Southeast Asia

The economies of Southeast Asia showed a mixed performance in the first half of 2003. This stemmed from different levels of strength in domestic demand and in the external sector, as well as from the varying impacts of the SARS epidemic. Investment remained generally weak due to a continuing uncertain business environment. Inflation is not an issue in most countries. The subregion's economic prospects are still primarily dependent on external developments, in particular, the strength of the recovery in the US, euro zone, and Japan. The subregion is forecast to grow by 3.9% in 2003 and by 4.9% in 2004.

Macroeconomic Assessment

GDP Growth

The countries of the Southeast Asian subregion continued to vary in terms of economic performance in the first 6 months of 2003, with Cambodia, Lao People's Democratic Republic (Lao PDR), Thailand, and Viet Nam experiencing relatively higher economic growth. For countries where quarterly data are available, quarter-on-quarter figures show a contraction for the Philippines in the first quarter of 2003 and no growth in the second, while Singapore experienced a severe contraction in the second quarter, mainly as a result of the outbreak of SARS. (See Part 3 for a fuller analysis of the impact of SARS on the subregion.) In the first half of 2003, quarterly expansion was strongest in Indonesia. While consumption remained a major factor in GDP strengthening (except in Cambodia and the Lao PDR), the contribution from investment continued to decline in the first half of 2003 in the subregion as a whole. External demand is recovering in general, though in Singapore and Thailand services exports were hard hit in the second quarter by SARS. Despite a fairly expansionary monetary and fiscal policy stance in the subregion, inflation remained subdued, generally coming in lower than the *ADO 2003* projections (with the notable exception of the Lao PDR). In most countries in the subregion (Cambodia and Viet Nam excepted), merchandise export and import growth was somewhat lower in the first half of 2003 than projected in *ADO 2003*. The aggregate current account surplus for the subregion is projected at about 6.1% of GDP in 2003.

GDP growth in Cambodia decelerated slightly in both 2001 and 2002, and a turnaround is unlikely this year. Riots in January in Phnom Penh and the outbreak of SARS had adverse impacts on the economy, particu-

Table 2.2 Selected Economic Indicators, Southeast Asia, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	*Update*	*ADO 2003*	*Update*
GDP Growth					
Average	4.1	4.0	3.9	4.8	4.9
Cambodia	5.5	5.0	5.0	5.5	5.5
Indonesia	3.7	3.4	3.4	4.0	4.0
Lao People's Dem. Rep.	5.9	6.0	5.5	6.5	6.0
Malaysia	4.1	4.3	4.1	5.1	4.9
Myanmar	-	-	-	-	-
Philippines	4.4	4.0	4.0	4.5	4.5
Singapore	2.2	2.3	0.5	4.2	4.5
Thailand	5.3	5.0	6.0	5.5	6.0
Viet Nam	6.4	6.9	6.9	7.1	7.1
Inflation Rate (CPI)					
Average	4.1	4.2	3.1	4.0	3.5
Cambodia	3.3	3.5	3.0	4.0	3.5
Indonesia	11.9	10.0	6.6	8.5	6.2
Lao People's Dem. Rep.	10.6	8.0	14.0	7.0	10.0
Malaysia	1.8	1.9	1.3	2.2	2.6
Myanmar	-	-	-	-	-
Philippines	3.1	4.5	4.0	4.5	5.0
Singapore	-0.4	0.5	0.4	1.0	1.2
Thailand	0.7	1.3	1.4	1.6	1.6
Viet Nam	4.0	5.0	4.0	5.0	4.0
Current Account Balance/GDP					
Average	7.8	6.3	6.1	6.0	6.7
Cambodia	-9.8	-8.9	-11.0	-9.3	-11.2
Indonesia	4.3	3.0	3.0	3.3	3.3
Lao People's Dem. Rep.	-5.6	-5.7	-4.0	-7.1	-5.0
Malaysia	7.6	6.3	6.2	5.7	7.2
Myanmar	-	-	-	-	-
Philippines	5.0	2.0	2.0	2.5	2.5
Singapore	21.5	21.5	20.8	19.3	22.0
Thailand	6.1	4.1	4.1	4.5	4.5
Viet Nam	-2.8	-3.7	-6.2	-5.2	-5.8

- = data not available; CPI = consumer price index; GDP = gross domestic product.

Sources: *ADO* database; staff estimates.

larly tourism—the number of tourist arrivals declined by 17% in the first 6 months of 2003 compared to the same period in 2002. The run-up to the general elections in July delayed investment decisions, especially in the private sector. Nevertheless, agriculture is expected to recover, having experienced a contraction in 2002, while the industry sector should maintain its solid growth, albeit at a slower pace. So far in 2003, the garment subsector has recorded a strong export expansion, following an increase in the country's export quota to the US.

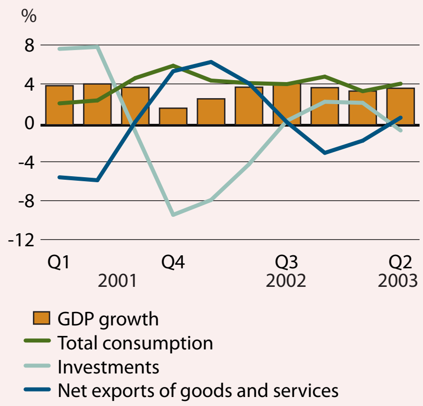
The Indonesian economy withstood the October 2002 Bali bombings relatively unscathed. GDP growth rates in the last quarter of 2002 and the first quarter of 2003 were higher than the prior-year figures. GDP grew faster in the first half of the year than in the same period in 2002 at a modest rate of 3.6%. The transport and communications subsector led the expansion, growing by 7.3%, while manufacturing posted a disappointing 2.5% growth rate. Meanwhile, household spending grew at a steady year-on-year rate of 4.7%, maintaining the trend of the last 2 years. Investment spending, which has been quite erratic over this same period, contracted in the second quarter of 2003, although this was not enough to offset the large gain in the first quarter. Nevertheless, the prognosis for investment has been clouded by the terrorist attack in Jakarta in August 2003. Through 31 July 2003, US$4.7 billion of foreign investment had been approved, or 46.3% higher than the corresponding period in 2002. Its translation into actual expenditure will, however, depend on developments in the investment climate. Although private capital inflows have gained momentum through the sale of some state assets, FDI remains limited in view of investors' concerns over security, underutilization of capital, and poor governance.

