

3. The international and regional environment

The outlook for global growth in 2007 is similar to that presented in the previous April 2007 East Asia Update - decelerating from 3.9 percent in 2006 to 3.5 percent in 2007 (from 5.3 to 5.1 percent respectively in purchasing power terms). The main difference from six months ago is that 2008 is now likely to be a year of further mild deceleration in growth (easing to 3.4 percent), rather than one of mild revival, (Table 6) while the risk of a more serious downturn has also increased. Growth projections for 2008 have been reduced for all the main developed regions, most emphatically for the US, where they have been cut from 3 percent six months ago to only 2 percent now.. This hefty adjustment reflects the likely depressing effects of the sub-prime crisis and the associated tightening of credit markets that began in August, the unexpectedly deep recession in the US housing market and the impact of higher than previously forecast oil prices. But growth projections have also been tuned lower for the Euro area, which is also likely to feel the effects of the credit squeeze flowing from the sub-prime crisis, and Japan, where consumer spending has remained sluggish, belying earlier expectations of a revival (with both Europe and Japan also suffering from the impact of higher oil prices). World trade volume growth is projected to dip from over 10 percent in 2006 to around 7 ½ percent in 2008.

Table 6. International Economic Environment

	2005	2006	2007	2008
% Change from previous year, except interest rates				
GDP Growth				
World	3.4	3.9	3.5	3.4
World (PPP Weights)	4.7	5.3	5.1	5.0
OECD	2.4	2.8	2.3	2.2
United States	3.1	2.9	1.9	2.0
Euro Area	1.5	2.8	2.5	2.1
Japan	1.9	2.2	2.0	1.8
Developing Econ.	6.8	7.5	7.3	7.0
World Trade (Volume)	7.8	10.2	9.2	7.5
CPI Inflation - G7 ^{a/}	2.0	2.0	1.7	1.7
Oil Price - \$/bbl	53.4	64.3	68.0	72.4
- % Change	41.5	20.4	5.7	6.6
Non-oil Commodity Prices				
LIBOR - US\$. 6 Mo.	3.7	5.2	5.3	4.8
-Euro 6 Mo.	2.2	3.2	4.3	4.0
Source: World Bank DEC Prospects Group October 2007. a/ In local currency aggregated using 2000 weights.				

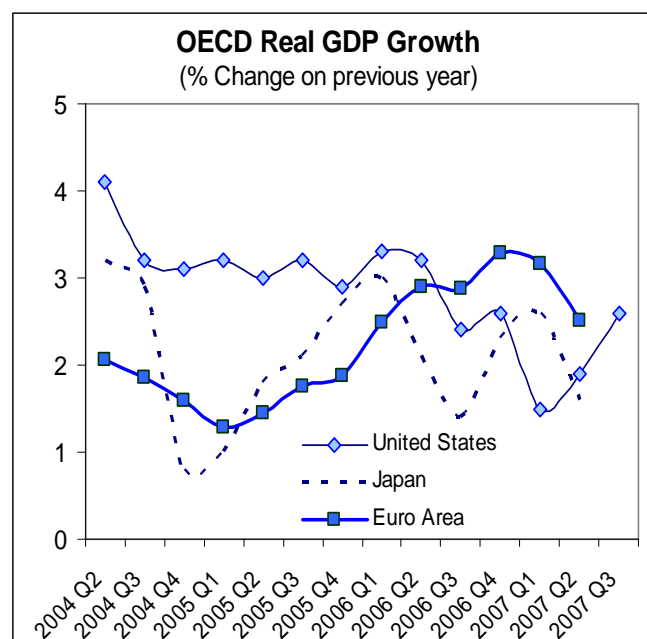
Yet, despite the more somber outlook for world growth in the near term, there are also countervailing elements in the global picture that suggest resiliency and the potential for recovery. For one thing, despite its slower trend, the US economy continues to show obstinate strength, picking up to 3.9 percent growth in the third quarter of 2007, for example. While US import growth has already slowed to a crawl in 2007, this does not seem to have had

much discernable impact on growth in China, the rest of East Asia, or developing countries as a group, which have been relying more on domestic demand to offset slower export growth. Unlike in 2001, the slowdown in world growth is not spearheaded by a recession in the global high tech industry, which is by far East Asia's most important export sector. Indeed global high tech demand appears to have been rebounding in the third quarter of the year. Recent research also confirms that the world economy has become a lot more resilient to high oil prices, with the estimated impact on developed economies in the last two decades half or less than half of what it was in previous times.

3.1. A slowing trend in the developed world

Growth in the *United States* fell to 1.7 percent (year on year) in the first half of 2007, down by almost half from a 3.3 percent pace in the first half of 2006. (Exhibit 7). Two thirds of the fall in growth was due to housing investment, which contracted by 16.5 percent from a year earlier. Growth in business equipment and software investment also fell to virtually zero in the first half of the year. Continued steady growth in personal consumption in the 3 percent range helped prevent a more severe downturn in overall activity, as did an upturn in net exports. Exports continued to grow at a 7-8 percent year on year pace while import growth slowed to 2 ½ percent in the first half of 2007 from around 6 ½ percent a year earlier. US growth in the third quarter surprised to the upside, rising 3.9 percent from the second quarter (saar, or 2.6 percent on a year earlier). The growth rebound in the third quarter reflected a pickup in personal consumption and non-residential investment, as well as a large and rising contribution from net exports, all adding up to more than outweigh a continued steep decline in housing.

