Asia-Pacific
Economic Cooperation

2005 APEC Economic Outlook

APEC
Economic
Committee

Published by

APEC Secretariat, 35 Heng Mui Keng Terrace, Singapore 119616
Tel: (65) 6775 6012 Fax: (65) 6775 6013
Email: info@apec.org
Website: www.apec.org

ISSN 0218-9763
APEC#205-EC-01.1

TABLE OF CONTENTS

Paper Two: Terrorism and FDI Flows: Cross-Country Dynamic Panel Estimation

FIGURES AND TABLES

Chapter One

Chapter Two

Annex I

FOREWORD

The *APEC Economic Outlook* is submitted annually at the Ministerial Meeting. The first part of the publication is an update and summary of recent developments and prospects of the APEC region. The second part explores the host economy's topical structural issues of particular interest at the time the report is produced.

The *2005 APEC Economic Outlook* is the eleventh in this series. According to the report, the macro-economic development of the APEC region shows strong economic growth. Along with strong world-wide economic growth, the APEC economy continues its strong expansion after its peak of overall real GDP growth at 4.3 percent in 2004 (4.1 percent for the world). Consistent with global economic forecasts, overall APEC economic growth has moderated over the year but is expected to remain robust in the coming years. Based on the reports received from member economies, APEC is projected to continue its growth at 3.5 percent and 3.3 percent in 2005 and 2006, respectively. Growth is also underpinned by strong domestic demand and favourable external markets. Aggregate APEC exports and imports grew at 20.1 percent and 20.6 percent, respectively, in 2004 as high intra-APEC trade expanded. Despite the strong economic expansion in APEC, no significant improvements have been seen in the employment sector. In many Southeast Asian economies, the unemployment rate increased slightly or even deteriorated. Oil markets are also likely to remain tight. Despite economies' efforts to mitigate the impact of high oil prices and strong domestic demand (by reducing import prices through exchange rate adjustments), they may eventually harm growth. As for fiscal policies, APEC economies have shown mixed directions. Fiscal consolidation is underway in many economies in Southeast Asia, while some economies continue tax relief measures to support growth. In addition, Many APEC economies are undertaking structural reform initiatives in the areas of financial systems, fiscal reform, privatisation, capital market reform and more.

In the second chapter titled, "The Economic Impact of Terrorism and Counter-Terrorism in the APEC region," Canada set up a framework for thinking about the economic costs of terrorism, and applied that framework to 9/11 while the co-leader of the project Korea analysed the FDI flows and trade with regard to terrorism.

The Economic Committee Chair's Office leads the first part of the *Outlook*, analysing the economic performance and prospects of the APEC member economies, while Canada and Korea lead the structural chapter. As an integral part of the preparation for the *Outlook*, Canada and Korea hosted the 2005 APEC Economic Outlook Symposium. "The Economic Impacts of Terrorism and Counter Terrorism" was held at the East-West Center in Hawaii. It brought together views and inputs from academia, government, the business sector, and international organizations.

A very special thanks goes to Dr. Peter Thurlow and Dr. Hong Shik Lee for leading the structural chapter of the *2005 APEC Economic Outlook*. I would like to also thank Dr Hong Yul Han and his team for their distinguished analysis for chapter one of the same publication. And as always, I must not forget to mention Dr Sangkyom Kim, Ms Carmen Mak, and Ms Swan Park for their support and dedication in seeing this publication through.

Dr Kyung Tae Lee
Chair, APEC Economic Committee
Seoul, October 2005

CHAPTER ONE
ECONOMIC PERFORMANCE AND PROSPECTS IN THE APEC REGION

EXECUTIVE SUMMARY

The world economy has continued its strong expansion in 2005 although the pace slowed after its peak in 2004. Along with continued global economic growth at 4.1 percent in 2004, the aggregate real GDP growth of APEC economies was 4.3 percent in 2004. The APEC economies sustained a relatively balanced growth across APEC sub-regions. Major economies including the United States, China and most emerging Southeast Asian economies continued their brisk economic paces, thanks to both strong domestic demands and favorable external markets. Southeast Asian APEC economies grew fastest at 6.3 percent followed by Northeast Asian APEC economies in which overall growth registered at 4.5 percent. Western Hemisphere and Oceania APEC economies grew at 4.1 percent and 3.4 percent, respectively. The high fuel prices have boosted the Russian economy significantly. Consistent with global economic forecasts, overall APEC economic growth has moderated over the year but is expected to remain robust in coming years. Based on APEC member economies' reports, it is projected that APEC will continue to maintain strong growth at 3.5 percent and 3.3 percent in 2005 and 2006, respectively.

The broad expansion of APEC economies accelerated trade growth. Aggregate APEC exports and imports grew at 20.1 percent and 20.6 percent in 2004, respectively. High Intra-APEC trade continued though the Western Hemisphere APEC economies rely heavily on the US market while Asian economies increasingly rely on the Chinese market. Due to the strong regional economy, most sub-regions showed faster import growth than exports. The current account remains a major imbalance in APEC. The Western Hemisphere APEC sub-region recorded a current account deficit at -4.8 percent of aggregate GDP. In contrast, Northeast Asia and Southeast Asian recorded a surplus at 4.05 percent and 5.14 percent, respectively. Most trade deficits of the US originate from trade with the Asian part of APEC even though both regional economies have continued to lose market shares reciprocally since the 1990s. In 2005, both exports and imports are projected to slow, recording 11.8 percent and 14.7 percent, respectively.

In spite of the overall expansion of APEC economies, however, there are no clear signs of significant improvement on the employment front. In many fast-growing economies in Southeast Asia, unemployment rates only slightly improved or even deteriorated because more new workers were introduced into labor markets than the number of jobs created. In contrast, the United States; Hong Kong, China; and Australia experienced a sizable reduction of unemployment rates. Also, inflation was held down at modest levels in 2004. Exchange rate adjustments of most APEC currencies helped mitigate the impact of high oil prices and strong domestic demand by reducing import prices. Entering the latter half of 2005, however, high oil prices are being transmitted to domestic prices. As conditions in oil markets are likely to remain tight, there is an increasing likelihood of risking growth and employment because governments and business sectors have less room to respond.

APEC economies showed mixed directions in fiscal policies. Fiscal consolidation is underway in many economies in Southeast Asia, while some economies continue tax relief measures to support growth. Also, most APEC economies are moving from an accommodative monetary policy to a neutral one in order to keep their inflation within target rates. Many APEC economies are undertaking structural reform initiatives in the areas of financial systems, fiscal reform, privatization, capital market reform, and so on.

1. OVERVIEW

Continued Strong Economic Expansion

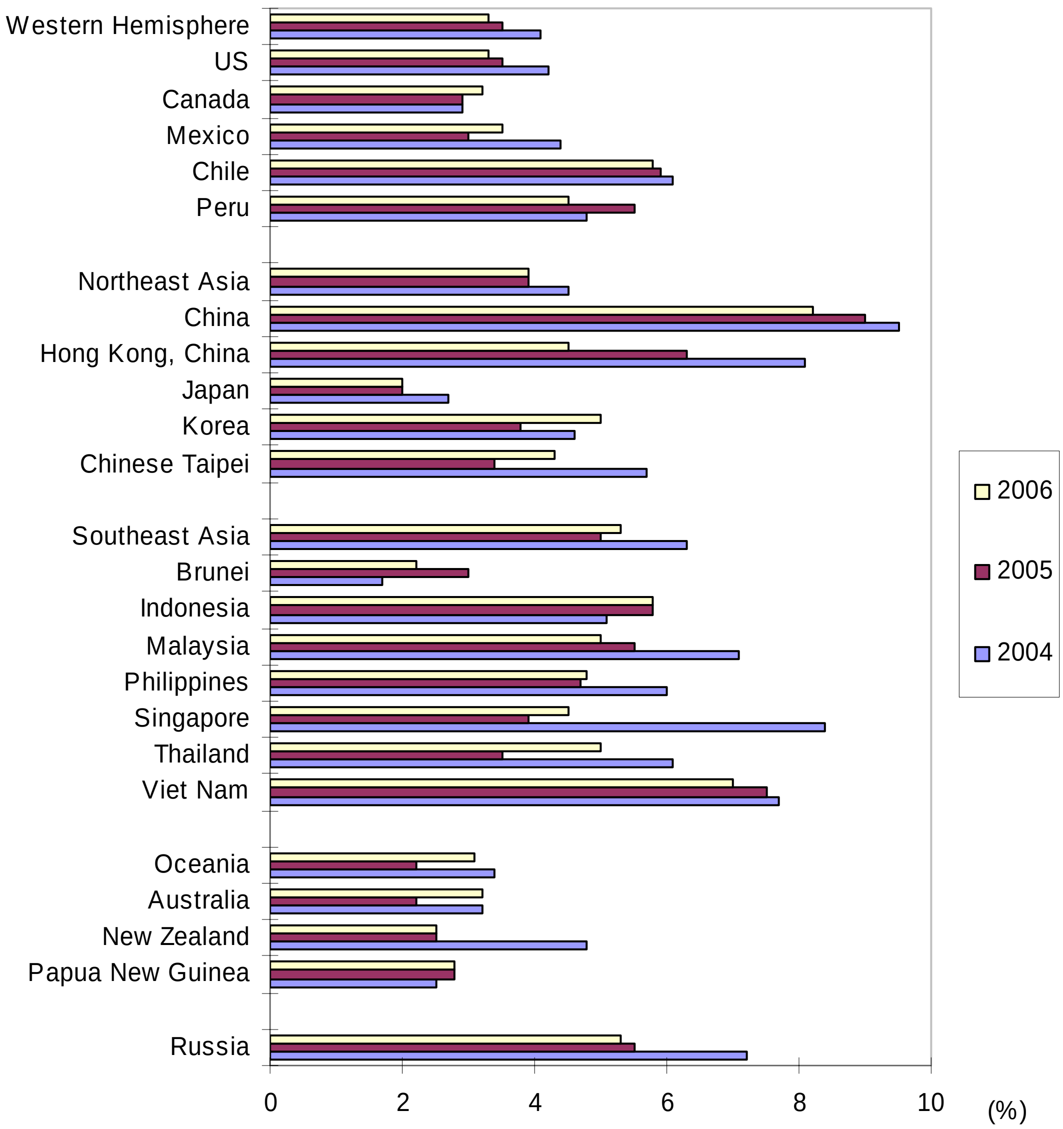
The world economy continues its strong expansion in 2005 although the pace has slowed after its peak in 2004. Along with the continued global economic growth at 4.1 percent in 2004, the APEC economies also maintained a strong expansion.[1] The aggregate real gross domestic product (GDP) growth of APEC economies was 4.3 percent in 2004. While the world economy still witnessed globally unbalanced expansion in 2004, the APEC economies sustained a relatively balanced growth across APEC sub-regions. Except for a few APEC economies, major economies including the United States, China and most emerging Southeast Asian economies continued to grow at their brisk economic paces. Southeast Asian APEC economies grew fastest at 6.25 percent, followed by Northeast Asian economies at 4.54 percent. Western Hemisphere economies' and Oceania economies' overall growth registered at 4.13 percent and 3.40 percent, respectively. Consistent with global economic forecasts, overall APEC economic growth has moderated over the year but is expected to remain robust in coming years. Based on APEC member economies' reports, it is projected that APEC will continue to maintain strong growth in 2005. Overall aggregate real GDP growth of APEC is projected at 3.5 percent in 2005. The medium-long term projection of APEC's annual growth is 3.6 percent over the period of 2006 to 2010.

Along with strong real GDP growth, APEC regional economies share several notable characteristics of the current world economic situation. First, we witness globally unbalanced growth. The global economic expansion has been mostly led by the US and Asian emerging economies. It is expected that these economies will remain robust in the near future while the euro area is still suffering from weak recovery. The growth imbalance in the APEC region is not as evident as in the global picture but some member economies still wait for the full recovery necessary for strengthening the growth dynamism in the region. Second, in spite of strong world economic growth and high oil prices, inflation has been held at a manageable level so far thanks to stabilized import prices via exchange rate adjustments as well as intensified international competition. However, entering the second half of 2005, the continued increase in oil prices started to translate into rising domestic prices. As most of the fast growing economies are oil importers, further oil price increases are likely to slow overall regional economic growth. Third, imbalances in the external balance persist. The regional structure of the external imbalance still remains, which increases pressures for policy coordination, including of exchange rate arrangements, among APEC economies.

---

[1] Global Insights, Second Quarter 2005. IMF's PPP based world economic growth in 2004 was 5.1 percent

Figure 1.1 Real GDP Growth (%)



S

Sources: Individual Economy Reports.
IMF, World Economic Outlook, September 2005
Global Insights, World Overview, Second Quarter 2005

Regional Composition of Economic Growth

Although overall APEC economies showed strong growth, individual economies performed somewhat differently. However, unlike the world economy which experienced globally unbalanced growth, APEC economies showed relatively more balanced growth. APEC economies are increasingly dependent on US and Chinese economic expansion. Also, the strong growth of emerging economies falls far short of reducing the income gap among regional economies.

The expansion of APEC economies was mostly underpinned by strong domestic demands and favorable external markets. The recent US expansion is supported by strong consumption with almost zero household savings as well as healthy business sectors, coupled with the effects of fiscal stimulation in previous years. Even though there exists some risk of housing market booms and a more consolidated fiscal policy is desired, the US economic expansion is expected to continue. On the other hand, the structural trade deficits continue to negatively contribute to the US growth. Also, the high oil price, if it persists further, is likely to drag on the US economy by discouraging private sector expenditure.

The Japanese economic recovery has been led by private demand without fiscal supports. The real GDP growth rate in FY2004 is 1.9 percent, of which private demand accounts for 1.8 percent. The recovery of the corporate sector is gradually spreading over to household sectors through the improvement in employment and income situations.

China, another APEC growth engine, expanded its economy above the official target with strong support from both domestic and external demand in spite of the Chinese government's effort to limit excess investments in some sectors. Double digit investment spending and continued foreign direct investment (FDI) inflows in service sectors as well as a low labor cost manufacturing sector have led the sustained rapid economic growth of China. Its exports and imports increased by more than a third in 2004. The recent revaluation of its currency seems to have had only limited effects.