In the Lao PDR, the vital tourism subsector—though still difficult to analyze given the lack of data—is likely to have been significantly affected by the SARS epidemic in the first half of 2003. Consequently, GDP growth in 2003 is likely to slow somewhat to 5.5%, from a 5.9% expansion in 2002.

The Malaysian economy grew by 4.5% in the first half of 2003, significantly faster than the growth in the same period in 2002, but at a gradually slower pace (on a quarter-on-quarter basis) from the third quarter of 2002. Growth continued to be driven by aggregate domestic demand expanding by 4.4% in the first half of 2003, boosted by a $1.9 billion economic stimulus package in late May (although the package will more strongly impact growth in the second half of the year) and the central bank's decision to cut interest rates by 50 basis points to 4.5%, a 10-year low. Total consumption expenditure remained robust, rising by 5.6% in the first two quarters of 2003, largely due to public sector consumption, which grew strongly by 12.2% in the first half of 2003, which in turn was supported by higher expenditure on salaries, defense, and supplies. Gross fixed capital formation improved somewhat from a 5.1% contraction in the first half of 2002, but to only a 2.0% increase in the first half of 2003. Despite weak export growth resulting from the decline in electrical and electronic exports, external demand has increased its contribution since import decelerated in the first half of 2003. On the supply side, all sectors except for services and construction improved in comparison with the same period in 2002. The resource-based industries registered the highest sector growth rates in the first half of 2003, with mining at 7.4% and agriculture at 7.0%; services showed a modest 3.6%. Performance in the services sector was epitomized by contraction of the hotel and restaurant subsector, which was adversely affected by the SARS outbreak.

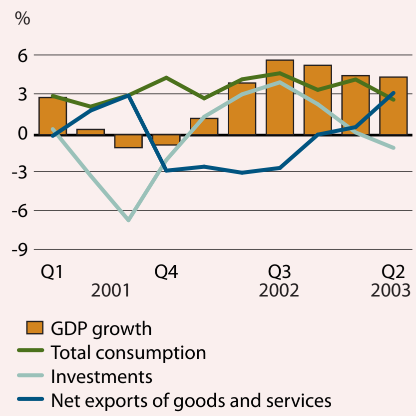
Despite a slight slowdown in GDP expansion to 3.9% in the first half of 2003, the Philippine economy remains relatively resilient, as shown by several indicators. Growth in gross national product accelerated to 4.8% in the first half of 2003 from 3.3% the year before, fueled by the surge in overseas worker remittances, which pushed up net factor income from abroad by nearly 18%. Also, a significant part of the deceleration in GDP is attributed to exogenous factors, including the effect of El Niño on agriculture, where growth decelerated to 2.3% in the first half of 2003 from 3.5% in the same period in 2002. In addition, after posting an exception-

Contribution to GDP Growth, Indonesia



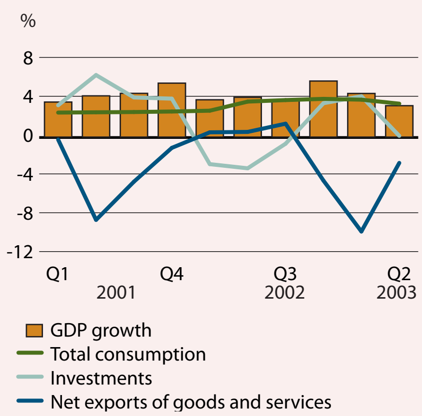
Sources: www.bps.go.id; CEIC Data Company, Ltd.

Contribution to GDP Growth, Malaysia



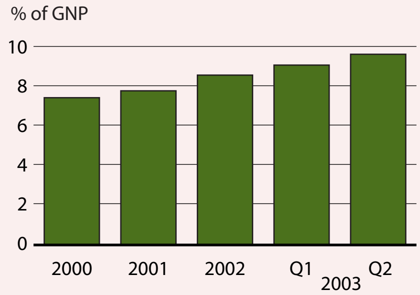
Source: www.statistics.gov.my.

Contribution to GDP Growth, Philippines



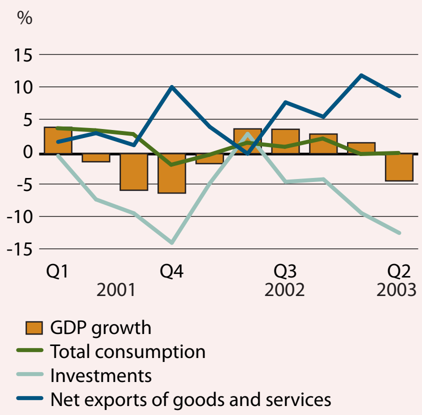
Source: www.nscb.gov.ph.

Overseas Workers' Remittances, Philippines



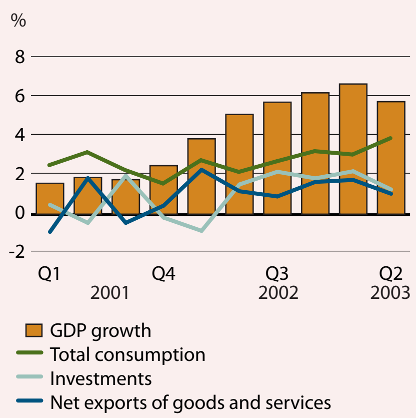
Source: www.bsp.gov.ph.

Contribution to GDP Growth, Singapore



Source: www.singstat.gov.sg.

Contribution to GDP Growth, Thailand



Source: www.nesdb.go.th.

ally high rate of 51% in 2002, it was natural that the expansion in mining and quarrying would slow. Finally, robust strengthening in food manufacturing underpinned the manufacturing sector, which rose at a faster rate in the first half of 2003 than in the same period in 2002. However, the continuing decline in public construction expenditure remains a concern, and was deep enough to result in a second quarter contraction in total fixed investment.