Exhibit 7



However, despite the rebound in the third quarter, other events in the quarter were mostly adding to the risks of a renewed weakening in demand and activity in coming quarters. The sub-prime crisis is contributing to further decline in the already weak housing market, as borrowing restrictions increase and housing credit conditions tighten. Housing starts tumbled 10.2 percent in September, the biggest monthly fall in more than a decade, to stand 31 percent below year earlier levels, and almost 50 percent down from their peak in January 2006. The S&P Case/Shiller Composite 10 City Index of house prices has been falling since mid 2006 and was 4.5 percent below year earlier levels in July 2007. Durable goods and capital goods orders, which are a good proxy for business fixed investment, also took a sharp turn lower in August. Looking forward there are concerns that investment may be curtailed by the impact of the sub-prime crisis on high yield spreads, on the profits and balance sheets of banks and hence on new lending in the wider economy.

Labor market conditions are also gradually easing. In the six months through September monthly gains in non-farm employment have averaged around 110,000 jobs, down from gains of over 200,000 per month in late 2005 and early 2006 (although October surprised to the upside, with a gain of 166,000 jobs). The unemployment rate has been creeping up, from 4.4-4.5 percent in the early part of the year to 4.7 percent in September and October. Retail sales during the third quarter show that US consumers remained surprisingly resilient, with sales in September 2007 continuing to run 6 percent up on year earlier levels. However consumer sentiment has swung lower during the third quarter and consumer spending, the bedrock of the US economy, could weaken if the sharp rise in oil prices in October is sustained, and as home prices continue to fall, credit conditions in the housing market tighten and labor market conditions ease.

Consensus views for US economic growth have been reduced for both 2007 and 2008. We now project US growth of only 1.9 percent in 2007, with only a modest pick up to 2 percent in 2008, even factoring the impact of rising US net exports and a declining current account deficit. Risks to the forecast are mostly to the downside, given large uncertainties about the full extent of disruptions in credit markets that could result from the sub-prime crisis and the recent surge in oil prices.

The *Japanese economy* has been growing at around 2 percent since 2003, although often with volatile movements from one quarter to the next, with non-residential investment spending and net exports providing the largest contributions to growth. Strong investment has reflected the substantial restructuring undertaken by firms over the past decade and more, and the stronger profitability and balance sheets that have resulted. Consumer spending has however remained relatively weak. Consumer confidence fell sharply in the second and third quarters of 2007 as households remain concerned about the increasing use of part time workers and declining nominal wages. Slowing consumer spending growth was one factor behind

an unexpected 1.2 percent decline in GDP in the second quarter of 2007 (quarter on quarter, saar). Residential and non-residential investment also fell. Looking forward, growth is expected to moderate from 2 percent in 2007 to 1.8 percent in 2008, as export growth moderates in line with slower world growth and as consumer spending remains sluggish.

Europe has enjoyed a broad based acceleration in growth since the end of 2004, with year on year Euro Area growth exceeding 3 percent in late 2006 and early 2007. Growth slowed to 2 ½ percent in the second quarter, or only 1.4 percent on a quarter to quarter basis, mainly reflecting a falloff in investment. Looking forward, growth is expected to moderate from 2.5 percent in 2007 to 2.1 percent in 2008. Hitherto strong export growth should moderate with softening world demand and the impact of a strong euro exchange rate. European banks have also been more exposed via off-balance sheet investments to sub-prime problems, and the resulting losses and constraints on new lending could adversely affect housing and business investment.

3.2. China - growth expected to remain strong

Growth in China exceeded earlier expectations by a wide margin through most of 2007, running at 11.1, 11.9 and 11.5 percent in the first, second and third quarters respectively. Earlier expectation had been for a continuation of the trend seen in 2006, when growth decelerated modestly to around 10.5 percent in the second half of the year, mainly reflecting administrative tightening measures that helped slow nominal fixed asset investment growth from around 30 percent in the first half of 2006 to around 20 percent in the second half.¹² This pattern of moderating investment growth did not continue into 2007, however. Instead a new acceleration of investment growth (to around 27-28 percent in nominal FAI terms) has provided the main contribution for the rise in overall GDP growth so far in 2007. Despite the administrative tightening measures, the underlying incentives for investment remain strong. Profit margins have been rising while industrial profit growth remains at high levels, as does growth in credit. Interest rates have been raised several times, with one year nominal lending rates now at 7.3 percent, which however remains low relative to estimated rates of return on investment. This year's rapid growth is also supported by personal consumption (retail sales are growing at about 12 percent in real terms) and net exports, contributing 3-4 percentage points to overall growth.

Looking forward, China is projected to grow 11.3 percent in 2007 and to slow only modestly to 10.8 percent growth in 2008. Although there are some macroeconomic and financial trends that could pose a risk to this strong growth forecast and which need careful watching, none

¹² FAI is an imperfect measure of fixed investment and differs significantly from the national accounts measure. It is, however, available in a monthly data series.

appears serious enough at present to derail the current momentum of growth, or to cause the authorities to make major policy changes that would lead to a marked slowing in the near term. (These domestic trends and risks are discussed further in the paragraphs on China in the Country Sections later in the report).