The strong economic performance of Asian emerging markets in 2004 was also backed by a marked revival of business investment, particularly in Southeast Asian economies. The revival of business investment, combined with continuing or strengthening consumption demand in most of these economies translated into robust rates of growth. Many Asian economies adopted relatively flexible monetary policies and their fiscal positions are being improved as fiscal consolidation is underway. These policy directions are complemented by other structural reforms that will help maintain a solid foundation for further growth. Economic growth of other APEC economies remains modest although Russia's rapid growth benefited from high fuel prices.

In spite of an overall expansion of APEC economies, however, there are no clear signs of significant improvement on the employment front. In many fast growing economies like China, Russia, Singapore, Indonesia and Malaysia, unemployment rates only slightly improved or even deteriorated. For instance, the unemployment rates of China and Malaysia improved by only 0.1 percent in 2004 and those of Indonesia and the Philippines increased. Although these economies continued to create a number of new jobs, more new workers were introduced into labor markets. In contrast, the United States; Hong Kong, China; and Australia experienced a sizable reduction in their unemployment rates.

Accelerated Growth of Trade

The broad expansion of the world economy accelerated world trade growth. In 2004, the value of world trade grew fastest since 2000 at 21.0 percent continuing the strong recovery of 2003 at 17.0 percent (10.2 percent and 5.5 percent, respectively, on a volume basis)[2]. The overall trade growth of APEC economies matched the world trend; aggregate growth rates of exports and imports recorded 20.1 percent and 20.6 percent, respectively, in 2004. Among APEC sub-regions, Russia and the Asian emerging economies expanded their exports faster than others. In fact, the average growth rate of the Western Hemisphere region was lower than the world average. While US exports also expanded rapidly, the accelerated US economic growth induced even faster import growth in 2004. Also, China's exports and imports increased over one third. APEC economies intra-regional exports showed no clear pattern of changes. However, Russia's and Peru's export shares to APEC increased significantly.

Due to the strong regional economy, most sub-regions showed faster growth in imports than exports, which led to a deterioration of trade balances in APEC's Western Hemisphere sub-region. This implies a severe trade and current account imbalance in the region considering, in particular,

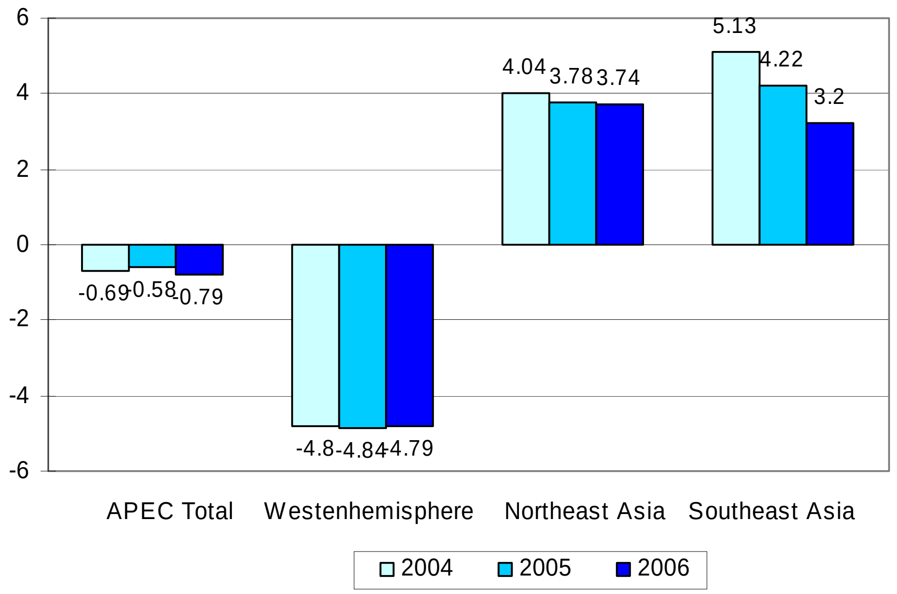
[2] WTO, WTO Trade Report (2005)

the sizable trade surpluses of Northeast Asian economies. In fact, most US trade deficits originate from trade with the Asian economies of APEC, even though both regional economies have continued to lose market shares reciprocally since 1990s. In 2005, both exports and imports are projected to slow, recording 11.8 percent and 14.7 percent, respectively.

Persistent External Imbalance

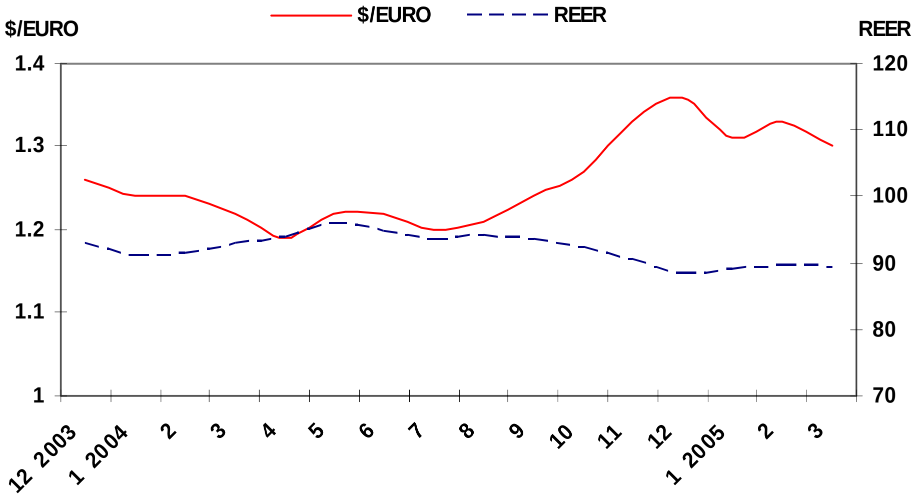
Though APEC's overall current account remains relatively balanced, there is a stark imbalance among APEC sub-regions. The aggregate ratio of current account to the aggregate APEC GDP recorded -0.69 percent. Due mainly to the unprecedentedly high US current account deficit of 5.7 percent of GDP, the same ratio for Western Hemisphere sub-regions of APEC marked -4.8 percent. Southeast Asia and Northeast Asia recorded +5.13 percent and +4.05 percent, respectively. Although Asia's current account surpluses are projected to diminish to below 4.0 percent in the next two years, the current account deficit of the Western Hemisphere sub-region will remain at the current level because of the persistent US deficit. The regional pattern of the current account balance is mostly attributable to continued strong domestic consumption and investment in the US, while domestic demand in Asian economies remained relatively weak—except in China. Even though many Asian emerging economies recorded fast growth of investment, the size of this growth is not sufficient to reduce the gap.

Figure 1.2 APEC Current Account



According to the members' reports, the regional imbalance of the current accounts is projected to persist, though the current account of Southeast Asian economies will shrink somewhat. The persistent current account imbalance could limit further global and regional growth and trade. Although the savings and investment gap is the source of current account deficits, the severe imbalance is likely to increase the pressure for exchange rate and interest rate adjustments as well as a change in the fiscal policy mix of regional economies. While the recent revaluation of the Chinese renminbi is welcomed, the overall exchange rate adjustment among member economies' currencies seems insufficient to correct the current account imbalance, in light of the experience in the 1980s when the US dollar appreciated substantially against major currencies. As economic growth of most emerging Asian economies is largely dependent on export growth, dollar appreciation against major Asian currencies is not going to happen easily. Also, fiscal consolidation on the part of the US is not part of its policy objectives and fast economic growth of APEC economies is not sufficient to increase US exports to reduce the current account gap.

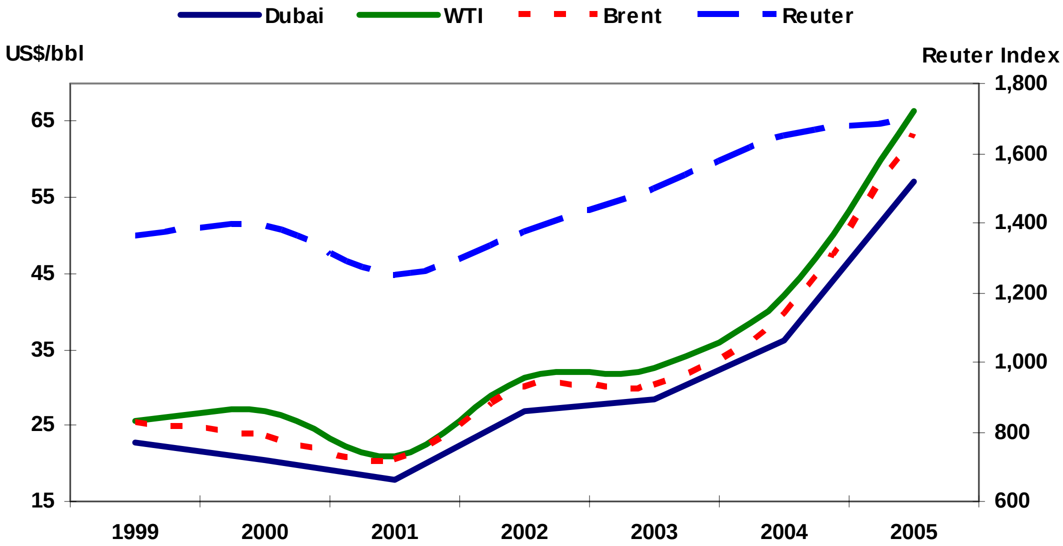
Figure 1.3 US Dollar Exchange Rate



Inflation subdued but likely to rebound with high oil prices

With few exceptions, inflation was held down at modest levels across the APEC region in 2004. Exchange rate adjustment of most currencies helped mitigate, though to a limited extend, the impact of high oil prices and strong domestic demand by reducing import prices. Most APEC economies' currencies, with few exceptions, gained in value against the US dollar until they stabilized at the beginning of 2005. At the same time, ever increasing international competition helped stabilize prices through lower import prices. Nearing the end of 2005, there is an increasing threat of higher inflation, due mainly to higher energy prices. However, the Individual Economy Reports (IERs) indicate that the monetary authorities of the APEC economies are responding to this trend by moving from accommodative monetary policies to neutral ones.

Figure 1.4 Oil and Commodity Prices



However, the recent movement of oil prices has started to affect domestic prices. If the oil price increases further, it is likely to have a significant impact on the world economy by increasing input costs and reducing consumption and investments, particularly in oil importing economies. It will aggravate the oil importers' trade balance and their currency values will decrease. As most APEC economies are net oil importers, the aggravated terms of trade may lead to lower national incomes. The oil market condition is likely to remain tight for the foreseeable future as demand continues to rise while oil supply remains inelastic in the short run. Government and business sectors seem to have insufficient room to respond to the high oil prices. As many economies, particularly the Asian emerging economies, are moving from an accommodative monetary policy and trying to cut budget deficits, it is not likely they will undertake further contractionary policies that would harm growth and employment. As far as firms are concerned, they face ever-increasing international competition so that the pass-through ratio of the oil price increase is high. The danger of high oil prices seems to be here to stay. APEC oil importing economies will have to be prepared with proper policy measures. Also, it is time that APEC economies seriously consider regional cooperation aimed at reducing the risks and uncertainties of oil markets.

2. RECENT ECONOMIC PERFORMANCE AND TRENDS

2.1 Broadening Economic Expansion

Western Hemisphere

In 2004, the Canadian economy grew by a solid 2.9 percent following a previous growth of 2.0 percent in 2003. Strong growth in final domestic demand offset weakness in export growth, particularly in the second and third quarters of 2004, as a result of the significant appreciation of the Canadian dollar against the US dollar. Strong final domestic demand growth reflects healthy job creation, high levels of income and consumer and business confidence and record levels of corporate profits. However, much of this demand continues to be channeled into imports, reflecting past appreciations of the Canadian dollar. Thanks to appropriate macroeconomic policies, final domestic demand growth has been robust—particularly consumer spending, residential investment and business investment. The recent strength of investment in machinery and equipment is a good indication that Canadian businesses are responding well to the challenge of the higher dollar. The stronger dollar also makes it easier for firms to invest in equipment that is priced in US dollars. Looking ahead, solid domestic fundamentals, low interest rates and high levels of consumer and business confidence are expected to support healthy Canadian economic growth.

The Chilean economy bounced back in 2004. It showed an economic growth of 6.1 percent, thanks to the favorable international environment and strong domestic demand. The export of goods and services expanded by 12.8 percent this year, due to the rise of 14.1 percent in the exports of goods and 8.0 percent in the export of services, which added 3.7 percentage points and 0.6 percentage points, respectively, to the growth rate of GDP. Exports from the mining sector displayed a noticeable growth due to the favorable performance of copper exports. Exports of industrial goods also displayed a sharp increase, highlighted by the export of a wide array of products, especially from the foodstuff; wood and furniture; paper and printed products; as well as metallic goods, machinery and equipment sectors.

The Peruvian economy grew by 5.1 percent in 2004, achieving 42 months of consecutive growth. This performance was mainly associated with sound macroeconomic and growth-promoting policies as well as to a positive international environment. Domestic demand grew by 3.9 percent this year, explained mainly by the expansion of private investment (9.4 percent). This was associated with mining and gas projects as well as with the increase in the construction sector. Private consumption expanded 3.3 percent in a context of a greater increase in family incomes (5.7 percent) and a larger number of consumer credits granted by financial institutions. On the other hand, exports of goods and services recorded a 15.2 percent growth, reflecting the important expansion of mining, agricultural, fishing and textile exports. GDP growth was driven by the expansion of non-primary activities such as non-primary manufacturing (7.2 percent), construction (4.7 percent) and other services (6.0 percent). Primary activities grew by 2.8 percent led by the dynamism of metallic mining (5.2 percent) and fishing (28.3 percent).

The US economy continued its strong growth in 2004. The real GDP growth recorded 4.4 percent, supported by gains in consumer spending, business fixed investment, and, to a lesser extent, housing investment, inventory accumulation, and government spending. The rise in crude oil prices reduced growth somewhat during 2005. It is expected that real GDP will grow 3.5 percent during the four quarters of 2005, driven by continued gains in consumer spending, investment growth (although slower than in 2004), and stronger net exports.

