook reflects improving Indonesian economic performance.

- GDP on track to accelerate from 5.6% in 2005 to 6.3% in 2006 -- fastest pace in 11 years.
- Indonesia's foreign reserves rose 23% in 2006.
- Budget deficit down from 2.5% of GDP in 2002 to expected 1.1% of GDP in 2006.

However, foreign direct investment (FDI) dropped 33% from 2005 to 2006.

- To strengthen financial security, mix of capital inflows must shift from volatile portfolio investments (stocks and bonds) to more sustainable FDI.

24 April 2007

Indonesian court clears Denver-based Newmont Mining of pollution charges.

- Indonesian Police charged Newmont with polluting a bay off Sulawesi Island with mercury and arsenic runoff from its mine.
- If convicted, Richard Ness (Newmont chief in Sulawesi) was facing up to 3 years in jail and $55,000 fine; Newmont faced $110,000 fine.
- Doctor who made original complaint against Newmont later retracted it.
- World Health Organization study and others found no evidence of pollution.

Economic Advisor's Comment:

In the past, foreign investors were concerned about Indonesia's shoddy legal system and government's failure to push through a new law governing investment in the mining sector.

- As a result, Indonesia has been missing out on a global boom in prices for commodities like gold, copper, coal and nickel.
- While Russia and Chile attract investment, Indonesia's mining companies have broken no new ground on a major mine since Asian financial crisis.

Not-guilty verdict is likely to restore a measure of confidence in the country's legal system and help reassure foreign investors.

22 May 2007

Indonesia – Finance Minister says economy is on track will enjoy fastest growth in 12 years. In written statement to parliament, he forecasts the economy to accelerate to 7% of GDP growth in 2007.

- Consumer confidence hit 4-month high in April.
- Foreign reserves rose to record $49.2 billion in May.
- Stock market recently hit an all time high.
- Rupiah is best performing currency in region in May

Economic Advisor's Comment:

- Jakarta decisively cut energy subsidies and curbed subsequent inflation.
- That enabled Jakarta to responsibly cut interest rates 11 times in past year.
- Lower borrowing costs stimulated consumption and investment.

New investment law passed in March is friendlier to foreign direct investment, which is also rising.

LAOS

• CHAPTER 9 •

Sharon Strickland and Miemie WInn Byrd

Executive Summary.

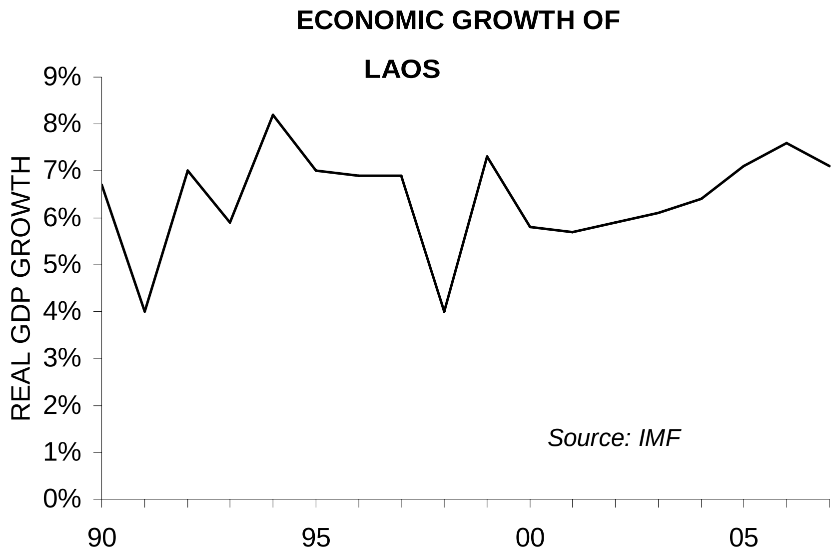
Enough positives counter the negatives, when taking a snapshot of Laos' economy.

- Laos has made tremendous progress towards a market economy, through the help of the mining and hydropower sectors, private sector development, and tourism.
- Laos' economy grew at a record 7.6%. Strong growth and relatively low inflation continues to reduce poverty in both rural and urban areas.
- A positive outlook lies ahead for the economy in 2007, as investment and exports continue to increase.
- Further expansion is anticipated to continue due to the government's accomplishment of major milestones in recent years;
    - However, its commitment to reforms remains vital in obtaining future economic gains for Laos.
- Meanwhile, Laos is still considered a Least Developed Country (LDC) with an average income of $570 per capita for 2006 and it continues to rely heavily on international donor assistance.

Selected Historical Data

Laos	2001	2002	2003	2004	2005	2006
Purchasing Power $B	9	10	10	11	13	14
GDP $B (Nominal)	1,317	1,457	1,687	1,862	2,011	2,106
GDP Growth (Real)	5.7%	5.9%	6.1%	6.4%	7.1%	7.6%
Inflation	7.8%	12.1%	15.5%	10.5%	7.2%	6.8%
Exports $B	0.3	0.3	0.4	0.4	0.5	...
To U.S. $B	0.0	0.0	0.0	0.0	0.0	0.0
Imports $B	0.5	0.4	0.5	0.5	0.7	...
From U.S. $B	0.0	0.0	0.0	0.0	0.0	0.0
FDI held by U.S. $B	…	…	…	…	…	...
held in U.S. $B	0.004	0.004	0.004	0.004	0.004	...
Gross Intl Reserves $B	0.2	0.2	0.2	0.2	0.2	0.3
Savings /GDP	…	16.4%	19.6%	18.3%	…	…
Fiscal Balance /GDP	-7.6%	-8.3%	-7.8%	-4.8%	-5.3%	-3.9%
External Debt /GDP	0.1%	0.1%	0.1%	0.1%	...	...
Current account/GDP	-8.3%	-7.2%	-8.1%	-14.3%	-19.9%	-13.4%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

Laos's economy grew at a record 7.6% in 2006, largely due to continuing investments in mining and hydropower.

- Further expansion is anticipated to continue in 2007 as investment and exports continue to increase.
- Despite the recent remarkable growth rates, primitive infrastructure remains to be a major setback to achieve sustainable growth for the Laotian economy.

Political Background.

Laos has made tremendous steps towards eradicating poverty and improving their situation. A nominally Marxist-Leninist state is ruled by the Lao People's Revolutionary Party (LPRP) that has an operating National Assembly.

- They adopted a new constitution in 1991, which formalized the establishment of a market-oriented economy.
  - Under the new constitution, a citizen is guaranteed the right to own property, greater freedom to travel, choice of employment and the development of a fledgling private sector.

Good News.

Movement is in the right direction.

- Laos has sustained its momentum towards a market economy through structural reforms in trade, private sector development and public financial management.
- Tourism receipts continue to perform well, with visits growing over 20% a year, along with other non-traditional exports.
  - The Lao government is targeting ecotourism, which is expected to be an area for future growth.
- Mining of gold and copper exports have been rising rapidly over the last two years, primarily due to China's increasing appetite for raw materials.

- **FDI**. Foreign direct investment (FDI) inflows into mining and the hydropower sector, both driven by strong regional economic growth, remain buoyant.
- **International Players**. Laos's economy is dominated by neighboring Thailand, Vietnam, and China.
  - From 2005 to 2006 China-Laos bilateral trade has ballooned by 70%, making China the second largest trade partner for Laos.
  - Australian and French companies hold significant market shares in certain sectors.
  - Currently, U.S. private sector is a non-player in Laos.
- **WTO**. Laos's on-going efforts to join the World Trade Organization (WTO) since 1997 provide a huge incentive for the LPRP to persistently march down the path of reform.
  - The government sees further integration of its economy into the world trading system as the key to economic development and poverty alleviation.

Bad News.

Laos still faces many obstacles.

- High debt continues to hamper macroeconomic stability.
- Agriculture sector has reaped disastrous consequences due to floods and droughts, affecting the livelihood of 80% of its population.
- Despite experiencing record economic growth, domestic revenue is still insufficient in reaching the Millennium Development Goals.
- Though poverty has been reduced in recent years, half of its population in the Northern part of the country still live significantly under $1 a day.

Progress…Albeit Slow…in Structural Reforms.

Implementation of structural reforms has continued, even if slow.

- LPRP continues to take action to open trade and private investment.
  - However, commercial laws and the commercial court system are developing slowly and are not transparent.
  - Customs procedures are opaque and prone to the exploitation of corrupt officials.
- **Problematic SOEs**. Large state-owned enterprises (SOEs) are undergoing restructuring and tariff adjustments.
  - The government has lowered subsidies for SOEs and state-owned banks are reducing their lending to the inefficient SOEs.
  - Despite that, overall restructuring is not going well. There is an urgent need to implement the modified 'Governance Agreements' and make better use of International Banking Advisors.
- **Slow Privatization of Banks**. Banking sector is still extremely weak.
  - To improve banking services in the country, the government must 'level the playing field' for all the private banks that are competing against the state-owned banks.
  - Progress in this direction has been very slow.
  - More importantly there is a need to obtain private strategic partners.

Improving Fiscal Governance.

Public expenditure management reform has gained considerable momentum over the last year.

- Expanded intra-government dialogue on key aspects of central-local fiscal relations, i.e. greater central control and administration of customs and taxes.
- A more consolidated treasury management and increased use of budget norms to ensure that the needs of the provinces are reflected in national priorities.

Improving Macroeconomics.

Laos has maintained relatively stable macroeconomic conditions. Monetary and fiscal discipline has improved. Nevertheless, there are a number of fiscal risks that will have to be managed to sustain macroeconomic stability.

- On the expenditure side, budget consolidation efforts have generated errors and lowered non-wage recurrent spending.
- On the revenue side, the fiscal situation could deteriorate if:
  - The mining royalties collected are not remitted by provinces to the central budget.
  - Non-resource tax administration slackens.
  - Greater central control over customs and taxes is not restored.
  - External balance needs to improve.

External Position of Laos has Strengthened.

- **Reserves up.** A surge in mining exports, combined with buoyant tourism receipts and substantial foreign direct investment inflows, helped raise the external reserves to more than 3 months of imports.
- **Stable currency.** The kip/baht exchange rate has been stable and current account deficit has increased significantly to accommodate foreign investment inflows to the mining and hydropower sectors.
- **Falling external debt.** External debt is down from 83.4% of GDP in 2004 to 77.4% of GDP in 2005, but it remains a concern. If reforms continue to be implemented as planned, new borrowing would be mainly on concessionary terms, and continued robust growth in medium term, debt-burden ratios would be projected to fall further.

Negative Socioeconomic Conditions Still Exist.

Laos' socioeconomic indicators are among the lowest in the Asia-Pacific region.

- Life expectancy is 55 years compared to 70 years in other regions.
- Child mortality is 98 per 1,000 deaths, more than double of the regional average of 37.
- The reduction of poverty from 46% in 2002-03 to 29% in 2004-05 is a success, until closer scrutiny:
  - The spread of poverty is still unevenly distributed throughout the country based on geography.
  - Half of all the poor reside in the North -- in some Northern provinces, nearly 75% of the population is poor.

Still Hooked on Aid.

Continued aid from international donors is critical in providing basic services to a majority of the population and to Laos's economy despite the recent increase in foreign investment and economic growth. While U.S. assistance to Laos totaled $13.7 million in 2006, Japan is by far the largest aid donor to Laos.

Weak Infrastructure.

Primitive infrastructure remains a huge hindrance to sustaining economic growth and even distribution of prosperity amongst the Lao citizens.

- Most of Laos have no railroads and at best, a rudimentary road system.
  - However, there is the promise of new improvements on the horizon, reconstruction of a major road that traverses the capital and links the country's major airport in Vientiane with the International Friendship Bridge that crosses the Mekong River to Thailand.

- Electricity is only available to a few urban areas.
- Limited availability of external and internal telecommunications.

Natural Calamity Strikes.

Every eighteen months since 1966, mostly in the central and Southern regions of Laos, have been struck by severe floods.

- The government's National Disaster Management Committee is doing everything they can to develop strategies to protect the country's agriculture.

Minimizing Impact.

- Avian influenza is a continued concern with the possibility of another breakout.
- With the continued risks and adverse weather conditions, the future of the agriculture sector is filled with uncertainties.

By implementing prevention strategies, through education, awareness and emergency preparedness, disasters may not have the social and economic impacts that it has experienced in the past.

Rising Food Prices.

The price of rice, the staple food of the country, has been growing steadily due to floods that damaged several crops around the country.

- Transporting rice cost from Southern and Northern regions and importation cost from Thailand has been more than usual.
- Sales of chickens, duck meat and eggs have plummeted since the avian flu outbreaks. Therefore, the rise in demand of meat is contributing to the increase in meat prices.

Will Cash Crops Help Laos' Economy to Stay Afloat, even with the Uncertainty of Rice Harvests?

- Natural disasters are convincing local rural people that cash crops may be the better route in pursuing a decent livelihood.
- Promotion to diversify is recommended, with the combination of cash crops and rice crops during the dry season, to protect farmers from catastrophic losses.
- **Coffee.** Coffee harvest hit its lowest level in a decade due to drought and pestilence.
    - Luckily, thanks to high world coffee prices, farmers were still able to match last year's earnings.

Energy, Mining and Construction.

Imports of fuel, construction materials and machinery have widened the trade deficit.

- Imports of capital goods are in support of the new mining and hydropower projects.
- Exports will remain strong in 2007-08; driving factors are projected to be the growing demand for electricity in Thailand, as well as an increase of gold and copper exports due to new mines constructed.

CONCLUSION

As one of the world's least developed countries, land-locked by China, Vietnam, Cambodia, Thailand and Burma, Laos still relies heavily on donor assistance. Many challenges will have to be overcome by investing in education, healthcare and transportation, while at the same time reducing the impacts of natural calamities.

Strong macroeconomic framework has been put into place, yet domestic revenues are still inadequate for reaching the Millennium Development Goals. In order to overcome poverty and socioeconomic problems, growth rates of 7% must be sustained until 2020. The increased economic growth in recent years has been a remarkable feat, primarily driven by the expansion in energy, construction and mining sectors. Hopefully these triumphant milestones will continue to fuel improvements, alongside the preparation for becoming a member of the WTO.

MALAYSIA

• CHAPTER 10 •

Leif R. Rosenberger

Executive Summary.

Malaysia remains on track and moving in right direction.

- Three reasons for optimism: political stability, economic reform and solid growth.
- Under Prime Minister Abdullah, Malaysia is cracking down on corruption.
- Budget austerity in the past provides a foundation for improving infrastructure.
- Modern infrastructure will increase Malaysia's potential GDP without inflation.
- Malaysia enjoyed solid 5.9% GDP growth in 2006; expect the same in 2007.
- The country is running a large surplus in its current account (goods and services).
- Malaysia's capital controls during the Asian financial crisis made it a pariah.
- Malaysia's de-pegging currency to U.S. dollar is winning back investor confidence.

Introduction.

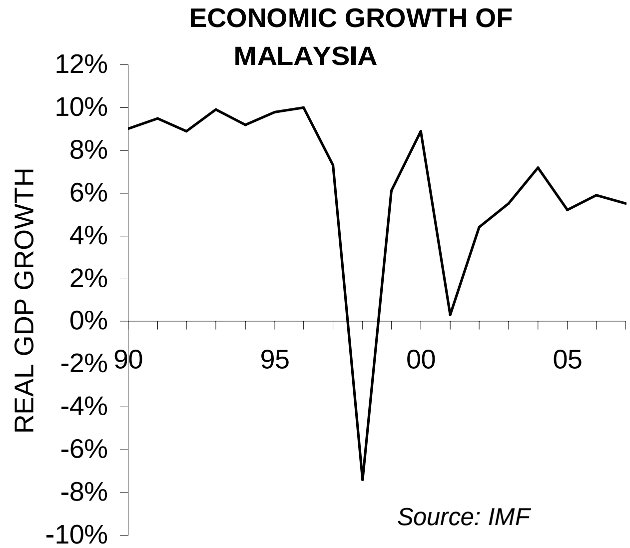
Malaysia remains on track and moving in the right direction.

- Its economy is on a roll and Abdullah has stabilized things politically.

Selected Historical Data

Malaysia	2001	2002	2003	2004	2005	2006
Purchasing Power $B	211	224	241	266	288	313
GDP $B (Nominal)	158	164	170	181	189	197
GDP Growth (Real)	0.3%	4.4%	5.5%	7.2%	5.2%	5.9%
Inflation	1.4%	1.8%	1.1%	1.4%	3.0%	3.6%
Exports $B	88.0	94.1	104.7	126.5	140.9	...
To U.S. $B	9.4	10.3	10.9	10.7	10.5	12.6
Imports $B	73.9	79.9	83.3	105.3	114.6	...
From U.S. $B	22.3	24.0	25.4	27.5	33.7	36.5
FDI held by U.S. $B	3.1	4.2	5.7	6.5	5.6	...
held in U.S. $B	0.3	0.3	0.3	0.3	0.4	...
Gross Intl Reserves $B	30.8	33.7	44.2	66.2	70.2	82.2
Savings /GDP	42.5%	41.8%	42.1%	43.0%	43.3%	...
Fiscal Balance /GDP	-5.5%	-5.6%	-5.3%	-4.1%	-3.1%	-2.2%
External Debt /GDP	28.8%	29.7%	28.9%	28.3%	...	...
Current account/GDP	8.3%	8.4%	12.7%	12.6%	15.2%	15.8%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Why optimism?

Three Reasons: political stability, reform and solid growth.

Virtuous Circle.

These three drivers 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.

Abdullah's Success Story.

Mahathir's successor as Prime Minister, Abdullah Ahmad Badawi, is a quieter sort, who prefers steady, behind-the-scenes policy making to banner headlines.

Quiet Leadership.

Admittedly, Mahathir was more flamboyant.

- But the less-controversial Abdullah is exactly what Malaysia needs right now.
- He may help the nation become the economic power it should be.
- The forward-looking nature of Abdullah's policies can be seen in his emphasis on Islamic finance.
- Fast-growing market brings Malaysia closer to becoming a global financial hub.

Raising the Bar.

Abdullah is pushing for next phase of Malaysian development.

- One focus of his 9th Malaysia Plan (2006-2010) is to move Malaysia (a middle-income country) up the value added ladder of manufacturing industries and services.

Economic Reforms.

Abdullah is also racking down on corruption and demanding greater transparency.

- Education reforms are being stepped up, as are efforts to make the government more efficient when dealing with the business world.

- These steps are meant to attract foreign investment at a time when so much of it is flowing to China.

Fiscal Responsibility.

Abdullah has taken a number of dynamic actions that are reaping dividends.

- Most impressive was Malaysia’s ability to sustain optimum economic growth while at the same time responsibly reducing its budget deficit.
- Budget deficit has fallen from 4.3% of GDP in 2004 to 3.4% of GDP in 2007.
- Abdullah's success in cutting budget deficit bolstered country's debt ratings, making it cheaper for companies like Telekom Malaysia to borrow overseas.

Fiscal Elbow Room.

After several years of budget austerity cited above, Malaysia now has enough fiscal elbow room to responsibly launch several big infrastructure projects.

- That includes a huge development project in the Southern state of Johor as part of the 9th Malaysian Plan.

Capacity Building.

Improving the infrastructure boosts Malaysia’s “potential economic growth.”

- That enables Malaysia to stimulate demand and increase its “actual economic growth” without increasing inflation.
- Malaysia’s 48% rise in total investment in 2006 equated to a record U.S. $13bn in total investment.

Growth.

Malaysia's economy expanded 5.9% in 2006.

- That’s close to Malaysian average annual growth rate of 6% since 2000.

Drivers.

While Malaysia enjoys balanced growth, domestic demand was the big driver in 2006.

- Consumer spending and the service sector were both up.
- Oil and electronics also remain solid contributors.
- Increased government spending in 2007 should partially offset weaker demand from the U.S. for Malaysian electronics as U.S. economy slows.

Economic Outlook.

Economic growth prospects for Malaysia are expected to remain favorable for 2007.

- The government predicts that GDP in 2007 will reach 6%.
- However, private economists forecast that growth will slow in 2007 amid softening global demand for electronics, Malaysia's biggest industry.
- While services grew by 7% in 4Q 2006 from a year ago, manufacturing increased by only 4.3 per cent, underscoring a slowdown in exports of semiconductors, hard disk drives and other electronics products.

Trade Surplus.

Malaysia’s trade balance is impressive.

- Malaysia is running a surplus in its current account (that measures goods and services) of 22% of GDP.

- Malaysia recently reported a trade surplus of M$ 108bn for 2006.
- And for the 1st time ever, the total amount of goods that Malaysia imported or exported exceeded 1 trillion ringgit.

U.S. Slowdown.

Nevertheless, Malaysia's exports may decline in 2007.

- Expected U.S. slowdown in 2007 may slow Malaysian export growth.

Strong Ringgit.

The rising value of Malaysian currency – known as the ringgit or Malaysian dollar (M$) -- could also slow Malaysian export growth in 2007.

- 05 April 2007: Ringgit hit 8-year high of M$ 3.45 to the U.S. dollar.

Removing Ringgit Peg.

M$ 3.45 figure is up from fixed rate of M$ 3.80 when its peg to the U.S. dollar was abandoned on 21 July 2005.

Flying Below Radar.

Malaysia received little attention when it followed China's lead by removing the ringgit's peg to the U.S. dollar. Flying below the radar serves two purposes:

- One, it helps Malaysia avoid the speculative frenzy that has focused on China since their decision to revalue the yuan.
- Two, it's a reminder of how much Malaysia's leadership has changed since the Asian crisis years.

Important Step.

Yet Malaysia's de-pegging its ringgit is important, and timely.

- A vestige of the Asian crisis, the ringgit's peg had outlived its usefulness.
- Because it brought stability and predictability to the economy, however, the government was reluctant to scrap it.
- The fact that the ringgit was undervalued also helped bolster exports.
- And with a current account surplus of 22% of GDP, Malaysia no longer needs a weak exchange rate.

New Confidence.

Scrapping the peg and letting the ringgit rise should be seen as a sign of confidence and maturity.

- It indicates that Malaysia's financial system has completed a sweeping change and is again ready to face the judgment of global markets.

No More Free Rides.

In the past, Malaysian exporters enjoyed a "free ride" due to currency weakness and undervalued goods and services.

- Higher interest rates and a stronger won will also force exporters to increase productivity and become competitive in global markets.

Investor Confidence.

Malaysia's rapidly developing middle class and expectations for 6% economic growth in 2007 are pulling investors back to a place many fled in the late 1990s.

- The economy's recovery and speculation that the currency would appreciate spurs investors to buy ringgit assets.

Down Side: Hot Money.

On the negative side, expectations of further changes in currency policy could increase.

- Currency speculators, the crowd that prompted Mahathir to peg the ringgit in 1998 - are again at Malaysia's gate.
- But this time they're at least making profits from Malaysia’s economic strengths, rather than punishing it for its economic weaknesses.

Final Thoughts.

Malaysia is not about to let the ringgit float freely.

- That's a lost opportunity because the economy is ready for it.

Although dollar peg is gone, ringgit will trade in a managed (or dirty) float system.

- Central bank will intervene and prevent supply and demand from defining its value.

Yet investors shouldn't miss the message Malaysia sent in scrapping its peg:

- Malaysia’s economy has come full circle from the Asian financial crisis.

Malaysia’s de-pegging currency to U.S. dollar is winning back investor confidence.

- It’s time for those die-hard investors who still want to punish Malaysia as a pariah to give Malaysia another chance.

CONCLUSION

How’s Malaysia’s economy doing?

- On track and moving in right direction.
- Malaysia enjoyed solid 5.9% GDP growth in 2006.
- Expect the same in 2007.
- Malaysia is running large surplus in trade balance.

Why the optimism?

- Virtuous circle of political stability, economic reform and solid growth.

How is Prime Minister Abdullah making a difference?

- Cracking down on corruption.
- Past budget austerity provides foundation for improving infrastructure.
- Modern infrastructure will increase Malaysia’s potential GDP.

Why was Malaysia considered a pariah state in financial circles?

- Mahathir opted for capital controls during Asian financial crisis.

Is Malaysia still a financial pariah?

- No. Malaysia’s de-pegging currency to U.S. dollar is winning back investor confidence.

CHRONICLES OF ECONOMIC HIGHLIGHTS

08 March 2006

U.S. opened trade negotiations with Malaysia for a free-trade agreement (FTA).

- Green light to launch talks came this week after Malaysia agreed to lift its ban on U.S. boneless beef, imposed in December 2003.

Economic Advisor's Comment:

FTA with Malaysia is significant because it would link U.S. with another fast-growing Asian economy and a strategically important moderate Muslim country in Asia.

- Malaysia is 10th-largest trading partner of U.S., with $44bn in two-way trade last year.
- Malaysia is a growing market for U.S. agricultural goods, with U.S. farm exports rising by 40% in 2005.

FTA talks with Malaysia add to an already packed schedule of bilateral trade talks.

- POTUS seeks to make up for the sluggish progress of the multilateral Doha round.

While POTUS is likely to gain strong support in Congress, negotiating a meaningful deal is likely to prove challenging.

- Malaysia has a virtually closed auto sector and U.S. will wants to see this opened up.
- Malaysia has restrictions on foreign entertainment, such as screen quotas to encourage national programs.
- U.S. also wants to see Malaysia financial sector opened up.

POTUS is also running out of time to negotiate both bilateral and multilateral deals.

- Trade promotion authority, which allows POTUS to submit trade deals to Congress for an up or down vote with no amendments, expires in July 2007.

01 August 2006

Malaysia urges Lloyd's of London to drop war-risk rating for Malacca Strait – but Lloyd's refuses to budge.

- Malaysia says war risk rating could hurt economies in region.
- Malaysia's request came after International Maritime Bureau (IMB) reported last week that attacks against ships in Malacca Strait in 2006 have fallen to lowest level since 1999.

Economic Advisor's Comment:

Piracy attacks in the Malacca Strait began to rise sharply in 1998, making this choke point the worlds most dangerous for shipping.

- Upsurge in piracy attacks was mainly blamed on Indonesia's deteriorating economy triggered by Asian financial crisis.
- Separatist revolt in Aceh has also resulted in rebels attacking ships to kidnap crew members and gain ransom payments for their cause.

But conditions have generally improved in 2006, with Aceh rebels signing a peace agreement and Indonesia's economy recovering.

- Indonesia, Malaysia and Singapore have also increased sea and air patrols.

IMB warned, however, that though number of Malacca Strait piracy attacks in first half of 2006 had fallen from 8 to 3 a year earlier, there had been a recent rise with 4 attacks in July.

- Two attacks were against UN aid relief vessels carrying relief supplies to Aceh, which was severely damaged by the 2004 tsunami.

As a result, Lloyd's last week said it would retain its war-risk designation in spite of the overall decline in piracy attacks in 2006.