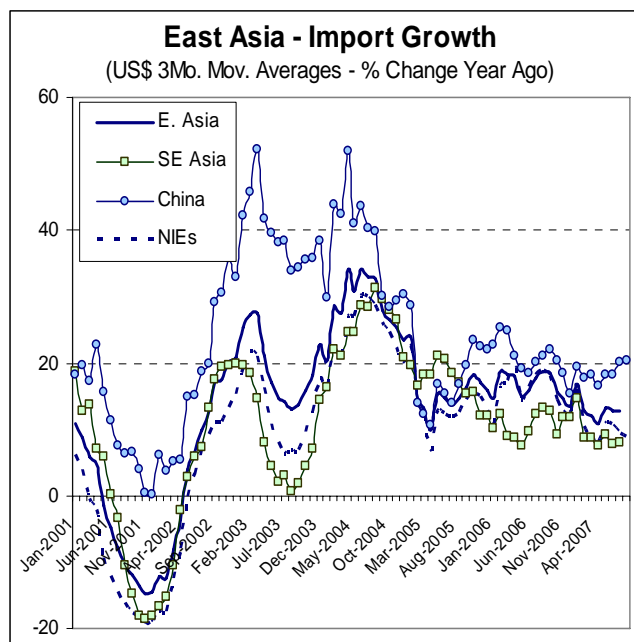
External conditions are no doubt a greater source of risk to the robust growth forecast for China in 2008 than are current domestic conditions. Nevertheless, as the earlier discussion of regional growth indicated, although US import growth has already slowed to near zero over the course of 2007, the impact on China's export growth has been relatively modest, in part as China has continued to gain market share in US imports and in as part as slower growth in exports to the US has been offset by continued or accelerating export growth to other markets, notably Europe, which is now a larger export market than the US for China. The current global forecasts assume only a modest further slowdown in the world economy. China's export growth is also expected to slow only moderately, dipping to around 18 percent in real terms from 23 percent in 2007. Indeed a moderate global slowdown could have some beneficial effects for China, helping to moderate aggregate demand growth, inflation risks and the rise in the trade surplus.

Clearly exports would be more seriously affected in the event of a US recession and a more severe slowdown in the world economy, although the impact on output growth may be more limited. During the 2001 recession, for example, world imports contracted 3.5 percent (in dollar terms), while China's export growth also slowed sharply to around 7 percent, from 28 percent the year before. But China's GDP growth was hardly affected, running at 8.3 percent in 2001 compared to 8.4 percent in 2000. China would likely be more significantly affected by a sharp export slowdown today because exports are now a bigger share of GDP than in 2001, although it is worth noting that exports in value-added terms are significantly lower than the gross numbers suggest, due to the importance of imported components. In addition, given China's strong macroeconomic position, domestic policies could also be eased to support domestic demand, should this be needed in the event of an export slowdown.

China's growing importance in the world economy and the likelihood that it could maintain relatively fast growth during a global slowdown has raised the question to what extent it could provide an independent locomotive for the world economy. China now comprises around 15 percent of world GDP in purchasing power parity terms and it made the largest single arithmetical contribution to global growth during the first half of 2007, measured at both market exchange rates and in purchasing power parity terms. For arithmetical reasons (if no other) this contribution would likely increase during a global slowdown, as growth in other parts of the world fell. However the locomotive effect of growth in China on stimulating export growth in the rest of the world may be more limited than suggested by

its recent contribution to world GDP growth. First, China's share of world imports is rather smaller than its share of world GDP, only 7 percent in 2006. Thus if China's imports continued growing at about 20 percent in nominal dollar terms, as they have been in the last two years, (Exhibit 8), they would contribute only about 1-2 percentage points to world nominal import growth. Second, China's economy is already growing at over 11 percent. It could not grow much faster than it is now and therefore could not offset a sharp slowdown in global demand elsewhere in the world.

Exhibit 8



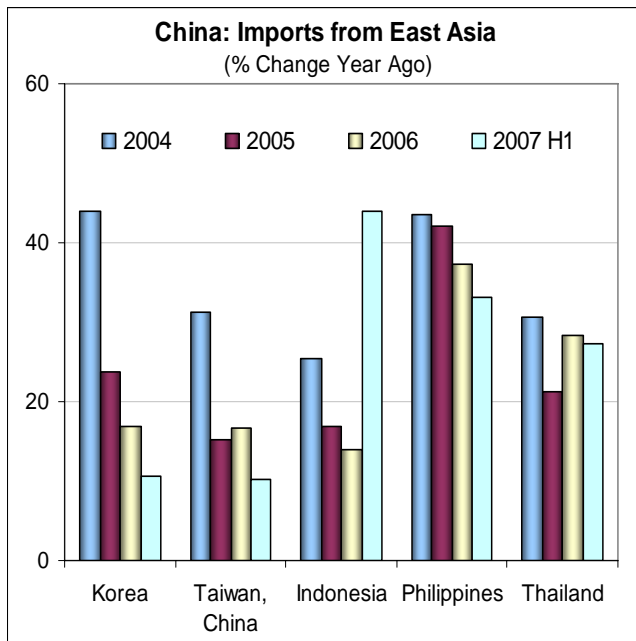
The impact of growth in China on sustaining exports from the rest of East Asia would undoubtedly be greater. In 2005 some 22.5 of exports from 7 other main East Asian economies went to China and Hong Kong, up from 13.3 percent in 1995. Nevertheless, as many researchers have observed, a large proportion – perhaps half – of other East Asian exports to China are various kinds of components for use as inputs in China's own exports.¹³ Thus a slowdown in China's exports to the rest of the world tends to be swiftly reflected in lower imports of inputs from the rest of East Asia, even though China's own domestic demand may continue growing rapidly. During the 2001 global high tech recession, for example, when China's exports to the US slowed, its imports from the rest of East Asia fell from 36 percent the year before to almost zero in 2001, despite GDP growth in China of over 10 percent.