Northeast Asia

China kept its rapid pace of economic growth in 2004. The real GDP growth in 2004 was 9.5 percent. It was supported by strong demand in private sectors. The investment in fixed assets of the economy was up 25.8 percent over the previous year, or 1.9 percentage points lower as compared with the growth in 2003. Retail sales of consumer goods increased by 13.3 percent. Total trade volume increased by 35.7 percent and totaled US$1.15 trillion which moved China up to third place.

It is remarkable that the economy of Hong Kong, China, entered into a full-fledged upturn in 2004, following the swift rebound in the second half of 2003 after the waning of the negative impacts due to the Severe Acute Respiratory Syndrome (SARS). This once again demonstrated the resilience and strength of the economy of Hong Kong, China. For 2004 as a whole, the gross domestic product (GDP) grew by a remarkable 8.2 percent in real terms, distinctly faster than the 3.1 percent growth in 2003. The economy continued to expand at a brisk pace in the first half of 2005, with GDP growing by 6.2 percent in the first quarter and 6.8 percent in the second quarter. The growth continued to be broad-based, underpinned by strong growth in merchandise exports and exports of services, a pick-up in investment demand as well as steady growth in consumer demand.

The Japanese economy is emerging from prolonged stagnation after the burst of the bubble economy and realizing private demand-led economic growth. Japan was in an economic environment of negative growth with large amounts of non-performing loans (NPLs) when the "Intensive Adjustment Period" (FY2002-FY2004) began. However, under the progress of structural reform, the target of halving major banks' NPL ratio has been achieved. In the corporate sector, there has been progress in overcoming the problem of excess employment, excess capital stock and excess liabilities. As a result, the corporate structure has been strengthened and corporate profits have been improving. The recovery of the corporate sector is gradually spreading to household sectors through improvements in the employment and income situations. The Japanese economic recovery has been led by private demand without fiscal supports. The real GDP growth rate in FY2004 is 1.9 percent of which private demand accounts for 1.8 percent. The government projected the real GDP growth rate for FY2005 to be about 1.6 percent (with the nominal GDP growth rate about 1.3 percent) in the "Economic Outlook for FY2005 and Basic Economic and Fiscal Management Measures" (the "Outlook") decided by the Cabinet in January 2005. In August, the Cabinet Office made a forecast of the economy based on the recent developments, "A Forecast of Economic Situation for FY2005 (estimated by Cabinet Office)" (the "Forecast"). In the Forecast, the Cabinet Office forecast the real GDP growth rate to be about 1.6 percent (with the nominal GDP growth rate about 1.0 percent). According to the Forecast, by virtue of the spillover of good corporate sector performances to the household sector, the Japanese economy will continue to follow a growth path of recovery mainly led by private demand. On the other hand, the possible ramifications of oil price fluctuations on the domestic and overseas economy require attention.

Korea showed a moderate economic growth in 2004 at 4.6 percent. Exports and investments in fixed assets contributed to the growth. However, due to sluggish domestic demand of durable goods and overall services, private consumption recorded a fall of 0.5 percent. In 2005, the annual rate of growth is estimated as 4.9 percent, which is close to the potential growth rate of Korea. For the second half of this year, given favorable domestic economic conditions with an impressive increase in private consumption stemming from the progress made in household debt adjustment, the Korean economy shows signs of gradual recovery at a mere 5 percent potential growth rate .

Table 2.1 Real GDP Growth (percent)

	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	5.5	5.2	1.8	3.4	2.0	2.8
Chile	-0.8	4.5	3.4	2.2	3.3	6.1
Mexico	3.8	6.6	0.0	0.8	1.4	4.4
Peru	0.9	2.8	0.3	4.9	3.8	5.1
The United States	4.5	3.7	0.8	1.9	3.0	4.4
Northeast Asia						
China	7.1	8.0	7.3	8.0	9.1	9.5
Hong Kong, China	4.0	10.0	0.6	1.8	3.1	8.2
Japan	-0.1	2.4	0.2	-0.3	1.4	2.7
Korea	9.4	5.5	2.8	7.0	1.9	3.8
Chinese Taipei	5.4	5.9	-2.2	3.9	3.3	5.7
Southeast Asia						
Brunei Darussalam	2.6	2.8	3.0	3.2	3.6	1.1
Indonesia	0.8	4.9	3.8	4.3	4.5	5.1
Malaysia	6.1	8.3	0.3	4.1	5.3	7.1
The Philippines	3.4	4.4	3.0	4.3	4.7	6.1
Singapore	6.8	9.6	-2.0	3.2	1.4	8.4
Thailand	4.4	4.6	1.9	5.3	6.7	6.0
Viet Nam	4.8	6.8	6.8	7.0	7.2	7.7
Oceania						
Australia	4.5	3.3	2.7	3.6	3.3	3.2
New Zealand	4.0	3.9	2.5	4.3	3.5	4.8
Papua New Guinea	7.6	-0.8	-3.4	-0.5	2.5	2.5
Russia	6.4	10.0	5.0	4.3	7.3	7.1
APEC	**3.6**	**4.0**	**0.7**	**2.4**	**3.5**	**4.3**
WORLD	3.1	4.0	1.4	1.7	2.7	4.2
WORLD*	3.7	4.7	2.4	3.0	4.0	5.1

Note: The APEC-wide and sub-regional averages were calculated using the previous year's nominal GDP, valued at market exchange rates, as weights.

* Using the previous year's GDP valued at purchasing power parity (PPP) exchange rates as weights.

Sources: Individual Economy Reports.
IMF, *International Financial Statistics*, July 2005
IMF, *World Economic Outlook*, September 2005
Global Insights, World Overview, Second Quarter 2005

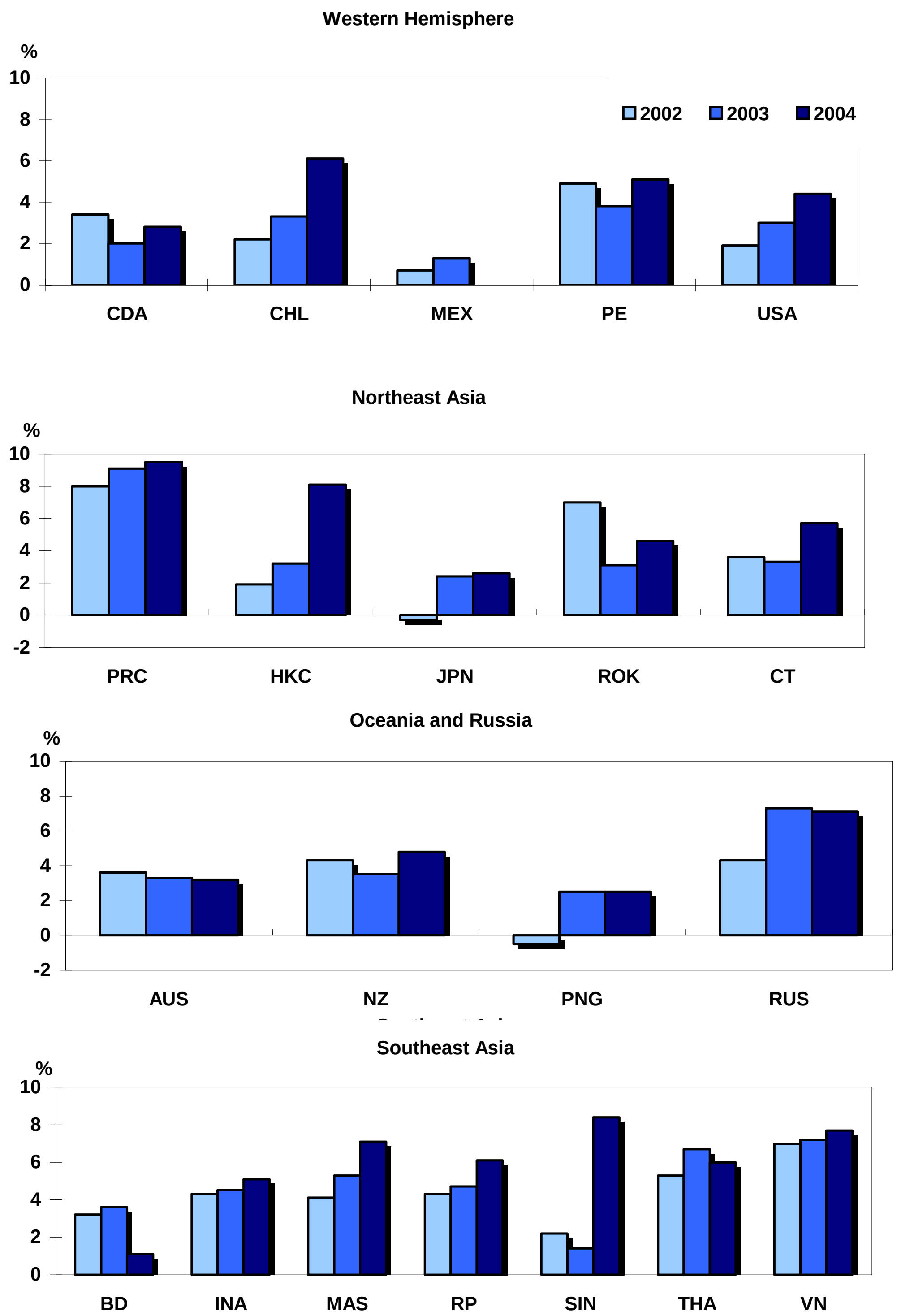
The Chinese Taipei economy improved significantly during 2004. The economic growth was recorded at 5.7 percent, which was 2.4 percentage points higher than its 2003 growth. The high growth is mostly attributable to strong domestic demand as well as a pick-up in exports. Private consumption and private investment grew 3.13 percent and 28.2 percent, respectively, contributing 1.91 and 3.07 percentage points, respectively, to overall growth. Net exports and imports translated into a 0.02 percentage-point contribution to the overall growth. In contrast, government spending cuts negatively contributed to economic growth. Government consumption and investment shrank by 0.69 percent and 4.22 percent, respectively, contributing -0.09 and -0.16 percentage points to the overall growth.

Southeast Asia

Most of the Southeast Asian economies performed well in 2004. Indonesian economic growth strengthened in 2004 recording 5.1 percent up from the previous year's 4.5 percent growth. The growth had taken place across a wider spectrum of economic sectors, supported by investment and export pick up. The year 2005 has also witnessed continued expansion as indicated in the first quarter when real GDP was projected to grow in the range 5 to 5.5 percent year-on-year (y-o-y), mainly driven by significant growth in investment, exports and consumption. These positive developments are expected to continue and the Indonesian economy is forecast to reach 5.0 to 6.0 percent growth.

The Malaysian economy expanded by 7.1 percent in 2004, the fastest rate of expansion since 2000. The private sector continued to be the principal driving force of the economic expansion supported by low and stable inflation as well as improved labor market conditions. Aggregate domestic demand grew at 7.3 percent contributing 6.2 percent to the overall economic growth. Both private consumption and investment expanded strongly by 10.1 percent (2003: 6.6 percent) and 15.8 percent (2003: 0.4 percent) respectively due to sustained increase in disposable incomes, stable labor market conditions, low inflation and interest rate environment as well as improved consumer confidence. In contrast, the pace of public expenditure slowed with the on-going fiscal consolidation of the federal government. The growth of public consumption decreased to 6.6 percent in 2004 from 10.0 percent in 2003. Also, total government investment expenditure increased moderately by 3.1 percent due to the softening in infrastructure projects.

Figure 2.1 Real GDP Growth of APEC Economies



The economy of the Philippines posted 6.0 percent of overall growth in 2004 from 4.5 percent in 2003. The performance was stronger than expected and was supported by both domestic demand and exports. Gross domestic investments continued to recover, accelerating growth from 0.1 percent in 2003 to 12.7 percent in 2004. Personal consumption expenditure (PCE) grew by 5.8 percent in 2004, a slight increase from 5.3 percent the year before, due to increased rural incomes, election-related spending and remittances from OFW (Overseas Filipino Workers). Particularly, total real exports growth recorded 14 percent from the 4.4 percent growth in 2003. On the other hand, government consumption expenditure (GCE) contracted by 0.8 percent from 0.5 percent growth during the previous year due to the continued implementation of austerity measures to control the budget deficit.

The economy of Singapore rebounded significantly recording 8.4 percent growth in 2004 from its mere 1.4 percent gain in 2003. This was led by a turnaround in the growth of domestic demand as well as a continued expansion of external demand. While all major sectors improved compared to 2003, the manufacturing, and wholesale and retail sectors were the best performing sectors with growth of 13.9 percent and 14.6 percent, respectively, a marked improvement over the 2.7 percent and 6.7 percent, respectively, registered in 2003.

The economy of Thailand continued its strong economic growth of 6.0 percent. In 2005, the economic growth will be driven mainly by an expansion in domestic demand. Real GDP is forecasted to grow by 6.0 percent year on year. The growth is supported by (1) investment from the private and public sectors, especially in mega-projects with a value of 340 billion baht, to construct infrastructure such as a mass transit system, water grid, and new government office center; (2) the supplemental budget of 50 billion baht; (3) high rate of capacity utilization which will fuel private investment to push economic growth; and (4) a hike in private credit expansion within a low interest rate environment to facilitate an increase in private consumption and investment. Particularly, investment in machinery and equipment is anticipated to pick up strongly for replacement and new investment in manufacturing sectors. In 2005, private consumption and investment are expected to grow by 5.1 and 16.3 percent, respectively, year-on-year. Meanwhile, expenditure from the public sector is forecast to accelerate by 6.9 percent in public consumption and 24.0 percent in public investment.

Viet Nam’s economy grew at 7.7 percent in 2004 and is forecast to increase dramatically in 2005. The GDP growth rate is forecast to gain 8 to 8.5 percent, in which the agricultural, forestry and fishery sector increases by 4.0 percent, industry and the construction and service sectors increase by 11.0 percent and 8.0 percent, respectively. The GDP share of primary products decreased from 21.7 percent in 2004 to 19.0 percent in 2005 while that of industrial and construction sectors increased from 40.1 percent to 42.0 percent. Service sectors gained in its share from 38.2 percent to 39.0 percent.