- In 2005 Lloyd's Joint War Committee declared the Malacca Strait a war-risk zone based on a controversial report from London-based Aegis Defense Services that warned of potential seaborne terrorist attacks.
- Some maritime experts dismissed the recommendation as alarmist.

Malaysian transport minister said higher insurance premiums resulting from war-risk designation would make local ports less competitive.

- He expressed frustration that Lloyd's had refused to change its stance in spite of an improvement in security in Malacca Strait.
- He says at the very least Lloyd's should provide clear criteria for dropping war risk rating.

08 August 2006

08 Aug: Lloyd’s drops its war rating for Malacca Strait.

- Lloyd’s said patrols of Malacca Strait by Malaysia, Singapore and Indonesia now winning fight against piracy.

Lloyd’s surprise decision will cut insurance costs for shipping lines using the choke point.

- More than 50,000 vessels that transit waterway annually and carry 40 percent of global trade will benefit from decision.
- Countries such as Japan and China would be most affected by proposal since 80 percent of energy supplies to East Asia pass through Strait.

Economic Advisor’s Comment:

Malacca Strait came to be regarded as among world’s busiest and most dangerous sea lanes after a surge in piracy attacks after 1998.

- Indonesian economy deteriorated and Aceh rebels stepped up their military campaign.

A year ago Lloyd’s incensed the shipping industry and regional governments by imposing rating.

- International Maritime Bureau, which tracks global piracy, recently said attacks in area had fallen to their lowest level since 1999.

Lloyd’s said there had been a “significant improvement” in security along the 900km strait as Singapore and Malaysia increased naval and air patrols.

- In spite of increased patrols, IMB recently warned that piracy remains a problem, with four attacks in July and one reported so far this month.

Malaysia, which last week called for lifting of the designation, said it welcomed decision.

- Malaysia added it would push for shippers to pay fees to use Strait in an effort to help defray costs of security.

Lloyd’s said ships calling at North-East ports on Indonesian island of Sumatra would still be subject to war risk insurance premiums.

- Aceh separatist rebels on Sumatra have been blamed for many attacks.

Syed Hamid Albar (Malaysian foreign minister) said Malaysia, Singapore and Indonesia spent heavily to improve security and that other nations should help foot bill.

- He said Malaysia “was trying to work on a co-operation plan to find a way where the user states are also made responsible.”

13 February 2007

09 Feb: 5th round of U.S. - Malaysian FTA ended in deadlock.

- Malaysia refused to budge on its procurement policy favoring ethnic Malay-owned companies.
- Other sticking points over liberalizing Malaysian policies:
  - Services sector, highly protected car industry, ban on majority foreign ownership of banks, poor intellectual property rights and labor and environmental issues.

Economic Advisor's Comment:

- Key remaining stumbling block remains negotiators' difficulty in reconciling:
  - Government's affirmative action policies and National Treatment principle (requires each side to offer other equal treatment).
- FTA negotiations: too little, too late.
  - 01 Jul 07: Trade Promotion Authority (TPA) expires.
  - With Democratically controlled legislature, TPA renewal unlikely.
  - Without TPA, congress could add onerous, time consuming amendments.
- Actual timing is trickier yet.
  - Even with TPA, it takes 3 months to move package through congress.
  - Effective deadline for finalizing negotiations is 01 April, not 01 July.

12 April 2007

Construction of oil pipeline across Northern Malaysia will begin in August.

- Once operational in 2010, pipeline will ship 800,000 barrels per day.
- Equates to 10% of oil tanker transport across congested Malacca Strait.
- Pipeline will cut 3 days off oil shipment times to East Asia.

Two Malaysian refineries will be constructed: one at Yan, on the West coast, and one at Bachok, on the Eastern coast of Kelantan state.

- 320km pipeline will connect them as well as other downstream industries.
- Project also includes building shipyards, slipways and lubricant plants.

Economic Advisor's Comment:

Given U.S. tensions with Iran, Iranian hand in building and funding $14.5 billion project is an issue.

- Trans-Malaysia Petroleum will build the actual pipeline.
- National Iranian Oil Company (NIOC) and SKS Ventures, a Malaysian company will build Yan refinery.
- Malaysia's Merapoh Resources Corporation and unannounced foreign investors will build Bachok refinery.

Foreign investors: Iran, China, South Korea, Japan, and Saudi Arabia.

- Funding is 70% foreign; Malaysian state governments also have stakes.
- While revenue-sharing terms have yet to be finalized, Iran will fund a significant part of the project.

If U.S. – Iranian relations deteriorate, Iran could use oil pipeline to circumvent Malacca Strait as a vulnerable choke point in embargo scenario.

PHILIPPINES

• CHAPTER 11 •

Leif R. Rosenberger

Executive Summary.

The Philippine economy is on a roll.

- Philippines are enjoying its fastest growth in 17 years.
- GDP is up 6.9% in 1Q 2007; stock market recently hit 10-year high.
- Peso is at 6-year high against U.S. dollar; inflation is at a 7-year low.

Business sentiment is also rising.

- Texas Instruments is about to build a $1 billion plant in the country.

Remittances from overseas Filipinos are rising.

- Rising remittances is stimulating consumer spending.

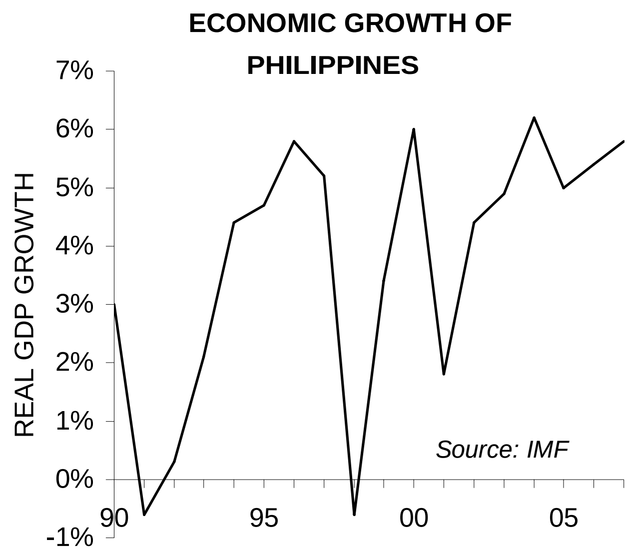
Kudos should go to President Arroyo for boosting business confidence.

- Raised taxes in 2006 to cut budget deficit.
- Built more roads, bridges, ports and other infrastructure
- This improved infrastructure is attracting foreign investment.

Selected Historical Data

Philippines	2001	2002	2003	2004	2005
Purchasing Power $B	318	338	362	395	428
GDP $B (Nominal)	367	383	398	422	448
GDP Growth (Real)	1.8%	4.4%	4.9%	6.2%	5.0%
Inflation	6.8%	2.9%	3.5%	6.0%	7.6%
Exports $B	32.7	35.2	36.2	39.7	41.3
To U.S. $B	7.7	7.3	8.0	7.3	6.9
Imports $B	34.9	39.2	40.5	44.0	47.4
From U.S. $B	11.3	11.0	10.1	9.2	9.2
FDI held by U.S. $B	2.5	2.7	3.5	3.2	3.9
held in U.S. $B	0.0	0.0	0.0	0.0	(0.0)
Gross Intl Reserves $B	15.6	16.4	17.1	16.2	18.5
Savings /GDP	16.8%	17.3%	19.5%	21.0%	20.1%
Fiscal Balance /GDP	-4.0%	-5.3%	-4.6%	-3.8%	-3.6%
External Debt /GDP	14.1%	14.0%	14.4%	13.0%	...
Current account/GDP	-2.5%	-0.5%	0.4%	1.9%	2.0%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



E c o n o m y o n a R o l l .

- Philippines are enjoying fastest growth in 17 years.
- GDP growth has accelerated from 5.4% in 2006 to 6.9% annual growth in 1Q 2007.
- Stock market recently hit 10-year high.
- Net foreign buying in stock market is up 74% in 1st 4 months of 2007.
- Peso is at 6-year high against U.S. dollar; inflation is at a 7-year low.
- Exports to China are up 46%.

R e m i t t a n c e s U p .

Remittances reached U.S. $11.4 billion in the first 11 months of 2006.

- Remittances remain primary driver of the economy.
- Remittances is accelerating from 15% growth in 2006 to 24% growth in 1Q 2007.
- Larger remittances stimulated rising consumer spending.
- Services sector, holds largest share of GDP at 48%, sustained growth of 6.0 - 6.3% for 2006.

R i s i n g B u s i n e s s S e n t i m e n t .

Texas Instruments is about to build a $1 billion testing and assembly factory.

- New factory will be located at Clark Freeport Zone, former U.S. AFB.
- Site will soon have its own dedicated power-generation plant.
- New plant will create 3,000 jobs -- positive underlying conditions to counter terrorism.

V o t e o f C o n f i d e n c e .

Philippine success in getting a 2nd factory, reflects Texas Instrument's:

- Satisfaction with highly skilled English speaking workers at existing chip plant in Philippines.
- Vote of confidence in Philippine economic revival and new financial stability.

B e a t s O u t C h i n a .

Philippine success in beating out China for the new site also reflects:

- Rising costs in China encourage investors to consider other locations.
- Land prices on China's industrial coastal belt are rising.
- Chinese wages have been seeing double-digit growth for several years.
- China's wages are sometimes higher than the cost of hiring skilled workers in other countries such as the Philippines.

Kudos to Arroyo.

Kudos should go to President Arroyo for boosting business confidence.

- She helped raise taxes in 2006 to cut budget deficit.
- She helped build more roads, bridges, ports and other infrastructure.

Improved infrastructure is attracting greater foreign investment.

Economic Resilience.

Philippines economy has proven to be resilient.

- Ongoing progress in executing its fiscal reform program (which started in 2005 to address a looming fiscal crisis) has contributed to financial market stability.
- This financial stability is reflected in a stronger currency, rising stock market, and manageable borrowing costs for the public sector.
- Government revenue has been further boosted by raising the value-added tax (VAT) to 12% early in 2006 and other tax-enhancement measures.

Debt Reduction.

The improvement in government finances has led to a fall in government debt, which is on track to fall from 72% of GDP in 2005 to 58% by 2010.

- Improved fiscal performance has eased pressure on lending rates and reduced spreads on government debt instruments.
- Despite progress on the fiscal front, the economy is still vulnerable to financial shocks as current debt levels remain high, with interest payments accounting for one third of total government expenditure.

Way Ahead.

- To sustain economic gains, the government is committed to continue economic reforms in areas such as infrastructure, tax policy and administration, and further deregulation and privatization of the economy.
- Sustained results in tax administration will be essential in building credibility and will provide the basis for strengthening macroeconomic stability. Notably, tax revenues in 2006 were 19% above 2005 levels.

CONCLUSION

How's the Philippine economy doing?

- On a roll -- fastest growth in 17 years.
- Stock market recently hit 10-year high.
- Peso is at 6-year high against U.S. dollar and inflation is at a 7-year low.

How is Philippine business sentiment?

- Business sentiment is also rising.

- Texas Instruments is about to build a $1 billion plant in the country.

What's the major driver?

- Rising remittances are stimulating consumer spending.

Who should get the credit besides overseas Filipinos?

- Kudos should also go to President Arroyo for boosting business confidence.

What did President Arroyo do?

- She helped raise taxes in 2006 to cut budget deficit.
- She helped build more roads, bridges, ports and other infrastructure.
- Improved infrastructure is attracting more foreign investment.

Is the Philippines financially stable?

- Yes.

What are the indicators of this financial stability?

- Stronger currency, rising stock market and manageable borrowing costs.

CHRONICLES OF ECONOMIC HIGHLIGHTS

24 January 2006

Philippine budget deficit fell 22% in 2005 - a 4-year low.

- Budget deficit was 146.5 billion pesos in 2005 - sharply under 187 billion pesos in 2004.
- Manila collected more taxes and kept spending below planned levels.
- A 14% rise in total revenue far outpaced 6.2% rise in total spending.

Increased cigarette and beer taxes in 2005 boosted total revenue.

- Manila also expanded coverage of value-added tax (VAT) to include oil and power.

Economic Advisor's Comment:

Philippine President Arroyo started out with a responsible fiscal strategy.

- However, politicized Judiciary at first undermined her execution.

Initially Supreme Court stopped Manila's plan to expand coverage of the VAT.

- Expanded VAT included oil, power and other previously exempt products and services.

Credit agencies reacted negatively in July to initial Supreme Court decision.

- S&P, Fitch and Moody's assigned a negative outlook to Philippine debt ratings.
- S&P and Moody's rated bonds lowest since they started assessing Philippine debt in 1993.

However, Supreme Court lifted suspension on expanded VAT on 18 October.

- Manila started to implement expanded VAT on 01 November.

Smaller 2005 budget deficit raises prospects of a credit rating upgrade in a couple months.

- S&P, Moody's and Fitch may reverse negative outlook for Philippine bonds.
- First, Manila must execute plan to boost VAT rate from 10% to 12% on 01 February.

Market is already rewarding Manila for its responsible fiscal policy.

- Interest on 25-year U.S. dollar-denominated bonds fell from 9.5% a year ago to 7.75% in January 2006.

Smaller borrowing costs release more funds for a) subsidized food and medicine for poor and b) building roads, bridges and school buildings to drive long term growth.

- This resource strategy reduces negative underlying conditions that foster violent extremism.

24 February 2006

Philippine peso suffered its biggest drop in more than 3 years – the worst fall yesterday of any currency in the world.

- Philippine stocks and bonds also slumped as President Gloria Arroyo declared a state of emergency.
- Philippine central bank stated that it had intervened in foreign exchange market to fight off a possible run on the peso.

On 24 February Fitch credit agency stated that continued political discord could undermine the country's creditworthiness.

- Fitch added that "If interest rates and exchange rates move the wrong way…it makes the government tax burden all the heavier."

Economic Advisor's Comment:

Philippines relies on good financial market sentiment to reduce the cost of borrowing to finance its large budget deficit and national debt.

- Philippines is Asia's 2nd largest issuer of sovereign debt after Japan.

Financial markets dropped on concern political upheaval may threaten the government efforts to reduce the budget deficit and debt burden.

- In the past, President Arroyo has struggled to build and maintain a political consensus in the legislature to take tough fiscal actions to reduce the debt.
- That consensus will be tested once again, even if she survives the immediate political crisis.

Nevertheless, the economy is in much better shape to weather the storm than it was a year ago.

- This successful turnaround is due in no small part to President Arroyo's economic leadership.

Philippines earned the confidence of international markets by introducing new tax measures to stabilize its fiscal position.

- The most recent step was increasing the rate of its value added tax from 10% to 12%.
- That plus a record $10.7 billion in remittances from Filipino working overseas helped fuel a sharp rise of the peso (from 56 pesos/dollar to 50 pesos/dollar).
- As a result, Philippine peso was Asia's biggest gainer in 2005 and Philippine bonds were also Asia's best performer, thus reducing Manila's financial burden.

While yesterday's fall of the peso was biggest drop since 27 July 2002, its value at the close of trading was 52.20 pesos/dollar – still higher than before Arroyo's economic turnaround.

01 June 2006

Political deadlock over new FY 07 budget threatens stability.

- Stalemate will slow growth, worsen financial problems and provide fertile ground for violent extremism.

Ten months ago GMA submitted a $19bn budget for FY 07 to Congress for approval.

- Congress dithered and started summer break today and will resume 24 July.

- New impeachment activities against GMA will crowd out movement on budget.

Manila can spend previous budget levels for recurring costs such as state workers' salaries and government operating expenses.

- Outlays for new budget items, including most infrastructure projects, disallowed.

Economic Advisor's Comment:

GMA hoped that her planned 2% rise in infrastructure spending this year -- biggest increase in a decade -- would help lift economic growth.

- GDP growth slowed from 15-year high of 6.1% in 2004 to 5% in 2005.

Failure to pass budget could shave at least a percentage point from future growth.

- Political dithering limits plans to boost spending for public works projects and social services.

Manila says its only hope for further growth is continued inflows from overseas Filipino workers (OFW).

- Over 8 million doctors, nurses, engineers, domestic helpers and entertainers are sending home $10.7bn per year (more than 10% of the economy) and have been called a secret weapon.

Given how much the $98bn economy depends on the cash sent home to support families by OFW, it's not surprising they are treated like heroes.

- Money sent home supports banks; boosts the telecommunications, retail, transportation and real-estate industries; and helps the government pay debt.

Bad sign: One of the biggest growth industries in economy is expatriates.

- PI is growing complacent amid all the cash flowing in from abroad.

Remittances plug a rickety financial system and help the government service debt that swallows a third of the budget through interest payments.

- With so much money coming in and so many Filipinos set to leave and send even more home, it weakens incentive to fix one of frailest economies in Asia.

Migration also creates a potential brain drain with economic implications.

- Labor pool greatly depleted when young Filipinos move overseas. Exodus also relieves pressure on government to provide decent jobs and higher living standards.

Instead, Manila needs to use growth to reduce national debt and improve education, health care, roads, bridges, ports and power systems.

- This would help reduce the demand for violent extremism.

19 July 2006

Budget deficit was cut by half during first 6 months of 2006 - lowest seen in 8 years.

- New taxes swelled state coffers while government cut spending.
- Well positioned to achieve balance by 2008.
- June--third month straight a surplus reported.

Economic Advisor's Comment:

Lowered deficit is partial result of failure to pass 2006 budget.

- Government spending capped at 2005 level (15% lower than proposed for 2006).
- Used previous budget levels for recurring costs (salaries and operating expenses).
- Disallowed outlays for new items (most infrastructure projects).

Congress broke for 6 weeks in June without approving $19bn budget.

- Resumes 24 July, but officials not hopeful of passing budget.
- New impeachment activities may crowd out budget decisions.

Finance Secretary warned spending shortfall (nearly 44bn pesos [$8.35 million] below target through June) could put long-term economic growth at risk.

- Inadequate social services provide insurgents fertile propaganda about “social and economic injustice.”
- Social services freeze creates opportunity for insurgents to access new recruits.

24 July 2006

In her 6th annual state of nation address to Congress on Monday, GMA unveiled plans to boost economic growth and create more jobs.

- In past, pessimistic GMA scared off investors by warning that country was on verge of Argentine-style financial collapse.
- Today, optimistic GMA is seeking political vote of confidence for a) fiscal turnaround and b) stronger financial position to address critical social and economic needs.

GMA claims Philippines now has the money to “pay down its debt” and “address social inequity and economic disparity.”

- GMA adds "We now have the funds to pay not just the interest [on public debt] but to fund education, good roads and bridges, health services and more work for our countrymen."

Economic Advisor’s Comment:

Good news -- tax collections rose by more than 1/5 in first 6 months of 2006 from a year ago, allowing the government to cut budget deficit in half -- lowest in 8 years and 2/3 below target.

- New revenue puts government on track to wipe out budget shortfalls by 2008.
- 50% lower budget deficit alleviates investors’ concerns that Philippines might default on its huge foreign currency debts.

Bad news -- there are still doubts about whether Manila could afford all the projects proposed by the president.

- Benjamin Diokno, a former budget secretary, estimates GMA’s proposed projects would cost around 500bn pesos.
- However, money from new taxes would likely reach only half of that in the next 3 years.

Another challenge for GMA is to spread the fiscal benefits by creating jobs and reducing poverty in areas outside Manila.

- Although only 1/3 of country’s total population are considered poor (or earning less than the government’s poverty threshold of 60 U.S. cents a day), poverty rate is at least 50% or higher in 20 of the country’s 79 provinces.

To accelerate growth in country’s poorest areas, GMA is regrouping 16 regions into 4 enlarged sub-economies to improve links between poor towns and prosperous areas.

- Strategy is also aimed at maximizing the benefits of government spending by giving priority to projects that will enhance each region’s competitive strengths.

GMA’s “divide and conquer” geo-economic strategy means:

- Northern part of the country’s main island of Luzon will be developed into an “agri-business quadrangle” that would export food to China and other East Asian countries.

- Central and Southern Luzon will be an “urban and industrial beltway” hosting export-oriented factories and business process outsourcing (BPO) facilities.
- Central region of Visayas will become a tourism hub while Southern island of Mindanao will focus on production of food and mineral ores.

GMA’s focus on economic programs in her closely-watched annual address is positive sign -- she has fighting chance to weather renewed challenges to her leadership by political opponents.

- Last month the opposition filed a fresh impeachment complaint against the president, accusing her of exercising dictatorial powers to stifle dissent and engaging in corruption, only months after she survived a similar attempt.

But GMA’s plans could be easily undermined by political conflicts, especially if she fails to win over majority of Senate, which has been critical of GMA’s policies.

- Political bickering between the President and the Senate has held up approval of the 2006 budget, forcing the government to spend no more than last year’s levels.

30 November 2006

GDP growth slowed from 5.8% in 2Q to 4.8% in 3Q.

- Consumer spending is key driver, but external demand moderating.

Economic Advisor’s Comment:

Bad News: Slower growth worrisome:

- 8-9% GDP required to half poverty to 19% by 2010.

Good News: Due to higher taxes, power rate increases and fiscal policy tightens.

- Budget deficit falling: 5.5% of GDP in 2002, less than 3% today.
- Reduced debt to GDP ratio: 80% in 2004, 65% today.

14 January 2007

China Export-Import Bank wins key water financing deal in Philippines over Asian Development Bank (ADB).

- Philippine state water agency withdrew application for a $70 million loan from ADB.
- Loan meant to finance repair of aqueduct supplying 9% of Manila water needs.

Bank won bid by promising cheaper rates and faster approval.

- China does whatever it takes to gain access to energy and raw materials.
- Loan agreement signature session scheduled for next week.
- China now 4th biggest provider of low-cost funds to PI, after Japan, ADB and World Bank.

Economic Advisor’s Comment:

ADB hoped financial deal would showcase new flexible lending facility.

- New facility aims for maximum flexibility to borrowers, thus does not require commitment fees for an entire package.
- $70 million loan planned as first segment of $400 million loan planned to finance related projects in Manila.
- Initial withdrawal prompted ADB to freeze $330 million.

ADB setback highlights diminishing power of multilateral lenders over developing countries.

- ADB policymakers concerned about growing Chinese status as quick, low cost lender requiring little financial due diligence.

01 Febuary 2007

2006: Economic growth accelerated.

- GDP growth rose from 5% to 5.4%.
- 4Q: Typhoon kept growth from being stronger.

Economic Advisor's Comment:

The economy is benefiting from rising exports, increased overseas remittances and lower borrowing costs.

- Nov 2006: Moody's raised outlook on public debt from negative to stable.
- Foreign exchange reserves rose to all-time high of $23bn.
    - Balance of payments highest in 7 years.
    - Foreign investment in stocks and government debt jumped 24%.
        - Spurred stocks to highest level in 10 years.

Increased tax revenues facilitated smallest budget deficit in 8 years.

- 2007: Ample room to increase spending on ports/roads.
    - If money spent on roads in Mindanao, then underlying social and economic conditions fostering peace and prosperity become enhanced.

20 Febuary 2007

13 Feb: Philippine President Arroyo announced plans to double infrastructure budget.

- To spend almost $21bn on roads, bridges, ports, etc over next 4 years.

Economic Advisor's Comment:

2002: Philippines over-borrowed; budget deficit of 5.4% of GDP well over Maastricht criterion of 3% (signaling financial vulnerability).

- Back then boosting infrastructure spending was non-starter.

2006: Arroyo improved economy by cutting budget deficit to 8-year low of 62.2bn pesos (circa 1% of GDP).

- On track to wipe out budget deficit in 2008.

Government can now afford to boost infrastructure spending without fear of defaulting on debt.

- Building new roads, bridges, ports, hospitals, and schools.

New infrastructure increases aggregate supply, enabling economy to expand capacity to absorb more demand without inflation.

- That increases Philippines' potential economic growth from 7% in 2007, to 8% in 2008 to 9% in 2009.
- New infrastructure will also attract much needed foreign direct investment.
- Result: Job creation, which reduces social discontent that fosters violent extremism.

24 April 2007

Government misses 1Q 2007 fiscal target for 1st time in 2 ½ years.

- 1Q 2007 budget deficit exceeded Manila's target by 13.5%.
- President Arroyo's painful fiscal reforms over the past two years were expected to generate far more tax revenue.

Economic Advisor's Comment:

President Arroyo had promised scores of high-profile road and civil works projects.

- Projects counter negative underlying conditions that foster terrorism.
- Shortfall will rekindle worries about the government's ability to reach its goal of balancing the budget while boosting spending on infrastructure and social services.

08 May 2007

Philippines is chosen as location for new $1 billion Texas Instruments (TI) testing and assembly factory.

- New factory will be located at Clark Freeport Zone, former U.S. AFB.
- Will soon have its own dedicated power-generation plant.
- New plant will create 3,000 jobs -- positive underlying conditions to counter terrorism.

Economic Advisor's Comment:

Philippine success in getting a 2nd factory reflects Texas Instrument's:

- Satisfaction with highly skilled English speaking workers at existing chip plant in Philippines (at Baguio).
- Vote of confidence in Philippine economic revival and new financial stability.

Philippine success in beating out China for the new site also reflects:

- Rising costs in China encourage investors to consider other locations.
- Land prices on China's industrial coastal belt are rising.
- Chinese wages have been seeing double-digit growth for several years.
- China's wages are sometimes higher than the cost of hiring skilled workers in countries such as the Philippines.

01 June 2007

Philippines – Fastest growth in 17 years.

- GDP up 6.9% in 1Q 2007.
- Stock market at a 10-year high.
- Peso at a 6-year high against the dollar.
- Inflation at a 7-year low.

Economic Advisor's Comment:

Philippine economy is on a roll.

- Business sentiment is rising.
- Texas Instruments to build $1 billion plant.
- Exports to China up 46%.
- Remittances from overseas Filipinos up 24% in 1Q 2007 from 15% in 2006.
- Larger remittances stimulated rising consumer spending.

Kudos to President Arroyo for boosting business confidence.

- Raised taxes in 2006 to cut budget deficit.
- Built more roads, bridges, ports and other infrastructure.
- Improved infrastructure is attracting rising foreign investment.
- Net foreign buyig in stock market up 73% in 1st 4 months of 2007.

SINGAPORE

• CHAPTER 12 •

Leif R. Rosenberger

Executive Summary.

- Rote learning and hard work used to be enough for Singapore's success.
- But its boom and bust economy revealed cyclical and structural weaknesses.
- Overdependence on electronics made it vulnerable to volatile global economy.
- Singapore needed to diversify its economy to cushion electronic down cycles.
- Risk adverse Singapore also faced an entrepreneurial shortfall.
- Entrepreneurs that Singapore needed to attract found old Singapore too staid.
- Singapore reinvented itself with a casino economy and other reforms.
- A more exciting Singapore is just what the doctor ordered.
- In 2006, GDP was up 7.7%, making it one of fastest growing Asian economies.
- More diversified economy can now weather storm of electronics down cycle.
- GDP is on track to grow at least 5% in 2007 despite the slowdown in the U.S. economy.