But even this pattern of links between China's exports to the wider world and its imports from East Asia is subject to change. Observers have noted that China's increasingly sophisticated domestic production capacity is allowing it source more of its input needs from within

¹³ World Bank East Asia and Pacific Update, November 2005.

China. This has led to an increasing delinking of imports from exports in the last 2-3 years, a slowing in import growth to substantially less than the pace of export growth and a sharp rise in the trade surplus. Exhibit 9 shows that growth in China's imports from Korea and Taiwan (China) – among its more sophisticated suppliers - has slowed quite sharply. Cui and Syed (2007) provide a more systematic econometric demonstration of this effect. They find that the association of China's imports with its exports fell sharply in both size and statistical significance between 1994-99 and 2000-05, while the association with domestic demand increased just as dramatically.¹⁴ This trend represents both a threat and an opportunity for the rest of East Asia. The new challenge for the rest of East Asia will be in successfully making the transition from supplying inputs for China's exports - a process that was helped along by the international supply chains of multinational companies that have a foot in both China and the rest of East Asia – to also directly supplying the Chinese domestic market, something that might require significantly different research, production, branding and marketing skills and channels.

Exhibit 9



3.3 Oil and other Commodity markets

Oil markets

Crude oil prices have moved almost continuously higher over the course of 2007, from \$53.4 per barrel in January to \$81.4 in October, a monthly record in nominal terms, reaching nearly \$90 at the end of the month.¹⁵

¹⁴ Li Cui and Murtaza Syed: "The Shifting Structure of China's Trade and Production." IMF Working Paper WP/07/214. September 2007.

¹⁵ This reference price is an average of Brent, Dubai and West Texas Intermediate (WTI) crudes.

(Exhibit 10). In inflation adjusted terms the average oil price in October 2007 was about 21 percent lower than the record of \$102 per barrel (in 2006 US prices) set in the fourth quarter of 1979. (Exhibit 11).

Exhibit 10

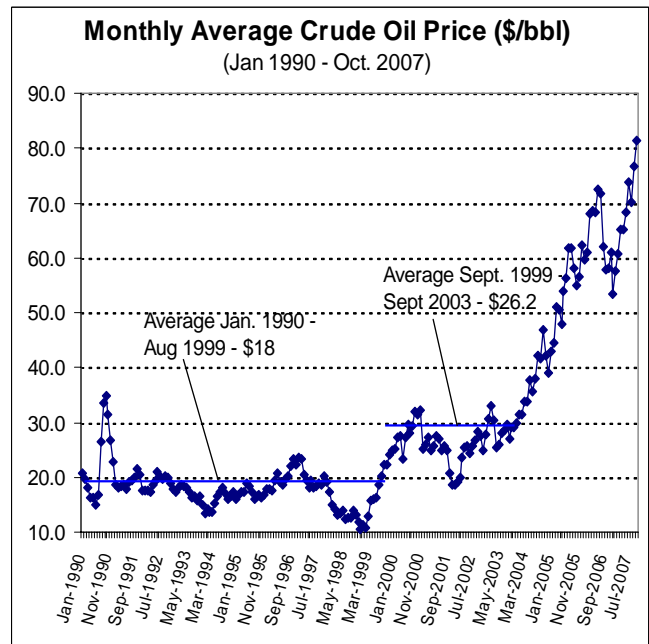
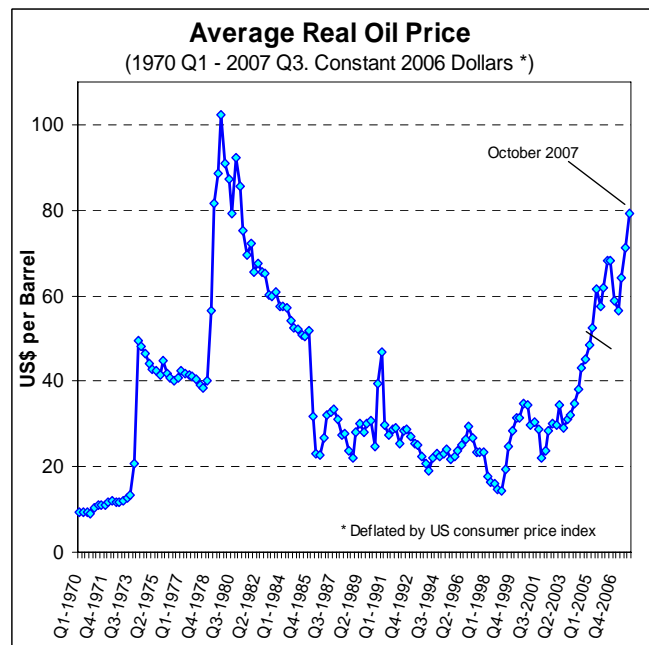


Exhibit 11



The tightness in the oil market is underpinned by both demand and supply factors. World demand is continuing to grow despite the 130 percent rise in crude oil prices between 2003 and the average of the first 10 months of 2007, primarily because of demand in developing economies. Although high prices have curbed consumption

in OECD countries – which fell 1.1 percent in 2006 and is forecast to be flat in 2007 – oil demand in developing economies is expected to rise 3 - 4 percent this year, with China increasing oil consumption by 4-5 percent.¹⁶ Based on the IEA's assumptions, world demand will have increased by 6.3 million barrels per day between 2003 and 2007, with China alone accounting for 32 percent of the increase and other developing (non OECD) economies accounting for another 57 percent.