Oceania and Russia

Australia’s real GDP increased by 3.0 percent in 2004 (year-average terms), slightly below the growth rate recorded in 2003. Household consumption grew by a very strong 5.5 percent in 2004 reflecting low unemployment, solid wages growth and high household wealth as a result of past rises in house prices. Strong growth in house prices also supported high levels of dwelling investment over most of 2004. However, house price growth and dwelling investment both moderated towards the end of the year. Business investment increased by 10.2 percent in 2004, building on the very strong growth experienced in each of the two previous years. Public final demand grew by 4.2 percent in 2004 following growth of 3.8 percent in 2003. Net exports subtracted 2.1 percentage points from growth in 2004. This reflected sustained strong growth in imports and only modest growth in exports, partly due to the effects of the exchange rate appreciation and a lagged supply response to increased demand for non-rural commodities.

The economy of New Zealand peaked at 4.8 percent in 2004. The 2005 Budget Economic Update forecasts the rate of growth in the New Zealand economy to slow in the next two years as a number of influences begin to weigh against growth. Amongst them are higher exchange and interest rates, the continuing slowdown in net migration inflows, slower trading partner growth in 2005 and a forecast decline in the terms of trade. It is expected that the economy will slow to 2.3 percent in the March 2006 and 2.5 percent in March 2007, but will then pick up to 3.5 percent in the following year and 3.0 percent in the year up to March 2009.

In 2004, Russia's GDP increased by 7.1 percent y-o-y (7.3 percent in 2003). Industrial output expanded by 7.3 percent in 2004 versus 7.0 percent in 2003 and the freight transport turnover of transport companies rose by 6.2 percent y-o-y compared with 7.7 percent in 2003, accordingly. Virtually all types of transport registered growth in their freight turnovers: railways by 8.0 percent, automobile transport by 5.2 percent, pipeline transport by 6.2 percent and air transport by 9.4 percent. Among other branches of Russia's economy the communication sector expanded by an impressive 27.3 percent in 2004 (27.8 percent in 2003). Retail turnover rose in 2004 by 12.1 percent as against 8.4 percent in 2003, while the growth of real disposable incomes and real wages was 8.2 percent and 14.9 percent, respectively. This means Russian consumers, mostly from the top and middle income brackets, preferred spending money on buying goods instead of saving it. The volume of services rendered to natural entities went up by 7.0 percent in 2004 compared to 6.7 percent in 2003.

2.2 Stable Prices So Far

Western Hemisphere

Canadian core inflation was held down and remained relatively stable, fluctuating in a range between 1.6 and 1.9 percent since the beginning of the year. However the consumer price index (CPI) showed some volatility due mainly to fluctuations in gasoline prices. The 12-month rate of increase in the consumer price index rose to 2.4 percent in April then fell to 1.6 percent in May. In contrast, according to the July 2005 Monetary Policy Report Update, economic growth is projected to continue to operate near its production capacity, with some reduction of monetary stimulus required in the near term.

Chilean price increases in 2003 were lower than expected, due to the impact of supply factors, such as the peso appreciation and less compressed margins in specific sectors, reflecting greater competition and/or efficiency gains in the production and distribution chains of non-perishable goods and fuels. In December 2004, the annual consumer price inflation was 2.4 percent.

The CPI of Peru recorded 3.5 percent in 2004, meeting the target set by the Central Bank (2.5 percent +/- 1 percentage point) for a third consecutive year. Core inflation, an indicator of the actual trend of prices in the economy by excluding high volatility price items, was 2.63 percent in 2004. The non-core inflation recorded a relatively high rate of 5.2 percent due to temporary supply shocks that affected goods like fuel, public utilities and transport.

Most US measures of inflation increased during 2004 following very low inflation during 2003. The CPI increased 3.3 percent in 2004, well above the 1.9 percent rise during the previous year. Excluding the volatile food and energy components, core consumer prices increased 2.2 percent during 2004, up from 1.1 percent during 2003. About 0.4 of a percentage point of the year-to-year acceleration in the core CPI is accounted for by used car prices, which dropped sharply in 2003 before rebounding in 2004. Consumer energy prices increased 17.0 percent in 2004—with particularly large (27.0 percent) increases in petroleum-based energy prices. Food prices increased 2.7 percent during 2004, down slightly from their 3.6 percent rise in 2003. Last year's inflation appears likely to have been a temporary phenomenon rather than the beginning of a sustained increase. Inflation, as measured by the CPI, is expected to stabilize at a 2.4 percent annual rate in future years, up only slightly from the 2.2 percent increase in the core CPI during 2004.

Northeast Asia

The Chinese CPI went up by 3.9 percent over the previous year. The CPI for service sectors and merchandise retail prices increased 2.3 percent and 2.8 percent, respectively. Producers' prices increased significantly and for manufactured goods showed a 6.1 percent increase. The purchasing prices for raw materials, fuels and power went up by 11.4 percent. The prices for investment in fixed assets were up 5.6 percent. Producer prices of farm products increased by 13.1 percent.

The economy of Hong Kong, China, came out of its 68-month long deflation in mid-2004. The decline in the composite CPI narrowed to 0.4 percent in 2004 from 2.6 percent in 2003. Consumer price inflation has been gradually edging up in 2005, alongside the increasingly entrenched economic recovery, and as the drag effect of the earlier fall-offs in private housing rentals gradually waned. For the first seven months of 2005 as a whole, consumer price inflation was still very moderate, averaging at only 0.7 percent. The near-term inflation outlook is for a further climb-up in the coming months, as local business costs are expected to rise in the course of an increasingly entrenched recovery, and as high oil prices and the recent 2.0 percent renminbi revaluation feed through to lift import prices. Still, on the whole, local price pressures are expected to be well contained through the end of 2005. For 2005 as a whole, the forecast rate of change in the composite CPI is at 1.5 percent.

The Japanese economy is in a mild deflationary phase. The domestic corporate goods prices index (CGPI) has been rising due to increased raw material prices. The CPI has been on a slight declining trend year-on-year. The Japanese government projected in its Outlook that the percentage changes for FY2005 over the previous fiscal year of CGPI and CPI would be about 0.4 percent and 0.1 percent, respectively. According to the Forecast, the CGPI and CPI are estimated to be about 1.3 percent and 0.1 percent, respectively.

Korea's CPI rose by an annual average of 3.6 percent. In addition, core inflation increased by an annual average of 2.9 percent hovering around the Bank of Korea's target rate of 3.0 percent. Due to the rise in international oil prices and raw materials, and plummeting costs of agricultural, livestock and fishery products resulting from intense heat and 'mad-cow' disease, there was much room for a price hike in light of costs. From a demand-side perspective, due to the torpid domestic demand the room for a price increase is limited. In addition, the revaluation of the foreign exchange rate and stable public rate management by the government helped stabilize prices. The CPI growth rate increased 3.1 percent, stabilizing a little above the 3.0 percent forecast by the government, while during the first half of 2005 core inflation rose to 2.8 percent. Even though there were difficulties in controlling prices due to mounting pressure for cost increases following soaring oil prices, the revaluation of the foreign exchange rate and the stable price of agricultural products (helped by the mild weather since April/May) have helped the CPI maintain its stable trend. In the second half of 2005, stable consumer prices are expected to persist and maintain a low 3.0 percent average rate.

Chinese Taipei's CPI showed a slight increase while the Wholesale Price Index (WPI) soared in 2004. The CPI's modest increase of 1.6 percent resulted from intensifying competition in the domestic market, damage wreaked by typhoons and other extreme weather conditions on fruit and vegetable production, and the falling prices of residential rents. The core CPI, excluding fresh food and energy prices, increased by only 0.7 percent. However, the WPI rose by 7.0 percent owing to the rising international prices of oil, raw materials, and steel products.

Southeast Asia

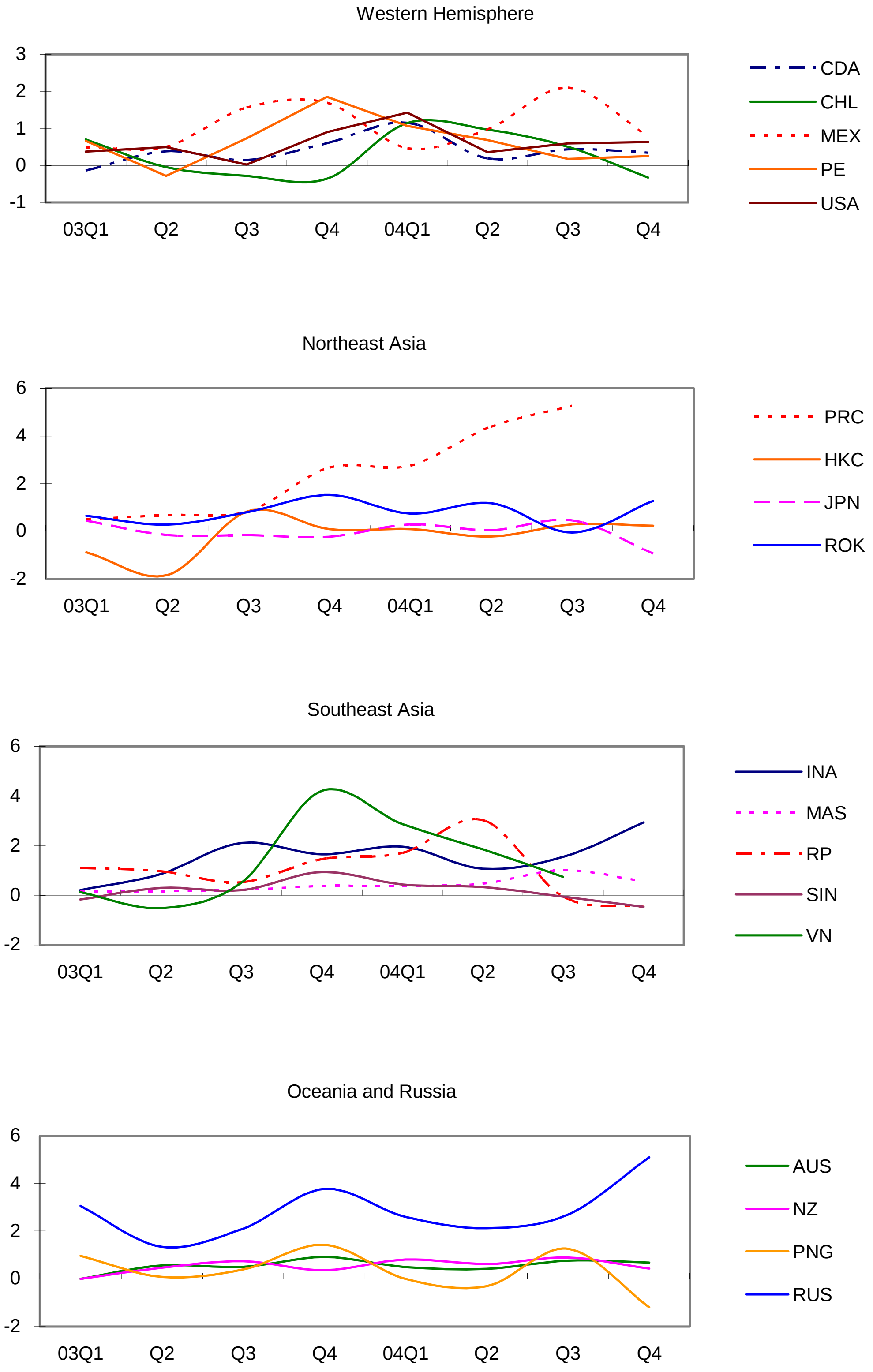
Indonesia's inflation was recorded at 6.4 percent in 2004, up from 5.1 percent in 2003 but still remaining within the target rate of 5.5 ±1 percent, thanks to well-controlled base money and stable exchange rate of the rupiah. The main contributors to inflation in 2004 were prices for housing, followed by food, transportation and communication. In the first quarter of 2005, inflation rose to 8.81 percent (y-o-y), which is attributable to the actual increase in fuel prices and earlier higher inflation expectations stemming from the government's plan to increase fuel price and the depreciating trend of the rupiah exchange rate. It is however within the target rate for 2005 of 8.0 ±1.0 percent. Also, CPI is forecasted to be slightly higher than in 2004 following expectations of further inflation and a hike in domestic demand as actual output of industry has almost reached its full capacity.

Table 2.2 Consumer Price Inflation (percent)

	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	1.7	2.7	2.5	2.3	2.7	1.8
Chile	3.3	3.8	3.6	2.5	2.8	2.4
Mexico	12.3	9.0	4.4	5.7	4.0	5.2
Peru*	3.7	3.7	-0.1	1.5	2.5	3.5
The United States	2.2	3.4	2.8	1.6	2.3	3.3
Northeast Asia						
China	-1.4	0.4	0.7	-0.8	1.2	3.9
Hong Kong, China	-4.0	-3.8	-1.6	-3.0	-2.6	-0.4
Japan	-0.3	-0.7	-0.7	-0.9	-0.3	0
Korea	0.8	2.3	4.1	2.7	3.6	3.6
Chinese Taipei	0.2	1.3	-0.0	-0.2	-0.3	1.6
Southeast Asia						
Brunei Darussalam	-0.1	1.3	0.6	-2.3	1.5	1.2
Indonesia	2.0	9.4	12.6	10.0	5.1	6.4
Malaysia	2.8	1.6	1.4	1.8	1.2	1.4
The Philippines	6.7	4.4	6.1	3.0	3.0	5.5
Singapore	0.0	1.3	1.0	-0.4	0.5	1.7
Thailand	0.3	1.5	1.6	0.6	1.8	2.7
Viet Nam	0.1	-0.6	0.8	4.0	3.0	7.7
Oceania						
Australia	1.5	4.5	4.4	3.0	2.8	2.3
New Zealand	-0.1	2.6	2.6	2.7	1.6	2.3
Papua New Guinea	13.2	8.9	10.5	14.8	8.4	
Russia	36.5	20.2	18.6	15.1	12.0	10.9

Sources: Individual Economy Reports.
IMF, *International Financial Statistics*, July 2005

Figure 2.2 CPI Trends of APEC Economics



Malaysian inflation remained low in 2004. The CPI edged up slightly to 1.4 percent in 2004 from 1.2 percent in 2003 due to increases in prices of food, beverages and tobacco as well as an upward adjustment in retail prices of petroleum products. The inflation remained at a manageable level because labor market conditions remained stable supported by productivity growth and an expansion of production capacity.