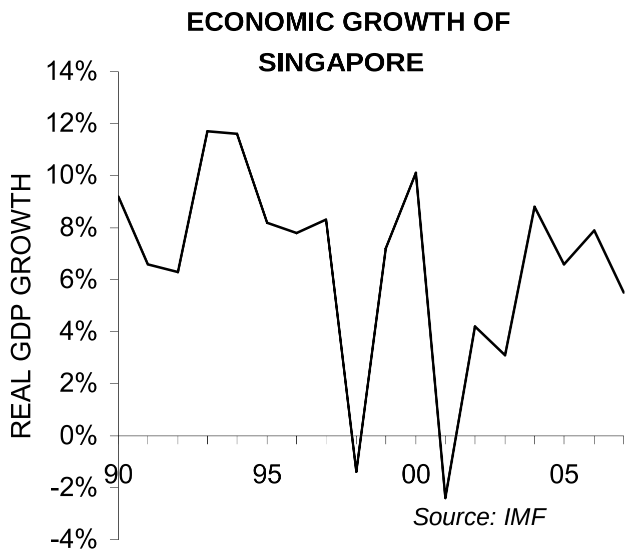
Selected Historical Data

Singapore	2001	2002	2003	2004	2005
Purchasing Power $B	97	102	108	120	132
GDP $B (Nominal)	98	97	96	100	100
GDP Growth (Real)	-2.4%	4.2%	3.1%	8.8%	6.6%
Inflation	1.0%	-0.4%	0.5%	1.7%	0.5%
Exports $B	121.8	125.2	159.9	198.6	229.6
To U.S. $B	17.7	16.2	16.6	20.4	20.6
Imports $B	116.0	116.4	136.2	173.6	200.0
From U.S. $B	15.0	14.8	15.1	15.4	15.1
FDI held by U.S. $B	10.9	12.1	14.9	18.0	17.6
held in U.S. $B	1.2	1.5	2.2	2.0	2.4
Gross Intl Reserves $B	75.4	82.3	96.3	112.8	116.6
Savings /GDP	45.8%	44.2%	47.1%	47.3%	48.6%
Fiscal Balance /GDP	4.8%	4.3%	6.5%	3.4%	3.3%
External Debt /GDP	165.4%	166.7%	181.2%	188.0%	...
Current account/GDP	14.0%	13.7%	24.2%	20.1%	24.5%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO

Introduction.

Rote learning and hard work used to be enough to propel the Singapore economy. Whenever problems did present themselves, the government could make ad hoc adjustments on the fly. In fact, Singapore has, over the years, proven itself remarkably adept at solving whatever problems come its way.



Boom and Bust.

But more recently, the government discovered it could not just tweak the economic model when things went wrong. Since the Asian economic crisis in 1997 the economy has experienced a frustrating pattern of boom and bust.

- 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 boomed once again 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.

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 Unemployment.

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.

WHAT WENT WRONG?

Why was the richest country in SE Asia performing so poorly?

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 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.

Reason #3: Entrepreneurial Shortfall.

While Singapore's top-down economic model still appeared to have some life left in it, the government fretted that its people lacked 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 also wanted to move away from rote learning and towards creative thinking and critical thinking skills.

Reason #4: Overdependence on Electronics.

Overdependence on electronics made it vulnerable to volatile global economy.

- 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.

Reason #5: Geographic Vulnerability.

A problem Singapore cannot do anything about—its geographical position—also creates problems.

- With just four million people, Singapore is too small to make it on its own.
    - So Singapore desperately needs the surrounding countries of Indonesia, Malaysia, Thailand, and the Philippines to provide a stable backdrop to attract investors, while also serving as a vibrant market for its own goods and services.
    - So it needed trade agreements to connect better to its neighbors.

HOW TO GET IT RIGHT?

Diversification.

At a minimum, Singapore needed to diversify its economy to cushion electronic down cycles.

- Singapore has been making 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.

Reinventing Itself: Casino Economy.

The political leadership is well aware that the economic strategy that delivered such impressive spurts of economic growth in the past needed to change to produce a more sustainable economic performance.

- Risk adverse Singapore also faced an entrepreneurial shortfall.
- The entrepreneurs Singapore needed to attract generally found old Singapore too staid.
- Singapore successfully reinvented itself with a casino economy.

Economic Success.

A more exciting, diversified, more regionally integrated Singapore is just what the doctor ordered.

- In 2006 GDP was up 7.7%, making it one of fastest growing Asian economies.
- Stocks rose 27% in 2006 – a record.
- The Singapore exchange rate hit its highest level in a decade.
- GDP is on track to grow at least 5% in 2007.
- Unlike past years when Singapore even went into recession on occasion, this new and more diversified economy can now weather the storm of a weak global economy and electronics down cycle.

Tourism on a Roll.

- Tourist arrivals hit a record 9.5 million visitors in 2006.
- Tourism is projected to nearly double to 17 million visitors by 2015.
- Gambling resorts are spurring both job creation and a boom in construction and property.
- Construction broke a 6 year contraction and rose 2.4%.
- These upward trends are also underpinning consumer demand.

Other Reforms at Home.

Singapore is also taking the challenge of globalization seriously. In response to the globalization challenge, its war cry is "only the paranoid survive." To attract and retain foreign investment, Singapore is attempting second generation reforms:

- Liberalizing its own economy.
- Embarking on yet another wave of corporate restructuring to ensure it remains globally competitive.
- Putting into practice the corporate governance lessons of the regional financial crisis.
- Transforming the education and business environments to encourage Singaporeans to take creative risks necessary to make it in a knowledge-based global economy.

While Singapore has not been 100% successful in all these areas, the important thing is the country is moving in the right direction.

Reforming ASEAN.

In addition, Singapore must help the region open up. In this regard, Singapore sees itself as a catalyst or enabler, attempting to cajole the ASEAN states toward free trade and economic integration.

- Intra-regional trade is increasing.
- More air, rail, and road links are increasing the region's connectivity.
- The region is working to reduce tariffs and simplify customs procedures.

Free Trade Agreements (FTAs).

But it is no longer enough for Singapore to improve the investment climate in ASEAN.

- For its own success, the island is aggressively pursuing bilateral free trade agreements.
- In a further effort to underpin its entrepot status, Singapore has formed bilateral free trade agreements with the U.S., Australia, Jordan, India, Japan, South Korea, New Zealand and Panama as well as multilateral FTAs.

CONCLUSION

Not long ago, Singapore was considered a role model for the rest of Southeast Asia. If you work hard and follow the rules, you will get ahead. This rote learning, don't make waves approach started to falter with the rise of the knowledge economy and the rise of globalization. The Singapore economy started a pattern of boom and bust, which in turn revealed cyclical and structural weaknesses.

- Its overdependence on electronics made it vulnerable to a volatile global economy.
- Singapore somehow needed to diversify its economy to cushion electronic down cycles.

Risk adverse Singapore also faced an entrepreneurial shortfall. But the government soon discovered that the kind of entrepreneurs it needed could not be totally home grown. Try as it may, it discovered that the rote learning model was too deeply entrenched for many Singaporeans. They were risk adverse. But when the government looked around the world, it discovered that entrepreneurs were not always eagle scouts. People who take risks are a different breed.

So the government reinvented Singapore with gambling and "a casino economy." A more exciting, diversified Singapore is just what the doctor ordered. The government's decision to relax gambling has changed Singapore's staid image and attracted more visitors. The construction industry ended its 6 year contraction with solid growth. The government also diversified the economy and implemented other domestic reforms.

- Its overdependence on electronics is lessening.
- Free trade agreements have helped it develop new markets and diversify the economy.
- There is an increased emphasis on domestic spending.

While global demand in 2007 is slowing for electronics, Singapore now is diversified enough to weather the storm while still maintaining relatively strong growth.

CHRONICLES OF ECONOMIC HIGHLIGHTS

01 February 2006

On 01 Feb Singapore announced its jobless rate fell to 3.2% in 2005 -- a 5-year low.

- Singapore's unemployment rate has almost come full circle.
- Prior to the Asian economic crisis Singapore's jobless rate was only 2%.

- By 01 Oct 2003 jobless rate hit 5.9% -- a 17-year high.

Economic Advisor's Comment:

Why has Singapore been on such an economic roller coaster ride?

- Low cost rivals (China, India and Malaysia) gained market shares at its expense.
- Singapore lost its previous competitive edge in manufacturing and had to reinvent itself.
- Singaporeans were forced to upgrade skills to compete with foreign labor.

Government felt Singaporeans lacked entrepreneurial urges needed to exploit opportunities in the new economy.

- That explains government's fervent desire to recruit international managerial talent.
- The country is starting to move away from rote learning and towards creative thinking.

Strongest job growth is in service sector (IT, financial services, tourism and media).

- Companies tend to employ younger workers in these industries.
- Recent government report highlights job discrimination for elderly.
- It's difficult to "teach an old dog new tricks."
- Top creative thinkers from U.S. businesses are rarely eagle scouts.

That said, Singapore is making successful transition to higher-value added economy.

- New government survey says manufacturers are optimistic about outlook for 1st half of 2006
- Such value added sectors as biomedicine are on a roll and creating jobs.

Finally, Singapore has diversified exports, which are driving growth and job creation.

- China is single biggest contributor to non-oil export growth.

21 August 2006

U.S. anti-Iran sanctions hit Chinese-Singapore joint air cargo venture.

- USG cracked down on Great Wall Airlines (GWL) - a new Chinese airline -- and 3 other Chinese airlines for supplying missile parts to Iran.
- USG called for a freeze of any corporate assets under U.S. jurisdiction.

U.S. anti-Iran sanctions also hit Singapore Airlines (SIA) and Temasek Holdings, Singapore state investment company that controls SIA.

- SIA/Temasek own 49% of joint air cargo venture with GWL.
- GWL was first big investment by SIA in China.

Economic Advisor's Comment:

GWL began operations shortly before U.S. decided to impose sanctions on GWL and its subsidiaries.

- GWL denied USG allegation about selling missile parts to Iran and is trying to appeal USG decision.
- GWL claims USG sanctions "have nothing to do with operations of GWL."

GWL operated two Boeing 747 aircraft, which rely on technical support from U.S.

- GWL (which started business in May) has now suspended operations.

SIA, which is world's 3rd largest air cargo operator, viewed its venture with GWL as a way to expand existing services with China by handling PRC exports to U.S. and Europe.

- Several other international carriers, including Germany's Lufthansa, have recently set up similar air cargo joint ventures in China.

GWL deal is 2nd troublesome foreign investment that Temasek has made this year.

- 1st setback was Temasek's attempted takeover of Shin Corp, Thai telecommunications group, which triggered a political crisis in Thailand.
- Thai regulators are examining whether Temasek breached foreign ownership limits by using proxy companies to gain control.

11 September 2006

08 Sep: IMF and World Bank rebuke Singapore over ban of representatives invited to annual meeting (11-20 Sep in Singapore).

- Singapore promised to facilitate entry of 500 accredited representatives under memo of understanding (MOU).
  - Now blocking entry of 19 civil society representatives who allegedly pose security threat.
- IMF/World Bank accusing Singapore of violating terms of MOU to host event.
  - Only informed last week of new Singapore plan.

Crackdown part of tough security measures implemented during meetings.

- Will ban all outdoor demonstrations and target violent protesters.

Economic Advisor's Comment:

Incident represents blow to IMF/World Bank credibility.

- Seek to improve relations with NGOs (accuse IMF/World Bank of ignoring plight of poor).

World Bank wanted to walk the walk of conference theme -- transparency, good governance and accountability.

- Embarrassed and frustrated by unintended hypocrisy.

NGOs banned by Singapore include:

- UK-based World Development Movement, Thailand's Focus on Global South, Freedom from Debt Coalition in Philippines and Forum on Indonesian Development (Infid).

IMF and World Bank say NGO representatives have: a) IMF/World bank accreditation and b) clearances to attend meetings from their respective governments.

- Strongly urge Singapore to act swiftly and reverse decision on entry and access for these representatives.

Singapore police force compiled list of potential "troublemakers."

- Says every country reserves sovereign right to determine foreign entry eligibility.

World Bank representatives may meet barred activists at alternative venue.

- Some NGOs planned rallies on neighboring Indonesian island of Batam.
- Indonesian police said seminars welcome but banned protests.

18 September 2006

15 Sep: Singapore bowed to international pressure and agreed to allow 22 of 27 banned activists to attend annual IMF/World Bank meeting.

- Backed off after Paul Wolfowitz, World Bank president, said rejection was "unacceptable."

- Partial policy turnaround meant to deflect mounting controversy.

Controversy threatened public relations disaster as Singapore hosted biggest-ever conference.

- Continued refusal to admit five activists could keep issue alive.
- Singapore to consider admitting last five activists, but will make decision only when they arrive.

Mr. Wolfowitz said Singapore had suffered “enormous damage” to reputation.

- Claims initial mistake “self-inflicted” by refusing to honor previous agreement allowing attendance.
- “This could have been an opportunity to showcase to the world [Singapore’s] development process” rather than its “authoritarianism.”

Economic Advisor’s Comment:

Concession represents rare policy reversal for traditionally steadfast government.

- Initial decision to ban 27 activists was "violation of the understanding we had drawn up” with government, said Mr. Wolfowitz.

Singapore initially promised to facilitate entry of invited participants.

- Decision to prevent some activists from coming fulfilled opposing obligation under different agreement to protect personal security of delegates.
    - Those blacklisted allegedly posed security threat.
    - Singapore position: "While we cannot disclose specific details about the individuals, we can affirm the decision was carefully considered,”

Rodrigo Rato, IMF managing director, said invited activists well known to all organizations -- had no doubts they would act responsibly.

- He warned: Singapore “would be making a mistake” if it did not reverse decision.

Actions provoked anger among NGOs, who questioned IMF/World Bank commitment to encourage participation.

- More than 160 NGOs, many of which were invited, called for boycott.

More than 20 activists walked out (in protest) of dialogue session with IMF and World Bank heads.

- Activists demanding harder line be drawn with Singaporean authorities.

NGOs argue barred activists had nothing to do with terrorism or physical security.

- Activists suspect Singapore worried they would criticize authoritarian politics.

Ironically, initial action to bar them dramatized authoritarianism more than a protest from activists.

- Chee Soon Juan, Singapore opposition leader, planning protest march today. Says: Authorities wanted to crack down on foreign activists because “they don’t want local groups to pick up bad habits that would encourage Singaporeans to protest.”

26 Febuary 2007

Singapore government paves way for Temasek to sell Shin satellite back to Thailand.

- Singapore Foreign Minister George Yeo says Singapore will not object to reversing original sale.
- Temasek originally bought Shin Satellite as part of 2006 parent Shin Corp take-over ($3.8bn).

  - Purchase from Thaksin's family led to protests over tax-free sale and helped trigger military coup in September.
  - Feb 2007: Tensions rose after Thai Army Chief Sonthi Boonyaratkalin called for return of Shin Satellite to Thai ownership.
    - Accused Singapore of using satellite operator to spy on Thai communications.

Economic Advisor's Comment:

- Yeo's comment may signal a face-saving compromise soon to be concluded to resolve diplomatic dispute.
- Temasek would dispose of Shin Satellite in a deal portrayed as a commercial decision made without political interference.
  - Portrayal of sale as commercial decision that would benefit both sides.
    - Singapore avoids impression as bowing to political pressure.
    - Thailand assures foreign investors Thai businesses are safe from political intervention.
- Three Thai firms – Dragon One, Samart, and Loxley – and Thai government pension fund reportedly expressed interest in buying Shin Corp stake in Shin Satellite.
- Temasek has not commented on whether they are willing to dispose of Satellite unit.
  - Might allow sale to shift focus to growth of Advanced Info Services, Shin Corp's main asset and biggest Thai mobile phone operator.

18 April 2007

Singapore and China: Singapore Prime Minister Lee warns U.S. is losing influence in SE Asia to China.

- In contrast to his perceptions of U.S. "disengagement" from the region, Lee sees China as skillfully increasing its economic and political clout.
- Lee says this waning U.S. influence potentially weakens U.S. counter-terrorism cooperation in the region.
- Lee is scheduled to have talks with President Bush early next month in Washington.

Economic Advisor's Comment:

Lee's argument about the rise of China's influence in SE Asia also has relevance to the rest of Asia and the Pacific.

- Earlier Asian fears of China as a possible commercial threat have largely given way to a sense of shared prosperity with China.
- Japan and South Korea now trade more with China than with the U.S.
- In 5 year span (2000-2005) Australia's merchandise trade with China soared 248% while U.S. -- Aussie trade only grew 13%.

Lee would like to see a clearer U.S. vision and strategy of how to respond the China's economic and political rise.

17 May 2007

Singapore plans a U.S. $330 million Asian development fund.

- Temasek Holdings, Singapore state investment company, will set it up.
- New fund will support education, healthcare and disaster relief programs.
- Promotes improved state regulatory environment in Asia.

Economic Advisor's Comment:

Singapore is under public relations fire for buying strategic assets in Asian states.

- Nationalist backlash over owning Thai and Indonesian telecom companies.
- Similar backlash in China, where it bought stakes in two state banks.

Fund follows Singapore breakthroughs in relations with Malaysia and Indonesia.

- This week Singapore and Malaysia agreed to establish a joint committee.
- Singapore may invest in Malaysia's proposed Iskandar special economic zone.
- Singapore may increase its existing investments in economic zones in Indonesia's Riau Islands.

THAILAND

• CHAPTER 13 •

Leif R. Rosenberger

Executive Summary.

Back in 2006 Thailand enjoyed relatively strong export-led economic growth (5%).

- Investors hoped economy would do even better without Thaksin's cronyism.
- When tanks rolled into Thai streets, foreign investors were still optimistic.

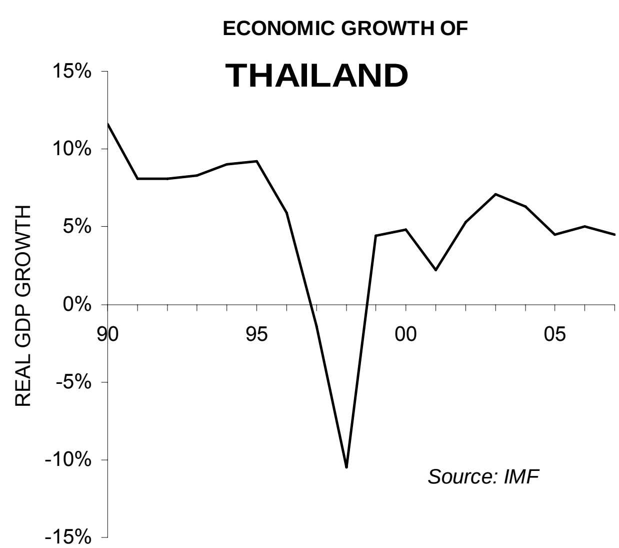
But then post-coup Thai government opted for capital controls.

- Thai stock market crashed, investor confidence fell in new government.
- Capital controls were partially removed, but the damage was done.
- Economy is slowing down; much needed foreign investment is drying up.
- Muslim insurgents' economic targets in the South worsen slowdown.

Selected Historical Data

Thailand	2001	2002	2003	2004	2005
Purchasing Power $B	404	432	473	516	555
GDP $B (Nominal)	167	168	171	176	184
GDP Growth (Real)	2.2%	5.3%	7.1%	6.3%	4.5%
Inflation	1.7%	0.6%	1.8%	2.8%	4.5%
Exports $B	65.0	68.1	80.3	96.2	110.1
To U.S. $B	6.0	4.9	5.8	6.2	7.2
Imports $B	62.0	64.6	75.8	94.4	118.2
From U.S. $B	14.7	14.8	15.2	16.9	19.9
FDI held by U.S. $B	3.6	4.3	5.0	4.3	5.2
held in U.S. $B	0.1	0.1	0.2	0.2	0.2
Gross Intl Reserves $B	33.0	38.9	42.1	49.8	52.1
Savings /GDP	31.4%	30.5%	28.7%	25.8%	29.4%
Fiscal Balance /GDP	-2.1%	-2.2%	0.6%	0.3%	0.0%
External Debt /GDP	40.4%	35.3%	30.3%	28.7%	...
Current account/GDP	4.4%	3.7%	3.4%	1.7%	-4.5%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

Back in 2006 the Thai economy enjoyed relatively strong 5% growth.

- But many Thai's complained about Prime Minister Thaksin's cronyism.

Exports: Good News in 2006.

Strong exports helped offset weak domestic demand.

- Thailand enjoyed surplus in current account (goods and services) of 1.9% of GDP.

Optimism.

After tanks rolled into Thai streets in September 2006, investors were optimistic.

- They hoped economy would be even better after Thaksin's cronyism was gone.

Pessimism.

Foreign investors are now saying: "Be careful what you wish for."

- Foreign investor optimism has given way to pessimism.

Slowdown.

4Q 2006: Thai economic growth was slowest in almost 2 years, slowed from 4.7% in 3Q 2006 to 4.2%.

- Muslim insurgents' economic targets in South potentially worsen slowdown.

Why Slowdown?

Slowdown reflects a number of factors:

- January 2007: New vehicle sales dropped 23% to 4-year low.
- 2006: Value of applications to build new Thai factories/facilities down 24%.

Corporate Woes.

Thai Corporate earnings down:

- Siam Cement 4Q profits down 12%.
- 2006: Land & Houses (biggest homebuilder) profits fell 37% to 5-year low.

Exports: Bad News in 2007.

Exports expected to be weaker in 2007.

- Central bank says weak global demand will cut growth in Thai exports (60% of economy) from 17% (2006) to 7.5% (2007).

Weaker U.S Demand.

Thai slowdown reflects weaker U.S. demand for Thai goods.

- Former Fed Chairman Greenspan: 33% chance of U.S. recession in 2007.
- U.S. growth is likely to be at least slower than in 2006.

CAPITAL CONTROLS: BAD IDEA

Capital Controls.

In December 2007, foreign investor confidence fell in response to central bank's new capital controls on foreign investment.

Stock Market Crash.

Controls triggered biggest stock market fall in 16 years.

- January 2007: Business confidence fell to 4-month low.
- Same month consumer confidence fell to 5-month low.
- How did all this happen?

Financial Turmoil.

Financial turmoil is nothing new to Thailand.

- December 2006 stock market crash triggered painful memories of 1997 Thai financial crises.
- But there is one important difference:

July 1997 Crisis.

Bangkok worried about speculative outflows of capital, as investors bet against baht.

- Downward pressure on baht prompted Bangkok's controls on capital outflows.

December 2006 Crisis.

Bangkok worried about inflows of capital. Times have changed.

1997: Weak Thai Economy.

Back then Thai economy was fundamentally weak:

- Big current account deficit (8% GDP), low reserves/short term foreign currency debt.
- Downward pressure on baht overvalued at 25 baht to U.S. dollar.

Like Mexico.

To speculators Thailand in 1997 looked like Mexico in 1994.

- Current account deficit also 8% of GDP.
- Speculative pressure started to build up in early 1997.
- Those mild controls on outflows did not work in 1997.
- Baht collapsed in July 1997 after a futile attempt to defend baht at 25 baht to 1$ U.S.

Polar Opposites.

Thai financial crises in 1997 and 2006 are polar opposites.

2006: Massive Capital Inflow.

Capital is flowing in, not out.

- Thai baht was appreciating rather than facing depreciating pressures.
- Foreign exchange reserves are high.
- Short term foreign currency debt is low compared to 1997.
- Thai's running 1.9% current account surplus (rather than deficit before 1997 crisis).
- Therefore, Thai economic fundamentals are much stronger than in 1997.

Origins of Crisis.

It all started with good intentions.

- Thai central bank began searching for a way to stop rapid strengthening of the baht.

Rising Baht.

Through the 1st 11 months of 2006, the Thai baht rose up 17%.

- Thai baht hit 9-year high on 11 December.
- Thai baht increased 37% since 1997 Asian financial crisis.

Why Capital Inflow?

Foreign money was flowing into Thailand.

- Foreign investors were lured by high Thai interest rates and prospects of rising baht.
- Thai's worried that if capital inflow continued, Thai exporters would be priced out the market, undercut by China, which doesn't let its currency move as freely as the baht.

Thai Exporters Complain.

Thai exporters complained strong baht over-priced exports.

- Central bank blamed hot money inflow for over-pricing baht.
- Officials felt the situation might become dire.

Undue Fears?

Inexperienced Thai leadership arguably over-reacted to Thai business concerns about an over-valued exchange rate threatening exports.

- Despite cries of pain from domestic industrial lobbies, Thailand's exports were up 20.9% on a year-to-year basis to end of Oct – performance second only to China's.
- Thailand ran healthy current account surplus of 1.9% of GDP.

Over-Shoots Mark.

Thai central bank simply overshot the mark.

- As fuel prices subsided and the baht strengthened, inflation dropped, which effectively boosted real interest rates.
- Speculators eyed prospects for quick profits via interest rate differentials.
- That argued for a significant cut in interest rates, which didn’t happen.

Monetary Policy Tightens.

Instead, Thai central bank steadily raised interest rates.

- On eve of crisis, interest rates stood at 5%, which in turn attracted capital inflow.
- As central bank raised interest rates, more capital inflow strengthened Thai baht.

Policy Dilemma:

Bangkok had to weigh 3 realistic courses of action:

COA # 1 – Let Baht Rise.

Thailand could let inflow lead to appreciation of its currency.

- That was a totally unacceptable non-starter for Thai military government.
- Bangkok felt baht rise was excessive, over-pricing exports.

COA # 2 –Use Market Tools:

Intervene in Foreign Exchange Market. How?

- Sell Thai baht to weaken foreign exchange rate/lower interest rates.

- This would arguably have been best strategy; unfortunately, Bangkok ignored this.

COA # 3 – Capital Controls.

18 Dec, Bangkok opted for capital controls.

- Foreign investors had to keep money in country for 1 year.
- They would lose 1/3 of investment in the event of early withdrawal.
- Bangkok initially imposed a 30% reserve requirement on all foreign capital exchanged for domestic currency.
- Central bank withheld 30% of all foreign currency inflows (over $20K) on deposit - interest free.
- Move affected foreigners' baht investments in bonds, stocks & other assets.
- Trade transactions and Thai residents' repatriation of money home were exempted.

Initial Impact:

But capital controls did little to calm investors:

- In fact, controls backfired.
- It shattered investor confidence in Thailand.

Market Hysteria.

Stock market crashed – falling 15% in just 1 day.

- $22bn was wiped off stock market - 12% of GDP, largest one-day fall since 1997 crises.

Partial U-Turn.

Government partially lifted capital controls.

- Reversed plans to impose 10% withholding tax on short-term foreign purchase of Thai stocks.
- Withholding tax remained on capital inflows for short-term purchases of debt.
- While financial U-turn was embarrassing reversal, it was clearly the right thing to do.

Market Reaction to U-Turn.