Singapore's economy stalled in the second quarter of 2003, falling by 4.2% from growth of 1.7% in the previous quarter. This was due both to weak external and domestic conditions. External demand grew by only 4.8% in the second quarter, down from 13.6% in the first, due to the SARS epidemic and the consequent fall in tourism earnings. Meanwhile, uncertainties over the global economy saw domestic private investment fall sharply for the fourth consecutive quarter, by 11%. While public consumption improved slightly in the second quarter, private consumption rose by only 0.2%, down from 0.9% in the first quarter. On the supply side, industries in both the goods and services sectors weakened in the second quarter of 2003. Weak manufacturing and construction activity contributed to a 7.0% decline in industrial output. Among the services sectors, hotels and restaurants were hardest hit and plunged by 33%, reflecting the impact of SARS. The economy remains fragile as retail sales have staged only a sluggish recovery, and visitor arrivals to Singapore were still 10% down year on year in August, indicating a prolonged impact from the SARS epidemic.

In Thailand, the momentum associated with the solid GDP growth of 5.3% achieved in 2002 carried through to the first half of 2003, despite a weaker global economic environment. The 6.2% recorded in the fourth quarter of 2002 was surpassed in the first quarter of 2003, with an outturn of 6.7%, though by the second quarter of 2003 the momentum had slowed somewhat to 5.8%. Domestic demand accounted for the bulk of this first half growth. This is also reflected in a second quarter decline of 13.9% in output of the hotels and restaurants subsector. The negative impact of SARS was felt in the fall in real services exports by 29.9% in the second quarter. Nonetheless, nominal merchandise exports continued their healthy progress, averaging 11.8% in the first half of 2003, given the improved external conditions.

Viet Nam was the fastest growing economy in the subregion in the first half of 2003, registering an estimated 6.9% annualized GDP growth. Despite some adverse impact of SARS, the services sector in general posted growth of 6.4% in the first half of 2003, which was higher than the growth during the same period in the previous year (5.9%). SARS affected tourist inflows mainly in April/May. As a result, tourist and business hotels experienced low occupancy, and to a certain extent tourist-related services including transport were affected. However, SARS did not affect local consumption. The vigorous economic expansion was buoyed by domestic demand that was led by both consumption and investment. Retail sales recorded a year-on-year rise of 10.5%. Total investment in the first half of the year is estimated at 34% of GDP, representing an increase of 20.5% on a yearly basis, due to robust performances of the nonstate and foreign-owned sectors, which rose by 24.5% and 22.0%, respectively, year on year. Continuing broad-based economic expansion and further improvement of the legal framework and administrative procedures have made the business environment more attractive to investment from both private domestic and foreign sources. On the supply side, industry and construction—the sector mainly responsible for the strong growth—posted an increase of 16.1% year on year.

Fiscal Situation

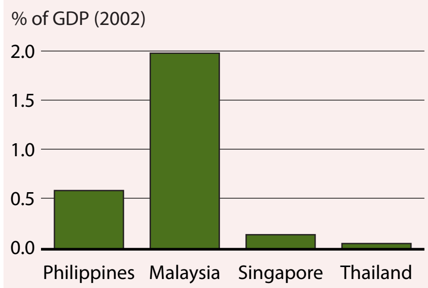
Fiscal deficits remained prevalent throughout the subregion. The fiscal situation of Cambodia remains a serious concern. Despite steady improvements in revenues—which reached 11.1% of GDP in 2002—the central government deficit breached 6.0% of GDP in 2001 and in 2002. Recent developments have not augured well in this area. Revenue collection in the first 5 months of 2003 reached only 35% of the total budget, less than the target of 42%, due to a fall in revenues from trade- and tourist-related activities. Meanwhile, donor-supported capital expenditures have been disbursed faster than programmed. Election-related spending may have caused part of the fiscal slippage.

The Indonesian Government has not announced any fiscal stimulus package in 2003. The tight fiscal stance of the last 2 years continued in the first half of 2003, when the overall deficit in the state budget was Rp2.5 trillion, or only 7.3% of the total planned deficit for the year. This was mainly because oil prices fared better than assumed in the budget and because subsidies and development expenditures were delayed. Nevertheless, no change has been made to the Government's deficit target of 1.8% of GDP for the full year, because of higher spending in the second half of the year, and possibly weaker revenue performance and unbudgeted costs.

In the Lao PDR, current revenues amounted to 13.4% of GDP and total expenditures to 18.2% of GDP in FY2002 (ended 30 September 2002). The Government has filled the budget gap of 4.8% of GDP largely with grants and concessional loans. Based on the preliminary estimates of the Ministry of Finance for the first 6 months of FY2003 however, tax collections remain significantly below target, with revenues reaching only 11.3% of GDP so far in FY2003. In response to the emerging shortfall, the Government introduced a series of measures at end-May 2003, of which the main points are (i) the reimposition of import duties and excise and turnover taxes on imported petroleum products; (ii) the introduction of a new, inflation-based excise tax on luxury goods (e.g., mobile phones); and (iii) the reimposition of fees and the collection of other service charges, including stamp duty.

The Malaysian Government announced a major stimulus package of $1.9 billion in May 2003, equivalent to 2.0% of GDP. The measures, aimed at providing relief to SARS-affected industries, included tax exemptions, extra government spending, and a cut in the central bank's intervention rate. The 7-month exemption given to hotels and restaurants under the stimulus package until December 31 will involve 940 hotels and 2,600 restaurants. While the economy is likely to show resilience for the rest of 2003, increased expenditure and lower revenue will likely widen the forecast government deficit to 6.0% of GDP from the 4.0% projected in *ADO 2003*. Although businesses continue to complain about the 28% corporate tax rate, fiscal pressures may make the Government less willing to cut taxes in the near future.

Relief and Fiscal Stimulus Packages for SARS, Selected Economies



Sources: www.nscb.gov.ph; www.statistics.gov.my; www.singstat.gov.sg; www.bot.or.th.