The Philippines' inflation rate reached 6.0 percent in 2004, above the target rate of 4.5 to 5.0 percent. The high inflation mainly came from the supply-side. The Philippines experienced upward price pressures for food, beverages and tobacco. The prices increased from 2.2 percent in 2003 to 6.2 percent in 2004 because of supply constraints brought about in part by the typhoons that occurred in the latter part of the year. Meat prices also increased due to the spread of SARS. The prices for services and fuel, light and water increased from 5.6 percent and 6.3 percent, respectively, in 2003 to 7.4 percent and 9.2 percent, respectively, in 2004. Inflation continued to rise during the first quarter of 2005, again due to supply-side factors. Average inflation during this period was at 8.5 percent, up from 8.1 percent in the previous quarter and up from 4.1 percent a year ago. Food inflation decelerated relative to the previous quarter as supplies recovered from the impact of the typhoons, but this remained higher than the level recorded during the first quarter of 2004. Meanwhile, non-food inflation increased compared to both the previous quarter and the first quarter of 2004, driven primarily by the renewed surge in global petroleum prices that led to successive local fuel price hikes. This pushed inflation up particularly in water and electricity services, and most other services.

Singapore experienced upward pressure on prices, particularly on commodity prices, due to the strength of economic activity both in Singapore and in foreign economies in 2004. The CPI edged up to 1.7 percent from 0.5 percent a year earlier as prices of certain products and services increased significantly. The largest gain in prices was the 6.0 percent increase for healthcare services. Costs of education and stationery rose by 4.2 percent in 2004, supported by higher prices of newspapers as well as higher tuition fees charged by foreign universities. Prices of recreation and others rose by 2.3 percent, reflecting higher cigarette prices. Food, transport and communications, and clothing prices saw gains of 2.0, 1.2 and 0.1 percent, respectively. However, housing costs declined slightly in 2004 by 0.1 percent.

With Thailand's economic expansion, rising oil and farm prices, headline inflation started to take off by increasing to 3.1 percent year-on-year in August 2004. It signaled the inflationary pressure on the Thai economy due to the continuously increasing capacity utilization, rising domestic oil prices, and a tightening labor market. All these would exert pressure on core inflation, the monetary policy's target. Therefore, the Bank of Thailand (BOT) started to raise the 14-day repurchase rate, by 25 basis points, from 1.25 to 1.50 percent per annum in August 2004. Later, the 14-day repurchase rate was raised twice by 25 basis points, in October and December 2004. In addition, in March 2005, the BOT made a decision to further raise the policy rate, from 2.00 to 2.25 percent per annum, in order to strengthen economic stability and sustain growth in the long term.

In 2005, Viet Nam's national bank continues to execute a floating exchange rate policy to control the spread of price increases, and maintain alignment with economic development assistance. The total money in circulation is to increase by 22.0 percent, while the overall mobilized deposit increases by 20.0 to –21.0 percent and the total credit surplus increases by 23.0 percent. Although the credit to debt ratio is quite high compared to the consumer price index of 2004 (an average 9.5 percent in 2004 and 4.3 percent, respectively, in the first 4 months of 2004), it still does not create a considerable change in the monetary market.

Oceania and Russia

In Papua New Guinea, the annual inflation outcome for 2004 was 2.1 percent in year-average terms, the lowest annual outcome since 1989 and the second lowest annual outcome since independence. This is a significant improvement on the very high rates of previous years, and is clearly attributable to prudent fiscal and monetary management and a stable exchange rate. Inflation has continued to decline in 2005, with the annual inflation rate in the March quarter (in through-the-year terms) of 0.1 percent, the lowest annual inflation rate since independence.

The Australian CPI increased by 2.6 percent through 2004. This outcome was in the middle of the medium-term inflation target band. The major contributors to inflation during the year were housing, transport and food prices while clothing and footwear prices fell. Excluding the impact of automotive fuel prices, the CPI increased by 2.0 percent through the year.

New Zealand experienced increased inflationary pressures in 2004 due to high capacity utilization, strong employment growth and low unemployment. In March 2005, a net 40.0 percent of firms reported facing higher costs in the quarter, up from a net 35.0 percent in the previous quarter. A net 23.9 percent of firms raised their prices in the March quarter and 31.0 percent intended to do so in the following quarter. These figures point to increasing inflation pressure and declining profit margins as firms are squeezed by increased input costs, and competitive markets, the strong exchange rate and lower manufacturing costs in Asia restrict their ability to raise prices to final consumers.

In Papua New Guinea, there has been an improvement in economic activity that continued in 2004, with the economy growing by 2.7 percent in real terms. The non-mining economy grew by 3.2 percent in real terms, reflecting continued solid growth in the agriculture sector, with increased exports of cocoa, copra, palm oil and tea partly offset by lower coffee exports. Economic growth is expected to reach 3.0 percent in 2005, with non-mining GDP expected to grow by 3.2 percent in the year. The improvement in the economic outlook for 2005 reflects increased investor and consumer confidence following a period of macroeconomic stability—reflecting the Papua New Guinea Government's prudent management of fiscal and monetary policy—and high commodity prices.

Russia experienced a relatively high CPI increase at 11.7 percent following 12.0 percent in 2003. The fuel price increase contributed most to the high inflation because fuel prices are linked with world fuel prices, which soared in 2004. Also, increases in prices for gasoline, diesel fuel and other lubricants, which outstripped inflation, resulted in an extra climb of the consumer price index by approximately 1.2 percentage points and accelerated the upswing.

2.3 Mixed Performance of Unemployment Rates

Western Hemisphere

The Canadian labor market has remained remarkably healthy, despite the shock to the economy from the appreciation of the Canadian dollar. In 2004, the economy created 230,000 new jobs, all of which were full-time positions. The employment rate reached a record high of 62.8 percent in May 2004 and remained close to that level for the rest of the year and into 2005. With strong job creation in Canada, the unemployment rate fell from 7.3 percent in December 2003 to a thirty-year low of 6.7 percent in June 2005, despite near record rates of participation in the labor market.

The unemployment rate in Chile went up to 8.8 percent in November 2004, from 7.8 percent in the last three months of 2003. Up to November 2004, employment increased by 153,000 jobs, in comparison to the same period of the previous year (a 2.7 percent annual increase). Discounting seasonality, 120,000 jobs were created between the moving quarters ending in July and November (equivalent to a 2.1 percent increase).

In Peru, urban employment increased by 2.7 percent in 2004 based on the estimates by the Ministry of Labor made through the National Survey on Monthly Variation of Employment in firms with 10 employees or more.

US non-farm payroll employment increased about 2.2 million during 2004, the largest annual gain since 1999. The unemployment rate declined to 5.4 percent by December 2004, well below the 6.3 percent peak of June 2003. The unemployment rate in 2004 was below the averages of the 1970s, the 1980s, and the 1990s. Job gains were spread broadly across major industry sectors in 2004. The service-providing sector accounted for 85.0 percent of job growth during the year, in line with its 83.0 percent share of overall employment. The goods-producing sector accounted for the remaining 15.0 percent of the gains, in line with its 17.0 percent share of overall employment. Within the goods-producing sector, employment growth was concentrated in construction; manufacturing employment also increased, the first such gain since 1997. The administration projects that employment will increase at a pace of about 175,000 jobs per month on average during the 12 months of 2005—a projection that is in line with the consensus of private forecasters. The unemployment rate is projected to edge down from its December 2004 level of 5.4 percent to 5.3 percent by the fourth quarter of 2005. Employment growth is not expected to slow by as much as output growth because productivity (output per hour) is projected to increase at a slower pace than in 2004, and more of the projected output growth may be translated into labor demand and employment in 2005 than in 2004.

Northeast Asia

In China, 9.8 million new jobs were provided to urban residents, 800,000 more than the expected target, and 5.1 million laid-off workers were re-employed in 2004. The urban registered unemployment rate was 4.2 percent at the end of 2004 or 0.1 percentage point lower than that in 2003. The central government increased funding for reemployment subsidies by US$268.8 million, up 54.6 percent year-on-year. Local authorities also made corresponding allocations for employment subsidies, effectively contributing to employment and re-employment efforts.

Labor market conditions in Hong Kong, China, improved visibly further in 2004, in tandem with the strong revival in overall economic activity. The unemployment rate fell almost continuously, from 7.3 percent on a seasonally adjusted basis in the first quarter to 6.6 percent in the fourth quarter, as well as extensively across many different economic sectors, occupation categories and educational attainment levels. This improved unemployment situation was mainly attributable to a strong expansion of 2.8 percent in total employment, which more than offset the 1.6 percent growth in the labor supply. Meanwhile, there was a shift in the employment composition from part-time and temporary workers to full-time workers alongside the upturn in business activity. Labor demand remained strong in the first eight months of 2005, underpinned by the sustained pick-up in the economy. As a result, the seasonally adjusted unemployment rate came down further to 5.7 percent in June - August 2005, the lowest level recorded since August - October 2001.

In Japan, the employment situation was severe as the unemployment rate remained within the 5.3 percent to 5.5 percent range from late 2001 to the middle of 2003. However, it has decreased gradually to around the 4.5 percent level, reflecting the increase in employees and the decline in unemployed persons, and has been on the downward trend. Wages have been increasing moderately after a long decline as the rising trend for part-time workers, which has been a major contributor to lowering wages, has almost stopped. The government projected the unemployment rate for FY2005 to be about 4.6 percent in the Outlook. According to the Forecast, it is estimated to be about 4.3 percent.

Korea has witnessed a 420,000 increase of employment after the 30,000 decrease in 2003. Thanks to the positive trend in the labor market, the economically active population increased significantly by as much as 450,000 persons, along with a y-o-y increase of 0.6 percent in the labor force participation rate and reaching a record of 62.1 percent. In spite of the increase of the employed, the unemployment rate was set at 0.1 percent higher and posting 3.7 percent due to the growth of the economically active population. The number of employed rose at a slow pace in the beginning of 2005, increasing 260,000 compared to the previous year. The unemployment rate was 3.6 percent during the first half of this year. During the second half of 2005, it is expected that the number of persons employed will increase by 350,000.

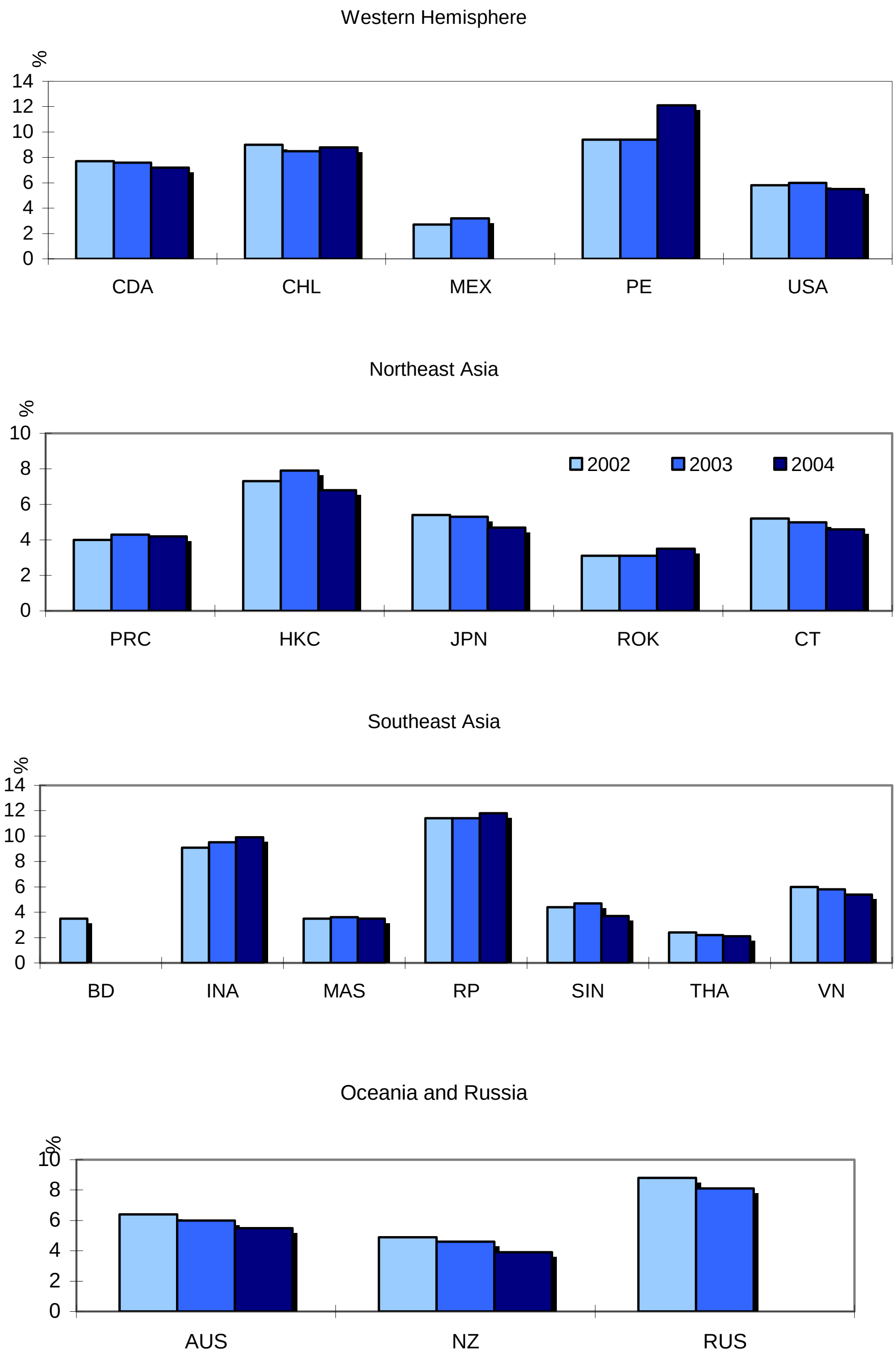
During 2004, Chinese Taipei created 213,000 new jobs. Employment rebounded to a growth of 2.2 percent. The unemployment rate fell back to 4.4 percent from 4.99 percent in 2003. Among the unemployed, 34.8 percent had lost their jobs due to business closures or downscaling. The average monthly earnings of labor in industry increased 2.3 percent. In Chinese Taipei, knowledge-based employment has been growing in line with the development of the knowledge-based economy, with its ratio of total employment rising from 29.5 percent in 2004 to 30.1 percent in 2005. Between 1992 and 1997, such employment increased at an average annual rate of 4.4 percent. Although it slowed to 2.7 percent between 1998 and 2003, it was still above the economy-wide average.