Market initially reacted favorably to U-turn on stocks.

- On Tuesday 19 December, stocks rose 10%.
- But much of this was bargain-hunters buying dirt cheap stocks.

Stocks Fall Again.

But on Wednesday 21 December stocks fell again – by 2.4%.

- So in the 48 hours since 15% stock market crash of 18 December, stocks only regained half of their pre-crisis capitalization.
- Investors were unhappy that controls were still in place deterring investment in commercial paper and government securities.

Thai Baht Falls.

Bangkok's goal of using capital controls to weaken Thai baht is working. But Thai's may be saying -- "be careful what you wish for."

- Thai baht fell by most in over 7 years, almost 4% fall since 18 December.
- Investors say they have waning confidence in the Thai monetary policy.

Removal of Capital Controls?

On upside: Bangkok announced that all capital controls would be removed circa mid-March once the baht "stabilized."

Big Let Down.

However, Bangkok defied market expectations when it announced partial capital controls on financial inflows would remain in place.

- 15 Mar news conference: Finance minister and central bank chief said they would continue to enforce withholding requirement on many types of foreign capital.

Withholding Rule.

Withholding rule requires that 30% of some foreign-capital inflows be deposited in non-interest-bearing accounts at the central bank for one year.

- Withholding rule still applies to foreign-capital inflows used to purchase many types of bonds and money-market instruments.

CONCLUSION

Economic Nationalism.

Maintaining partial capital controls tells foreign investors that Thai economic nationalists are still calling the shots.

- That will reduce much needed foreign investment.

Lesson Learned.

The controls were a surprise and unexpected.

- That is why investors reacted very sharply. Investors do not like surprises.
- To foster investor confidence, central banks need to be predictable and stable.
- Bangkok needs open capital markets.

THAI CAPITAL CONTROLS: INSIGHTS AND LESSONS LEARNED

Background.

Financial turmoil is nothing new to Thailand. The Thai stock market crash on 19 December brought back painful memories of the Thai financial crisis of 1997.

- But there is one important difference:

July 1997 Crisis.

July 1997 Bangkok was worried about speculative outflows of capital, as investors bet against baht.

- Almost 10 years ago Asian crisis started when pressures on Thai baht prompted Bangkok to impose mild controls on capital outflows.

December 2006 Crisis.

What triggered this financial crisis were Thai concerns about inflows of capital. So times have changed.

1997: Weak Thai Economy.

Back then Thai economy was fundamentally weak:

- Large current account deficit (8% of GDP).
- Low foreign exchange reserves relative to short term foreign currency debt.
- Downward pressure on overvalued baht pegged at 25 baht to U.S. dollar.

Like Mexico.

To speculators Thailand in 1997 looked like Mexico in 1994.

- Current account deficit also 8% of GDP.
- Speculative pressure started to build up in early 1997.
- Those mild controls on outflows did not work in 1997.
- Baht collapsed in July 1997 after a futile attempt to defend baht at 25 baht to dollar.

Polar Opposites.

Thai financial crises in 1997 and 2006 are polar opposites.

2006: Massive Capital Inflow.

Capital is flowing in, not out.

- Thai baht was appreciating rather than facing depreciating pressures.
- Foreign exchange reserves are high.
- Short term foreign currency debt is low compared to 1997.
- Thailand has been running current account surpluses (rather than the large deficits before 1997 crisis).

Therefore, Thai economic fundamentals are much stronger than in 1997.

GLOBAL CONTEXT

Weak U.S. Dollar.

Fed's loose monetary policy was starting to impact foreign shores.

In early Dec 2006, Thai central bank chief said Thailand was struggling to resist:

- Falling U.S. dollar and rising Thai baht.

Rising Asian Currencies.

Rising baht vis-à-vis the dollar, while steep, wasn't unique.

- Korean won and other Asian currencies have all experienced appreciation pressure this year in the face of dollar weakness.
- Even China's RMB has risen against the U.S. dollar, albeit more gradually.

PRC Distortions.

China has been aggressively intervening and preventing a more rapid appreciation of its currency.

- As a result, all Asian currencies are experiencing the same capital inflows and are forced to intervene to prevent excessive nominal and real appreciation.

Any I & W?

Even though Thailand's central bank has complained about the baht's rise recently, it was hard to spot this fiasco coming.

- After grabbing power in October's bloodless coup, the military junta installed a technocratic, broadly free-market roster.

- A respected former central bank governor moved into the Finance Ministry.
- Thailand's former ambassador to WTO became Commerce Minister.

Origins of Crisis.

It all started with good intentions two weeks ago.

- Thai central bank, began searching for a way to stop rapid strengthening of the baht.

Rising Baht.

Through the 1st 11 months of 2006, the Thai baht rose up 17%.

- Thai baht hit 9-year high on 11 December.
- Thai baht has increased 37% since 1997 Asian financial crisis.

Why Capital Inflow?

Foreign money was flowing into Thailand.

- Foreign investors were lured by relatively high Thai interest rates and prospects of rising baht.
- Thai's worried that if capital inflow continued, Thai exporters would soon be priced out the market, undercut by China, which doesn't let its currency move as freely as the baht.

Thai Exporters Complain.

Thai exporters complained strong baht was over-pricing exports.

- Central bank blamed hot money inflow for over-pricing baht.
- Officials felt the situation was becoming dire.

Undue Fears?

Inexperienced Thai leadership arguably over-reacted to Thai business concerns about an over-valued exchange rate threatening exports.

- Despite cries of pain from domestic industrial lobbies, Thailand's exports were up 20.9% on a year-to-year basis to end of Oct – performance 2nd only to China's.

Over-shoots Mark.

Thai central bank simply overshot the mark.

- As fuel prices subsided and the baht strengthened, inflation dropped, which effectively boosted real interest rates.
- Speculators eyed prospects for quick profits via interest rate differentials.
- That augured for a significant cut in interest rates, which didn’t happen.

Monetary Policy Tightens.

Instead, Thai central bank steadily raised interest rates.

- On eve of crisis, interest rates stood at 5%, which in turn attracted capital inflow.
- The more central bank raised interest rates, the more capital inflow strengthened Thai baht.

POLICY DILEMMA

Bangkok had to weigh 3 realistic options:

COA #1 – Let Baht Rise.

Thailand could let inflow lead to appreciation of its currency.

- Totally unacceptable non-starter for Thai military government.
- Bangkok felt appreciation was excessive, leading to over-priced exports and worsening external balance.

COA #2 – Use Market Tools:

Intervene in Foreign Exchange Market. How?

- Sell Thai baht to weaken foreign exchange rate/lower interest rates.
- This would arguably have been best strategy.
- Unfortunately, Bangkok ignored this strategy.

COA # 3 – Capital Controls.

On 18 Dec, Bangkok opted for capital controls to counter rapid baht appreciation.

- Foreign investors must keep money in country for 1 year.
- They would lose 1/3 of investment in the event of early withdrawal.
- Bangkok initially imposed a 30% reserve requirement on all foreign capital exchanged for domestic currency.
- Central bank withholds 30% of all foreign currency inflows (over $20K) on deposit - interest free.
- The move affected foreigners' baht deposits and investments in bonds, stocks and other assets.
- Trade transactions and Thai residents' repatriation of money home were exempted from the new rules.

Initial Impact:

But capital controls did little to calm investors:

- In fact, controls backfired. Controls triggered stock market crash.
- It shattered investor confidence in Thailand.

Market Hysteria.

Stock market crashed – falling 15% in just 1 day.

- $22bn wiped off stock market - 12% of GDP.
- Largest one-day fall since 1997 Asian financial crisis.

Partial U-Turn.

Partial lift on capital controls.

- Reversed plans to impose 10% withholding tax on short-term foreign purchase of Thai stocks.
- Withholding tax will remain on capital inflows for short-term purchases of debt.
- While financial U-turn was embarrassing reversal, it was clearly the right thing to do.

Market Reaction to U-Turn.

The market initially responded favorably to Bangkok's U-turn on stocks.

- On Tuesday 19 December, stocks rose 10%.
- But much of this was bargain-hunters buying dirt cheap stocks.

Stocks Fall Again.

But on Wednesday 21 December stocks fell again – by 2.4%.

- So in the 48 hours since the 15% stock market crash of 18 December, stocks have only regained half of their pre-crisis capitalization.

- Investors remain unhappy that controls are still in place deterring investment in commercial paper and government securities.

Thai Baht Falls.

Bangkok's goal of using capital controls to weaken the Thai baht is working. But Thai's may be saying -- "be careful what you wish for."

- The Thai baht has fallen by the most in more than 7 years.
- The Thai baht has fallen almost 4% since 18 December.
- Investors say they have waning confidence in the Thai monetary policy.

Removal of Capital Controls?

On upside: Bangkok announced that all capital controls would be removed once the baht "stabilized."

- What's not clear is at what baht exchange rate against U.S. dollar is the baht "stable."
- And would controls return if the baht rose again?

Lesson Learned.

The controls were a surprise and unexpected.

- That is why investors reacted very sharply. Investors do not like surprises.
- To foster investor confidence, central banks need to be predictable and stable.

STRATEGIC IMPACT

Political Context.

Thailand had little new capital expenditure in the past year, as political turmoil paralyzed the government and prompted companies to defer new investments.

- Many hoped the ousting of former Prime Minister Thaksin in a September 19 military coup, and the installation of a technocratic cabinet, would spur an investment pick-up.
- Capital controls fiasco means investment pick-up is unlikely to happen anytime soon.

Confidence Problem.

Capital controls will likely depress consumer confidence, with a return of investor confidence at best delayed.

- The capital controls fiasco has already cost Thai military government much of its credibility among international investors.
- It has also inflicted long-term damage to economic growth because of weakened consumer and investor confidence.
- Foreign investors will think twice before trusting post-coup government.

Higher Costs: For Government and Industry.

Even if consumer confidence can somehow be overcome, there is now reduced liquidity in the Thai debt markets from the capital controls.

- Less liquidity will result in higher long-term cost of capital.
- That means higher funding costs for the Thai government (and companies) just as many are looking for a pick-up in capital investment.
- The image of top economic policymakers caught totally off-guard by the predictable impact of their ill-considered measures has sharply heightened perceptions of investment risk in Thailand.

Global Outlook.

While Thailand shot itself in the foot with controls, this fiasco shows that in world of integrated capital markets, hot money inflows are a real problem to manage.

- Even traditional inflow controls may not work when a country is already fully integrated in global capital markets.
- Unless China allows its currency to appreciate more, most other Asian currencies will face dilemmas and tradeoffs outlined above in dealing with these hot money inflows.
- China needs to let RMB appreciate at a faster rate.
- That would allow other Asian currencies to appreciate more without undue risk of weak RMB under-pricing its exports against other over-priced Asian currencies.
- This is region-wide problem for all of Asia that Thai's may not be able to resolve alone.

CHRONICLES OF ECONOMIC HIGHLIGHTS

07 February 2006

Prime Minister Thaksin's $1.85 billion business deal set off an outcry over weekend, with 60,000 demonstrators calling for his resignation on 04 February.

- Protest was largest in over a decade.

Economic Advisor's Comment:

Protesters reacted to Thaksin family's sale last week of their 49.6% stake in Shin Corp telecoms conglomerate to Temasek Holdings.

- Temasek Holdings is investment arm of Singapore government.

Initial bone of contention was that Thaksin used legal loopholes to enable his family to sell Shin Corp's shares tax-free.

- Thaksin used a waiver on capital gains for transactions on Stock Exchange of Thailand (SET).

Thaksin is also accused of using his political influence to "rob the country" in order to enrich his family.

- Protesters say he sold "strategic national assets" to a foreign government.

Thai regulators say Thaksin's son probably broke the law by failing to disclose information about changes in share holdings.

- However, Security and Exchange Commission said it found no evidence that Thaksin's son was guilty of insider trading.

Thaksin made a statement that he would not resign unless King orders him to do so.

03 March 2006

Thai political turmoil is having a negative impact on Thailand's political economy.

- Bangkok has suspended ongoing free-trade talks with U.S.
- Bangkok has also postponed signing of a Free Trade Agreement (FTA) with Japan.

Economic Advisor's Comment:

Thai FTAs would boost Thai trade ties with U.S. and Japan, which are already valuable for all parties.

- Two-way trade between U.S. and Thailand reached $25.7 billion in 2005.
- Thai trade with Japan was even bigger at $41.2 billion.

Thai FTA talks with U.S. have been thorny and progressing slowly.

- Thai FTA talks with U.S. are bogged down by disagreements over opening up Thailand's closely protected financial sector and intellectual property rights (IPR).
- PM Thaksin's decision to dissolve Parliament and call a snap election for 02 April further complicates a drawn-out process.

Thailand was scheduled to sign its free-trade pact with Japan on 03 April.

- Signing will be delayed at least until a new government is sworn in.
- Bangkok says this may delay the launch of the trade pact until 2006, originally intended to take effect in Oct 2005.

Auto manufacturers (like Ford, GM and Toyota) that assemble cars in Thailand (and export from there) have a large financial stake in getting the FTA talks back on track.

17 March 2006

Thai business community is now urging Thai PM Thaksin to relinquish power.

- Influential Thai business community is increasingly concerned that a prolonged period of political uncertainty could affect their fortunes.

Prominent businessmen calling for Thaksin to step down include:

- Chief Executive of industrial estate developer Amata Corporation.
- Vice-President of the Federation of Thai Industries.
- President of the Thai Contractors Association.

Economic Advisor's Comment:

Even before political crisis, Thai business support for Thaksin has been softening.

- Many resent Thaksin channeling money almost exclusively to his corporate cronies.

Crisis has united businessmen in their desire for a swift end to the tensions.

- The longer political instability lasts, the worse it is for the political economy.

Political instability has already had negative economic consequences:

- Signing of a free-trade accord with Japan has been postponed.
- Negotiations on a similar agreement with the U.S. have been put on hold.

Thai businesses are putting fresh investment on hold.

- Thai banks are slowing down new loans.
- At risk is a deadline for firms bidding for a slice of $43.8 billion earmarked for public works.
- Hotels and restaurants report that they are already feeling the pinch.

In spite of these economic problems, Thai financial markets remain stable.

- Foreign stock market investors have so far remained relatively calm, expecting a quick resolution to the drama without lasting economic damage.
- Baht has remained stable, with little outflow of foreign funds from the stock market.

What's the down side if Thaksin steps down?

- That could set a bad precedent of mob rule over sound democratic institutions.
- If investors fear popular uprisings, they may decide to put their money somewhere else.

05 April 2006

Thai financial markets rally on belief that Prime Minister Thaksin is quitting, with hopes for a more durable market driven economic strategy.

- Thai stocks had biggest jump in Asia - with stock index rising 3.1% to 768 at market close on 2005 April -- highest point since January 2004.
- Thai foreign exchange rate hit 38.39 baht to U.S. dollar at market close on 2005 April - a 1% rise and its highest point in over 12 months.

Economic Advisor's Comment:

Even before the recent political crisis, Thai business support for Thaksin was softening.

- Many resented Thaksin channeling money almost exclusively to his corporate cronies.

Crony capitalism was just part of "Thaksinomics"-- old-fashioned, debt-financed pump priming economic strategy.

- Thaksin boosted domestic demand and export growth, while emphasizing domestic consumption.

Economic Strategy Track 1 consisted of cheap consumer credit-driven growth.

- Thaksin handed out $25,000 in loans to each of the country's 70,000 villages, extended debt relief to farmers, subsidized crops and rolled out a 30-baht-a-visit (77 cents) medical plan.
- Millions of people became heavily indebted, with average household debt rising 53% between 2001 and 2004.
- Thaksin was forced to scrap this over-borrowed consumer spending party.

Thaksin then opted for Track 2, consisting of massive government infrastructure spending.

- Thailand high level of off-budget government debt is now a big economic concern.

Neither of these two tracks is sustainable over the long term.

- Thaksin recklessly sacrificed medium term financial health for politically popular, short-term economic gains.

Therefore, Thailand economy could benefit from some fresh thinking.

- Succeeding Thai Prime Minister needs to formulate a more durable market driven strategy.

26 April 2006

Thai economy is slowing down and increasingly vulnerable in the face of political stalemate.

- Fitch (International Credit Rating Agency) reduced its Thai economic forecast from GDP growth of 5% for 2006 to 4.3%.
- Thai Chamber of Commerce says economic growth could fall as low as 3.2% if political uncertainty continues.

Economic Advisor's Comment:

Political tensions have eased since Prime Minister Thaksin announced he would not accept premiership.

- Fitch outlook for Thailand is still stable.

However, political stalemate has not been resolved.

- Can be almost as detrimental to economy as political turmoil.
- If instability persists, a new budget may not be in place for new fiscal year.

Bangkok announced in April that infrastructure spending would be delayed.

- Infrastructure delays jeopardize a potential 1.7% of economic growth.

Domestic demand is shaky across the board.

- Consumer confidence keeps sliding, with household spending already faltering and unlikely to bounce back.

- Corporations are holding back on investment spending until they see more political clarity.

In the face of weak domestic demand, Thailand is more reliant than ever on export growth - its one remaining economic engine.

- Thai exports soared 17.3% in 1Q 2006.
- Unfortunately, a strong baht is squeezing profit margins of Thai corporations despite rising export orders.

Baht has increased 7.3% against the U.S. dollar in 2006.

- Most regional currencies whose products compete with Thai exports have not risen as much.
- Korean won, Philippine peso, Singapore dollar and Malaysian ringgit have increased 4.7%, 3.3%, 3% and 2.8% respectfully.

As a result, Thai businesses fear that a strong baht will over-price their exports.

- Higher export prices could threaten Thai competitiveness in export markets.
- If exports falter, there will be no economic engine left to drive Thai economic growth.

05 June 2006

Thai economy expanded in 1Q 2006 at slowest quarterly pace since GDP contracted in 1Q 2005 in wake of Dec 2004 tsunami.

- GDP in 1Q 2006 only grew 0.7% compared with 4Q 2005.
- Stock market has fallen 9% since its peak on 10 May.

Economic prospects for all of 2006 also look worse than last year.

- Bangkok cut forecast for 2006 from about 4.5% to 5.5% range to 4.2% to 4.9% range.

Economic Advisor's Comment:

Investors see Thai political situation as uncertain.

- Government has been in a caretaker role since late February.
- While PM Thaksin resumed his duties last month, Thai courts nullified 02 April vote.
- Tentative date of 15 October for new polls has failed to help matters.

On domestic front, demand remains weak.

- Domestic demand growth slowed in 1Q 2006 – from 7.0% in 4Q 2006 to 2.3% in 1Q 2005.
- Investment grew just 1.5% quarter on quarter, its slowest pace in 5 quarters.

Government spending on long awaited big-ticket infrastructure projects is on hold.

- That's because lack of functioning parliament is creating serious delays in budget process.

Normally, parliament approves budget for next fiscal year (which starts on 01 October) by August.

- But Thailand will not have a functioning government until November or December.

Weak 1Q 2006 is mirrored in April 2006, with almost all economic sectors growing slowly.

- Bank of Thailand reports private consumption and investment slowed in April.
- Business confidence also worsened in April.

On foreign front, economic performance is a mixed bag.

- Talks with U.S. on a free trade agreement are at a standstill.
- Foreign investors are holding off on new investments until political stability returns.
- Fortunately, Thai export performance remains strong and keeps economy afloat.

There's also plenty of other bad economic news.

- Record high oil prices and high inflation (which hit 6.2% in May) are eroding consumer confidence.

Interest rates may have to rise further to contain inflation.

- Higher interest rates would further slow down economic growth.

19 September 2006

Thai baht fell most in 4 years after Thai military seized control of Bangkok.

- Thai bonds and a New York - traded fund of the nation's stocks declined.
- The baht fell 1.3% to 37.79 per dollar at 2 p.m. in New York, from 37.29 late yesterday, the biggest decline since July 2002.

Shares of mutual funds that invest in Thailand dropped in U.S. trading.

- Thai Fund Inc. fell 3.8% to $8.35 as of 1:45 p.m. in New York after tumbling as much as 7.1% earlier.
- Thai Capital Fund Inc. lost 4.3% to $9.71.

Risk of owning Thai government bonds jumped to a two- year high.

- Price of the contracts rose to more than $47,000 from $33,000 today.

Economic Advisor's Comment:

While immediate blow to financial markets should not be minimized, Thailand is in relatively good shape to weather storm.

- Back in 1997 when Thai baht fell, Thailand was running a huge current account deficit of 8% of GDP.
- Not so today – Thailand is on track to post a current-account surplus of $3.6 billion, or 1.8 % of GDP for all of 2006.

Thailand reported a $309 million current account surplus in July, following an excess of $65 million in June.

- Exports are at a record high.

Before coup announcement, record exports and large trade surplus had boosted Thai baht to biggest advance among Asian currencies in 2006.

- Thai baht had been trading at its highest since 2000.
- Even with the current coup and fall of recent fall of the baht, Thai baht is still up 8.6% against the dollar so far in 2006.

That still beats Indonesian rupiah and makes Thai baht best currency performance since January.

Coup is unlikely to trigger declines in emerging Asian market securities as Thailand's devaluation did in 1997.

- That event prompted bonds, stocks and currencies from South Korea to Indonesia to tumble.
- For now risk of that kind of financial contagion in Asia is relatively low.

21 September 2006

Financial fallout from coup appears to be shallow and short-lived.

- Buoyant exports, previously strong baht and 4% growth help Thai economy weather storm.

S & P and Fitch put Thailand on negative credit watch following coup.

- But Moody's is more confident: Affirmed Thai credit rating with a stable outlook.
- U.S. Embassy Bangkok assesses such violence as unlikely -- but it cannot be dismissed.

Economic Advisor's Comment:

Mr. Thaksin's removal breaks political impasse that clouded Thai business outlook.

- Thai political crisis caused international fund managers to be underweight or neutral.

Main casualty of political uncertainty was low business confidence and weak investment.

- Growth in private investment slowed from 7.2% in 1st quarter to 3.6% in 2nd quarter.
- High oil prices and high interest rates also caused weak consumer spending.

Upside scenario: Strong interim government enjoys legitimacy and pushes through government's infrastructure investments on hold for past year.

- Confident consumers and business boost domestic consumption and private investment.
- Confident government launches U.S.-Thai Free Trade Agreement.

Downside scenario: Struggling interim government keeps bashing Thaksin for selling Thai crown jewels (telecommunications) to Singapore (Temasek).

- Interim xenophobic government turns foreign direct investment (FDI) into a political football.
- Crackdown on FDI threatens Thai reputation as a hospitable place to do business.

Its time to focus on long-standing anomalies in Thailand's FDI policies.

- In law, foreign ownership of property and many service industries is heavily restricted.
- In practice, foreign investors have worked around obstacle, with tacit government consent.

Thailand has lots at stake: FDI generates 60%of manufactured exports.

- Thai's have strong gains from FDI in retailing, tourism and telecoms.

Recommendation: New interim government must modernize FDI laws.

- Continued fudging of FDI rules is untenable and could permanently poison Thailand's business climate.

27 November 2006

Bangkok is to designate Muslim South a Special Economic Zone (SEZ).

- Includes provinces of Pattani, Narathiwat, Yala, Songhkla and Satun.
- Acting PM Surayud Chulanont will delegate economic strategy execution to army chief Sondhi Boonyaratakl.

Economic Advisor's Comment:

Bangkok economic strategy tracks include:

- Addressing underlying social and economic factors that foster unrest and/or violent extremism.

Acting PM Surayud points out Muslim South economy has shrunk.

- In response, SEZ intended to:
  - Lower tax rates to boost employment.
  - Promote trade and industrial development.

06 December 2006

Post-Coup Thai economic performance improving:

- Booming exports driving 5% growth for 2006.
- Lower oil prices reducing inflation, with interest rate cuts likely in 2007.

Big omission is corporate earnings growth.

- Corporate earnings forecast to fall shy of 5% in 2007.
- Consumption remains weak.
- No spur to revise estimates upwards for domestically-oriented companies.

Banking and energy sectors are forecasting slower growth.

- Dividends, already a generous 66% of profits, unlikely to grow.

Economic Advisor's Comment:

Since tanks rolled onto Thailand's streets 2 months ago:

- Foreigners invested net $600M+ into stock market.
- Capital inflow helped Thai baht to hit 8-year high.

Positive portfolio (stocks/bonds) investment climate:

- Political risk in abeyance, rosier macro-econ picture, cheap prices.

Why is foreign direct investment (FDI) sluggish?

- Concern over backlash associated with Thaksin's controversial sale of telecoms conglomerate Shin Corp to Singapore.

To boost FDI, military government mandate -- reinstate rule of law.

- Clarify legal framework for foreign investment.
- Push through stalled infrastructure projects.

05 January 2007

Thai stock market dropped 3.1%.

- Already under fire following pre-Christmas attempt at capital controls.
- 8% total drop since 31 Dec explosions.

Economic Advisor's Comment:

Investors are becoming jittery about stability of military-installed government.

- Concerned about economic nationalism.

Government may crack down on foreign ownership of subsidiaries in service sector.

- Could force many foreign companies to reduce Thai holdings.

Ambiguous foreign investment laws previously allowed foreign companies control over their Thai subsidiaries.

- Considering tougher laws and stronger enforcement.
  - If new laws force foreign companies to sell their Thai holdings to meet more stringent requirements, Bangkok could be accused of expropriation of property under WTO guidelines.
  - Many prominent foreign companies' local subsidiaries would be in breach of new law.
  - Antagonizes foreign firms by forcing them to change holdings in Thai subsidiaries could cause financial turmoil.

To avoid turmoil, foreign investors propose exemption for existing investors.

- Also desire liberalized service sector rules to allow greater foreign participation.

09 January 2007

09 Jan: Thai cabinet passes new foreign investment rules.

- Investor anxiety deepens:

  - New rules force foreign companies (telecoms and some service companies) to reduce ownership to 49% or less.
  - If Council of State deems new laws legal, legislature must still vote to pass them.

Economic Advisor's Comment:

New rules further reduce investor confidence:

- Late Dec: Central Bank introduced capital controls on foreign investments.
- Dec 31: bombings in Bangkok further eroded confidence.

Cabinet decision rattled foreign investors.

- Stocks fell 2.7% -- lowest point in two years.
- Stocks have fallen 16% since 18 Dec.

Domestic and foreign financial agencies criticized Thai cabinet decision.

- Thai Chamber of Commerce concerned about revised laws hurting "thousands" of businesses.
- Standard Chartered Bank warned of "raised risk" of large capital outflows.
- Standard and Poors: "very strong chance" S & P will lower outlook on Thai credit rating.

Effects of revised laws on business climate could have been worse.

- Banks and retailers not included in revised laws.

01 March 2007

27 Feb: Thai Finance Minister, Pridiyathorn Devakula, resigned.

Economic Advisor's Comment:

After September coup, investors initially welcomed his appointment.

- Widely respected for principled leadership of Thai central bank and resistance to Thaksin's pressure.