In the Philippines, the fiscal deficit is the Achilles heel of macroeconomic management. Thus, the recent improvement in the national Government's budget balance is significant and needs to be maintained. Continued progress in revenue collections allowed the Government to contain its budget deficit to P79.6 billion in the first half of 2003, well below the first half year deficit target of P102.2 billion. While this is a welcome development, no change has been made to the *ADO 2003* forecast of a 4.5% deficit of GDP for the year.

The relief package announced in August by the Government of Singapore will widen the fiscal deficit to S$2.3 billion or 1.4% of GDP in FY2003 (ending 31 March 2004), much higher than the S$900 million shortfall estimated by the Government in February this year. It will be an unprecedented third consecutive year of fiscal deficit for Singapore. The major component of the fiscal measures is a S$600 million plan to accelerate public infrastructure projects in FY2003 and FY2004, thereby helping the construction sector, which has experienced a contraction for nine straight quarters despite heavy government spending. The Government will also set aside S$100 million for a tourism recovery fund and S$40 million for a fund for unemployed Singaporeans. The anticipated budget deficit has forced the Government to postpone cuts in both corporate and income taxes, which currently have a top rate of 22%. Meanwhile the proposed 2% increase in January 2003 to 5% in the Goods and Services Tax was deferred to 2004; an increase of only 1%, to 4%, was applied.

In Thailand, the budget deficit for FY2003 (ending 30 September 2003) is expected to fall to just 0.7% of GDP, significantly lower than the 2.2% recorded in FY2002. This is mainly the result of buoyant tax receipts, accruing from strengthening economic growth. Tax revenue grew by more than 11% in the first 8 months of FY2003, reaching 70% of the annual target. The fiscal package for the SARS-affected industries announced in May amounted to B3 billion (0.1% of GDP), providing further fiscal stimulus to the economy in FY2003.

In Viet Nam, due to continued strong economic growth in the first half of 2003 and to strengthened tax management, total revenue in the first half of the year was estimated to have grown by 9.5% on a yearly basis, equaling 52% of the target for the whole year. Expansionary fiscal policy was maintained in the first half of the year in order to maintain the current investment level, to meet the expenses of ongoing reforms, and to finance preparations for the Southeast Asia Games in November. Total fiscal expenditure in the first half of 2003 grew by 14% year on year, accounting for 45.2% of the projected target for the whole year. As a result, the fiscal deficit is expected to widen to 4.8% of GDP from 3.5% in 2002.

Money and Prices

Inflation is not an issue in most of the countries in the subregion except for the Lao PDR. Generally low inflation and international interest rates have encouraged central banks in the subregion to continue their very accommodative monetary policies. The primary target has been domestic investment, which has been faltering in many countries. Some economies, however, are still constrained by a weak financial sector, which has limited the supply of credit.

Following a rise in 2002 due to poor agricultural performance, year-on-year inflation in Cambodia decelerated in the first 7 months of 2003 to 1.6%, from 3.3% in 2002. This stemmed partly from a stable exchange rate, slightly lower growth in money supply, and a sharp drop in real estate prices. It can also be attributed to seasonal factors, reflecting the fact that the main rain-fed rice crop is harvested in December–January.

Declining food prices and some appreciation in the rupiah helped reduce inflationary pressure in Indonesia in the first half of 2003. In the 12 months to July 2003, the CPI had risen by 5.8%, the lowest increase seen in 4 years. At its current pace, inflation is projected to average 6.6% in 2003, well below the *ADO 2003* forecast of 10.0%. Due to this favorable development, the yield on the 1-month Bank Indonesia Certificate (SBI) fell from 11.0% in January to 9.1% in early August. Over this period, the rupiah appreciated by about 5% against the US dollar.

Inflation in the Lao PDR was recorded at 16.3% year on year in the first quarter of 2003, with some improvement to 15.0% in July. If prudential monetary and fiscal policies are not closely observed, inflation may once again pose a serious threat to macroeconomic stability. A number of factors are responsible for the higher prices, including greater bank borrowing for a widening budget deficit, increased food prices, and depreciation of the kip.

Year on year, CPI inflation in Malaysia slowed to 1.0% in July from 1.7% in January 2003, due mainly to a slower rate of price increases for transport and communications. Monetary policy was further loosened as Bank Negara Malaysia lowered its 3-month intervention rate by 50 basis points to 4.5% in May. Since the Malaysian ringgit is pegged to the US dollar, it depreciated against most subregional currencies in the first 8 months of 2003, in the range of 0.2% to 2.1%.

Inflation year on year in the first 8 months of 2003 averaged 3.0% in the Philippines, well below the full year target of 4.5–5.5% set by the Bangko Sentral ng Pilipinas (BSP). Inflation has been stable even though the peso/US$ rate depreciated by about 4% in the first 8 months of the year, indicating that the exchange rate pass-through has been significantly reduced. Lower than expected inflation, greater exchange rate flexibility, and falling international interest rates allowed BSP in July 2003 to reduce its policy rates each by a quarter percentage point—overnight borrowing (to 6.75%) and lending (to 9.0%). The generally accommodative monetary policy stance has helped bank lending recover and grow by 3.9% year on year for the first 6 months of 2003 as compared to a contraction of 0.9% in 2002.

In Singapore, inflation averaged 0.4% in the first half of 2003 year on year, slightly higher than the 0.2% in the fourth quarter of 2002. On 10 July 2003, the Monetary Authority of Singapore recentered the exchange rate policy band at the lower level of the Singapore dollar leaving the width of the policy band unchanged, so allowing the Singapore dollar to depreciate slightly against the US dollar (by less than 0.5%), giving some spur to exports. The 3-month Singapore dollar interbank rate eased from 0.81% at end-2002 to 0.63% at end-June. Reflecting the weakening of the Singapore dollar as well as lower domestic interest rates, overall monetary conditions remained expansionary in the first half of 2003, and are expected to remain accommodative for the second half of the year, given the sluggish economic recovery.