Table 2.3 Unemployment Rates (percent)

	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	7.6	6.8	7.2	7.7	7.6	7.2
Chile	9.8	9.2	9.0	9.0	8.5	8.8
Mexico	2.5	2.2	2.5	2.7	3.3	3.8
Peru	8.0	6.5	8.9	9.4	9.4	9.4
The United States	4.2	4.0	4.8	5.8	6.0	5.5
Northeast Asia						
China	3.1	3.1	3.6	4.0	4.3	4.2
Hong Kong, China	6.2	4.9	5.1	7.3	7.9	6.8
Japan	4.7	4.7	5.0	5.4	5.3	4.7
Korea	6.3	4.1	3.8	3.1	3.4	3.5
Chinese Taipei	2.9	3.0	4.6	5.2	5.0	4.6
Southeast Asia						
Brunei Darussalam	4.5	4.7	5.6	3.5	N.A	4.8
Indonesia	6.4	6.1	8.1	9.1	9.5	9.9
Malaysia	3.4	3.1	3.6	3.5	3.6	3.5
The Philippines	9.8	11.2	11.1	11.4	11.4	11.8
Singapore	2.8	2.7	2.7	3.6	4.0	3.4
Thailand	4.2	3.6	3.3	2.4	2.2	2.1
Viet Nam	7.4	6.4	6.3	6.0	5.8	5.4
Oceania and Russia						
Australia	6.9	6.3	6.8	6.4	6.0	5.5
New Zealand	6.3	5.6	5.4	4.9	4.6	3.6
Russia	12.9	10.5	9.0	8.8	8.1	8.2

Sources: Individual Economy Reports
IMF, *International Financial Statistics*, July 2005

Figure 2.3 Unemployment Rates of APEC Economies



Southeast Asia

During 2004, Indonesia's open unemployment rate rose to 9.9 percent (10.3 million people) from 9.5 percent in 2003. This was due to the relatively low number of jobs created (2.3 million) compared with the introduction of new workers into the labor market (3.7 million). In addition, the development of the labor market was also burdened by layoffs in several manufacturing industries, including textiles and footwear, and at state-owned enterprises (SOEs) involved in the aerospace industry. Unemployment is expected to remain a serious challenge in 2005 as the economy is expected to grow only slightly more than in 2004

The Malaysian unemployment rate improved marginally at 3.5 percent in 2004 from 3.6 percent in 2003. Robust domestic economic activities continued to generate more job opportunities while growth in labor productivity as measured by real sales value of product per employee in the manufacturing sector rose by 15.6 percent, exceeding the 1.8 percent growth in real wages.

In the Philippines, total employment grew by 3.2 percent, from 30.6 million in 2003 to 31.6 million in 2004. An additional 977,000 workers were employed in 2004 compared to 574,000 during the previous year. The services sector was the leading employer for the year and generated the most new jobs (658,000). However, these gains were not enough to accommodate the 1.3 million new entrants into the labor force in 2004, and resulted in an increase in the average unemployment rate from 11.4 percent in 2003 to 11.8 percent in 2004. Total employment in January 2005 was registered at 31.6 million, a 0.3 percent increase compared to the 31.6 million in January 2004. However, the employment rate decreased from 89.0 percent in January 2004 to 88.7 percent in January 2005. Employed persons in the agricultural sector increased by 1.7 percent in January 2005, an improvement from the 0.2 percent growth registered in the same period in 2004. Employment in the industry sector declined by 1.4 percent in January 2005, while the number employed in the services sector increased slightly, by 0.2 percent. The unemployment rate in January 2005 stood at 11.3 percent, a slight increase from the 11.0 percent posted a year ago. However, the incidence of underemployment decreased from 17.5 percent to 16.1 percent.

Singapore's labor market improved in 2004. Total employment grew by 71,400, which exceeded the cumulative job losses of 35,900 over the preceding three years. Employment gains were largely due to the services-producing industries. In tandem with the economy's strong performance, retrenchments slowed to 10,200 workers in 2004, a marked decline from the 16,400 retrenched in 2003. Consequently, the overall seasonally adjusted unemployment rate fell to 3.0 percent in December 2004, a significant drop from the 3.8 percent registered a year ago. For the whole year, unemployment rate averaged 3.4 percent compared to 4.0 percent in 2003.

Thailand's employment situation has improved for three consecutive years. As of December 2004, total employment increased to 34.7 million from 33.8 million in 2003. The unemployment rate stood as low as 2.1 percent. With the strong economic recovery, the unemployment rate has remained lower than 3.0 percent since 2002. In 2005, it is expected that the Thai economy will expand strongly, therefore employment conditions will improve and the number of employed workers is expected to increase by 743,000 positions.

In Viet Nam, total employment grew by 1.6 million. Industry and construction sectors attracted 4,448,000 employees and the number of employees in these sectors increased to 10.9 million. The number of the labor force in agricultural, forestry and fisheries sector is estimated to be 104,000, while the services sector attracts 748,000 more employees. The total number of employees in the services sector is estimated to be 10.9 million. Labour exports are forecast to be about 70,000. Urban unemployed labor accounted for less than 5.4 percent of the work force.

Oceania and Russia

Employment grew by 2.6 percent through 2004 in Australia. The unemployment rate fell steadily over the year to reach 5.1 percent in December. Wages, as measured by the wage price index

(WPI), rose 3.5 percent through the year to December. Public sector wages increased by 4.1 percent through the year to December while private sector wages increased by 3.4 percent.

In New Zealand, with economic growth expected to slow over the next two years, employment growth is also forecast to slow. However there will be some offset to total labor income from increased wage growth. Growth in full-time equivalent employment is forecast to fall to a low of 0.7 percent in the year till June 2006, but is expected to recover to 1.1 percent by the end of 2007. This slowing in employment growth is forecast to contribute to a lift in the unemployment rate, which will increase to 4.5 percent in June 2009.

In Papua New Guinea, employment in the total private non-mining formal sector increased marginally by 0.3 percent in the year-ending 2004 compared to 6.4 percent for the year-ending 2003. The highest employment growth of 4.4 percent was recorded in the manufacturing sector, followed by wholesale, financial/business and other, retail and transportation.

Out of Russia's economically active population of 73.4 million, 67.4 million, or 91.8 percent, were employed and 6 million, or 8.2 percent, were classified as unemployed by the International Labor Organization (ILO) methodology. The number of jobs in large and medium-sized companies decreased 0.8 percent in 2004 (y-o-y) compared to 2003. The most significant declines in job numbers were registered in machine-building, the non-ferrous metallurgy sector, flour and cereals and mixed fodder industries. Full-time workers and employees of large and medium-sized companies accounted for 58 percent of the employed in the economy and 1.8 million people, or about 2.7 percent, worked in these companies on a part-time basis or by contract (an equivalent of full employment). The number of the officially registered unemployed has been rising since 2002, due to job cuts at large and medium-sized enterprises and the raising of the minimum unemployment allowance in pace with the increase of the subsistence minimum. The number of officially registered jobless rose 6.4 percent in 2004 y-o-y to 1.7 million. 2.1 million jobless were registered with the government employment service at the end of 2004, of whom 1.9 million had unemployed status according to Russia's Federal Labor and Employment Service.

2.4 Accelerated Growth of Trade

Western Hemisphere

In Chile, the volume of export goods rose close to 50.0 percent. The increase was mainly due to the growth in volumes and prices of mining and industrial goods, which showed an increase in value in US$ terms of 94.4 percent and 25.5 percent, respectively. The accumulated value of exports was close to US$32 billion, which is a historic record.

Peru's trade balance, a historical record, registered a surplus of US$2.7 billion for the third consecutive year. This reflected the growth of exports by 40.0 percent, mainly associated to better terms of trade of mining exports. Traditional exports were led by copper, because of higher prices and volumes, as well as higher prices of gold in the international market. Non-traditional exports, particularly textiles, increased as a consequence of the Andean Trade Promotion and Drug Eradication Act (ATPDEA). Imports grew by 19.0 percent, mainly due to higher oil prices as well as larger imports of intermediate and capital goods for industry and durable consumer goods.

US real exports increased 4.0 percent as economic growth strengthened among major trading partners, but real imports increased even faster at 7.2 percent, partly due to the more robust recovery in the United States than abroad. The trade deficit on goods and services reached about 5.6 percent of GDP in the fourth quarter of 2004. The rapid increases in real imports were widespread and included capital goods and industrial supplies, petroleum, and consumer goods. All the major categories of real non-agricultural exports (capital goods, industrial supplies, motor vehicles, consumer goods, and services) contributed to the growth of overall exports. Agricultural exports declined, however, as exports of beef fell on concerns about "mad cow" disease. Due to the detection of the first known case of "mad cow" disease in the United States in late 2003, a number of economies that together account for most of the US beef exports have completely or partially halted purchases of American beef. As a result, beef exports—which were $3.1 billion in 2003—fell by about $0.6 billion in 2004.

Northeast Asia

The total value of China's imports and exports in 2004 reached US$1,154.8 billion, up 35.7 percent over the previous year. Of this total, the value of exports was US$593.4 billion, up 35.4 percent, and the value of imports was US$561.4 billion, up 36.0 percent. China had a trade surplus of US$32.0 billion, an increase of US$6.5 billion as compared with that in the previous year.

Hong Kong, China's total exports of goods picked up distinctly further to a 15.9 percent growth in value terms to US$259.3 billion in 2004. Imports of goods were likewise robust, leaping by 16.9 percent in value terms to US$271.1 billion in 2004. On balance, the visible trade deficit reckoned on a GDP basis widened in absolute terms, to US$9.3 billion. The corresponding ratio to the value of imports of goods was 3.5 percent in 2004. However, benefiting from an enlarged invisible trade surplus of US$24.2 billion, there was a combined surplus of US$14.8 billion, equivalent to 5.0 percent of the total value of imports of goods and services in 2004. In the first half of 2005, Hong Kong, China's total exports surged further, by 11.6 percent over a year earlier to US$132.7 billion, while imports of goods increased by 9.1 percent to US$139.3 billion over the same period. On balance, the visible trade deficit reckoned on a GDP basis narrowed in absolute terms, to US$5.0 billion. The corresponding ratio to the value of imports of goods in the first half of 2005 was 3.7 percent. Together with an enlarged invisible trade surplus of US$12.7 billion, a combined surplus of US$7.7 billion, equivalent to 5.0 percent of the total value of imports of goods and services, was recorded in the first half of 2005.

Japanese export volumes started to increase in the second half of 2003, after the soft patch between the end of 2002 and mid-2003, with weakening global economic resilience as the main cause. Although the export volumes decreased once in the middle of 2004, it is picking up. Import volumes have been on an increasing trend since the beginning of 2002 with a recovery of domestic demand.

Chinese Taipei's merchandise exports and imports both registered double-digit growth rates in 2004. The value of merchandise exports grew by 20.7 percent to US$173.2 billion, mainly driven by persistently steady growth in the global economy and in the information technology (IT) industry worldwide. The value of merchandise imports rose by 32.2 percent to US$156.7 billion, primarily led by stronger derived demand arising from the expansion in exports and the recovery in domestic investment, along with surging international oil and commodity prices. The trade surplus on goods decreased to US$16.5 billion for the year, a decrease of 33.9 percent from the previous year.

Southeast Asia

Indonesia's balance of payments performance in 2004 continued to improve. The current account recorded a surplus alongside the improving export performance.