While demand continues to grow, the supply response to higher prices has turned out to be more sluggish than previously expected due to rising input costs in oil production capacity development and uncertainties about political conditions and the investment climate in a range of developing economy oil producers. IEA estimates suggest that world oil production in the first three quarters of 2007 was running at about the same pace as in 2006. Production declines in OECD countries (mainly due to falling North Sea production) and in OPEC – where production (ex Angola) was down 1.8 mb/d in June compared to a year earlier – were only partly offset by higher production in non-OECD countries outside OPEC (mainly Russia and other economies of the former Soviet Union). With demand growth exceeding supply, crude oil stocks in OECD countries fell sharply in the third quarter (although remaining near the upper edge of their five year range). In addition to tightening fundamentals oil prices have also been boosted by strong speculative investment demand.

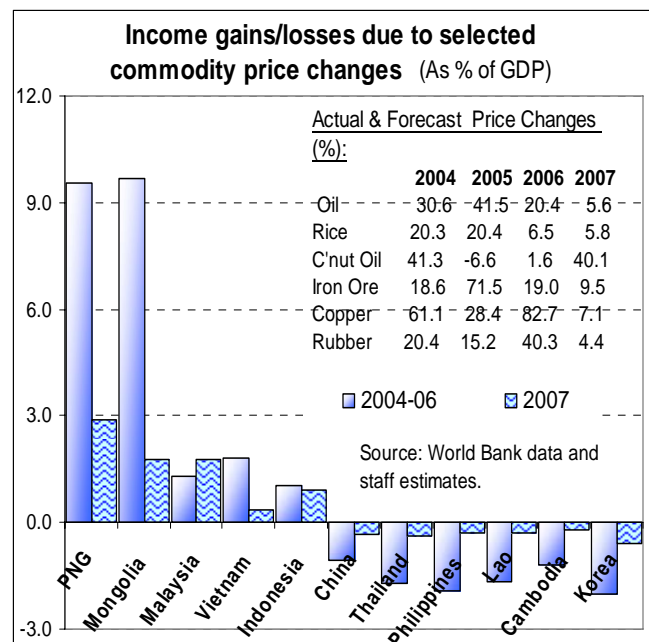
Looking forward, oil prices are likely to remain elevated and volatile over 2008-09, although perhaps not at the levels of the recent spike. Oil prices are currently forecast to average \$72 a barrel in 2008 and just under \$70 in 2009, rather less than the near \$90 per barrel reached at the end of October 2007. The fundamental factors that could support some easing from recent highs include the continued moderate slowing in OECD country growth (due to the housing recession in the US and the drawn out impacts of the sub-prime crisis and credit squeeze), as well as gradual moderation in China's growth towards its potential rate. Rising upstream investment in both OPEC and non-OPEC countries should result in new capacity that matches or exceeds demand growth, although, as the unexpectedly sluggish supply response of oil production in the recent past indicates, there are significant risks that unplanned project delays and cost overruns could lead to new disappointments.

Higher oil and non-oil primary commodity prices are estimated to have generated aggregate income losses in Emerging East Asia due to worse terms of trade of about 1 percent of regional GDP per year on average in 2004-06. Within the region net energy and non-energy primary commodity exporters such as Indonesia, Malaysia and Vietnam are estimated to have received windfall terms of trade gains of 1-2 percent of GDP per year in 2004-06,

rising to 9-10 percent of GDP in an economy like Papua New Guinea, which benefited not only from higher oil prices but also from surging copper and gold prices. (Exhibit 12). Mongolia too is estimated to have received net terms of trade gains worth 9-10 percent of GDP per year, with large gains in metal prices overriding its higher import bill for oil. On the other hand significant net oil importers like Korea, Lao PDR, Philippines and Thailand are estimated to have experienced terms of trade losses of 1.5-2 percent of GDP in 2004-06. China is estimated to have experienced more moderate income losses of about 1 percent of GDP per year.

The pattern of terms of trade losses and gains in 2007 is expected to be qualitatively similar to that of the last three years, although smaller in size. Terms of trade losses for the main net oil importers are generally expected to be less than 0.6 percent of GDP. The reason is that year average price changes for key commodities like oil and metals are likely to be rather smaller this year than in the previous years. Thus, while oil prices have risen sharply during the course of 2007, they had also fallen sharply in the latter part of 2006. Average oil prices in the first 10 months of 2007, for example, were only 4.5 percent up on 2006.