Inflation remained low in the first half of 2003 in Thailand. The CPI rose by 1.7% year on year in June, while core inflation (which excludes food and energy items) rose by only 0.2% over the same period; core inflation continued decelerating to register zero growth in August. Overall inflation would have been much lower had it not been for the sharp rise in food prices (4.9% year on year) as a result of unfavorable weather conditions. Inflation is expected to remain low for the remainder of 2003. The Bank of Thailand (BOT) has an official policy of inflation targeting, and monetary policy is aimed at keeping core inflation within the 0–3.5% range. Faced with the risk of deflation—with core inflation hovering around zero—BOT cut its benchmark 14-day repurchase rate by 50 basis points, to 1.25%, in June. This move was also a response to concerns relating to high levels of capital inflows triggered by interest rate differentials that were leading to a rapid appreciation of the baht. The nominal exchange rate against the US dollar appreciated by more than 3%, from January through July.

Though it is still difficult to analyze given the lack of data, rapid credit growth is emerging as a concern in Viet Nam because of significant liquidity provision by the State Bank of Viet Nam (SBV) to state-owned commercial banks. SBV aims to keep inflation below or equal to 5.0% in 2003 despite rapid credit growth; it is being helped by declining food prices. Overseas remittances to the country through SBV reached US$1.1 billion in the first half of 2003, an increase of around 12% compared to the same period in the previous year. The rise was mainly attributed to better oversight of the foreign exchange market by SBV, particularly in terms of better recording of remittances. The dong generally remained steady against the US dollar in the first 6 months, depreciating by 0.6% in this period

External Sector Developments

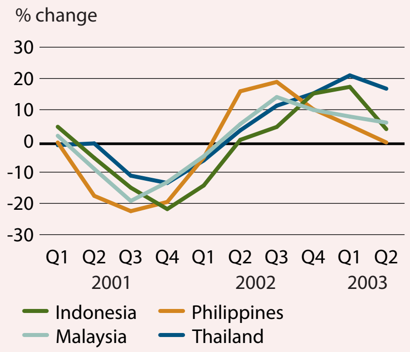
The economies of Southeast Asia generally exhibited sizable current account surpluses, except for Cambodia, Lao PDR, and Viet Nam. However the surpluses are lower than those projected in *ADO 2003*, and have declined. The subregion as a whole will have a total surplus of US$35 billion, or 6.1% of aggregate GDP.

US customs data indicate that exports from Cambodia to the US—which takes in roughly 65% of the country's total merchandise exports—surged by about 34% in the first half of this year, largely due to the expansion of the garments quota. Import growth in the first half of 2003 was also vigorous, partly due to increases of intermediate goods for the garment industry. The current account deficit, excluding official transfers, should rise above 10.0% of GDP again in 2003. Foreign exchange reserves in May 2003 were reported at US$664.4 million—about 3.4 months of imports—differing little from the US$663.1 million at end-2002.

Total merchandise exports from Indonesia rose by 10.5% year on year in the first half of 2003, reaching US$30.4 billion, driven mainly by the oil and gas sector, where exports rose by 23.0% year on year, due mainly to higher oil prices and strong demand for gas. Imports increased at a faster pace, by 16.8% to US$16.3 billion year on year. Nonetheless, the net merchandise trade balance for the year is likely to remain at around US$25–26 billion in surplus, as was the case in 2001–2002.

Exports grew by 3.6% in 2002 in the Lao PDR. Exports are expected to continue growing in 2003 on account of reduced tariffs in the PRC and Viet Nam, strengthening world commodity prices, and the implementation of Normal Trade Relations status by the US. Nevertheless, the Government's target of 10.0% annual export growth in 2003–2004 appears somewhat optimistic. Imports continued to fall in the first quarter of 2003, by 3.4%, following a contraction in 2002 of 1.8%. This trend, however, is likely to reverse itself as exports are expected to grow and as a significant share of imports constitutes inputs to export production. In addition, the further lowering of tariffs under the ASEAN Free Trade Area (AFTA) could lead to higher import growth. On balance, the Lao PDR's current account is expected to narrow moderately compared to the 2002 outturn and the *ADO 2003* projection, to 4.0% of GDP in 2003.

Growth Rate of Total Exports, Southeast Asia



Source: CEIC Data Company, Ltd.

In Malaysia, while the current account continues to post a surplus, the capital account is registering a deficit, putting the overall balance in slightly positive territory for the first half of 2003. Although exports of electrical and electronic products, the largest contributor to total merchandise exports, decreased by 6.1% in the first 6 months of the year, the export growth of 6.9% was supported by a surge in chemical products and metal manufactures, which grew by 27.5% and 29.3%, respectively, year on year. Total merchandise imports declined by 1.6% as against the same period in 2002. Among the trading partners, the PRC became a net importer, allowing Malaysia to record a marginal net trade surplus with the PRC in the second quarter of 2003; the share of exports to the PRC in exports increased to 6.2% in July 2003 from 3.1% in 2000. On the capital account, the balance turned to a deficit of RM8.2 billion in the first quarter of 2003 from a surplus in the first quarter of the previous year as a result of a net outflow of FDI, representing Malaysian investments overseas and acquisition of foreign interests by Malaysian companies. Portfolio investment, on the other hand, recorded a lower net outflow of RM0.7 billion in the first quarter of 2003 when compared to a net outflow of RM2.9 billion in the year-earlier quarter.

The Philippines recorded a trade deficit of US$1.5 billion in the first half of 2003, compared to US$0.19 billion in the same period in 2002. Imports for the first 6 months of the year grew by 9.9% but exports by only 2.1%, due mainly to a decline in electronics exports, which account for 65% of total export revenue. This is primarily a result of poor sales to the US. However, the surge in overseas worker remittances in the first 6 months of 2003 should ensure a current account surplus for the whole year. The overall balance of payments is projected to be in deficit in 2003 due to the rise in residents' investment abroad and the slowdown in FDI, both of which are expected to continue throughout the year in the wake of greater domestic political uncertainties. Despite the good management of debt and its generally benign profile—long maturity, little bunching, and a high proportion of official development assistance—the growing debt burden of the economy needs policy makers' attention. These problems are likely, if anything, to worsen, with the Government's increasing tendency to finance development through debt rather than tax revenues.