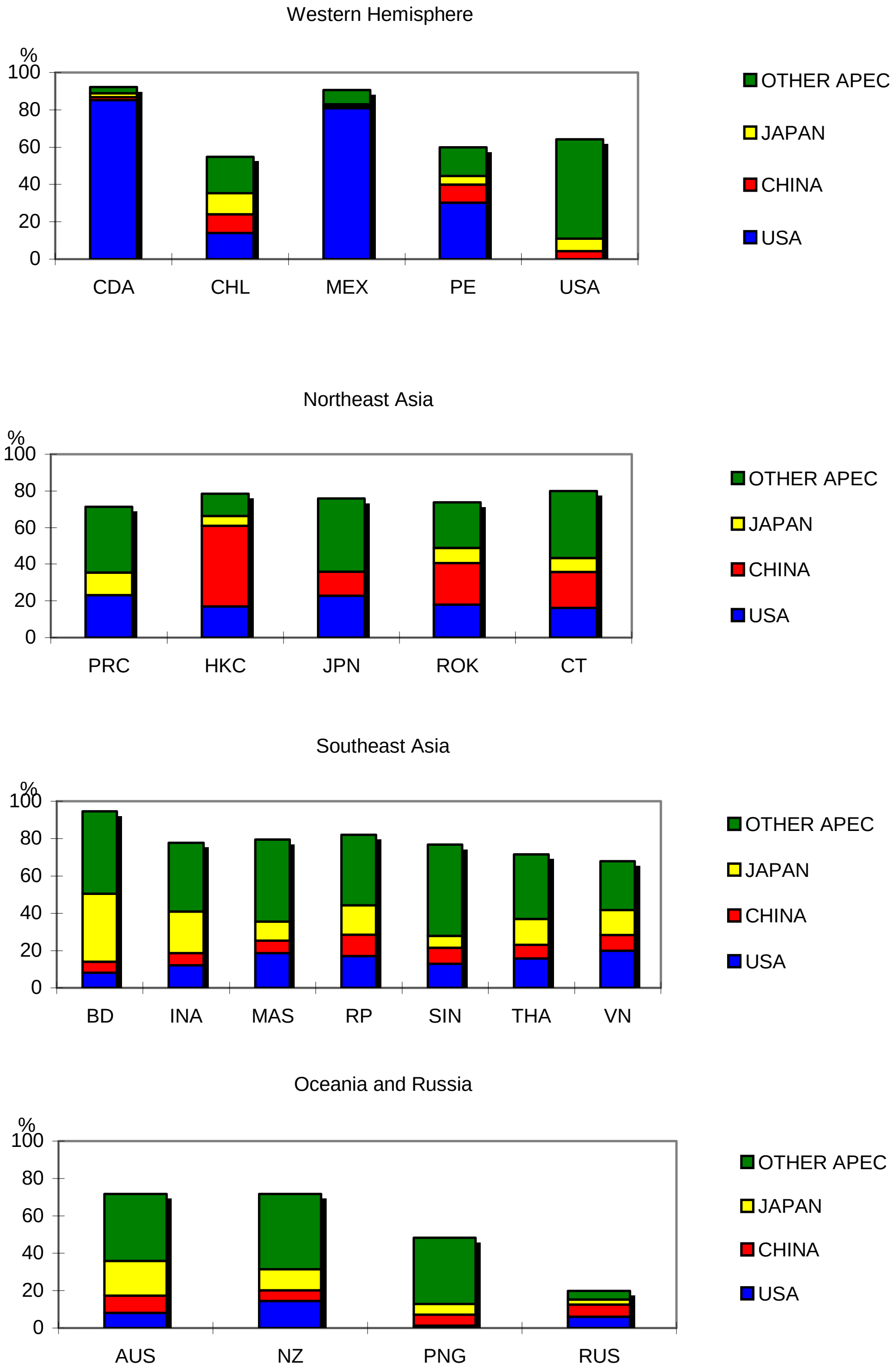
Malaysia's current account recorded a larger surplus of 56.6 billion ringgit or 13.4 percent of GNP in 2004 (2003: 50.8 billion ringgit; 13.7 percent). The trade surplus continued to remain large at 81.1 billion ringgit (2003: 81.3 billion ringgit) as a result of stronger growth in exports of manufactured goods and higher earnings from commodity exports. Malaysia has continued to enjoy a surplus in the current account since November 1997. Reflecting strong domestic activities, imports grew by 26.3 percent (2003: 4.4 percent).

Table 2.4 Change in Trade of Goods and Services (percent)

	Export						Import					
	1999	2000	2001	2002	2003	2004	1999	2000	2001	2002	2003	2004
Western Hemisphere												
Canada	10.7	8.9	-2.8	1.1	-2.4	4.98	7.8	8.1	-5.0	1.4	3.8	8.1
Chile	7.3	5.1	7.5	1.5	7.8		-9.5	10.1	4.1	2.4	8.8	
Mexico	12.4	16.4	-3.8	1.6	2.7	11.5	14.1	21.5	-1.6	1.5	0.7	10.2
Peru	7.6	7.9	7.1	6.8	5.9	15.2	-15.2	3.7	2.6	2.14	3.3	9.5
The United States	4.3	8.7	-5.4	-2.4	1.9	8.6	11.5	13.1	-2.7	3.4	4.4	9.9
Northeast Asia												
China*	6.1	27.8	6.4	22.3	34.6	35.4	18.2	35.8	8.2	21.2	39.9	36.0
Hong Kong, China	4.4	16.4	-1.7	9.1	13.1	15.3	-0.2	16.8	-1.5	7.5	11.5	13.8
Japan	1.5	12.1	-6.0	7.3	9.1	14.4	3.7	8.5	-0.7	1.3	3.8	8.9
Korea	14.6	19.1	-2.7	13.3	15.7	31.0	27.8	20.1	-4.2	15.2	9.7	25.5
Chinese Taipei	11.9	17.6	-7.8	10.0	10.9	16.57	4.4	14.5	-13.9	5.8	6.9	18.566
Southeast Asia												
Brunei Darussalam	31.2	52.7	1.4	-0.7	NA	11.1	-3.1	-1.8	14.2	-0.5	NA	4.4
Indonesia	-31.8	26.5	0.6	-1.0	6.6	8.19	-40.7	26.0	4.2	-4.0	2.8	2.73
Malaysia	13.2	16.1	-7.5	3.6	11.5	20.6	10.6	24.4	-8.6	6.1	4.8	25.1
The Philippines	3.6	17.7	-3.4	3.6	4.4	14.0	-2.8	4.0	3.5	4.7	10.2	6.3
Singapore*	5.7	20.1	-10.5	2.9	15.1	24.5	7.3	22.0	-13.7	1.8	8.5	27.5
Thailand	0.9	17.5	-4.1	10.9	6.5	7.8	10.5	27.3	-5.5	11.3	7.3	12.1
Viet Nam	23.3	25.5	3.8	10.0	19.0		2.1	33.2	3.4	19.4	26.7	
Oceania												
Australia	4.7	10.9	1.8	0.1	-2.3	4.2	9.3	7.6	-4.1	11.3	10.5	14.3
New Zealand	8.1	6.4	2.4	5.8	1.3	5.2	12.0	0.1	1.8	8.6	10.2	15.7
Papua New Guinea*	9.1	7.3	-13.7	-9.5	27.5		-0.1	-7.0	-6.4	14.6	-4.6	
Russia	9.5	9.8	2.7	9.9	25.7	350.	-9.6	20.2	19.8	14.5	21.4	26.6

Note: * Based on merchandise exports and imports.
Sources: Individual Economy Reports.
ADB, *Asian Development Outlook*, 2005
IMF, *International Financial Statistics*, July 2005

Figure 2.4 Export Structure by Main Destinations



In the Philippines, merchandise export earnings grew by 9.6 percent to US$38.7 billion, driven mainly by exports of electronics and machinery and transport equipment. On the other hand, merchandise import payments rose by 10.6 percent to reach US$45.1 billion as imports of all major commodity groups except capital goods increased. Imports of mineral fuels and lubricants posted the highest growth (25.2 percent), followed by imports of consumer goods (11.1 percent) and raw materials/intermediate goods (9.0 percent). Imports of raw materials accounted for about 58.2 percent of total imports, followed by capital goods (mostly electronic-related equipment and machines) at 19.4 percent, mineral fuels at 10.4 percent, and consumer goods at 6.7 percent. Coupled with the continuing deficit in services, the greater expansion in imports led the overall trade balance deficit to worsen, from US$7.2 billion in 2003 to US$8.2 billion in 2004.

With the benefit of the global economic recovery, especially in Thailand's trading partners' economies such as the United States, Japan and the EU, international trade exhibited strong performance. Export values have improved continuously. In 2002, export values amounted to US$68.6 billion, but in 2004, exports have exceeded US$90 billion and reached US$96.1 billion. The successful factors of export expansion come from the improvement in trading partners' economies, such as China, Chinese Taipei, Japan and the US, and aggressive bilateral trade negotiations. Now Thailand has signed free trade area agreements with six economies, namely, China, India, Australia, New Zealand, Peru, and Bahrain, and one economic group. Meanwhile, imports increased in line with exports as economic recovery raised demand for imports of consumer and capital goods for private consumption and investment. Import values in 2002 stood at US$64.3 billions while in 2004, it reached US$94.4 billions. The trade balance has been in surplus since after the crisis of 1997, but its trend is to lessen the extent of surplus following strong internal demand from economic expansion. In 2004, the trade surplus was US$1.7 billion.

Viet Nam's trade deficit was US$1.4 billion. The services balance will continue to decrease, to US$1.1 billion. The deficit of net income investment increases by US$100 million compared with that of last year and the estimated income from money transferring (of both private and state-owned enterprises) is US$2.6 billion.

Oceania and Russia

In 2004, Australia's export volumes increased by 4.2 percent while import volumes rose by 14.3 percent. The terms of trade increased by 9.8 percent in 2004, largely reflecting strong increases in non-rural commodity prices. The trade deficit widened slightly to $25.7 billion in 2004. For New Zealand, strong consumption and investment growth led to acceleration in import volume growth from 8.1 percent in the calendar year 2003 to 15.7 percent in 2004. Forecast falls in these major components of domestic demand will lead to a decline in import growth from an estimated 12.8 percent in the year to March 2005, to 4.1 percent in the year to March 2006, and then average 2.5 percent growth in the following three years. In the export sector, the recent appreciation of the exchange rate is expected to suppress export receipts and put some export volumes, namely manufactured and services exports, under pressure, leading to a period of weak growth. There is uncertainty about how the high exchange rate will impact on export receipts in the near term. For some commodity exports, notably dairy, beef and lamb, the exchange rate has been offset by historically high international prices, leaving prices above their decade average in New Zealand dollar terms. Forestry products are a notable exception to this commodity picture. For manufactured product exporters, the effect of the exchange rate depends on the markets they export to; while the New Zealand dollar has appreciated strongly against the United States dollar, it has not posted such large gains against other currencies. Some manufacturing exporters have a natural hedge in imported raw materials and some took out long-term forward contracts to protect their returns. However, many of these forward contracts are about to expire, leaving firms to face a potentially abrupt transition to current exchange rates.

Papua New Guinea's exports of goods and services in 2004 recorded 8,889 million kina, off-setting imports of goods and services of 7,831 million kina.

Table 2.5 Regional Export Structure (percent)

To / From	APEC									
	Western Hemisphere		Northeast Asia		Southeast Asia		Oceania		APEC Total	
	1991	2004	1991	2004	1991	2004	1991	2004	1991	2004
Western Hemisphere										
Canada	77.0	86.02	8.9	4.92	1.1	0.67	0.5	0.58	87.5	92.18
Chile	20.8	22.05	28.9	30.52	1.6	1.75	0.3	0.62	51.5	54.89
Mexico	21.6	87.30	26.1	2.50	1.6	0.41	0.3	0.36	49.6	90.58
Peru	28.8	39.81	20.8	18.80	1.1	0.77	0.2	0.69	50.9	60.06
The United States	29.0	37.26	22.0	18.73	4.9	8.76	2.3	2.37	58.3	64.22
Northeast Asia										
China	10.0	26.06	64.9	35.41	5.9	6.66	0.9	3.28	81.7	71.41
Hong Kong, China	25.0	18.6	38.7	53.9	6.6	6.0	1.6	1.4	71.9	79.9
Japan	32.9	25.18	20.4	34.87	12.0	12.87	2.4	3.06	67.7	75.99
Korea	30.2	21.42	28.1	40.49	10.3	9.44	1.6	2.54	70.2	73.88
Chinese Taipei	32.2	17.78	30.1	47.35	9.9	13.11	2.0	1.76	73.1	80.00
Southeast Asia										
Brunei Darussalam	1.1	8.34	75.7	56.12	19.9	16.60	2.8	13.54	99.5	94.59
Indonesia	12.7	13.44	54.0	43.18	11.3	17.98	2.2	3.16	85.7	77.77
Malaysia	18.0	20.04	29.3	30.53	29.0	24.90	2.0	3.99	78.2	79.46
The Philippines	37.6	18.85	31.2	45.03	7.2	16.84	1.3	1.28	77.3	82.00
Singapore	20.8	13.28	23.3	33.6	23.3	23.7	3.0	4.4	71.0	75.0
Thailand	23.0	17.61	27.6	28.13	11.7	19.79	1.6	3.19	64.0	71.57
Viet Nam	0.0	21.38	69.6	28.05	22.4	11.10	0.2	7.47	92.2	67.99
Oceania										
Australia	12.1	10.29	46.2	41.76	12.6	11.53	6.6	8.27	77.5	71.84
New Zealand	16.7	17.75	28.4	24.88	7.3	7.56	23.1	21.65	73.4	71.85
Papua New Guinea	2.1	1.24	33.4	13.27	7.4	5.42	40.88	28.30	83.7	48.22
Russia	2.2	6.72	11.5	11.93	1.5	1.19	0.0	0.07	15.2	19.88

Russia's merchandise exports value rose by 35.0 percent amounting to US$183.5 billion in 2004 or by US$47.5 billion in absolute terms (an increase of US$14.5 billion due to increasing physical volume and by US$33.0 billion owing to the price factor) compared to 2003. In 2004 the share of fuel exports was at the level of 54.7 percent of the total exports value as against 54.7 percent the year before. In 2004 fuel exports increased by US$26.7 billion, while shipments of other commodities went up by US$20.8 billion. Imports value in 2004 went up by 26.6 percent reaching US$96.3 billion or by US$20.2 billion in absolute terms (due to growing physical import volumes of US$14.3 billion and rising average contract prices of US$5.9 billion). Rapid growth of imports was based on expanding internal consumption due to rising real disposal incomes of the Russian population (8.4 percent), the GDP (7.1 percent) and real effective ruble appreciation of 6.1 percent in 2004 compared with 2003. Merchandise imports from the economies beyond the CIS were growing at a high stable rate (25.2 percent) in 2004 compared to 2003. The share of machines and equipment in total imports of goods increased to 41.2 percent in 2004 compared to 37.4 percent in 2003. At the same time the share of foodstuffs and raw materials for their production went down from 21.0 percent to 18.3 percent in 2004, and the share of chemical products (15.8 percent) was slightly lower than in 2003.

2.5 Unbalanced External Sector

Western Hemisphere

Canada's current account has improved dramatically from the deficits recorded in the 1990s. The current account moved into surplus late in 1999 and the surplus has remained healthy, despite the appreciation of the Canadian dollar against the US dollar. In 2004, the current account balance as a share of GDP stood at 1.6 percent, down somewhat from 1.9 percent in 2003. With sustained current account and fiscal surpluses over recent years, Canada's net foreign debt as a share of GDP has fallen from 43.8 percent of GDP in 1993 to less than 14.0 percent in 2004.