Exhibit 12



The renewed surge in oil prices in the latter part of 2007 has once more renewed concerns about negative impacts on global growth. However there is some comfort in the relatively limited impact on world growth that the more than doubling in oil prices over the last 3-4 years has had. One main reason for the muted impact appears to lie in the fact that oil prices in 2004-07 have been mostly pulled higher by strong world demand growth, particularly in developing countries, rather than pushed higher by a sharp reduction in supply. In this context higher oil prices are serving to ration available oil supplies to growing world demand (and to moderate growth to less than what it would

¹⁶ International Energy Agency. World Oil Market Report. October 11, 2007.

otherwise be), as well as provide a price stimulus for investment in new oil production capacity.

A second factor is that the rise in oil prices has been spread out over several years, avoiding sudden shocks to consumer and business confidence. Nordhaus (2007) calculates that the negative income effect of higher oil prices in the US has been about 0.7 percent of GDP per year in the recent period, which is only one third or less than the size of the annual income effects in the 1974-75 and 1979-80 oil shocks.¹⁷ As we showed above, the initial income effects of oil and non-oil commodity price changes for the Emerging East Asia region as a whole have averaged around 1 percent of GDP in 2004-06, during which period regional growth accelerated to 8 percent from around 6 percent in the preceding three years.

Recent research also suggests that the sensitivity of growth in developed countries to a given oil shock has fallen sharply in the last two decades. This is important for East Asia and other developing economies because it suggests that the indirect effects of an oil shock operating via reduced exports to developed countries are now smaller than in the past. Blanchard and Gali (2007) estimate that the impact on GDP growth in the US of a \$10 rise in the oil price fell from a decline of around 0.7 percent in the period before 1984 to around 0.3 percent in the period after it. They suggest a number of reasons for the reduced sensitivity of growth to oil shocks.¹⁸ First, a trend towards more flexible labor markets means that resources can be reshuffled to new uses more easily in the wake of an oil price shock, and the loss of output associated with stabilizing inflation is less than in the past. Second, the credibility of central banks in keeping inflation low has greatly increased over the last two decades. Global inflation expectations have remained well anchored in recent years, requiring less monetary tightening to keep inflation in check. Third, the oil and energy intensity of the world economy has fallen by over 30 percent in the last 25 years.

Energy intensity among major East Asian economies is clustered around 0.22-0.23 kilograms of oil equivalent per dollar of PPP GDP. (Table 7). This is roughly the same as in the US but about 20 percent higher than for developed economies as a group (and close to 50 percent higher than in Japan), meaning the region remains somewhat more vulnerable to oil and other energy price shocks. As regards trends over time, energy intensity for the region as a whole fell by close to 60 percent between 1980 and 2005. But nearly all of this dramatic improvement was due to China, where the transition from a planned economy to a market based economy has yielded enormous improvements in energy efficiency. Vietnam has also scored substantial gains during its market transition. However other East Asian economies that did not start out

burdened with an inefficient planned economic structure have seen energy intensity fall only modestly (Indonesia), remain flat (Korea) or even increase over the course of 1980-2005 (Malaysia, Philippines, Thailand). These trends in energy intensity are the result of many factors, including energy prices, taxes, regulations and other policies affecting energy use, per-capita income growth and evolving demands for more energy intensive products (household appliances, personal transportation, air-conditioning etc) and the rising share of the (relatively energy intensive) industrial sector in many economies.

Table 7. Energy Consumption

	Energy Intensity		Net Energy Exports	
	Kg per \$ of GDP (PPP) *	% Change	Mtoe **	As % of Energy Use
	2005	1980-05	2005	2005
China	0.219	-72.2	-100.1	-5.8
Indonesia	0.238	-11.7	83.5	46.5
Korea	0.225	-0.8	-176.2	-82.5
Malaysia	0.25	12	33.4	54.5
Philippines	0.118	10.5	-20.4	-45.6
Thailand	0.201	4.0	-46.6	-46.5
Vietnam	0.226	-38.5	17.6	34.3
East Asia	0.217	-57.3	-208.8	-8.8
Japan	0.152	-14.4	-439	-82.8
USA	0.212	-40.0	-734.9	-31.4
OECD	0.185	-28.7
World	0.208	-30.5

* Kilogram of oil equivalent per dollar of PPP GDP. ** Million tones of oil equivalent, Source IEA Energy Balances and World Bank.

The impact of rising consumer demands and industry shares means that task of achieving substantial improvements in East Asian energy efficiency going forward will not be a straightforward one. In China, for example, the big declines in energy intensity seem to have eased off around the year 2000. The economy wide energy intensity ratio has been relatively flat since then. A renewed focus on strengthening energy sector policies is therefore an important priority going forward for both economic and environmental reasons. Thailand took important steps in this direction when it removed fuel price ceilings in 2004, as did Indonesia when it sharply reduced fuel subsidies in 2005.

Table 8 shows that retail prices for premium or super gasoline in most East Asian economies are now 10-30 percent higher than in the US, or have at least substantially reduced the subsidy element that previously kept their prices well below those in the US. (The retail US gasoline price is a useful reference point for a largely market determined price, since it is not much affected by subsidies or taxes, beyond highway charges, which average about 10 cents per

¹⁷ William Nordhaus. (2007). *Who's afraid of a big bad oil shock?* September. Brookings Panel on Economic Activity.