Singapore's total merchandise exports decelerated significantly year on year to only 6.0% expansion in the second quarter of 2003 from 16.7% expansion in the first. Although all major trade components either registered slower growth or contracted in the second quarter, the receipts from travel services plummeted by 46.1%. Imports also contracted, by 0.3% in the second quarter, switching from 9.7% growth in the first. Taken together, the current account surplus fell slightly to S$11.1 billion in the second quarter, from S$11.8 billion in the first. Nevertheless, the current account surplus more than compensated for the net outflow of S$6.2 billion on the financial account, which largely reflected portfolio investments and net outflows from the "other investment" account.

In Thailand, the rebound in exports in the second half of 2002 accelerated in 2003. Exports of goods and services rose by an impressive 18.0% in the first quarter of 2003, but slowed to 9.5% growth in the second quarter due to a SARS-induced 24.7% decline in services. Recent strengthening in goods exports has been driven by increased demand from the PRC (particularly for fruits and vegetables) and from ASEAN countries. The share of exports to the PRC has increased significantly over last few years, from 4.1% in 2000 to 7.1% in July 2003. Imports of goods and services also continued to grow strongly in 2003, increasing by 13.0 in the first 6 months of the year. The pickup in domestic demand associated with rapid economic expansion was the main factor. A merchandise trade surplus of US$2.5 billion was posted for the first half of 2003. The current account surplus totaled US$3.8 billion, but the balance of payments recorded a deficit of about US$1.1 billion in the first half of the year due to a net outflow on the capital account. The slight increase in nonbank flows, including portfolio investment, was offset by significant commercial bank outflows.

External debt totaled US$55.7 billion at end-June 2003, down from US$59.5 billion at end-2002. The debt stock has been trending downward since 1997. The ratio of public sector debt to private sector debt also continued to fall in 2003. This drop is in line with government efforts to repay loans from multilateral agencies such as the International Monetary Fund (IMF), World Bank, and ADB. Indeed, Thailand paid off the last of the loan arranged by IMF in July 2003, 2 years ahead of schedule. With a comfortable current account surplus, growing international reserves, and declining foreign debt levels, particularly private sector short-term debt, external vulnerability has fallen considerably since the financial crisis.

Total merchandise exports in the first half of 2003 for Viet Nam were estimated at US$9.8 billion, representing an increase of 32.6% on a yearly basis, which was due mainly to healthy growth of major export items, namely crude oil, textiles and garments, fisheries products, and footwear. The 35.7% increase in crude oil exports was largely attributable to higher global oil prices. Soaring textile and garments exports, at 66.4%, were mainly the result of a surge in sales prior to the imposition of a quota by the US on Viet Nam's textile and garment exports. Imports totaling US$12.2 billion, however, exceeded exports, pushing the trade deficit to US$2.4 billion. The strong growth in imports is attributable to (i) demand from industry, including export processing and preparations for the upcoming Southeast Asia Games to be held in December; (ii) higher prices; and (iii) a more liberal import regime than in previous years. Tourist arrivals fell steeply, due to the SARS epidemic. The Vietnamese Tourism Authority estimates output loss of about US$570 million in the tourism sector as a result.

Policy Developments

In order to ensure long-run economic growth and minimize short-term macroeconomic volatility in their economies, Southeast Asian governments will need to address a series of policy issues. On the domestic front, financial restructuring and reform still have some way to go in several countries. Fiscal consolidation is also an important issue to be addressed.

Cambodia was recently admitted to WTO, during the Cancun meeting in September 2003. The Cambodian Government also signed bilateral trade agreements with various trading partners, including Australia, EU, and Japan in June–July 2003. In the trade agreements, Cambodia pledged to cut import tariffs on agricultural and nonagricultural products and liberalize its services sector. In the area of fiscal reform, in June 2003 the Government had discussions with World Bank, IMF, and ADB on an integrated fiduciary assessment and public expenditure review, which outlined the following reforms to support economic growth and poverty reduction: (i) strengthening resource mobilization, (ii) reducing fiduciary risk to public funds, (iii) rationalizing public expenditure policy and management to better focus on high priorities, and (iv) accelerating civil service reform. Better fiscal management will become doubly important when Cambodia's debt service increases substantially after 2004.

The Indonesian Parliament passed several laws aimed at rapid resolution of labor problems, and attracting investments in the first half of 2003. The law on labor, approved in April, would provide corporations with flexibility in hiring and firing workers as well as provide workers with stronger bargaining power. It guarantees minimum standards on working conditions, workers' right to strike, and severance and compensation payments. On other structural issues, Parliament passed a Law on Anti-Money Laundering to enhance transparency and overall governance. Progress has been made with regard to the sale of state-owned assets, with the sale of 51% of Bank Danamon in May 2003 and the initial public offering of 20% of Bank Mandiri, Indonesia's largest bank, in July 2003. In addition, the Government is likely to raise around US$1 billion from the sale of three more banks over the rest of 2003, with much foreign interest evident. The Government is also advancing the financial sector regulatory reform agenda. Under the proposed institutional arrangements for the Financial Services Authority (OJK), Bank Indonesia (BI) will be the lender of the last resort, but retain the banking sector oversight authority until OJK is established. BI's focus has recently been on facilitating the real sector recovery process through lower interest rates. In 2004, BI plans to initiate the implementation of the Basel Core Principles, which incorporate market and operational risks in the calculation of the capital-adequacy ratio.

While macro stability and rising inflation are major concerns in the Lao PDR, there was a positive development with regard to the external debt owed to the Russian Federation, which accounted for almost 70% of the Lao PDR's long-term debt. In June 2003, the two governments agreed to write off 70% of the Lao PDR debt and service the remaining debt, valued at US$378 million, over a period of 33 years at a preferential interest rate. This improved the Lao PDR's debt service capacity significantly. The country's debt service capacity should also be improved by the planned construction of the 1,070 megawatt Nam Theun 2 hydropower plant. Though there are uncertainties over financing the project, which requires a total investment of about US$1.1 billion, the plant would significantly increase revenues for the country through sales of electricity to Thailand.