However, he proved bitter a disappointment to foreign investors.

- Embraced and defended policies reflecting economic nationalism.
- 18 Dec 2006: imposition of capital controls.
  - Triggered 15% drop in Thai stock market.
  - Badly damaged foreign investor confidence.
  - Pridiyathorn blamed.
- Strongly defended government plans to revise laws and reduce foreign ownership.
  - Foreign businesses say these nationalistic moves may force some multinational firms to sell down holdings in Thai subsidiaries.
  - Economic nationalism scares off future foreign investment.

Pridiyathorn departure comes amid lower expectations for Thai economic growth.

- Government scaled down earlier GDP growth forecast from 5% to 4%.
- 28 Feb: Central Bank lowered interest rates to spur flagging economy.

07 March 2007

New Finance Minister: Chalongphob Sussangkarn.

- Pridiyathorn Devakula vacated post last week, after only 5 days.
- Current job: Chief of Thailand Development Research Institute.
- Former World Bank official with Ph.D. from Oxford; taught economics at UC Berkeley.

Economic Advisor's Comment:

Appointment comes as government struggles to revive consumer and investor confidence.

- Central bank cut interest rates twice this year to spur growth.

Investors cautiously optimistic about appointment.

- Chalongphob has strong free market credentials.
- Harsh critic of governmental capital controls.

Not clear if Chalongphob will have policy clout needed as Finance Minister.

- Economic nationalists in Government positions may undermine.

15 March 2007

Bangkok defied market expectations when it announced partial capital controls on financial inflows would remain in place.

- 15 Mar news conference: Finance minister and central bank chief said they will continue to enforce withholding requirement on many types of foreign capital.
- Withholding rule requires that 30% of some foreign-capital inflows be deposited in non-interest-bearing accounts at the central bank for one year.

Economic Advisor's Comment:

Bangkok introduced capital controls in Dec to halt rapid rise Thai baht against U.S. dollar.

- Investments destined for Thai stock market were quickly exempted from rule after announcement triggered plunge in Thai stock market.
- However, withholding rule still applies to foreign-capital inflows used to purchase many types of bonds and money-market instruments.

Maintaining partial capital controls tells foreign investors that Thai economic nationalists are still calling the shots.

- That will reduce much needed foreign investment.

03 April 2007

- Japan yesterday signed a free trade agreement (FTA) with Thailand
- FTA will eliminate tariffs on over 90% of trade between two countries in 10 years
- FTA will slash Thai tariffs on imported Japanese steel and car parts.
- Sensitive items, such as rice, were left out of the agreement.

Economic Advisor's Comment:

Since 1970s Thailand has depended heavily on large Japanese foreign investment inflows to propel its industrial growth.

- Japan is Thailand's biggest foreign investor and an important export market for Thai products.
- Trade between the two countries valued at $44.1 billion during calendar 2006.

FTA could entice more Japanese manufacturers of car parts, electronics and other items to relocate production to Thailand.

- FTA could also lead to more Thai-Japanese joint ventures (JVs).
    - o JVs would improve manufacturing techniques and create economies of scale, boosting competitiveness of Thai exports, including pick-up trucks.

16 April 2007

Thai Finance Minister Chalongphob Sussandkarn warns that Thai political and policy "chaos" is taking heavy toll on economy.

- Thai economic planners forecast growth as low as 4% in 2007.
- Well below 7.3% World Bank projects for emerging East Asian economies.

Economic Advisor's Comment:

Under Thaksin, Bangkok injected $1 billion a year into rural economy.

- Rural policies reversed quite sharply after the coup.

Finance Minister is reviving the flow of money to rural areas, which in turn should help counter underlying conditions fostering violent extremism.

- Financial stimulus and recent decision to cut interest rates from 4.5% to 4% should help revive growth.

29 May 2007

Finance Minister forecasts slowest growth in 6 years.

- Growth expected to slow from 5% in 2006 to 3.8% in 2007
- Central bank has cut interest rates 4 times in 2007 (to 3.5%) without success

Economic Advisor's Comment:

The economy continues to struggle:

- Consumer and business confidence are near 5-year lows.
- Investment growth is almost at a standstill, falling from 5.3% in Feb to 1% forecast.
- Consumer spending is also slowing from 4.4% to 3.5% forecast.

Volatile oil prices, unrest in the south and political uncertainty also slow down growth.

05 June 2007

Economic growth is better than expected.

- GDP up 4.3% in 1Q 2007 from a year earlier.
- Driver: Strong external demand, with export growth rising 6.5%.

Economic Advisor's Comment:

While strong exports help, Thai domestic economy in 1Q 2007 is still struggling.

- Thai investment suffered worst performance since 2001; down 1.4%.
- Consumption at lowest growth rate (1.3%) year-on-year since early 1999.

Political and policy turbulence weighs on investor and consumer confidence.

- Strong domestic economic pick-up not likely until nature of next government becomes clear.
- Recent lifting of Thai political ban is a small step in the right direction.

VIETNAM

• CHAPTER 14 •

Laura Emanovsky

Executive Summary.

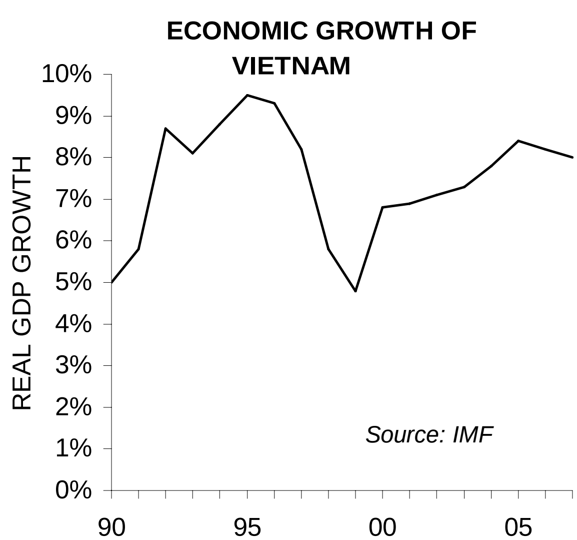
Vietnam is one of the top performing developing countries in the world. It has the potential to become a development model for other planned/market based economies. Year 2006 and the first quarter of 2007 have proven to be prosperous for the country. After 11 years of work, and eight years of negotiations, Vietnam became the World Trade Organization's (WTO) 150th member in January, 2007. Even with these successes, Vietnam is looking towards what can be done to prosper in years to come.

- Currently working towards Middle Income Country Status.
- Exploring its fruitful cooperation between the U.S. and Vietnam.
- Striving to protect its environment and strengthen its education system.

Selected Historical Data

Vietnam	2001	2002	2003	2004	2005	2006
Purchasing Power $B	173	189	207	229	256	284
GDP $B (Nominal)	165	171	182	197	214	229
GDP Growth (Real)	6.9%	7.1%	7.3%	7.8%	8.4%	8.2%
Inflation	-0.4%	4.0%	3.2%	7.7%	8.3%	7.5%
Exports $B	15.0	16.5	20.2	25.6	31.6	...
To U.S. $B	0.5	0.6	1.3	1.2	1.2	1.1
Imports $B	16.2	19.0	24.9	31.1	36.5	...
From U.S. $B	1.1	2.4	4.6	5.3	6.6	8.6
FDI held by U.S. $B	-	-	-	-	-	...
held in U.S. $B	-0.003	-0.004	-0.004	-0.001	-0.008	...
Gross Intl Reserves $B	3.7	3.7	5.6	6.3	8.6	11.4
Savings /GDP	27.0%	29.2%	28.3%	25.8%	30.2%	...
Fiscal Balance /GDP	-3.0%	-3.8%	-4.6%	-3.8%	-4.9%	-5.0%
External Debt /GDP	8.0%	7.7%	7.7%	7.3%	...	...
Current account/GDP	1.6%	-1.9%	-4.9%	-3.4%	0.4%	0.3%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Achieving Middle-Income Country Status by 2010.

One can't help but be impressed with Vietnam's achievements in successful planning and development. In less then two decades, after the inception of Doi Moi (Renovation), Vietnam came from extreme poverty to now setting its eyes on achieving middle-income status by 2010.[1] With Vietnam's economic growth topping 8% consecutively over the last two years, FDI rising to over $6 billion, and exports up to over 20%, this goal is achievable.[2] The following is a list of areas the government is focusing on improving:

- Working towards diversifying its economy.
- Creating networks, from transport infrastructure to value chain agriculture.
- Increasing separation between regulation and ownership by delegating and quality accounting.
- Gradually changing the relationship between state and society.
- Continuing to establish institution arrangements to handle its complex economy and continuous growth.

Burgeoning Construction Happening Every.

Vietnam is working hard to transform its infrastructure.

- In 1993, only 30% of the population lived within two km of an all-weather road. This number was increased to 83% in 2004 and now is even higher.[3]
- Last year, the country finished its massive project of constructing a 6.3km tunnel, the first of its kind in South-East Asia, in Central Vietnam. The tunnel cuts the bottle neck of traffic crossing the dangerous Hai Van Pass, once the only available route by road between Central and Northern Vietnam. The tunnel is expected to turn Danang City into an industrial hub.[4]
- Adding to this, Vietnam has plans to build a high-speed train connecting Hanoi to Ho Chi Minh City. Japan pledged 70% of the $33 billion it will cost to construct it. The train will cut travel time from Hanoi to Ho Chi Minh from 30 to 10 hours.[5]

These expansions in infrastructure are crucial factors helping to determine the pace and diversity of Vietnam's development.

ACCESSION INTO WTO

Vietnam has been traveling a long road, working towards WTO accession for over 11 years. After receiving Permanent Normal Trade Relations (PNTR) with the U.S., the Country finally qualified for member status. On January 11, 2007, Vietnam became the WTO's 150th member.

America's Role in Vietnam's Accession.[6]

Diplomatic and economic ties between the U.S. and Vietnam only began progressing in mid 1990's. A step towards normalization occurred with the signing of a bilateral trade agreement (BTA), signed by President Bush in 2001. In order for Vietnam to become a member of WTO, it is required each member has unconditional most-favored-nation (MFN) status or PNTR. On the other hand, U.S. trade relations with Vietnam are governed by Title IV of the Trade Act of 1974 and the Jackson-Vanik amendment (section 402), which prevents NTR status to certain Communist governments. Therefore in order for the President to grant Vietnam unconditional MFN status, Congress had to pass legislation removing Vietnam from Title IV. On December 8-9, 2006, the U.S. House and Senate passed H.R. 6406 and H.R. 6111, granting PNTR to Vietnam.

Benefits of Becoming a WTO Member.

- Gives a boost to inward FDI through becoming a larger global player and through domestic reforms.
- Protection of multilateral rules in trade with other WTO members.

- Fosters growing trade with the U.S. and other WTO members.
- Allows Vietnam participation in future trade and development negotiations, such as the upcoming Doha Development Agenda.
- In addition to these benefits are MFN treatment, National treatment of goods and services, transparency in government laws and regulations affecting trade, lowering trade barriers through negotiations, reliance on tariffs, and dispute settlement.

U.S. and Vietnam Trade.

- From 2001-05, bilateral trade grew from $1.4 billion to $7.6 billion. Most of this increase was in apparel products.[7]
- Bilateral trade is expected to nearly double to $15 billion by 2010 and U.S. investments in Vietnam to $8 billion this year.
- Vietnam appeals to many U.S. corporations because of its low wages and highly educated population.

Massive Privatization of State Firms is Occurring.

The current Socio-Economic Development Plan (SEDP) strives to have 53 corporations made public by 2010.[8]

- Major corporations such as Vietnam Airlines and Vietnam Textile and Garment Group will be equitized by 2008.
- Private enterprises now make up half of the investments made each year.
- Even state owned firms are doing well, bringing in 7-8 percent profit per year.

SEPD Found the Problems Vietnam Faces will be:[9]

- Creating proper institutional arrangements needed to handle its complex economy.
- Providing needed risk management for its diverse stakeholders through financial and infrastructure regulation and through social protection.
- Look towards increased protection of its environment.

Avoiding "Mega-Cities," by Planning for Urbanization.

The Vietnamese government is actually supporting urbanization. The Ministry of Planning and Investment (MPI) is forecasting 37 million people, or 40% of its population to be living in cities by 2010. To avoid mega-cities, development will be evenly distributed throughout Vietnam in three growth triangles[10]:

- Hanoi - Haiphong - Quang Ninh (North).
- Quang Nam - Danang - Dung Quat (Central).
- Ho Chi Minh - Dong Nai - Vung Tau (South).
    - Planning is for further industrialization and less agriculture.
    - Growth is expected to expand to 9% from 2006-2010.

Will Vietnam be able to Develop while Maintaining its Environment?

Rapid urban and industrial development has resulted in alarming levels of pollution in its water, air, and soil. The country is also facing rapid resource depletion.

- 10-14% growth in industry is requiring increased extraction of natural resources.[11]
- Water pollution regularly leads to fish kills, damaged crops, and skin and stomach problems for those living near the polluted water supply.

- Air pollution in urban areas is worsening with increases in factories, energy production, and vehicle emissions.

Vietnam is trying to combat its environmental problems with establishing new laws and regulatory agencies to monitor and inspect pollution levels and to respond to local complaints.

- The Law on Environmental Protection sets standards on air and water quality, used to levy fines and enforce protection.
- The National Environmental Agency (NEA) is responsible for industrial pollution.
- Departments of Science, Technology, and Environment (DOSTE) are located in each province to solve local environmental issues, as well as to monitor and inspect facilities.

The government is working to protect its environment while maintaining rapid growth. But, as is common in developing countries, capital is spread thinly, proper environmental know-how is lacking, and effective implementation often competes with bottom line profits and/or fear of companies picking up and going to less regulated governments.

Transforming the Education System.[12]

Vietnam understands education is the key to economic development. Currently the country is re-looking at its current plan to develop its education system with 41 objectives to attain by 2010. Below are a few of the objectives that have been successful thus far:

- Primary schools are now setting minimum standards of education for both teachers and textbooks.
- Primary enrollment was up to 94% in 2004 from 84% in 1993.

Future Education Concerns for Vietnam.

More than half of its population is under 25 years old, with 27% between the ages of 12 and 24.

- These individuals will need access to a variety of upper secondary and tertiary education programs.
- Currently many young people are taking jobs below their skill level.
- Curriculum will need to be enhanced to meet the needs of its changing environment so the students learn relevant and needed skills.

CONCLUSION

This next year, Vietnam is expected to have its largest amount of foreign direct investment ever. Reasons for this are not surprising. Vietnam holds the keys for success, plentiful natural resources, more than half its population under 25 years of age, wages still lower than China, and now WTO member status.

- This new FDI is expected to be invested into industrial production and construction, especially high-tech industries, mining and infrastructure development.[13]

However, several obstacles remain, such as:

- Modernizing it's institutions to achieve success in its changing environment.
- Maintaining the environment while maintaining growth.
- Providing the positions needed for their labor forces that compare to their level of education.

How has this progress affected the average Vietnamese person?

An interview with a local villager, Mrs. Hoa, in Quang Binh Province, illustrates how Vietnam's changing economy can be seen clearly from one generation to the next. Mrs. Hoa reflects on the changes from when she was a teenager, to what it is now like for her teenage son. "We had no electricity, we never knew what it felt like to have full stomachs, and we couldn't afford going to school. Now my 17 year old son has his own moped, he is tall and strong, and is considering what trade he will study."[14]

CHRONICLES OF ECONOMIC HIGHLIGHTS

05 January 2006

Vietnam's economy is on track to generate rapid growth in 2006.

- Vietnam's GDP expanded 8.45 percent in 2005 - faster than its 5-year average of 7.2% and the fastest pace of growth in nearly a decade.

Vietnam's poverty rate is falling almost as fast as its economy is growing.

- The proportion of the population that the government deems poor fell from 58% in 1993 to 20% in 2005.

Economic Advisor's Comment:

Vietnam benefited from the signing of a long-anticipated bilateral trade agreement with the U.S. in 2001.

- Surging exports drove Vietnamese growth up through 2004.

However, the pace of Vietnam's export growth slowed in 2005.

- The end of the Multi-fiber Arrangement after 01 Jan 2005 initially enabled PRC textile exports to rise at Vietnam's expense.
- However, aggressive Vietnamese business investment helped to pick up the slack in GDP growth.

Vietnamese exporters have also proven to be remarkably adaptable.

- For instance, shrimp and textiles that are being taxed by the U.S. have been diverted to Europe instead.
- Vietnamese farmers who suffered when the international coffee price fell (thanks largely to a huge leap in Vietnam's output) are shifting to cocoa and pepper.
- Vietnam's export-oriented garment industry also received a boost later in 2005 after Europe and the U.S. imposed safeguard measures on Chinese garment exports.

In many ways, Vietnam's economic performance seems unstoppable.

- Successive outbreaks of SARS, a respiratory disease, and avian influenza, which have killed a substantial amount of birds and a handful of people, barely registered in Vietnam's overall GDP performance.
- The high oil price has had little effect, since Vietnam is a big oil exporter.

That said, Vietnam does face some difficult economic challenges.

- Most importantly, Vietnam is still struggling to reach agreement with key trading partners, including the U.S., on the terms of its WTO accession.
- Vietnam is in the midst of trade disputes with both the United States and the EU.
- It stands accused of exporting everything from catfish to bicycles at predatory prices.

06 April 2006

Vietnam's economy is on a roll, with foreign investment pouring into this low-wage country.

- GDP growth was 8.4% in 2005 and 7.3% in 1Q 2006 despite weather problems cutting agricultural production.

Vietnam is a magnet for foreign capital, with 260 U.S. firms already investing in the country.

- In 2005 $5 billion in foreign investment poured into the country, with another $6 billion expected in 2006.

In late Feb, Intel – world's biggest semiconductor maker – agreed to build biggest single technology project in the history of Vietnam.

- Intel's $605 million plant will engage in the final process of chip-assembly, in which the chips are packaged in ceramic casing and tested.

Economic Advisor's Comment:

Intel's investment punctuates a major turning point for Vietnam's economy.

- While the country had attracted investments from a diverse range of companies, including Sony Corp. of Japan and Samsung of South Korea, none comes close to Intel's plans.

Most importantly, work at Intel requires a sophisticated work force, which is why chip insiders are impressed with the deal.

- It means Intel believes the Vietnamese can do more than low-skilled jobs.
- More foreign investment will surely follow Intel's lead.

What's the attraction? Why Vietnam and not China?

- The Vietnamese work very hard for very little by Western standards.
- The foreign private companies pay the best - on average, about $60 per month.
- Vietnam's state-owned enterprises only pay $19 per month.
- Those are cheap rates, even by Chinese standards.
- In contrast, China now faces a labor shortage and wages are rising.

16 May 2006

U.S. and Vietnam reached agreement in principle for Vietnam to join World Trade Organization (WTO) in 2006.

- Negotiators expected to sign agreement early June.

U.S. Congress must vote on Permanent Normal Trade Relations (PNTR) status.

- Congress expected to vote in favor of Vietnamese PNTR before August.
- Vietnam would then submit final request for WTO membership later in 2006.

Vietnam completed deals needed to join WTO with all other leading trade partners.

- Still needs to finish work on multilateral deal bringing overall trade regime in line with global rules before joining WTO.

Hanoi wants to be WTO member by the time it hosts POTUS in November for annual summit of 21-member Asia Pacific Economic Cooperation (APEC) forum.

Economic Advisor's Comment:

WTO agreement paves way for Vietnam to lower tariffs on U.S. industrial and farm products.

- Also removes other barriers that block U.S. firms (telecommunications, retailing, banking, insurance and energy) from doing business in Vietnam.

Many investors believe Vietnam emerging as "next hot investment zone" in Asia.

- Vast pool of low-cost labor and large consumer market of 85 million people.

Joining WTO should help Vietnam boost exports of manufactured goods and commodities such as rubber and shrimp.

- Also could force Vietnam to accept further economic reforms that would allow more FDI and growth.

WTO entry won't solve all of Vietnamese problems that frustrate investors.

- Vietnam lacks much basic infrastructure needed to support sustained strong growth, including roads, ports and adequate electricity supplies.
- Vietnam could require as much as $45 billion in investment just to get to level of infrastructure now in Thailand.

Bureaucracy and Hanoi tight control over some parts of economy remains another potential stumbling block.

- Central planners in Hanoi still must approve most large foreign investments.
- Foreign companies typically can't distribute or service products without creating partnerships with Vietnamese companies.

09 August 2006

Foreign investors all said no to oil refinery at Dung Quat in Northern Vietnam -- Vietnam now on its own.

- Kick-start of Dung Quat refinery in North Vietnam has been long-delayed.
- It shows central planning and North-South rivalry stunting long-term growth.

Vietnam has crude oil and natural gas to power refinery and make it a success.

- But these resources in far South, not up North at Dung Quat.

Hanoi's decision to build first oil refinery in Dung Quat, far from major markets, offers blunt reminder to investors:

- Communist mind-set and nonsensical state-planned economics are still pervasive.

Economic Advisor's Comment:

At present, Vietnam lacks facilities to convert own crude oil output (about 18 million barrels of crude oil a year) into usable fuels.

- Central planners decided to build a refinery - but problem was deciding where to build it.

Prosperous Southern Vietnam is logical place to build refinery.

- Closer to offshore oil fields and one of few deep-water ports where tankers can easily dock.

Communist political power, however, still lies almost completely in Hanoi.

- Strains from wars against France and U.S. and North-South rivalry haven't entirely healed.
- Hanoi wary of allowing South to continue gathering a disproportionate share of wealth.
- Planners decreed that oil refinery be built in comparative isolation of North.

Other challenges:

- Hanoi tried to instruct investors where to invest--foreign investors don't like being told where they can & can't place money.
    - o Investors from France, U.S., Malaysia and Russia all rejected refinery at Dung Quat because remote location is financial loser.
- That has left Vietnam to go it alone after prolonged delays.
    - o State oil company Petro Vietnam broke ground in Nov 2005, with completion date in 2009.

- o Vietnam's "politics-first" approach on Dung Quat refinery will burden economy in future.

And while high oil prices have improved Vietnam's margins in refinery business, they don't guarantee success.

- Only the right refineries in the right locations will be commercially viable.

25 August 2006

Vietnam banks block North Korean bank accounts inside Vietnam.

- Action supports U.S. led crackdown on overseas financial institutions serving as repository for Pyongyang's funds.

Move comes ahead of Communist Vietnam's anticipated entry of WTO later this year.

- Follows signing of bilateral trade agreement with Washington in May.

Economic Advisor's Comment:

Shows U.S. Treasury efforts to limit North Korea access to international banking is proving increasingly successful.

- U.S. crackdown started in September 2005 against Macao-based Banco Delta Asia.

USG seeks to curtail Pyongyang's counterfeiting and drug smuggling operations overseas.

- Crackdown cited by DPRK as major barrier to resuming six-party talks.

On Wednesday, Hanoi said it was only "investigating" U.S. allegations North Korean funds had been parked in accounts in country.

- Peter Beck, reliable North Korea expert with International Crisis Group, says he was told by expatriate general manager of DPRK's Daedong Credit Bank, Nigel Cowie, that Vietnamese banks shut North Korean accounts several weeks ago.
- Vietnam's crackdown followed Hanoi visit by Stuart Levey, U.S. Treasury official overseeing Washington's crackdown on international banks working for North Korea.

U.S. success in Vietnam provides clearer indication of why DPRK reacting so vigorously to Banco Delta Asia financial crackdown last fall

- Crackdown prompted Pyongyang to walk away from six-party talks on cusp of an apparent breakthrough.
- Beck claims "North Korea access to international financial markets is under threat" and U.S. push was now, from Pyongyang's perspective, biggest barrier to resuming six-party talks.
- Beck says crackdown left Pyongyang with diminishing number of banking options, with Russia "really one of the only countries -- perhaps only country -- in world that is allowing North Korea to bank."

06 November 2006

Dispute with Dutch bank ABN Amro awakens foreign investor concerns about Communist mindset.

- Incombank (state-owned Vietnamese financial entity) asked ABN Amro to conduct foreign exchange speculation.
- After ABN Amro lost $5.4 million, Hanoi incarcerated two ABN employees and questioned two others.

Prime Minister Nguyen Tan Dung is urging speedy prosecution.

- Hinted ABN staff might escape criminal charges if government compensated for losses.

Economic Advisor's Comment:

Dispute highlights Vietnam still has much to learn concerning realities of capitalism.

- All business entails financial risk.
- ABN mistakenly assumed business conduct considered normal/legal elsewhere acceptable in Communist Vietnam.
  - ABN broke archaic law: causing economic losses to state - a criminal offense, potentially punishable by death.
  - Foreign businessmen now fear dire personal consequences if they violate law.

Law frustrates negotiations with private investors in power generation projects.

- Delays plans for capacity expansion needed to relieve worsening electricity shortages.
- Deters foreign investment and a serious obstacle to economic development.

Faster privatization is obvious solution - but a non-starter for Communist leadership.

- Hanoi insists on micromanaging “commanding heights of economy."

Government should not make foreign investors scapegoats.

07 November 2006

WTO formally extends membership to Vietnam.

- 07 Nov: General Council approved accession.
  - Vietnam can join 30 days after National Assembly signs accord.
- Other than China, Vietnam has best-performing economy in Asia.
  - Expect 7.8% growth for 2006.
  - Foreign investment increased 41% in past year
    - Jun 2006: Intel Corp. announced $605 million investment.
- U.S. - Vietnam bilateral trade increased from $1.2bn in 2000 to $7.8bn in 2005.
  - Garment industry benefited tremendously from increased trade.

Economic Advisor's Comment:

- Despite positive progress towards economic freedom, government restricted by communist mindset.
- Highlighted by recent dispute between Hanoi and ABN Amro Bank.

16 November 2006

U.S. Congress rejects Republican proposal to normalize trade relations with Vietnam.

- Failed to secure 2/3 majority needed to pass without debate.

Economic Advisor's Comment:

- Bill still has strong bipartisan support.
  - Expected to pass with majority after debate next week.
- Setback for President Bush on eve of Asia Pacific Economic Cooperation (APEC) forum in Hanoi.
- Bad start in achieving bipartisan support for trade liberalization on Capitol Hill.

28 November 2006

28 Nov: Vietnam Legislature ratifies WTO membership.

- Overwhelming approval (444-3 vote, with 2 abstentions).

- Paves way for Vietnam to 18 Dec entry.

Economic Advisor's Comment:

There has been gradual implementation of free-market reforms over last 20 years.

- Incoming FDI almost 50% higher in 2005 than 2004 and is up in 2006.

At first glance, WTO entry opens floodgates to even more FDI.

- Vietnam agrees to open financial services and telecoms.

However, $4.5 million ransom paid to Vietnamese state bank by ABN Amro to secure release from Jail of four employees (following market loss) alarms foreign investors.

12 December 2006

10 Dec: U.S. Congress passed bill to permanently normalize trade relations (PNTR) with Vietnam with strong bi-partisan support.