¹⁸ Olivier Blanchard and Jordi Gali. (2007). *The Macroeconomic Impact of Oil Price Shocks: Why are the 2000s so different from the 1970s?* (August). NBER Working Paper 13368.

liter). Retail gasoline prices in China are state controlled, but adjusted on an ad hoc basis to reflect significant changes in market fundamentals. Prices were raised by 8 percent on November 1, after the surge in global oil prices led to higher costs and losses among domestic refiners, and to the emergence of shortages.

Table 8. Prices for Premium (“Super”) Gasoline

	2002	2004	2006	2007
	(US Cents / Liter)			
Cambodia	63	79	101	104
China	42	48	69	71
Indonesia	27	27	57	73
Korea	109	135	165	173
Lao PDR	36	54	86	104
Malaysia	35	37	53	57
Mongolia	38	61	88	86
Philippines	35	52	76	98
Thailand	36	54	70	91
USA	40	54	63	81
	As % of USA			
Cambodia	157.5	146.3	160.3	128.4
China	105.0	88.9	109.5	87.7
Indonesia	67.5	50.0	90.5	90.1
Korea	272.5	250.0	261.9	213.6
Lao PDR	90.0	100.0	136.5	128.4
Malaysia	87.5	68.5	84.1	70.4
Mongolia	95.0	113.0	139.7	106.2
Philippines	87.5	96.3	120.6	121.0
Thailand	90.0	100.0	111.1	112.3

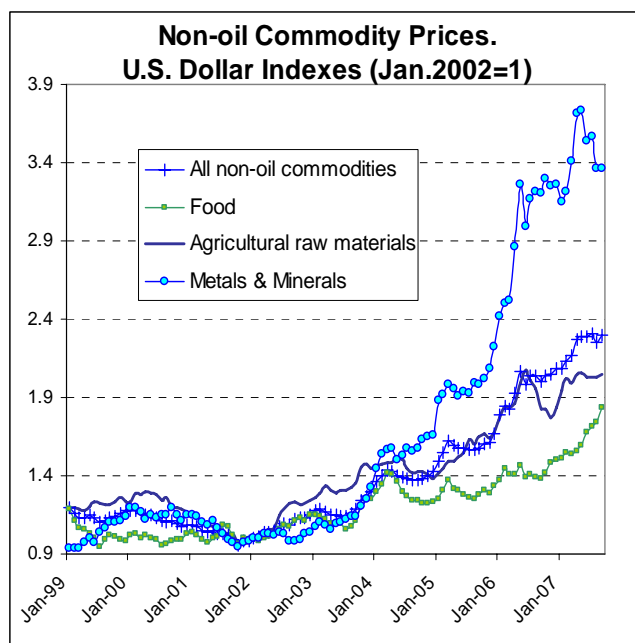
Source: GTZ “International Fuel Prices 2007” for November 2002, 2004, 2006. World Bank for October / November 2007.

Non oil commodity markets

Non-oil primary commodity prices continued to increase or remain at elevated levels in the first three quarters of 2007, although the pace of increase has moderated. The World Bank’s index of non-oil commodity prices in nominal US dollar terms increased 10 percent between the end of 2006 and September 2007, although there was much divergence in the performance of individual commodities. (Exhibit 13). While increases in metals and other industrial raw material prices had been at the forefront in earlier phases of the present commodity price boom, this year it is food prices that have made the running due to increased use of food crops for biofuels and weather related crop shortfalls. Edible oil and grains prices were up over 40 percent and 20 percent respectively in the first 9 months of the year. Metals prices have shown the largest gains over the period 2003-06 due to strong demand from China, underinvestment in earlier years and unexpected difficulties in bringing new capacity into production due to shortages of skilled workers and equipment. Metals prices have much more volatile this year, rising sharply in the first part of the

year and then giving up much of these gains after May. Metals prices are typically the most sensitive to the pace of global economic activity and credit conditions and are anticipated to peak in 2007 and decline by 6-7 percent in 2008 as global activity moderates and new supply capacity comes on stream.

Exhibit 13



The strength in metals prices has generated large windfall gains in small low-income mineral exporting economies such as Mongolia and Papua New Guinea over the course of 2004-06, and also to a smaller extent in 2007. Indonesia has also enjoyed smaller but still significant income gains from higher metals prices. The smaller heavily mineral dependent economies in the region in particular face the challenge of prudently managing the very large windfall terms of trade gains of recent years, especially as metals prices are expected to fall in 2008 and beyond. Agricultural exporters such as Malaysia, Indonesia and PNG are also enjoying significant income gains from higher prices for edible oils in 2007. Rubber prices are down from peak levels seen in 2006, but were still running at elevated levels of around 230 cents a kilogram in the third quarter of 2007, continuing to benefit exporters like Indonesia, Malaysia, Thailand and Vietnam. Estimates of overall primary commodity related income gains and losses in East Asia inclusive of oil prices were presented in the previous section.