The decline of FDI to Malaysia has become a priority concern to the Government. FDI inflow has been weakening over the past few years. To tackle the issue, a plan to relax rules governing ownership of companies and property by foreigners has been announced. This policy change will mark a significant change in the Government's 30-year policy of trying to promote the economic interests of the Malay majority by requiring foreign companies to have a 30% stake held by Malay interests. In addition, the central bank lifted capital controls that directly limited the operations of foreign banks and multinationals in the country. Since the early 1980s, the central bank had required foreign multinationals operating in Malaysia to raise a minimum of 50% of their banking credit from local sources. While the lifting of capital controls will only affect the 12 locally based foreign banks, helping reverse their declining market share, it will force local banks to pursue more innovative strategies to retain their share of the market.

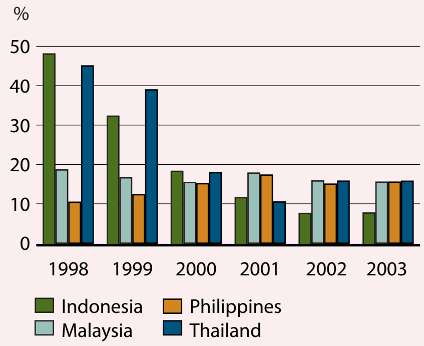
Fiscal consolidation is the primary macroeconomic challenge facing the Philippines. Recognizing this, the Government is in the process of implementing several measures, including (i) strengthening monitoring of large taxpayers, (ii) undertaking intensive audits on tax payments, (iii) filing bills in Congress on inflation-indexing of excise taxes and on redefining automobiles to remove excise tax loopholes, (iv) improving VAT collection, and (v) rationalizing fiscal incentives to minimize revenue leakages. Meanwhile, a bill has been prepared to restructure the Bureau of Internal Revenue (accounting for about 80% of budget revenue), which will lead to the establishment of an autonomous revenue authority. Significant efforts have also been made in financial sector reform. In January 2003, the Government introduced the Special Purpose Vehicle Act (SPV), designed to address the problem of constrained intermediation resulting from the high level of nonperforming assets of commercial banks, which now amount to 15.2% of total loans. The SPV gives to the private sector tax and accounting incentives to purchase NPLs. Further progress in cleaning the banks' balance sheets will not only improve their operations, but also pave the way for a larger presence of global investment banks in the Philippines. Better fiscal management and a reinvigorated financial sector should help spur private investment, which has not recovered from the Asian financial crisis. A persistently low investment rate is the most critical risk to higher, sustainable economic growth.

In Singapore, the Economic Review Committee, established in late 2001, announced recommendations in key areas in early 2003, to promote restructuring of the economy. Data from the US Department of Commerce on returns to US companies show that the economy no longer provides a rate of return superior to the Asian average.

Singapore signed free trade agreements with Australia, European Free Trade Association, New Zealand, and US in the first half of 2003. Discussions on free trade are ongoing with Canada, PRC, and Mexico. The agreement with the US brought preferential access to the local banking sector while waiving quantitative restrictions on wholesale and full foreign bank licenses for US-based banks.

In Thailand, there is a need to continue with reforms to further consolidate growth. The completion of banking and corporate sector restructuring remains vital for the recovery of business investment and the medium-term prospects for the economy. Unlike consumer spending, business investment has played only a limited role in the economic recovery. One reason is that over the past year, the pace of reform seems to have slowed somewhat, in the financial and corporate sector restructuring programs, after significant progress following the Asian financial crisis. The Government recently admitted that its target of reducing the banks' NPLs to 10.0% of total lending by end-2003 is unlikely to be met. Total NPLs now amount to B777 billion (approximately US$18.5 billion), or 16% of total bank lending. There has also been very limited progress in the development of the nonbank financial sector and capital markets. The key role played by exports in sustaining strong growth is seen in Thailand's continued program of trade liberalization. Recently, the Government started pursuing negotiations for free trade agreements on a bilateral basis with several key trading partners. These include an accord on closer economic relations and a free trade agreement with Australia, both of which are scheduled to be completed in October, and free trade agreements with PRC, India, and US.

Nonperforming Loan Ratios, Southeast Asia



Sources www.bi.go.id; www.bnm.gov.my; www.bsp.gov.ph; www.mas.gov.sg; www.bot.or.th.

Reform efforts to strengthen the banking sector in Viet Nam continued. In early June, in the second round of the Government's recapitalization program to help the five state-owned commercial banks raise their capital-adequacy ratios, the Ministry of Finance allocated D2.9 trillion (US$184 million) to four of them, and in the third round, in August, the Ministry allotted D2.1 trillion (US$135 million) to three of them. Meanwhile, reform efforts are continuing, so as to enhance Viet Nam's external competitiveness, to nurture the rapidly growing number of domestic private enterprises, and to further the country's regional and global economic integration. The Government has already carried out various policy measures under the framework of AFTA and of the bilateral trade agreement with the US. These are significant steps in Viet Nam's quest for WTO membership in 2005. The Government has made vigorous efforts to implement the public administration reform program and has achieved encouraging results in all the main areas covering legal and institutional, organization, and administrative procedures. The last element includes computerization and electronic-government initiatives, improving the quality of public officials, and decentralization.

Outlook for 2003–2004

The *Update* outlook for Southeast Asia for 2003 and 2004 is broadly in line with the *ADO 2003* projections that had sought to take into account the likely impact of SARS on countries in the subregion. However, projected average inflation for Southeast Asia is now notably reduced—from 4.2% to an estimate of 3.1% in 2003 and from 4.0% to 3.5% projected for 2004. This is because of faster than expected stabilization progress being made by Indonesia where inflation averaged nearly 12% in 2002. GDP growth for the subregion is now forecast at 3.9% versus 4.0% in

ADO 2003, because of weaker than projected performance in Lao PDR, Malaysia, and Singapore that is only partly offset by better than expected growth in Thailand. The subregion's current account surplus in 2003 is now expected to be 6.1% of GDP versus 6.3% forecast in *ADO 2003,* and well below the 7.8% of GDP surplus recorded in 2002.