- Final step in reconciliation.
- Ends Cold War-era requirement of annual evaluation of human rights record as pre-condition for renewing normal trade relations.

Reverses Capital Hill rejection of PNTR bill last month (required 2/3 majority to pass w/o debate).

Economic Advisor's Comment:

U.S. business community expressed strong relief at locking in PNTR.

- Ensures U.S. firms benefit from Vietnamese WTO entry on 28 Dec.
- Eager to tap into fast-growing market of 85 million people.
- Feared access would be blocked if Congress voted down.

Since bilateral trade deal signed in late 2001:

- Trade soared from $1.2bn to $7.8bn per year.
- Key driver: Garment shoe, furniture and seafood exports (to U.S.).

To join WTO, Hanoi agreed to liberalize domestic service industries such as:

- Banking and insurance -- sectors of keen interest to many U.S. companies.

28 December 2006

Vietnam bank tightens financial sanctions on North Korea.

- East Asia Commercial Bank – a Vietnam bank with strategic partnership with Citibank -- orders immediate closure of all accounts linked to Pyongyang.
- Previously, East Asia Commercial Bank in Vietnam acted as a “correspondent bank” for customers wanting to move money into and out of North Korea.

Economic Advisor’s Comment:

Vietnam’s financial crackdown on Pyongyang further isolates North Korea from global financial system.

- U.S. started targeting Pyongyang’s financial activities a year ago.
- Since then even those banks in friendly “communist” countries such as China and Vietnam have closed North Korean financial accounts.
- U.S. orchestrated financial crackdown makes it nearly impossible for Pyongyang to transfer money, illicitly earned or otherwise.

As Vietnam prepares to join WTO and forge closer economic ties with U.S., Hanoi has been co-operating with U.S. crackdown on DPRK financing.

- Back in Sept 2006 U.S. Treasury Sec Paulson thanked Vietnam for its cooperation with U.S.
- Vietnam's Military Bank helped coerce Pyongyang-based Tanchon Commercial Bank to close down its illegal accounts.
- U.S. Treasury exposed Tanchon as primary financial facilitator of North Korea's ballistic missile program.

04 January 2007

Hanoi eased foreign exchange controls on eve of 11 Jan Vietnamese WTO entry.

- 28 Dec: Hanoi eased restrictions on capital flows coming in and out of country for trade and investment purposes.
    - o Guarantees free convertibility of dong to other currencies.

Economic Advisor's Comment:

Previously, foreign investors could repatriate investments and earnings.

- Limit on amount of dong that could be converted.

Large foreign inflows cause confidence to surge.

- Hanoi guarantees right of investors to move foreign currency in and out.

Foreign direct investment set to rise upon WTO entry (Jan. 11).

- 2007 FDI expected to surpass $10 billion estimated for 2006.

23 January 2007

Trying to slow down soaring stock market and prevent boom and bust.

- 22 Jan (Hanoi): Vietnamese Deputy Finance Minister said government will keep 49% foreign-ownership limit for listed companies.
- Investors expected removal of cap for consumer goods and technology companies, but not in banking.

Economic Advisor's Comment:

Foreign capital is also pouring into other Asian stock markets.

- China and India: Stock markets scored spectacular returns in past 12 months.
    - o After years of lackluster returns, Chinese stocks on a tear.
    - o 22 Jan: PRC Shanghai stock (over doubled last year) rose 3.6% to another record.
    - o Indian stocks also reaching stratospheric valuations--47% gain in 2006 and 42% in 2005.

Similarly, Vietnamese stocks up over 30% in January after soaring 144% in 2006.

- Jan 2007 stock market capitalization at about $14.6bn compared to $1bn in Jan 2006.

However, Vietnamese effort to use 49% limit on foreign investment to slow down stock market is not whole solution.

- Domestic investors also driving up market.

08 March 2007

International Monetary Fund (IMF) warns Vietnam of risks from soaring stock market.

- Commercial banks at risk due to shaky loans to stock market speculators.

- Sudden stock market reversal could impede investor ability to repay loans.
- Vietnamese firms speculating in stocks instead of investing in core business.
- Large foreign inflows into stocks complicate monetary and currency policies.

Economic Advisor's Comment:

2006: Vietnam one of hottest markets in world.

- In 2006 stocks rose 145% and in 2007 stocks up another 51%.
- Since early 2006:
  - Market capitalization from $1bn to $15bn.
  - Licensed brokerage houses from 16 to 56.
  - Trading accounts up almost 4-fold from 32,000 to 120,000.

Overvalued stock market is vulnerable to sharp correction.

- Valuations for 20 largest firms trading at 73 times earnings – 6 times larger than comparable emerging markets.

IMF recommends prompt action to slow trajectory and avoid boom and bust scenario.

- Possible options:
  - Government may impose capital controls.
  - Capital gains tax on locals.
  - One-year lockup period on foreign investor money.
    - Could hurt some U.S. mutual funds and turn off foreign investors.

ENDNOTE

[1] See Vietnam Development Report 2007. *Vietnam: Aiming High*, Hanoi, World Bank Office, 2007.
[2] IDA at Work, *Vietnam: Laying the Foundation for Steady Growth.* Washington, D.C., World Bank, 2007, pp. 2-3.
[3] IDA at Work, p. 5.
[4] For further information refer to the website: http://www.danang.gov.vn/home/view.asp?id=83&id_tin=9280&id_theloai=1019
[5] For further information refer to the website: http://www.iht.com/articles/2007/02/06/business/vietrail.php
[6] See Mark E. Manyin and William H. Cooper, et al. *Vietnam PNTR Status and WTO Accession: Issues and Implications for the United States*, CRS Report for Congress, 2006.
[7] Manyin, p. 7.
[8] For further information refer to the website: http://www.thanhniennews.com/business/?catid=2&newsid=23785
[9] United Nations Country Team Vietnam. *The MDG's and Vietnam's Socio-Economic Development Plan 2006-2010.* United Nations, 2006.
[10] Dara O'Rourke, *Community-Driven Regulation: Balancing Development and the Environment in Vietnam*, London, 2004, pp. 38-39.
[11] O'Rourke, pg. 41.
[12] World Development Report 2007. *Development and the Next Generation,* Washington, D.C., World Bank, 2007.
[13] For further information refer to the website: http://news.monstersandcritics.com/business/features/article_1241692.php/Vietnam_eyes_investment_boom_as_newest_WTO_member
[14] Personal interview, Sub-Hamlet 2, Vo Thuan Hamlet, Tay Trach Village, Bo Trach District, Quang Binh Province, Vietnam, 3/20/07.

EAST TIMOR

• CHAPTER 15 •

Leif R. Rosenberger

Executive Summary.

At first, international financial institutions (IFIs) applauded the government.

- East Timor government avoided pitfalls of previous nation building efforts.
- Nobody blamed government for corruption, over-spending or over-borrowing.
- Energy money was invested in an oil fund in New York for future generations.
- But IFI optimism gave way to violence in East Timor in April and May of 2006.
- East Timor people (poorest in Asia) were frustrated and felt “future is now.”
- Real non-oil GDP growth in 2006 is estimated to have been negative.
- Non-oil economy is forecast to return to growth in 2007 and 2008.

Government failed to strike right balance between spending and savings.

- Government did very well at saving money, but badly at spending money.
- When peacekeepers left the country, there was a shortfall in aggregate demand.
- Government should have offset this with an expansionary fiscal policy.

Instead, government made things worse with a fiscal straightjacket.

- Central government gave too little money to district administrators.
- Rural banks were non-existent; money was physically carried around in carts.
- No serious attempt was made to build up a private sector.
- A public works program to rebuild shattered infrastructure was rejected.
- Opportunity was missed to employ angry youth and cut demand for violence.
- Money is like horse manure: Don’t pile it up -- spread it around inside East Timor if you want things to grow.

Introduction.[1]

Not long ago – in the early 2005 -- IMF and the World Bank praised East Timor as a nation building success story.

- But it didn’t take long before the economic optimism of these International Financial Institutions (IFIs) gave way to violence in East Timor in April and May of 2006.

Political Factors.

Political scientists are quick to chalk the violence up to political infighting.

- Admittedly, politics played its part.
- But was politics really the root cause?

Appearances can be Deceiving.

At first glance, violence would appear to be an open and shut case of rising expectations that were not being met.

- Once rising expectations were blocked, frustration turned to violence.

- Given the energy windfall that East Timor enjoyed, it's would normally be all too easy for the people of East Timor to think the worst.
- After all, energy had been the black curse in the other former Portuguese colony of Angola, where the corrupt elites hoarded profits from the population at large.

Avoiding Pitfalls.

But to be fair to the East Timor government, there is no evidence of corruption.

- Quite the contrary. The government bent over backwards to avoid pitfalls of other newly independent governments.
- It was almost as if government leaders had a checklist of lessons learned from the past.
- At the top of the do's and don'ts checklist were a) no corruption, b) no over-borrowing, c) no squandering national wealth on ill-advised projects, d) fiscal discipline, and e) monetary discipline.

Kudos from IFIs.

The IFIs praised this virtuous government record of avoiding standard pitfalls.

- The government placated the IFIs by choosing the dollar as a currency. That limited monetary risk of price instability.
- The IFIs were also impressed with the East Timor government's frugality.
- They also impressed the IFIs with their fiscal discipline. In 2005-2006 the government impressed the IFIs with a 33% fiscal surplus.
- In August 2005, the government opened an oil fund with the U.S. Federal Reserve's New York branch. By December of 2006, the government had piled up $1 billion in savings.
- The IFIs were impressed that the government was thinking about future generations.

Money is Like Horse Manure.

The IFIs and the East Timor government forgot some of the most basic realities in any economy.

- For starters, money is a lot like horse manure.
- If you pile it up outside the country, nothing happens inside the country.
- You got to spread it around inside East Timor if you want the East Timor economy to grow.
- If you hoard it in the capital, nothing happens in the East Timor countryside.

Future is Now.

- George Allen, former coach of the Washington Redskins, used to say "the Future is Now."
- When too much money is saved for the future, nobody is spending money in East Timor now.

WHAT WENT WRONG?

Bubble Economy.

Defenders of East Timor's leaders rightly point out the tremendous ramp-up on international presence after 1999.

- The ramp-up included an international program manned by 5,000 peacekeepers and 1,300 police officers.
- That ramp-up created an unsustainable bubble in business catering to them.
- Other words used to describe this bubble economy are "artificial economy" and "yo-yo money."

- The latter is most illustrative, because money spent on imported beer and at foreign-run hotels, swings into the country and then quickly back out.
- It does not contribute to a base that can then grow on its own.
- In short, the country had little absorptive capacity.

Economic Contraction.

East Timor's economic contraction was a sharp and sustained decline in terms of per capita income.

- As population rose 4% - 5% annually, the UN peacekeeping presence downsized from 2001 onward.
- In per capita terms, the GDP fell for 4 consecutive years.
- Real non-oil GDP growth in 2006 is estimated to have been negative.
- Non-oil economy is forecast to return to growth in 2007 and 2008.

John Maynard Keynes.

Too bad John Maynard Keynes, the great British economist, is not still alive and in charge of one of the IFIs.

- He would have immediately seen that there was a shortage of aggregate demand.
- During the Great Depression, Keynes used to say that when consumers and businessmen lose the confidence or ability to spend money, the government must temporarily close the gap and spend money.

NATURE AND EXTENT OF GOVERNMENT'S RESPONSE

So what did the East Timor government do to close the gap?

- Not much.

Fretilin: Fiscal Straightjacket.

The Fretilin government was much like Herbert Hoover in the great depression.

- Not only did the government not offset the per capita economic contraction with expansionary fiscal policy, the government actually made things worse with a fiscal straightjacket.
- Total state expenditure was only $82 million in 2005-06, around two-thirds of the budgeted amount.
- An inept East Timor administration that was simply unable to roll out desperately needed spending.

No Show: Where's Government?

This fiscal straightjacket was particularly visible on the ground.

- There was no sign of government activity.
- Youth unemployment was especially high.
- Small towns had no shops because the people living there had no money.
- Barter still remained a form of exchange in some remote areas.

There's plenty of blame to go around.

Blame: Micro-Management from the Center.

The Fretilin government was determined to show the IFIs that there was not a trace of even petty corruption.

- So the central government in the Capital insisted upon micro-managing even the smallest expenditure items.
- Former Prime Minister Mari Alkatiri[2] didn't trust his 13 district administrators to manage money.
- They were given a small autonomous budget of just $2,000 month.
- All other spending was controlled in the capital.
- That helps to explain why money never ended up where it was needed – on the ground and in the hands of the East Timor people in the countryside.

Needed: Public Works Program.

Back in 2004, UN representative Sukehiro Hasegawa privately urged a big expansion in public works.

- Unfortunately, the prime minister ignored this advice.
- It's time to resurrect this proposal.
- Building up the infrastructure would not only build capacity (or growth potential) in the economy, it would soak up surplus labor.

Needed: Help for Farmers.

Greater funding for basic road maintenance and municipal services might ensure that roads stay open in the wet season.

- That would allow farmers to get their produce to markets.

Spend Money in the Budget.

Government officials point with pride to the oil fund in New York. They argue that this money is for future generations.

- But what good is it to hoard all this oil money in New York while the poorest people in Asia become frustrated and turn to violence?
- In reviving East Timor's sagging economy, the government does not need to raid the oil savings in New York.
- Spending the money that is available in the budget would be the place to start.
- Under the Petroleum Fund Law of 2005 the government has a spending target of 3% of the present value of future petroleum receipts, together with the financial assets in the fund.
- This is the "sustainable income" which can be spent without prejudicing future generations.

Blame: Where are the Banks?

Given the fact that the World Bank says East Timor is the 2nd worst economy in the world in terms of fostering private sector activity, one might have imagined the World Bank and IMF would have made building up the private sector a priority.

- But no serious attempt was made in this area.
- What was needed was the establishment of a private sector foundation of low taxes, easy business registration, a clear investment framework or property security (particularly land title).

Needed: Rural Credit Bank.

Certainly if one is serious about boosting business development in rural areas, it helps to have rural banks.

- In fact, a critical spending target would be the expansion of credit to jump start private-sector activity, especially in rural areas.

- When billionaire investor George Soros visited the country in January 2006 he urged the government to create a rural credit bank.
- Unfortunately, there were no rural banks created.
- Money literally had to be carted around.

Needed: Expedite Trade with Indonesia.

The central government was also eager to please the IFIs with "monetary discipline."

- The IFIs loved the government's decision to use the U.S. dollar as its currency. That reduced monetary risk.
- By outsourcing monetary policy to the U.S. Federal Reserve, the East Timor government would avoid the common nation building pitfall of price instability.
- But nobody asked if this would harm international trade.
- An unfortunate consequence was to complicate trade across the border with Indonesia, its biggest trade partner.

Needed: Spruced Up Tourism.

The tragedy is that East Timor is potentially a beautiful place that could generate tourism income.

- East Timor has beautiful beaches and spectacular mountains.
- Unfortunately, the beaches are badly neglected and sidewalks have deep crevices.
- Once again, a solid public works program would make the country a more attractive place to visit and eventually pay for itself.

CONCLUSION

The story of the violence in East Timor in April and May of 2006 can be traced back to an overzealous government that wanted to placate the IMF and World Bank. In the process the government lost sight of the fact that they are in power to make a difference now in the lives of the East Timor people, the poorest in Asia. The International Financial Institutions (IFIs) were so used to arm wrestling with corrupt and irresponsible governments that squandered the national wealth that they fell in love with a seemingly virtuous government that did none of these bad things. Here was a government that practiced fiscal and monetary discipline – all those things they were preaching. In the process, the IFIs turned a blind eye to what was obvious to the poorest East Timor citizen. You can't have a healthy economy unless consumers, businesses and the government are spending money inside East Timor.

It's not so much that the government did anything seriously wrong. It's just that in bending over backwards not to do anything wrong and be politically correct, they didn't do anything right. The government failed to strike right balance between spending and savings. The government did very well at saving money, but badly at spending money. When peacekeepers left the country, there was a shortfall of aggregate demand. If John Maynard Keynes were alive he would have told the IFIs and the government to offset this contraction in per capita GDP with an expansionary fiscal policy. Instead, government made things worse with a fiscal straightjacket. The IFIs gave the government high marks for boosting national savings. But no serious effort was made to boost private or public investment. It doesn't take Keynes to see that money is like horse manure: Don't pile it up -- spread it around if you want an economy to grow.

Here was a country that the World Bank rated 2nd worse in the world in terms of starting a business. Yet no serious attempt was made to create and expedite business development in East Timor. For instance, if you want to develop a business in the rural areas, it helps to have rural banks. Yet no attempt was made to create rural banks. So money literally had to be carted around in the countryside. To avoid petty corruption at local levels, the central government kept almost all the money in the capital. To avoid over-spending at local levels, the central government shut off that option by keeping most of the money in the capital.

Finally, this was a country that had a shattered infrastructure from the days of violence with Indonesia. Rebuilding the infrastructure should have been a "no brainer." Instead, a public works programs to rebuild the shattered infrastructure was rejected. In the process, an opportunity was missed to employ angry youth and curb their demand for violence.

ENDNOTES

[1] This chapter draws extensively from discussions with a) U.S. government officials who work on East Timor, b) Asian Development Bank officials, The Economist Intelligence Unit *Country Report on East Timor* and Paul Cleary's "It's the Economy, Stupid," *Wall Street Journal*, 23 May 2007.

[2] Prime Minister Alkatiri was forced to stand down from his position in June of 2006.

AUSTRALIA

• CHAPTER 16 •

Leif R. Rosenberger

Executive Summary.

Australia's economy is on a roll. In 1Q 2007, Australia enjoyed its fastest growth in over 3 years.

- China's rising demand for Aussie goods and services is the strategic driver. China is like a huge vacuum cleaner sucking up all the energy and other raw materials it can find from every corner of Australia.

Despite close security ties, U.S. and Aussies see PRC economic rise differently.

- The economic rise of China divides the U.S. and Australia. Australia's commodity and service exports to China are booming.
- In contrast, the U.S. is losing the economic high ground with Australia. Sino-Australian merchandise trade rose 248% between 2000 and 2005. U.S.-Aussie trade was flat -- only growing 13% between 2000 and 2005.

Six years ago Australia traded twice as much with U.S. than with China.

- Today the situation has reversed itself. Australia now trades twice as much with China than with U.S.

China is far more important trade partner to Australia than U.S.

- In fact, China just eclipsed Japan as the #1 Aussie trade partner.

Aussie dilemma: How to strike balance between U.S. and China.

- Aug 2004: Aussie Foreign Minister Downer said Aussies are not bound to help U.S. defend Taiwan in war with Taiwan. Today – almost 3 years later – Aussie trade with PRC dwarfs trade with U.S. Aussies will try hard to placate U.S. while bending over backwards not to antagonize China and jeopardize close and strong economic ties to PRC.

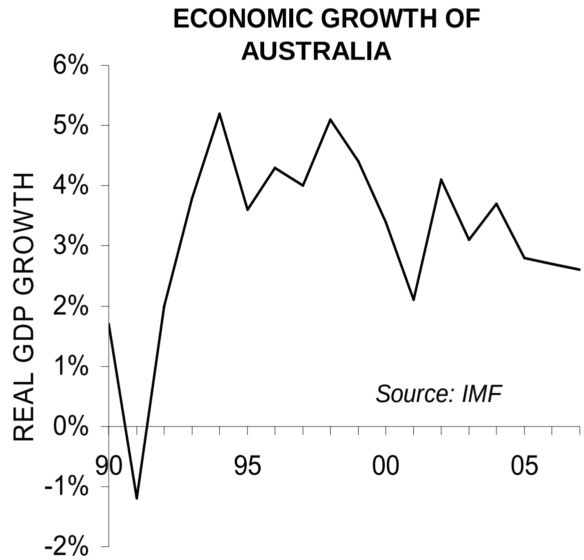
Closely related to economic rise of China is how U.S. and Aussies look at energy.

- U.S. economic nationalism/ideological problems with "Red China" mindset stands in contrast to Australia's shared prosperity with China.

Selected Historical Data

Australia	2001	2002	2003	2004	2005	2006
Purchasing Power $B	511	541	570	607	641	680
GDP $B (Nominal)	89	92	95	98	102	107
GDP Growth (Real)	2.1%	4.1%	3.1%	3.7%	2.8%	2.7%
Inflation	4.4%	3.0%	2.8%	2.3%	2.7%	3.5%
Exports $B	63.4	65.0	70.3	86.6	105.8	...
To U.S. $B	10.9	13.1	13.1	13.9	15.8	17.8
Imports $B	63.9	72.7	89.1	109.4	125.3	...
From U.S. $B	6.5	6.5	6.4	7.2	7.3	8.2
FDI held by U.S. $B	20.2	24.3	30.0	…	31.5	...
held in U.S. $B	19.5	34.2	37.1	40.9	44.1	...
Intl Reserves $B	21.2	21.2	30.9	35.4	43	55.1
Savings /GDP	...	18.7%	18.9%	...	...	...
Fiscal Balance /GDP	-0.8%	-0.4%	0.7%	0.8%	0.8%	...
External Debt /GDP	44	47%	45%	47%	46%	53%
Current account/GDP	-2.0%	-3.8%	-5.4%	-6.0%	-5.8%	-5.4%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

Not long ago it was fashionable in academic circles to complain about how developing countries faced adverse terms of trade.

- Many of these scholars argued that there was something “structurally wrong” with capitalism.
- Some were even brazen enough to argue for a “new global economic architecture” that would offset this "structural bias" and create "social justice" in the world.[1]
- These poor countries in the "South" allegedly suffered because they produced commodities for the rich “North.”
- This school of thought argued, “If only the South produced manufactured goods, their terms of trade would be higher.”

Times Have Changed.

- Well, guess again. Hopefully these "scholars" are now lost in academic obscurity so as not to harm anyone but themselves.
- Let’s fast forward to 2007. Nobody with any sanity in Australia is complaining that this country can extract raw materials and produces commodities.
- What's changed?
  - o China.

On a Roll.

In 1Q 2007, Australia enjoyed its fastest growth in over 3 years.

- Annual growth is accelerating -- from 2.9% in 4Q 2006 to 3.8% in 1Q 2007.
- Aussies had their biggest hiring surge in almost 18 years.

[1] For the call for a “new financial architecture,” see chapters 1, 2 and 3 in Volume 1 of APEU 2007.

- Jobless rate is at 32-year low in April.
- Consumer confidence hit record high in May.
- Aussie dollar has risen to 17-year high of about 84 U.S. cents.

Strategic Vacuum Cleaner.

China's rising demand for Aussie energy and raw materials is a strategic driver.

- China is like a huge vacuum cleaner sucking up all the energy and other raw materials it can find from every corner of Australia.
- Australia, in turn, is selling these raw materials as commodities and is making lots of money doing so.
- Businesses are boosting investment; consumers are on a spending spree.

Strategic Challenge.

Now let's turn to see how the Australia's blossoming economic ties to China affect its longstanding economic and security relationship with the U.S.

U.S. -- Aussie Special Relationship.

At first glance, the U.S.-Australian alliance has never been stronger.[1]

- Australia demonstrated its unwavering commitment to the United States immediately after the terrorist attacks on September 11, 2001 on the World Trade Center in New York City.
- Australian soldiers are fighting shoulder to shoulder with U.S. military forces in Iraq and Afghanistan.
- In fact, Australia remains America's most steadfast Asian ally in support of U.S.-led operations in Iraq. U.S. President Bush and Australian Prime Minister Howard are known to be personally close.[2]
- On the commercial front, the United States and Australia recently celebrated the one year anniversary of the launch of the U.S.-Australian free trade agreement (FTA).
- In addition, United States and Australian businessmen have close and extensive ties.[3]

Economic Challenges.

Nevertheless, the United States and Australia are facing some immediate economic challenges and several potentially difficult ones over the horizon that will arguably test the resiliency of the relationship.

- This section explores the nature and extent of these economic and financial challenges.
- We begin by looking at the contrasting ways the United States and Australia view the economic rise of China.

Competing Threat Perceptions.

- On balance, Washington views China as more of a commercial threat.
- In contrast, most Australians view China as a commercial blessing that has been critical to a booming Australia's economic performance.

Strategic Differences.

Interestingly enough, U.S and Australian responses to China's commercial challenges are strikingly different.

- Australia, a relatively small economy, chooses to compete rather than retreat from Chinese commercial competition.

- In contrast, the U.S. superpower is quick to blame China for its huge trade deficit, looks for ways to retaliate and if need be, retreat into protectionism rather than compete against China.

Different Perspectives on Energy.

Next we look at the different ways the United States and Australia deal with China in the closely related energy sector.

- In general, the pervasive Aussie view is that Australia benefits from shared prosperity with China's energy sector while the United States is more nationalistic and feels threatened by it.
- However, few Australians are discovering that there are limits to what Australia can expect from the Chinese market even in the booming resource area, especially when it comes to liquid natural gas (LNG).

Aussie Red Carpet for China.

In an interview marking 10th anniversary in office, Prime Minister Howard highlighted the rising Sino-Australian economic relationship.[4]

- He said Australia "would be crazy" not to cultivate its economic relationship with China.
- He added that China was a "huge and valuable market" for Australia.
- In that same interview Howard brushed aside concerns inside the United States over Sino-Australian ties.
- He underscored that Australia would "not go overboard" with China.
- That said, Howard rolled out the red carpet for Chinese officials in Australia.
- And Beijing did much the same when Howard visited China in late June/early July 2006.

U.S. Cold Shoulder for China.

Of course, President Bush also knows how to roll out the red carpet.

- Bush recently rolled out the red carpet for Japanese Prime Minister Koizumi in June 2006.
- In contrast, Bush treated Chinese President Hu differently during his visit.
- Michael Green, former NSC Director for Asia, and China expert Bates Gill criticize the Bush-Hu meeting in April 2006 as form over substance at a time when a serious summit was desperately needed to reconcile divisive U.S.-Chinese issues.[5]

"Protocol Nightmare."

Even the form of the meeting was a protocol nightmare.

- When Hu visited Washington the Bush administration refused to classify it as a "state" visit.
- Instead, Hu was given a "working lunch."
- Beijing was justifiably offended and felt it deserved the kind of political legitimacy commensurate with its status as a major global economy.

China Deserves Better Treatment.

China now has almost $1 trillion in foreign reserves.

- Most of these Chinese reserves are in U.S. dollar financial assets that allow the United Sates, rightly or wrongly, to pursue the war in Iraq, the war in Afghanistan and the war on terrorism without raising taxes and without any sacrifice for the American consumer.
- China is also a major trading partner of the U.S. Chinese political leaders have every right to ask: Where is the gratitude?
- And in an administration that carefully choreographs every little detail and every person invited to the White House, Hu was subjected to prolonged heckling by a Falun Gong protester at the opening ceremony.