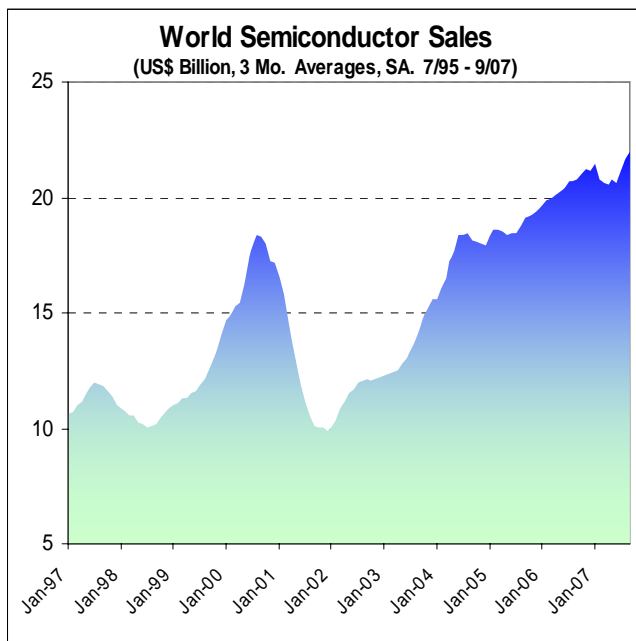
High tech

Global high tech markets – a key export sector for middle and high income East Asian economies – were lackluster in the first half of the year, but showed signs of a solid rebound in the third quarter. World semiconductor sales in the third quarter surged by 31 percent from the second (saar) after falling around 2 percent in the second

quarter. (Exhibit 14). The Semiconductor Industry Association noted that, in terms of end-products using semiconductors, demand for consumer electronic products remained robust. Demand for personal computers and cell phones, the two biggest drivers for semiconductors, remained very healthy. Orders for high tech goods in the G3 countries also picked up from a 9 percent decline in the first quarter to a 21 percent increase by July.

As the earlier discussion of exports indicates, the revival in global high tech demand has already been reflected in a rebound in high tech exports from East Asian economies. (Exhibit 5b above). Growth in high tech exports from 7 East Asian economies picked up to 21 percent (saar) in the three months through July, after having been virtually stagnant in the first quarter.

Exhibit 14



4.0 Domestic trends and policy challenges

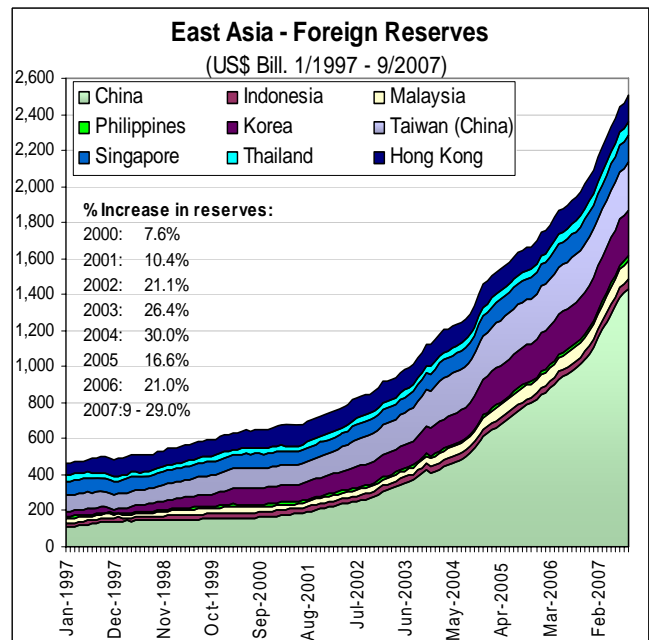
4.1 Balance of payments and financial markets

Emerging East Asia looks on the way to by far its largest ever increase in foreign exchange reserves (an overall balance of payments surplus) during 2007. Foreign reserves for the 9 largest economies increased by \$451 billion in the 9 months to September 2007, reaching \$2.5 trillion, compared to an increase of \$357 billion in all of 2006. (Exhibit 15). About four-fifths of the regional reserve increase was in China (\$365 billion in the first 9 months), but reserves were also rising at solid rates in most other economies.

The increase in regional reserves or overall balance of payments (BOP) surplus amounted to a 12.1 percent of regional GDP in the first half of 2007 – the period for which detailed balance of payments data are available - with BOP

inflows reaching an astonishing 19.2 percent of GDP in China. (See Appendix Tables 10a and 10b for details.) Overall inflows were not so large in most other economies, (although Malaysia came close with inflows worth over 18 percent of GDP), with most middle income economies in South East Asia seeing overall surpluses worth 4-5 percent of GDP. Overall inflows to the region have been running at over 5 percent of GDP since 2002. We look at the macroeconomic management challenges and potential risks posed by balance of inflows on this scale in the next section of this report, asking whether it amounts to “Too Much of a Good Thing?”

Exhibit 15



As in the last couple of years, the bulk of Emerging East Asia’s reserve accumulation in the first half of 2007 came from current account surpluses, which reached an aggregate \$322 billion (8.9 percent of GDP), almost as large as the regional current account surplus of \$356 billion in all of 2006. China’s current account surplus reached \$163 billion, or close to 12 percent of GDP. Current account surpluses on this scale are relatively recent in China, emerging only in 2005-06 as a result of large increases in domestic savings (especially in the business enterprise sector) outpacing exceptionally strong domestic investment. Growing technological sophistication has allowed firms to switch from imports to lower cost domestic sources for a growing range of industrial products, resulting in slower overall import growth (despite strong growth in domestic demand and a rising import bill for oil and other primary commodities).

Most of the other large economies in the region also continue to run significant current account surpluses - a median 5.7 percent of GDP in the first half of 2007 in the 8 main economies other than China. Most of these economies