GDP growth in 2004 is now forecast at 4.9%, marginally higher than the 4.8% projection in *ADO 2003*. All countries are expected to improve on or maintain their 2003 GDP growth performance, though current projections for the Lao PDR and Malaysia are trimmed and those for Singapore and Thailand edged up as compared to *ADO 2003*. The 2004 projection for the current account surplus for the subregion has been raised to 6.7% of GDP, from 6.0% in *ADO 2003*, as strengthened estimates for Malaysia and Singapore more than offset some estimated weakening in the current account developments in Cambodia and Viet Nam.

The outlook for 2003–2004 remains favorable in Cambodia, even though the country faces numerous challenges. GDP growth is expected to decline from 5.5% in 2002 to 5.0% in 2003, mainly due to lower tourist arrivals in the early months of the year, but then to increase modestly to 5.5% in 2004 as the world economy consolidates its recovery. However, economic expansion has not been broad-based and is concentrated mainly in garment exports and tourism. The expected phasing out of garment quotas with the expiry of the Multifiber Arrangement by end-2004 will therefore put part of this expansion at risk over the medium term. Moreover, the country is expected to face tougher competition in foreign markets. The exchange rate is expected to be stable. Meanwhile, inflation is forecast to reach 3.0% and 3.5% in 2003 and 2004, respectively. Macroeconomic stability and implementation of reforms in various sectors will be the major factors contributing to an improved investment climate and sustainable economic growth.

The fallout from recent terrorist attacks is likely to further cloud the investment climate in Indonesia. Economic growth is predicted to decelerate in the second half of 2003, bringing the full year average to 3.4%. Fiscal options in the future will be limited due to resource and debt constraints and unpredictable developments in the privatization program. For 2003, inflation is forecast to average 6.6%, aided by a fairly stable rupiah that has resulted from a strong current account surplus and hefty international reserves. The more favorable external environment and the absence of any further shocks should be enough to push the economy to higher growth of 4.0% in 2004.

GDP growth has been revised down by 0.5% to 5.5% in 2003 and to 6.0% in 2004 for the Lao PDR due to the onset of the SARS epidemic and higher than expected inflation outcomes. Despite the laudable fiscal measures introduced in May, inflation is still expected to remain in double digits in 2003 and 2004, though its acceleration should significantly diminish. Nevertheless, vigilance in the conduct of fiscal and monetary policies and the continued implementation of reforms in various sectors is going to be essential if macroeconomic stability is to be sustained in 2003 and 2004.

In Malaysia, the accommodative monetary policy and the fiscal stimulus package supported steady growth in the first 6 months of 2003. The economy is, however, projected to expand by only 4.1% in 2003 and by 4.9% in 2004, slightly less than projected in *ADO 2003*, because of the uncertain economic outlook in key export markets. Exports are projected to grow at a slower rate of 6.4% in 2003, rather than the 8.1% projected in *ADO 2003*, due to the weak growth in electronic and electrical exports in the first half of 2003. External demand became the major driver of economic growth in the second quarter of 2003 and, given the declining trend in investment and consumption, global recovery is key for the economy gaining momentum. The fiscal deficit is projected at 6.0% of GDP in 2003, or wider than the 4.0% projected in *ADO 2003*; the fiscal stance is expected to be expansionary in 2004, as a general election must be held by January 2005. The Government is not expected to balance the budget in the near term while the global economic recovery remains fragile and external uncertainties persist.

Political uncertainty, the continuing civil strife in the large southern island of Mindanao, and slow progress in key economic legislation and policy reforms complicate the economic outlook for the Philippines. Nevertheless, the economy's resilience, the prospects for an improvement in the fiscal deficit, and progress in financial reform, are likely to support a GDP growth rate of around 4.0% for the whole of 2003, in line with the forecast made in *ADO 2003*. In 2004, this is expected to accelerate to 4.5% with agricultural growth expected to pick up and investment to strengthen as the global economic environment improves further. However, without a stronger recovery in output, unemployment is likely to remain at around 10% in 2003–2004. In view of the recent fiscal revenue measures, it is expected that the budget deficit will be contained at around 4.5% of GDP for 2003 and fall slightly to 4.0% of GDP in 2004. In 2004, the current account is expected to remain in surplus, with an export pickup and continued strong overseas worker remittances.

The Government of Singapore will continue its expansionary policies and this, along with the end of the SARS epidemic, is expected to provide a more favorable environment for the second half of 2003. However, the steeper than expected 4.2% GDP contraction in the second quarter will bring down the 2003 GDP growth forecast to only 0.5% for the year compared to the 2.3% projected in *ADO 2003*. As a result, unemployment continues to remain high—the authorities forecast 4–5% for 2003. Recovery of investment demand is key for Singapore to regain its economic momentum. GDP growth is expected to strengthen in 2004 to 4.5% after the severe drop in 2003, though this prospect will be greatly affected by external events.

Thailand is the only Southeast Asian country where the *ADO 2003* forecast has been upgraded significantly—from 5.0% to 6.0%. Like most other countries, the recovery in global demand will be the main factor in growth in 2004, at 6.0%. Private consumption spending is expected to remain high for the remainder of this year and in 2004, supported by historically low interest rates. Despite some slowdown in the second quarter of 2003, investment spending and exports are also expected to strengthen in the second half of the year, and to improve further in 2004. Growth prospects still very much depend on external developments as exports have been a major factor driving the economy, although domestic demand has played an important role in recent years.

Viet Nam's full year GDP growth in 2003 should mirror the estimated first half performance, with an outturn of 6.9%. What may constrain future expansion is the widening current account deficit. The current account deficit is projected to widen considerably to 6.2% of GDP in 2003 from 2.8% in 2002. The imposition of the US quota will hurt exports of garments and textiles to the country, though a 10% export expansion is still projected. Heavy import demand will be sustained by reductions in the tariff level under the AFTA commitment and rising import requirements of an expanding industry sector. Nevertheless, FDI, private remittances from overseas Vietnamese, and overseas development aid should readily cover the current account deficit. Meanwhile, the Government is expected to maintain its expansionary fiscal policy to meet the costs of ongoing and forthcoming reform and additional infrastructure projects. Given these considerations, GDP growth in 2004 is expected to rise somewhat to 7.1%.