- Even worse was the introduction of the Chinese national anthem as that of the "Republic of China" the formal name for Taiwan.
- In short, Bush gave Hu the cold shoulder.

Strong U.S. - China Commercial Ties.

To be fair, Hu did get to see Bill Gates – U.S. Chairman and Founder of Microsoft and the richest man in the world.

- In fact, Hu also spent lots of time with U.S. business community. In addition, the U.S.-China commercial relationship is big. Just go into any Wal-Mart and you'll see that the store is flooded with products made in China.
- In this regard, China will soon overtake Japan as the America's third-biggest export market. U.S. exports to China rose nearly 37% in the first five months from a year earlier.[6]
- And it's true that American companies operating in China enjoyed another year of strong profits in 2005. U.S.-affiliated companies enjoyed record earnings of $3.2 billion in 2005.

Fly Under the Radar.

That said, corporate America goes out of its way to hide its successes in China. Why hide a U.S. corporate success story?

- U.S. Undersecretary of Commerce for International Trade Franklin Lavin says the U.S. export strength tends to get "washed out of people's minds" because imports from China are so much larger.[7]
- The U.S. reported an $82 billion trade deficit with China for the first five months of 2006.

Media Bashing.

The media is quick to bash China for this imbalance.

- CNN's Lou Dobbs frequently criticizes U.S. corporations that are reportedly exporting U.S. jobs to China.
- Given all this negative publicity in the U.S. about China linked to outsourcing and manufacturing job losses it makes U.S. corporations unpopular if they talk about doing well in China.
- Such economic nationalism has taken its toll on U.S. foreign direct investment (FDI) in China, which dropped 22.3% in 2005 from $3.9 billion in 2004 to $3 billion in 2005.

Different Political Cultures.

The key point is Australian exports of raw materials to China create jobs in Australia and is a political winner.

- In contrast, U.S. commercial relations with China are a political loser. CNN's Lou Dobbs would argue that Chinese exports to United States kill U.S. jobs.
- While Bill Gates and Microsoft are big enough to ignore Lou Dobbs, most U.S. corporations want to fly under the radar screen and hide their hand when they deal with China.
- Similarly, Lavin says, "Politically, strong U.S. exports to China are less salient since imports [from China] are so high."[8]

U.S. Trade Imbalance: Myths and Reality.

In this regard, the U.S. trade deficit with China is never properly understood in the U.S.

- If we take a broader view, the U.S. trade deficit with all of Asia hasn't changed much in the past 10 years.

- The U.S. used to have large trade deficits with countries like Japan and South Korea. But then China actually did what the USG asked it to do.

China's Open Door.

China opened its economy up to FDI.

- So now the final assembly of products that used to be made in Japan and South Korea are now being made in China.
- So it stands to reason that the so-called Chinese trade surplus has gone up to reflect this change in final assembly of foreign products in China.
- 2/3 of Chinese exports are from foreign funded or wholly owned foreign companies based in China.
- 90% of Chinese high tech exports are from these foreign companies based in China.[9]

Undervalued Yuan (Renminbi).

Instead, the U.S. blames the Chinese trade surplus on China pegging its weak currency to the U.S. dollar in order to under-price its exports.

- The U.S. argues that the 2.1% revaluation of the RMB back in July of 2005 was a drop in the bucket.
- Senators Charles Schumer and Lindsey Graham threatened to a 20-30% tariff on all Chinese goods coming into the U.S. unless China revalues by a similar percentage.
- The United States threatens to call China a currency manipulator if it refuses to opt for a bigger revaluation. In contrast, Australia is not about to bite the Chinese hand that buys its exports.
- So while the Sino-Australian political economy is relatively "warm and fuzzy" the U.S.-Chinese political economy is "ice cold."

Sino-Australian Shared Prosperity.

Now let's compare and contrast Australia's economic relationship with China with its longstanding economic ties to the United States.

- Australia's commodity and service exports to China are booming. In contrast, the U.S. is losing the economic high ground with Australia.
- Sino-Australian merchandise trade has skyrocketed 248% between 2000 and 2005. In contrast, U.S.-Australian trade has been virtually flat -- only growing 13% between 2000 and 2005.
- Five years ago Australia traded twice as much with U.S. than with China. Today the situation has reversed itself.
- Australia now trades twice as much with China than with the U.S.[10] From a trade perspective, therefore, China is more important to Australia than the U.S.
- In fact, Foreign Minister Downer stated on 25 May 2007 at the East West Center in Hawaii that China has just eclipsed Japan as the #1 Aussie trade partner.

Complementary Trade Partners.

China's emergence in the Northern hemisphere as world's manufacturing center has a counterpart in South.

- Australia is supplying much of iron ore, non-ferrous metals, coal and higher education that fuel China's industrial revolution.
- In this regard, the economic growth of China and its impact on the world's demand for resources is the single most important factor driving Australia's outstanding export performance.

- Aussie exports of resources to China alone surged by 87% to $8.3 billion in 2005. The tonnage of iron ore is a good case in point.
- The tonnage of Australian exports to China tripled between 2002 and 2005 to 112 million tons.
- And thanks to China's global demand, global prices have surged as well.
- Australia's iron ore miners received a 71% price increase in 2005 and gained a further 19% hike in 2006.[11]

Improving Aussie Terms of Trade.

In this regard, the continued growth in China is a vital underpinning for Australia's trade performance and its economy.

- Australia's Reserve Bank Governor Ian MacFarlane recently stated that in the past 3 years Australia's terms of trade have increased by around 30%.
- He pinpointed global demand for resources and the rise of China as being the driving factors.[12]
- The economic flow-on effects include strong growth in business investment, rising corporate profits and an increase in stock prices.
- The strong demand from China has continued in 2006. In the 10 months to April 2006 Australian exports to China soared to U.S. $14.5 billion – a 42% rise compared to the same period last year.[13]

Aussie Dilemma.

The result is a dilemma for Canberra.

- It must somehow strike a balance between its increasingly important commercial relationship with China and its longstanding security ties to U.S.
- In contrast, realists in Washington tend to see China as more of a commercial as well as a military threat than does Canberra.

Competing Energy Perspectives.

Washington also sees China as a threat on the energy front.

- This U.S. economic nationalism was visible in 2005 when China National Offshore Oil Corporation (CNOOC), a 70% Chinese government owned company, made a $19.6 billion offer to buy Union Oil Company of California (or UNOCAL), the U.S. oil and gas group.[14]
- It was the biggest overseas bid at that time by a Chinese company, the first to trigger a contested takeover battle with Chevron and the first to be made in a politically strategic sector in the U.S.

U.S. Fears of "Red China."

Most U.S. lawmakers argued that the CNOOC bid should be vetted on traditional national security grounds.

- They feared the U.S. would be losing a national energy asset if they did not work to block the CNOOC bid.
- They had mental images of CNOOC somehow hoarding Unocal energy for Chinese consumers.
- They argued that CNOOC threatened U.S. energy security.
- In the end, U.S. Congress effectively blocked any "Red China" takeover of Unocal.
- Had British Petroleum bid for Unocal, few people on Capital Hill would have objected.

U.S. Strategic Mistake.

U.S. lawmakers were ill-advised.

- Their fears are at odds with how the global energy market actually works.
- For starters, oil is a fungible commodity. For every barrel of oil China might divert for its exclusive use, China would import one less barrel of oil from other sources. Global price and availability of oil to the U.S. would remain exactly as before.
- While denial of access to oil can be used as a military tool in wartime, this depends not on ownership but on the ability to secure installations and blockade oil lanes. China is vastly more vulnerable to an oil squeeze than the U.S., with its unchallenged navy.
- A national security issue does exist here, but it cuts the other way. Moreover, CNOOC was taking the biggest commercial risk as well as a strategic risk:
  - If Sino-U.S. hostilities erupted, its proposed U.S. investment would be an early casualty.

Raw Meat for PRC Hard-Liners.

U.S. efforts to block PRC takeovers of U.S. companies play into the hands of PRC communist hard-liners.

- PRC hard-liners argue that China must prepare for an inevitable confrontation with the U.S. because the U.S. will never permit China to enjoy a peaceful economic rise.
- U.S. needs to prove that the PRC hardliners are wrong with evidence to the contrary.

U.S. Preaches Open Markets for Itself.

For years the United States criticized Indonesians for nationalism in its oil industry when Jakarta blocked EXXON-Mobil efforts to but Indonesian energy assets.

- Just recently the U.S. was successful in persuading Indonesia to open their oil reserves to Exxon-Mobil.
- The U.S. has a strong interest in persuading countries like Indonesia to open their oil reserves to U.S. investors.

U.S. Double Standard for "Red China."

- It's, therefore, inconsistent for the U.S. to criticize the Indonesians for nationalism in its oil industry if the U.S. is nationalistic in blocking foreign investment in the U.S. oil industry.
- This is the U.S. double standard and hypocrisy at its worst.
- The U.S. not only makes the rules but America also makes the exceptions to the rules.
- China must open its markets to U.S. and foreign investment.
- But the U.S. has the right to keep our markets closed to China.

Lesson Learned.

The point is the United States gains the moral high ground when it is consistent with open markets and the values of the Founding Fathers.

- The U.S. diminishes itself when it turns its back free markets.

Now let's contrast this U.S. tension with China on the energy front with Sino-Australia energy relations. Let's look first at nuclear energy.

Sino-Australian Energy Ties.

In early April 2006 China and Australia signed a nuclear safeguards treaty, which punctuates an increasingly important economic relationship.

- The treaty could pave the way for exports of uranium to China for peaceful uses.
- China is searching for new supplies of uranium as part of its strategy to diversify energy supplies away from coal-fired power stations.
- As part of its new-year economic blueprint, China is committed to reducing air pollution and reliance on coal.
- By 2020, China hopes to increase 4-fold the amount of nuclear energy it produces.
- And yet Australian Prime Minister John Howard says that Washington's efforts to curb nuclear enrichment worldwide may well be at odds with the energy requirements of Australia.[15]

LNG Deal.

Then in late June 2006 the prime ministers of China and Australia, Wen Jiabao and John Howard, proudly presided over the landing in China of the first commercial shipment of liquefied natural gas (LNG).

- Mr. Howard called the LNG shipment, part of an $18bn long-term contract guaranteeing supplies for 25 years, the largest single trade deal for Australia and "hugely significant" for its resource-dependent exports.
- He said it could be not only a big deal in its own right, but the beginning of an enormous additional segment of Australia's trade with China.

Limits to Sino-Australian Energy Cooperation.

- While Australia's pervasive perception of China as a golden commercial opportunity will no doubt continue, Australia is also learning that there are limits to what it can expect from China even in its booming resource trade with China.
- For example, the top-level turnout for the LNG tanker in late June 2006 only momentarily masked the disappointment in both China and Australia at how the gas market has stalled in China since the 2002 signing of the first supply contract. Since two contracts were signed in 2002 with suppliers in Australia, China has failed to negotiate any further LNG deals.
- China has balked at paying a price higher than the initial deals. Beijing has put pressure on Australia for a discounted price on the grounds that China would be an excellent long-term market.
- Such tactics have been mirrored in other commodity sectors, such as iron ore. China wanted to emulate the 2002 deal with Australian Woodside Petroleum for good reason.
    - That contract locked in the LNG against an oil price capped at $20-$25 a barrel.
- Gas exporters, frustrated and annoyed by the Chinese stance, resisted and have sold most of their available resource to Japan and South Korea, with other supplies also earmarked for the U.S.

CONCLUSION

In these sections, we've made the argument that biggest economic issue that divides the U.S. and Australia is over the economic rise of China.[16]

- In fact, when U.S. Secretary of State Condoleezza Rice visited Australia back in March of 2006, China dominated all other issues.
- While Washington generally sees China's economic rise as a commercial threat, Australia looks fondly at Sino-Australian shared prosperity.

Closely related to the economic rise of China is how the two sides look at energy issues.

- U.S. economic nationalism and U.S. ideological problems with Red China is evident in U.S. efforts to block China's attempts to buy U.S. energy assets, as was the case in the failed bid of China National Offshore Oil Corp. (CNOOC) to UNOCAL.[17]
- In contrast, Australia's energy exports to China are indivisible from its sense of shared prosperity with China.

Canberra is well aware that it sees energy relations with China differently than Washington.

- For instance, Australian Prime Minister John Howard says that Washington's efforts to curb nuclear enrichment worldwide may well be at odds with the energy requirements of Australia, one of the world's two largest uranium producers (along with Canada).[18]

CHRONICLES OF ECONOMIC HIGHLIGHTS

19 January 2006

Japan and Australia step up sanctions on North Korea. Japan will restrict withdrawals of money by groups and individuals suspected of ties to North Korea's weapons development programs.

- 15 DPRK groups and one individual must get approval from Tokyo before withdrawing funds from lenders in Japan and transferring money overseas.

Tokyo will also inspect about 270 lenders in Japan to ensure compliance.

- Inspections will be carried out for 3 months starting later in September.

Australia will bar North Korean related foreign currency transactions.

- Aussie sanctions target 11 DPRK banks and companies in Australia.
- Aussie sanctions also target a company and individual located in Switzerland, who reportedly help finance DPRK's nuclear and other WMD programs.

Economic Advisor's Comment:

While Canberra maintains diplomatic ties with North Korea, Tokyo does not.

- However, Japan and DPRK maintain some economic ties, including trade relations.

Japanese and Aussie measures track with 15 July UN Security Council resolution.

- Resolution demands North Korea suspends its missile program and bars it from acquiring or selling missile technology.
- UN resolution also "requires" all nations prevent North Korea from obtaining or transferring missile technology.

In July, Japan responded to DPRK missile launches by banning the Mangyongbong-92 ferry port visits for six months.

- This ferry is only passenger link between the two countries and an important lifeline for North Korea.
- It also prohibited North Korean government officials from entering Japan and urged Japanese citizens not to travel to North Korea.

Taken as a whole, U.S., Aussie and Japanese sanctions against DPRK are likely to have a significant impact on DPRK's dilapidated economy.

- These sanctions effectively curb North Korea's ability to earn money illegally or otherwise.
- USG is soon expected to announce even tougher sanctions against DPRK.

On down side, DPRK claims these sanctions create new hurdles to resuming nuclear negotiations, which have been foundering for a year.

02 February 2006

U.S. senators demand official Australian explanation about alleged bribe to help secure Australian wheat sales to Saddam Hussein's regime.

- U.S. Republican Senator Norm Coleman chairs a committee investigating illicit payments to the Iraqi regime under the scandal-plagued UN Iraq oil-for-food program.
- Senator Coleman has publicly revealed he wrote to Australia's Washington envoy demanding more information.

Economic Advisor's Comment:

Oil-for-food program that started in 1996 allowed Iraq to sell oil to buy food and medicine.

- Program hoped to ease humanitarian impact of sanctions on the Iraqi population.

Allegations of misconduct are 3-fold. Saddam Hussein:

- Skimmed billions of dollars from the program.
- Circumvented sanctions by smuggling oil out of Iraq and selling it to his neighbors.
- Used program to "buy influence."

First two allegations were well known at the time.

- 3rd allegation surfaced after documents were found in Baghdad after U.S. invasion.
- Indians and Australians were reportedly bribed to oppose U.S.-led pressure on Iraq and undermine sanctions.

U.S. GAO says Saddam Hussein made $10.1bn in illegal revenues between 1997 and 2002.

- Saddam Hussein smuggled oil out of Iraq and sold it to Iraq's neighbors (totally outside UN program).
- Saddam Hussein made $4.4bn from kickbacks and surcharges.

Saddam took advantage of a loophole in the program.

- He chose both recipients of its oil and food and medicine suppliers.
- He profiteered by demanding "surcharges" from oil sales and kickbacks from food and medicine suppliers.

Key question is: How much did Canberra know about the illicit payments by AWB, Australia's monopoly wheat exporter?

- Official Australian Case Commission Inquiry into AWB's conduct presented evidence suggesting Canberra was "aware of and complicit in the payments of illegal kickbacks" to Iraq.

28 Febuary 2006

In an interview marking 10th anniversary in office, Australian Prime Minister Howard highlighted rising Sino-Australian economic relationship.

- He said Australia "would be crazy not to cultivate (PRC) relationship" and stressed, "there's a huge valuable market for Australia."

PM Minister Howard was asked: Is there tension between your closeness to U.S. and your growing closeness to China?

- Howard replied: Australia was closer to U.S. than China.

- Brushed aside security concerns over China aired in U.S., and underscored that Australia would “not go overboard” with China.

Economic Advisor’s Comment:

China's emergence in Northern hemisphere as world’s manufacturing center has a counterpart in South:

- Australia is supplying much of iron ore, non-ferrous metals, coal and higher education that fuel China’s industrial revolution.

Now Australia is increasingly dependent on robust commodity and service exports to China.

- Result: Dilemma for Canberra -- How does Australia balance it's increasingly important economic relationship with China and its longstanding security ties to U.S?

Australia’s crosscutting loyalties were apparent back in August of 2004 during Australian Foreign Minister Downer’s official visit to China.

- Mr. Downer said Australia was not bound to help U.S. defend Taiwan in a China-Taiwan war.

Although PM Howard promptly reaffirmed Australia’s alliance with U.S., Downer incident in Beijing punctuates an ongoing dilemma for Canberra.

- How does Canberra keep satisfying U.S. in the security arena without antagonizing Beijing and possibly jeopardizing its booming commercial relationship with China?

03 April 2006

China and Australia sign a nuclear safeguards treaty, which punctuates an increasingly important economic relationship.

- The treaty could pave the way for exports of uranium to China for peaceful uses.

China is searching for new supplies of uranium as part of its strategy to diversify energy supplies away from coal-fired power stations.

- As part of its new-year economic blueprint, China is committed to reducing air pollution and reliance on coal.
- By 2020, China hopes to increase 4-fold the amount of nuclear energy it produces.

Economic Advisor’s Comment:

Sino-Aussie nuclear pact punctuates booming Aussie economic relationship with China at a time U.S. is losing economic high ground with Australia.

- Sino-Australian merchandise trade has skyrocketed 248% between 2000 and 2005.
- In contrast, U.S.-Australian merchandise trade has been virtually flat – only growing 13% over the same 5-year period.

Today Australia trades about twice as much with China than with the U.S.

- Back in 2000 Australia traded about twice as much with the U.S. than with China.

Worse still, Aussies view the U.S.-Australian free trade agreement (that went into effect on 01 January 2005) as the big buildup for the big let-down.

- In 2005 Aussie exports to U.S. fell by 4.7% while U.S. exports to Australia rose by 5.7%.

At a strategic level, China’s shared prosperity with Australia and other countries in AOR arguably give Beijing a stake in stability and make war less likely than when China’s trade in AOR was at a low-level.

- But if war breaks out between China and Taiwan, China’s shared prosperity in the region increases the risk for U.S. (due to possible access denial) at the operational level of war.

Back in Aug 2004, Aussie Former Minister Downer publicly told the Chinese in Beijing that Australia was not bound to help the U.S. defend Taiwan in a China-Taiwan war.

- Today -- 20 months after Downer's comment – Australia's trade with China dwarfs its trade with the U.S.
- Australia will now bend over backwards not to antagonize China and jeopardize its highly-prized economic relationship with China.

08 June 2006

In 1Q 2003 Australia's economy grew at its fastest pace in 18 months.

- GDP accelerated from annual growth rate of 2.9% in 4Q 2005 to 3.1% in 1Q 2006.
- Mining companies doubled their investment in 1Q 2006 from a year earlier to meet surging Asian demand.

Unemployment rate fell to 5% in March -- a 29-year low.

- Wages grew 4% in 1Q 2006 from a year earlier.
- Not surprisingly, consumer spending was also a major driver of growth in 1Q 2006.

Economic Advisor's Comment:

This strong economic growth is good news for Aussie defense budget.

- Australia's defense budget is set to rise 11% to $19 million in 2007.
- Canberra is also committing itself to increases of 3% a year from 2008 to 2016.

Sustaining such defense spending is financially sustainable for Canberra if:

- Growth remains strong, tax revenues stay high and defense budget targets are realistic.

However, Canberra is already concerned about rising costs of helping regional states in difficulty.

- Current defense budget projections may not be enough for multiple overseas deployments.

With 1,000 troops now deployed in East Timor, Aussie military/police presence in South Pacific is now at highest level since WWII.

- Aussie involvement in Solomon Islands alone is costing about $150 million a year – a relatively large sum to spend on a small nation of just 600,000 people.

Australia is in danger of being pulled into regional hot spots for years to come.

- Violent extremism from weak, failing states in its backyard is on the rise.
- Aussie stabilization missions in region are expensive and potentially open-ended.

Canberra's steadfast commitment to Afghanistan and Iraq has demonstrated to POTUS that Australia is a loyal ally for U.S.

- However, such alliance cohesion has also raised U.S. expectations for more Aussie expeditions (and high-priced weapons) in the future.

Can rising U.S. expectations be satisfied while Australia is simultaneously being stretched too thin in its own backyard?

- Will Australia remain shoulder-to-shoulder with US in Iraq and Afghanistan – and perhaps elsewhere – if it cannot afford its primary mission of being a "regional sheriff" in South Pacific?

Critics in Australia are already questioning procurement of "non-essential equipment to fight non-essential wars" that are "not vital" to Australia's core interests.

- Canberra might be forced to reconsider buying so many Joint Strike Fighters – especially if per unit costs keep rising.

11 July 2006

Canberra is developing a response plan to Chinese commercial threat rather than simply Sino-Australian shared prosperity.

- PM Howard is reviewing policy and developing new plan to reposition existing industries and bolster support for new sectors.
- Addresses two issues: Rise of China and need for economic strategy beyond resources boom.
- Industry Minister, Ian MacFarlane, soliciting input from Aussie business community.

Australian business community is to release industry statement in early 2007.

- First since “Investing for Growth” (1997), this foreshadowed a $1bn increase in industry policy funding, including expanded funding for R&D.

Economic Advisor’s Comment:

Since last industry statement, Canberra approaches policy issues on problem-specific basis.

- Business community has growing sense of government drift on policy direction.

Businesses claim government too happy to ride on resources boom.

- Canberra should use revenue windfall to further develop economy or post-boom policy.

New plan targets some of these criticisms.

- Marketing plan as business aspect of agenda aimed at boosting productivity in workplaces and implementing industrial relations changes in the workforce.

New initiative comes just after release of report by Australian Industry Group which states:

- Up to 30,000 manufacturing jobs could be lost in 2007 due to competitive pressures created by rise of China and India and the relatively high exchange rates.
- Industry group seeking range of initiatives from Canberra to include tax cuts and export incentives.

While Aussies perceive China as commercial threat, their response is very different from U.S. counterparts.

- U.S. sees larger commercial threat, blames China and seeks economic sanctions to protect against competition.
- Aussies more confident and seeking ways to boost ability to compete rather than retreating from commercial challenge.

06 September 2006

Australia’s economy is growing at slowest pace in 3 years.

- Economy grew just 0.3% from 1st quarter to 2nd quarter.
- Growth in 2nd quarter only 1.9% from a year ago.

Higher interest rates and record fuel prices curbed consumer spending.

- Consumer confidence, with sharpest fall in 17 years, is now at 5-year low.

Economic Advisor’s Comment:

Australia’s economy is structurally unbalanced.

- 2-track economy consists of booming west and north versus stagnant eastern states.

Western Australia (WA), a land of few people but abundant resources, is storming ahead.

- WA is growing in excess of 10%, on a par with China.
- With just 10% of GDP, WA provided 50% of Aussie growth in 2nd quarter.

If not for a China-led mining boom in WA, Aussie economy would be in big trouble.

- To keep economy afloat, Canberra will bend over backwards not to antagonize China.

Struggling New South Wales (NSW), Australia's most-populous state:

- Narrowly escaped recession, with growth of just 0.2% in 2nd quarter.

NSW and Victoria also suffer more from global competition in manufacturing.

- Housing prices remain weak after housing boom ended, depressing consumer demand.

Regional economic disparity creates problems:

- Canberra cannot create "one size fits all" monetary policy to guide the economy on whole.
- In WA, low unemployment and soaring housing prices call for higher interest rates to curb inflation.
- But higher interest rates would threaten NSW or Victoria which are fighting off specter of regional recession.

05 October 2006

Australia is on course to run trade surplus for 1st time in more than 4 years.

- Australia has run a trade deficit for a record 53 consecutive months.

Australia should have a monthly trade surplus before the end of 2006.

- Trade deficit fell from a revised A $320 million in July to A $208 million in August.
- August exports rose 19% while imports rose 11% compared with a year earlier.

Key driver is commodities-driven economic boom – especially in iron ore and coal.

- Farming exports and car parts also boosted exports.

Economic Advisor's Comment:

Mining sector is overcoming various problems -- primarily labor and equipment shortages, and transport bottlenecks.

- These problems had held it back from being able to boost output in response to strong demand, principally from China.

Mining companies are starting to reap benefits of new projects and re-opening older mines.

- Mining sector's major producers have been investing significant amounts to improve production.
- Mining companies predict this new investment could lift output by 20-50% in 2007.

Exports values and volumes are moving higher as:

- Ongoing momentum in major trading partner growth continues.
- Australian dollar remains at competitive (low) levels.
- New capacity comes on stream.

Bad news: Drought threatens prospects for Australian agricultural exporters.

- But Australia's mining exports are 3 to 4 times bigger than its rural exports.

17 October 2006

Treasury Minister Peter Costello warns Australia could be heading into rural recession.

- Drought is worst on record in some rural areas.

Drought may well get worse before it subsides.

- Drought could be a problem next year – with El Nino still in its early stages.

Consequently, wheat production is expected to be less than half last year's 24 million tons.

- AWB – Aussie top wheat producer -- will stop exporting wheat from eastern coast.
- Shares in AWB recently fell 6.8% to a record low of A $2.59.

In response, Australia is boosting drought-relief funds.

- PM John Howard unveiled 350 million Australian dollar (U.S. $263 million) increase in drought-relief funding.
- Extra relief will be available chiefly in SE Australia and will come via income support and interest-rate subsidies through March 2008.

Economic Advisor's Comment:

Shrinkage in Australian wheat exports will mainly affect Japan, Indonesia and South Korea.

- These Asian wheat importers will have to seek imports from other wheat exporters from North America, Europe, Russia and the Ukraine.

These Asian importers of wheat will find an extremely tight global market.

- Stockpiles of wheat are at lowest level in 25 years.
- Level of wheat stockpiles relative to consumption has hit lowest level on record.

All of this has led to rising wheat prices.

- Soft red winter wheat futures on the Chicago Board of Trade have risen more than 19% since early October and 55% since early January.

Prices of other grains, including corn, have also risen.

- Deutsche Bank estimates global corn stockpiles have fallen to their lowest level since 1979.

Another concern is rise in demand for biofuel (ethanol and biodiesel) created from crops.

- Corn and wheat for biofuels are reducing food supply and keeping prices up.

Way Ahead – expect possible food crisis within next 12 months if there is another disappointing year of global production.

- While UN Food & Agricultural Organization (FAO) commodity specialist Abdolreza Abbassian says world is not facing a grain crisis yet, he warns:
  - "If we have another bad year of harvests because of droughts and poor weather then we could be looking at a very serious problem."

28 November 2006

Inquiry clears suspicion of Government wrongdoing in Saddam Hussein oil for food scandal.

- Cole Commission examined facts surrounding $200 million bribe from Australian Wheat Board (AWB) to Saddam Hussein to secure contracts worth more than $2bn.

Economic Advisor's Comment:

Still casts large shadow over Australia international trade reputation.

- Task force now must determine charges against 11 AWB employees.

Verdict fails to placate Aussie political opposition.

- Accuse Government of gross negligence
  - Claim failure to respond to diplomatic cables warning of AWB violation of UN sanctions.

06 June 2007

Australia has its fastest growth in over 3 years.

- Annual growth accelerating -- from 2.9% in 4Q 2006 to 3.8% in 1Q 2007.
- Biggest hiring surge in almost 18 years.
- Jobless rate at 32-year low in April.
- Consumer confidence hit record high in May.

Economic Advisor's Comment:

China's rising demand for Aussie energy and raw materials is strategic driver.

- Businesses are boosting investment; consumers on spending spree.
- Challenge: Aggregate Demand outpacing existing capacity (potential growth).
- Tight labor market driving wages up.
- Inflationary pressure is building.
- Central bank likely to raise interest rates to curb inflation.
- Investors buying Aussie dollars; anticipating higher interest rates will lift currency.
- Aussie dollar has risen to 17-year high of about 84 U.S. cents.
- Biggest drag: Drought hurting farm sector.

ENDNOTES

[1] For excellent background on the U.S.-Australian special relationship, see *Peter Edwards, Permanent Friends?: Historical Reflections on the Australian-American Alliance*, Lowy Institute Paper 08, 2005.
[2] See Garran, Robert, *True Believer: John Howard, George Bush, and the American Alliance*. Allen & Unwin, Sydney, 2004.
[3] See Donald Russell's paper on ties that bind the alliance.
[4] *FT On-line*, 28 February 2006.
[5] See Bates Gill and Michael Green, Sino-American relations need actions not words, FT, April 24, 2006.
[6] *FT Online*, 26 July 2006.
[7] *FT Online*, 26 July 2006.
[8] F*T Online*, 26 July 2006.
[9] See George J. Gilboy, The Myth Behind China's Miracle**,** *Foreign Affairs*, July/August, 2004.
[10] Discussions with officials from U.S. Commerce and U.S. Trade Representative (USTR), February and March 2006.
[11] *Australian Financial Review, (AFR)*, 6 July 2006, p.11.
[12] Australia's Reserve Bank Governor Ian MacFarlane testimony before Australia's federal parliament, February 2006.

[13] *AFR*, 6 July 2006.
[14] *FT On-line*, 24 June 2005.
[15] See Rafael Minder, Howard says Australia must assess impact of nuclear alliance , *FT Online*, 20 July 2006.
[16] For a discussion of Australia's difficult balancing act between the United Sates and China see Kelley, Paul, Poised between Giants, *Weekend Australian*, 23-24 July 2005.
[17] For a good discussion of the tension between globalization and economic nationalism, see Leo Suryadinata, (ed.), *Nationalism and Globalization*, Institute of Southeast Asian Studies, 2000.
[18] *Financial Times On-line (FT On-line)*, London, 20 July 2006.

FIJI ISLANDS

• CHAPTER 17 •

Miemie Winn Byrd and Leif R. Rosenberger

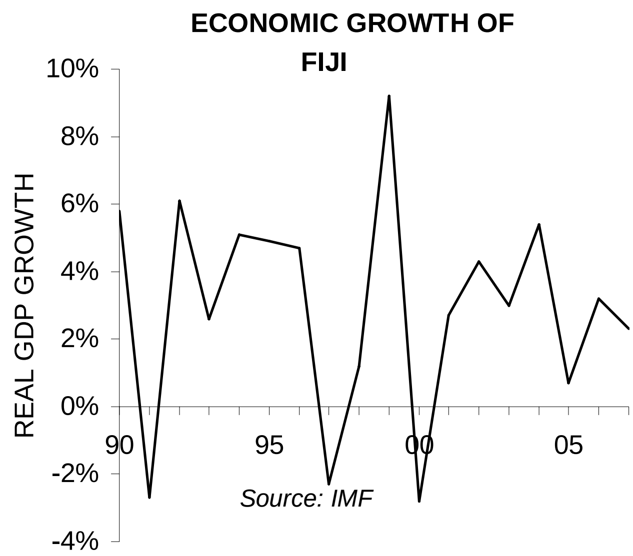
Executive Summary.

- Fiji's economy has struggled through much of 2006.
- The December 2006 military coup in Fiji made a bad situation worse.
- This coup was a painful reminder of three other recent coups in Fiji.
- A political crisis has ensued; receiving mostly negative responses form Asia, the Pacific, as well as the rest of the world.
- By March 2007, Fiji was running a current account deficit of 17% of GDP – twice the 8% figure of Thailand and Mexico before their financial crises.
- On 19 March 2007, Standard and Poors (S&P) downgraded Fiji's credit rating and gave it a negative outlook.
- Fiji may well have to go to the International Monetary Fund (IMF) for an emergency loan to avoid or manage a financial crisis.
- That said, it's important to note that the situation could be even worse.
- The EU and other important countries doing business with Fiji actually showed considerable restraint in terms of the nature and extent of their sanctions.

Selected Historical Data

Fiji	2001	2002	2003	2004	2005	2006
Purchasing Power $B	4	4	4	5	5	5
GDP $B (Nominal)	141	142	147	150	155	160
GDP Growth (Real)	2.7%	4.3%	3.0%	5.4%	0.7%	3.2%
Inflation	4.3%	0.8%	4.2%	2.8%	2.4%	3.4%
Exports $B	0.5	0.5	0.7	0.7	0.7	...
To U.S. $B	0.0	0.0	0.0	0.0	0.0	0.0
Imports $B	0.9	0.9	1.2	1.4	1.6	...
From U.S. $B	0.2	0.2	0.2	0.2	0.2	0.1
FDI held by U.S. $B	-	…	-	…	-	...
held in U.S. $B	-	…	-	-	0.001	...
Gross Intl Reserves $B	0.4	0.4	0.4	0.6	0.5	0.5
Savings /GDP	19.9%	…	10%	…	9.8%	…
Fiscal Balance /GDP	-6.6%	-6.2%	-5.9%	-4.8%	-4.3%	-2.4%
External Debt /GDP	0.2%	0.2%	0.2%	0.2%	...	...
Current account/GDP	-3.3%	-1.6%	-4.7%	-16.9%	-16.9%	-20.4%

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



Introduction.

In December 2006, Fiji's military launched a coup that brought to power the military government lead by Commodore Frank Bainimarama. The response in Asia and much of the world was generally negative. An already shaky economic and financial situation worsened.

Militant Legacy.

Unfortunately, political and economic crises are nothing new to Fiji.

- Since Fiji gained its independence in 1970, Fiji has experienced four coups.

Political Crisis of 2000.

A group led by George Speight toppled Prime Minister Mahendra Chaudhry's government in May 2000. Commodore Bainimarama then organized a counter-coup and was instrumental in the rise of power for Prime Minister Laisenia Qarase, whose government he recently ousted in December 2006. Following the May 2000 coup, Australia and other countries introduced a range of sanctions. International trade unions also imposed trade sanctions.

- The political crisis of 2000 resulted in a loss of 2.8% GDP for Fiji's economy during that year.
- Substantial increases in unemployment contributed to the "brain drain," as the skilled and professional workforce migrated overseas. This migration created skill shortages in many industries; reportedly more pronounced in the construction sector.
- The majority of the skilled workforce never returned to Fiji. This phenomenon resulted in Fiji's over reliance on overseas worker remittances. The remittances are now the second largest foreign exchange earner.
- Recorded reasonable growth in tourism from 2001 to current.
- Business confidence and private investment have recovered somewhat, but not to the level sufficient for a sustained growth.

Bad News: Before Coup.

While Fiji was able to cover somewhat from the 2000 crisis, Fiji's political economy was struggling on the eve of the coup.

- The expected economic growth (prior to the coup) of 2% for 2007 was considered insufficient to generate the employment and incomes needed to substantially reduce poverty and improve welfare.

- 34% of the population still lives below the poverty line.
- Cost and timeliness of doing business in Fiji is still cumbersome despite relaxed investment restrictions.
- Fundamental problems of infrastructure and land tenure still exist.
- Sugar and garment industries face increasing pressures from external forces and stiff global competition.
- Since the end of Multi-Fiber Arrangement (MFA -- a quota system for garment exports) in January 2005, China's garment industry has threatened Fiji's clothing industry. So far 6,000 garment workers, predominantly women, have lost jobs as the result.
- Clothing and footwear sector once accounted for one third of total merchandise exports.
- Poor performances in the agricultural, forestry, and fishing industries has hurt exports.

December 2006 Coup.

Commodore Bainimarama, unsatisfied with the way Prime Minister Qarase's handled the policy of showing leniency towards those who were involved in the 2000 coup, claimed that rampant corruption within the Qarase's government "forced" him to overthrow it and "reluctantly" assumed the power of the Presidency in December 2006.

Sanctions.

If Commodore Bainimarama expected a favorable response, he badly miscalculated.

- General impression was one of the Fiji military shattering a democratically elected government. EU, U.S. and Australia condemned the military coup and called for the immediate restoration of democratic civilian rule.
- That said, Australia, New Zealand, EU and U.S. governments seemed to be applying a measured response rather than absolute sanctions.

After-Effects of Coup.

As if things were not bad enough, the economic costs of the coup made a bad situation worse.

- By March 2007, Fiji's economy was on the ropes.
- Tourism workers are feeling the pinch.
  - Tourist arrivals so far were down 15% from 2006.
  - Business revenues were down due to heavy discounting.
  - Forward bookings on Air Pacific were down 30%.
- The Asian Development Bank (ADB) announced on 27 March 2007 the suspension of U.S. $212 million of funds earmarked for capital projects in Fiji.
- Government bonds lost 10% face value since the coup, therefore additional government borrowings would require exorbitant interest rates.
- The foreign reserves level held by Reserve Banks are alarmingly low. Realistically, it only has about FJ $250 million, which can cover about one month worth of imports.
- Fiji's huge current account deficit of 17% of GDP is setting off alarm bells – this is twice the 8% figure for Thailand and Mexico at the time of their respective financial crises.
- The Interim Finance Minister, Mahendra Chaudhry, admitted the state of the economy was "extremely dire."

S & P Downgrade.

In the face of extraordinarily bad economic and financial indicators, Standard and Poor's (S & P) downgraded Fiji's foreign exchange debt and gave it a negative outlook.

- Large deficit in current account (goods and services) is particularly alarming.

- December 2006 coup hit tourism hard and discouraged foreign investor interest in Fiji.
- Closure of gold mines and weak sugar, fishing, and forestry performances has hurt exports.
- Other downgrades may occur soon unless Fiji can turn its negative credit rating.

Negative Future Trends.

The future is also looking bad:

- Fiji's Tourism Action Group (TAG) estimated a 25% contraction in this sector as Australia and New Zealand, the two main tourist markets for Fiji, issued travel advisory warning immediately following the coup.
- Local investment is expected to fall approximately 18% -- this could undermine productivity in the poorly performing agriculture, forestry, and fishing industries.
- The ADB is forecasting a recession and estimated that Fiji's economy will shrink by 2.3% in 2007.
- The interim government has yet to fulfill its promise for major reforms on land tenure, legislation and their constitution. This has extended the election timetable by another year to 2011.

IMF in the Wings.

Given its negative financial situation, Fiji may have to go to IMF for a financial package to avoid a crisis or manage one if the financial state of affairs erupts.

- IMF will only give Fiji a bailout if Fiji agrees to replace its economic strategy with a more responsible one that gives Fiji a fighting chance of paying back the loan.
- The U.S. and its friends and allies will also have an opportunity to push for a return to democracy and other political and strategic objectives.

Restraint.

While the economic and financial situation looks grim in March of 2007, it's important to note that the situation could be much worse.

- Most of the countries doing business with Fiji actually showed considerable restraint in terms of how they reacted to the coup.
- Australia:
  - Canberra suspended a) all funding for Fiji's military involvement in the Regional Assistance Mission to the Solomon Islands (RAMSI) and b) aid to parts of Fiji's public sector such as police and prisons.
  - But, Canberra avoided sanctions that would harm the general population.
  - Canberra maintains aid in areas such as health, education, and community.
  - Wellington has dismissed imposing trade sanctions on Fiji – this could hurt business in New Zealand.
- New Zealand:
  - New Zealand businesses in Fiji have warned that sanctions against the country would scare off desperately needed investments and ordinary Fijians would bear the brunt.
  - New Zealand's private investors account for $600 million annually in Fiji's economy.
- EU:
  - The Fiji Sugar Research Institute made a plea with European Union (EU) not to block its funding for the restructure of the sugar industry as a result of the coup.
  - EU seemed to realize the sugar industries importance to local Fijians and not those who were responsible for the coup.
  - EU issued a warning in March 2007, but so far restrained from pulling back a $350 million sugar restructure aid to Fiji.

CONCLUSION

The interim military government inherited very difficult economic conditions, now further exacerbated by the after-effects and economic costs of the coup.

- However, unlike the 2000 coup, the international community seems to be giving the interim military government the opportunity to take the next step in the right direction, hopefully in restoring democracy.
- However, the March 2007 S & P's credit downgrade did not bode well for Fiji. It will further diminish investor confidence.
- Public disillusionment will grow with the interim government as Fiji's economic hardship mounts.

The nose-diving Fiji economy is near a balance of payments crisis.

- Earnings from tourism have fallen sharply in 2007.
- Exports are down 5.6% in 1st 5 months of 2007 compared to same period last year.
- Record low foreign reserves means Fiji may soon be unable to finance essential imports.
- Fiji's overvalued exchange rate is overpricing tourism and farm exports.

The obvious solution should be to devalue the foreign exchange rate.

- Stronger exports would move Fiji away from brink of a balance of payments crisis.

Unfortunately, the government rejects devaluation as an option.

- It fears higher import prices will worsen poverty and trigger a political backlash.

Instead, it opted for higher interest rates and exchange controls to keep the currency up.

- This ill-advised strategy has cut economic growth and worsened unemployment.
- Inevitable devaluation would be a bigger shock later than if it opted for a smaller one now.

CHRONICLES OF ECONOMIC HIGHLIGHTS

08 January 2007

Fiji Army troops took physical control of Vatakuola gold mine.

- Investor anxiety deepens.
- Emperor Mining, Aussie parent company of Vatakuola, "very concerned" about military action.

Bainimarama called for inquiry into Emperor closing operations in Fiji.

- 08 Jan: Military told media: "Soldiers sent to safeguard explosives and ensure evidence is secured".

Economic Advisor's Comment:

Emperor is in the process of closing a 75-year-old mine, which operates in financial loss.

- Dec 2006: 3-month review completed -- mine found to be financial loser in present form.
- Estimated potential loss of $60 million (U.S.) or more over next two years.
- Examining further exploration and revival possibility in adjacent areas.

The company is one of the biggest employers with a workforce of 2,250.

- Lost money in past 4 years -- but also significant export earner.

Economy is reliant on sugar and tourism.

- Tourism immediately hit by coup.
- Hotel occupancy rates down to about 80%.

- Sugar exports in limbo; EU weighs revoking preferential market access extended Fiji.

21 March 2007

Standard and Poor (S & P) lowered Fiji's credit rating and assigned a negative outlook. S & P says:

- Another downgrade may occur soon unless Fiji can turn its negative credit rating.
- Large deficit in current account (goods and services) is particularly alarming.
- 2005 December coup has hit tourism hard and discouraged foreign investor interest in Fiji.
- Closure of gold mine and weak sugar, fishing and forestry performance has hurt exports.

Economic Advisor's Comment:

- In our PACOM financial early warning system, we have indicators for financial turmoil.
- See p. 23 of Volume 1 of APEU 2007: (http://www2.hq.pacom.smil.mil/J0/J01E/default.asp?tab=0).
- Current account (CA) deficit of 3% of GDP is in safety zone; 5% figure is cause for concern.
- 8% figure is cause for alarm -- where Thais and Mexicans were before their financial crises.
- Fiji has a huge CA deficit of 17% of GDP – over twice 8% figure for Thailand and Mexico.
- Fiji's low foreign reserves make it difficult to cover capital outflow for essential imports.
- Fiji may well have to go to IMF to avoid or manage financial train wreck.

GUAM

• CHAPTER 18•

Miemie Winn Byrd

Executive Summary.

Following several years of stagnation and decline, Guam's economic outlook is brighter than it has been in recent years.

- The recent announcement by the Pentagon to relocate forces from Okinawa to Guam is expected to inject $15 billion into Guam's economy over next 10 years.
- The real estate sector has been recovering from a recession.
- Real estate prices are rising in anticipation of the U.S. military build up.
- The tourism industry had experienced encouraging growth in last three years.
- The Japanese accounted for nearly 80% of Guam's total visitor arrivals in 2006. Japan's recovery is driving the rise in tourism.
- That said, Guam's financial mismanagement remains a formidable obstacle.

Difficult Journey.

Before we explore factors driving the recent economic recovery and growth, 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 inadequate.

Grim Economic Legacy.

Until recently, Guam was suffering through a substantial and continued erosion of the economic base since the mid-1990s.

- Guam's GDP fell as much as 25-35% in the past decade.
- Guam lost nearly 20 percent 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.

Japanese Recession.

In late 1980s & 1990s, Guam became increasingly dependent on Japanese tourists and less on military 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 percent of well over a million tourists in 2004 came from Japan.

- 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 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 percent.
- The December 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.

Expected Surge in DoD Spending.

In early 2006, the Pentagon made a decision to relocate significant military forces and resources to Guam.

- This is the largest military build up post WWII on Guam.
- It is expected to boost Guam's economy beyond anything it has experienced in its history.
- Local construction firms, environmental services, facilities maintenance, food services, and administrative jobs are anticipated to reap the benefits of increased military spending on the island.
- Moreover, this type of spending actually adds more momentum to economic and financial recovery than tourism.
- Furthermore, this increased spending will act as a catalyst in improving the island's aging infrastructure and attract foreign capital and skills to launch the next stage of business and economic growth.
- DoD spending has a higher multiplier effect then tourism, since more of the DoD 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 dropped 17.1 percent in 1998.

- A modest recovery followed in 1999-2000, when it 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 Recovery.

In January 2004, tourist arrivals increased 76% to 101,515 from 57,826 in January of 2003. Guam received 1,227,587 visitors during 2005.

- Annual tourist traffic seemed to be returning to normal volume, which is over one million visitors.
- 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 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 cut backs on educational programs.

- This will have long-term implications for the island's economic development.
- 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.

CONCLUSION

Guam's economy is experiencing positive trends. Why?

- The Pentagon's latest global redistribution of forces is resulting in military build up on Guam.
- This build up is expected to bring in $15 billion over the next 10 years.
    - Local construction firms, environmental services, facilities maintenance, food services, and administrative jobs are anticipated to reap the benefits of increased military spending on the island.

Tourism is also rising. Why?

- Booming U.S. and Japanese economies.
- Good possibility of future Chinese tourist as the Chinese economy grow.

That said, are there significant economic problems?

- Yes. Government debt is too high.
- Local tradition of avoiding to layoff employees has resulted budget deficits for operational expenses.
- That’s an opportunity cost in the form of cutbacks in education.

TONGA

· CHAPTER 19 ·

Miemie Winn Byrd

Executive Summary.

- Tonga's economy was already struggling before the riots.
- Business confidence had dwindled as the result of the riots.
- Overseas remittances are increasingly important to Tonga's economy.
- Tourism is recovering.
- The new king and the parliament have a difficult task of balancing political reforms, responsible fiscal policy, the need to provide social programs, and recovery/reconstruction efforts.

Introduction.

The death of King Taufa'ahau Tupou IV in September 2006, and the severe rioting in the capital city of Nuku'alofa in November 2006, had forced the government of Tonga to begin to address and implement political reforms. Siaosi Tupou V, the new king and the son of the recently deceased king, may have difficulty in moving quickly enough to satisfy its populace's high expectations for reform.

Slow and Bureaucratic Political Reform Process.

After the National Committee for Political Reform (NCPR) presented its report to parliament, they dithered on making decisions towards political reform. This non-action aggrieved some of the populace, who are frustrated with endemic corruption within the government. The riots ensue.

Weak Economic Performance.

Economic growth in 2006 checked in at 1.9%, down from 2.3% in 2005.

- Agriculture, forestry, and fisheries contracted for a third consecutive year, due to weaker pumpkin squash prices and low tuna catches.
- Construction growth decelerated after completion of major public projects and a slow down in the housing construction sector.
- Trade and current account deficits rose as imports rose and exports fell to 6.2% of GDP in 2006.
- Official foreign reserves can cover about 4.5 months of imports at the end of 2006.
- Budget deficit was estimated to be at 6.1% of GDP. Primarily due to a 60-80% pay raise in civil service salaries.
- Inflation was at 13.4% over the past two years – a regionally high level due to high demand created by the significant inflows of overseas worker remittances and rapid credit growth.

Fragile Business Confidence.

The November riots destroyed significant portion of the central business district in Naku'alofa.

- Some 144 businesses suffered total losses estimating U.S. $100 - $150 million.
- The riots prompted Northpower, a New Zealand utility company, to pull out of negotiations to buy Shoreline Power, a Tongan electricity company. The sale was a crucial step in limiting royal family's pervasive involvement and monopoly on Tonga's economy.
- BP Oil, the supplier of diesel fuel for Shoreline, refused to make further deliveries of critical fuel supplies until paid in full.
- The riots significantly increased the "Country Risk", "Insurance Risk", and "Currency Risk" for foreign investors in Tonga.

Good News.

Overseas workers remittances came to the rescue and tourism seems to be recovering from the initial negative impact of the riots.

- The number of Tongans living overseas has been estimated at 35,000 (34% of total estimated population of 101,800).
- Emigration has become a significant factor in providing income support through remittances.
- It will serve as an informal social safety net during the recovery and reconstruction period.
- Most of the tourists from Europe did not seem to be aware of the riots, since media coverage on the unrest was rare in Europe.
- Travel advisories from Australia and New Zealand are now positive. With the help of Air New Zealand, Tonga Visitors Bureau conducted seminars with tour operations and travel agents to boost consumer confidence in Tonga's tourism.

Bad News.

Even before the riots, Asian Development Bank (ADB) has forecasted the economic growth to be at 0.9% in 2007, taking into account the planned reduction in civil service by 1,000 personnel.

- The Minister of Labor, Commerce, and Industries announced that the cost of rebuilding the central business district and business recovery costs would require U.S. $196 million of "new money."
- So far, donor agencies from the World Bank (WB), ADB, New Zealand and Australia have come up with U.S. $3 – $4.6 million to finance businesses that were affected during the riots.
- The longer Nuku'alofa has to wait for reconstruction, the further Tonga's economy deteriorates.
- It seems that the recovery and reconstruction of Nuku'alofa will be slow, costly, and painful.
- Planned reduction in civil service has been put on hold after the riots. This would have long term implications on the government's budget deficit.

China Factor.

The Tongan government is looking to borrow U.S. $49 million from China to help fund the recovery and reconstruction efforts. This request is being considered, but unlikely to bear fruit based on lack of success in the recent past.

- Prime Minister Feleti Sevele asked for a grant of U.S. $6 million for balancing the budget during the China-Pacific Island Countries Economic Development and Cooperation forum in April 2006.
- The Prime Minister also asked for a soft loan of U.S. $30 million from Premier Wen to repurchase the electric utility company back from the then crown prince.
- Beijing denied both requests.
- Most of Beijing's assistance to Tonga has been RMB-funded projects, such as the Tonga High School and renovation of Dateline Hotel.

Ethnic Tensions Brewing.

Ironically, while the Tongan government is trying to develop closer ties with Beijing, the recent result of the NCPR Report highlighted the average Tongan citizens' fear of a growing influx of Chinese immigrants.

- Chinese businesses were hit hardest during the November 2006 riots.
- Historically, Tonga has been known for its peaceful and tolerant nature.
- Tonga wants to avoid the ethnic violence similar to the one in Solomon Islands in early 2006.
- However, it was an unexpected surprise finding during the surveys conducted by the NCPR.

CONCLUSION

- King Tupou V inherited difficult economic conditions, now further exacerbated by the after-effects and economic costs of the riots.
- The recovery and reconstruction of Nuku'alofa would place a heavy burden on the government budget that was already in the red before the riots.
- The new king and parliament have a difficult task of balancing political reforms, implementing responsible fiscal policy, providing needed social programs, and recovery/reconstruction efforts. Radical reforms and tightening of fiscal policies could negatively impact the poor. This could trigger further rioting similar to the November 2006 unrest.

Asia-Pacific Economic Update

Comments on Asia-Pacific Economic Update

"The Asia Pacific Economic Update is now mandatory reading for every new officer reporting to PACOM."

~ Admiral William J. Fallon, Commander, U.S. Pacific Command (February 2005 - March 2007)

"I found the Asia Pacific Economic Update an up-to-date analysis of the complex economic challenges facing the region. Your no-nonsense economic diagnoses are just what busy U.S. and Asian strategic leaders need to help them better formulate and execute their national security strategies. Your argument that financial quicksand throughout much of Asia is a weak foundation for long term military planning is right on the money."

~ General (Ret) John Shalikashvili, Former Chairman of the Joint Chiefs of Staff

"The Asia Pacific Economic Update is an authoritative and indispensible tool for policy-makers and scholars on the Asia Pacific region. Pulling together the policy concerns most relevant to the specialists in this region, the Update also includes summaries to complement the raw data on trends in the theater. Current and timely, the Update also offers highlights on issues of concern for the near, immediate, and longer term, complementing economic data with analysis on potential political and military consequences. Essential, unique and accessible to anyone working on this field."

~ Cynthia Watson, PhD, Professor of Strategy, National War College

"I am writing to congratulate you and your staff on this year's Asia-Pacific Economic Update. The report is unique in its assessment of critical economic issues and trends in the region and serves as an important complement to research being conducted at think tanks and universities and in the private sector (the latter tends to charge a small fortune for work that is frequently quite specialized and of lesser policy/strategic relevance). The members of NBR's board of directors found it extremely useful."

~ Richard J. Ellings, President, The National Bureau of Asian Research

"This study is extremely useful. It provides an excellent overview of the economic situation in the region, as well as good analysis of specific problems and prospects. The timing couldn't have been better - I've used portions of the Southeast Asia section to inform some current projects."

~ Sheldon W. Simon, Professor of Political Science, Arizona State University