In 2004, Chile's balance of payments posted a current account surplus close to US$1.9 billion, which represents close to 2.0 percent of GDP. This is mainly due to a surplus in the goods and transfers accounts that reached US$9 billion and US$0.9 billion, respectively. These figures were partially counter-balanced by deficits in the rents and services accounts that registered net outflows of US$7.5 billion and US$0.5 billion, respectively.

Peru's current account deficit dropped from 1.8 percent to 0.1 percent of GDP in 2004. The smaller deficit was attributable to the higher surplus in trade balance, helped by a 30.0 percent increase in remittances from Peruvians living abroad and partially compensated by the larger deficit in investment income. The trade balance registered a surplus of US$2.7 billion, a surplus for the third consecutive year and a historic record. This reflected the dynamism of exports by 40.0 percent mainly due to better terms of trade of mining exports. The financial account of the balance of payments recorded a positive flow of US$2.3 billion, up US$1.4 billion from 2003 due to higher direct investment associated with profits generated and retained by foreign companies to finance new projects. Foreign direct investment amounted to US$1.8 billion in 2004, mainly utilized by projects like Camisea, Alto Chicama and Yanacocha. Net international reserves increased US$2.4 billion, reaching a balance of US$12.6 billion. This level is equivalent to 2.7 times external debt due in one year, 15 months of imports and is 4.5 times the monetary base balance. These indicators reflect the economy's strong position and ability to face restrictive conditions in the international capital markets or an unexpected demand for foreign exchange. Medium- and long-term external debt, including bonds, totaled US$28.5 billion or 41.7 percent of GDP, an increase of US$1.3 billion over 2003. Public sector medium- and long-term debt went up by US$1.7 billion compared to 2003, of which US$1.1 billion was due to a net increase of indebtedness and US$0.5 billion to the depreciation of the dollar, mainly against the yen and the euro.

The US current account deficit widened to about 6.3 percent of GDP in the fourth quarter of 2004. While real exports increased 4.0 percent, as economic growth strengthened among the US major trading partners, real imports increased even faster (at a 7.2 percent rate), partly due to the more robust recovery in the United States than abroad. The rapid increases in real imports were widespread and included capital goods and industrial supplies, petroleum, and consumer goods. As a result, the trade deficit on goods and services reached about 5.6 percent of GDP in the fourth quarter of 2004. The recent US current deficit reflects the fallen savings rate, unlike the latter half of the 1990s and the early 2000s when domestic investment grew faster than savings.

Northeast Asia

China recorded a trade surplus of US$32.0 billion, an increase of US$6.5 billion compared with that in the previous year. The value of exports increased by 35.4 percent recording US$593.4 billion, and the value of imports increased by 36.0 percent recording US$561.4 billion. The year 2004 witnessed approval of the establishment of 43,664 foreign direct invested enterprises in China, up by 6.3 percent over the previous year. The contracted foreign capital through foreign direct investment stood at US$153.5 billion, up 33.4 percent, and the foreign capital actually utilized was US$60.6 billion, up 13.3 percent. In 2004, the accomplished business revenue through contracted overseas engineering projects was US$17.5 billion, up by 26.0 percent, and the business revenue through overseas labor contracts was US$3.8 billion US dollars, up by 13.4 percent. In 2004, a total of 109.04 million international visitors came to China for tourist, business or family reunion purposes, an increase of 19.0 percent year-on-year. Of all the international tourists, overnight visitors accounted for 41.76 million, up 26.7 percent. Foreign exchange earnings from international tourism topped US$25.7 billion, up 47.9 percent. A total of 28.85 million Chinese visitors went abroad, up 42.7 percent. Of this total, 22.98 million were on private visits, a year-on-year rise of 55.2 percent, or 79.7 percent of all outgoing visitors.

Hong Kong, China’s overall balance of payments recorded an enlarged surplus of US$3.3 billion, equivalent to 2.0 percent of GDP in 2004, compared with a surplus of US$1.0 billion, equivalent to 0.6 percent of GDP in 2003. The increase was attributable mainly to the marked reduction in net outflow of financial non-reserve assets brought about by the increase in resident banks’ external liabilities, comprising mainly loans and deposits from overseas economies. In the first quarter of 2005, a surplus of US$0.3 billion, equivalent to 0.8 percent of GDP in that period, was recorded. As to Hong Kong, China’s external debt, it stood at US$433.0 billion, equivalent to 260.8 percent of GDP at the end of 2004. Reflecting the status of Hong Kong, China, as a regional financial and business hub, more than 90 percent of this debt was associated with normal operations of banks and with inward direct investment.

As for the Japanese balance of payments for 2004, the current account surplus registered 18.6 trillion yen, an increase compared with the surplus of 15.8 trillion yen in 2003. The capital and financial account recorded a net inflow of 1.7 trillion yen, changing from the net inflow of 7.7 trillion yen in 2003. The year-on-year growth in reserve assets was 17.3 trillion yen, down from 21.5 trillion in 2003.

As Korea’s merchandise trade surplus rose significantly with the help of favorable conditions in exports, Korea’s current account surplus in 2004 was 2.3 times bigger than last year (US$11.95 billion) with an estimate of US$27.61 billion recording a surplus for the seventh consecutive year since 1998. The capital account balance recorded an inflow surplus of US$3.21 billion. While the securities investment account and direct investment account recorded an outflow, other investment accounts posted an inflow surplus owing to the payback of foreign loans by the deposit bank. The current account balance in 2005 is projected at US$14 billion, a lowered estimate than that of the previous outlook (December 2004), which states US$20 billion. As growth in exports declines due to the unfavorable foreign exchange rate and high oil prices, the surplus in merchandise trade balance is expected to decrease, and with an increase in overseas traveling, studying abroad and external dividend payment of the settling corporation, negative forecasts have been made in the services balance and income account balance that will affect the growth of the current account balance and cause it to lose its steam in 2005. As of the end of Q1 of 2005, Korea's total foreign debts were US$186.6 billion, an increase of US$8.6 billion from the end of 2004, while foreign assets amounted to US$295.5 billion, up by US$6.7 billion. Net assets were US$108.9 billion, a decrease of US$1.9 billion from the end of last year, although still remaining in the high US$100 billion range. Korea's foreign debt to GDP ratio is estimated at about 26.6 percent during the first quarter of 2005, which categorizes Korea as one of the economies with no foreign debt issues (within 30 percent) according to World Bank standards.

Chinese Taipei registered a decrease in the current account surplus of US$19.0 billion in 2004 or 6.0 percent of GDP because of narrowed trade surplus of goods and widened deficits in services and current transfers. The financial account recorded a net inflow of US$6.4 billion. Within the financial account, direct overseas investment by residents rose by 24.7 percent from US$5.7 billion in 2003 to US$7.1 billion in 2004. Direct investment in Chinese Taipei by non-residents posted a net inflow of US$1.9 billion, a significant increase of US$1.4 billion or 3.19 times that of the previous year, indicating a recovery of foreign direct investment. Portfolio investment exhibited a net outflow of US$6.4 billion in 2004. This net outflow was mainly attributable to the increase in investment in foreign securities with the aim of improving earnings. Other investment exhibited a net inflow of US$18.0 billion in 2004. This inflow mainly resulted from the borrowings from abroad by the local non-bank private sector and the banking sector in expectation of the NT dollar's appreciation against the US dollar. The overall balance of payments posted a surplus of US$26.6 billion in 2004, due to a current account surplus and a financial account inflow. External debt covers both public and private debt, broken down into long-term and short-term debt. Total external debt increased by 28.3 percent from US$63.0 billion at the end of 2003 to US$80.9 billion at the end of 2004. Most of the increase was in private debt, mainly attributable to an increase in banks' foreign borrowings. External public debt jumped to US$5 billion from US$0.2 billion in the same period, mainly because the central bank engaged in repurchase agreements involving government securities with foreign financial institutions. Long-term and short-term external private debt grew by 25.3 percent and 19.3 percent, respectively, in 2004.

Southeast Asia

Indonesia's balance of payments performance in 2004 continued to improve. The current account recorded a surplus alongside the improving export performance. Also, the capital account rebounded from a deficit in 2003 to record a surplus in 2004 as a result from an increase in private capital inflow. With these developments, the overall balance of payments in 2004 was in surplus and foreign exchange reserves by year-end rose to US$36.3 billion, equivalent to 5.6 months' worth of imports plus official foreign debt repayment. In 2004, 85.4 percent of Indonesia's public external debt was owned by the central government, leaving the remaining portion to that of the central bank. Although there was substantial progress in some indicators, the level of debt and the resultant burden still pose challenges in the future. Comparing the levels in US dollar terms, the public external debt has tended to increase. From US$69.4 billion in 2001, the debt rose to US$74.5 billion in 2002, then to US$80.9 billion in 2003. In 2004, it slightly decreased to US$80.3 billion due to debt repayments, which were partially offset by the strengthening of the Japanese yen (primarily), and other currencies (to a lesser extent), against the US dollar. Japanese yen-denominated debt accounted for 38.0 percent of Indonesia's total outstanding public external debt as of 31 December 2004. Although the level of public external debt was relatively high, other indicators showed improvements. The external public debt to GDP ratio in 2002 was 37.4 percent and the ratio has continuously declined, to 33.9 percent and 31.4 percent in 2003 and 2004, respectively. The debt to export ratio also showed better condition in 2004. The ratio, which was 110 percent and 114 percent in 2002 and 2003, respectively, has declined to 100.2 percent in 2004. The decrease in this ratio was not only attributed to the repayment of loans but also to a significant increase of exports and GDP. The source of the external public debt was mainly multilateral and bilateral creditors.

Malaysia's external sector continued to strengthen considerably, as reflected in the significant increase of internal reserves while the external debt position remained manageable. The current account recorded a larger surplus of 56.6 billion ringgit or 13.4 percent of GNP in 2004 (2003: 50.8 billion ringgit; 13.7 percent). The trade surplus continued to remain large at 81.1 billion ringgit

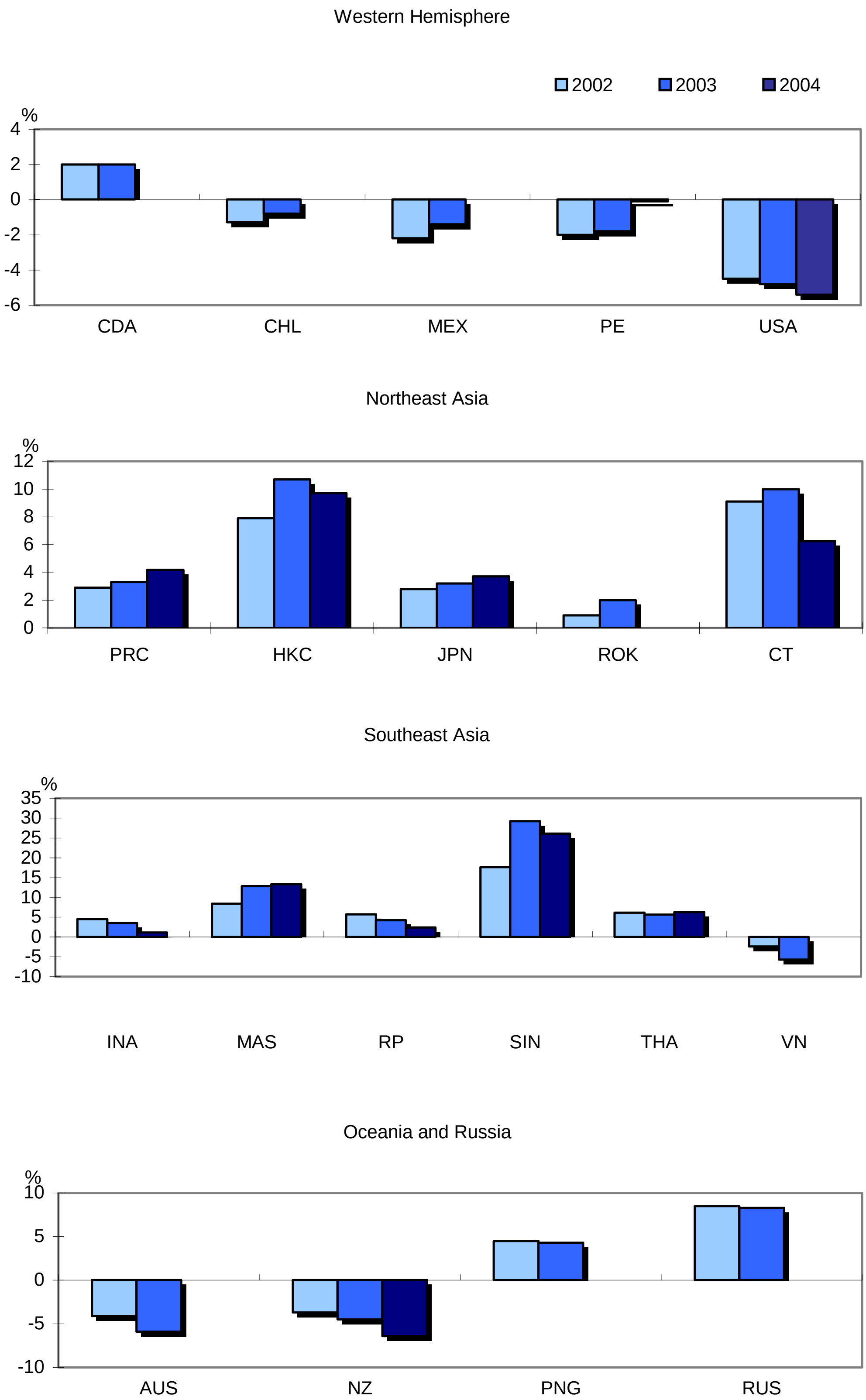
(2003: 81.3 billion ringgit) as a result of stronger growth in exports of manufactured goods and higher earnings from commodity exports. Malaysia has continued to enjoy a surplus in the current account since November 1997. Reflecting strong domestic activities, imports grew by 26.3 percent (2003: 4.4 percent). There was a significant improvement in the services account deficit due mainly to higher tourism receipts. The financial account turned around to record a net inflow of 15.4 billion ringgit in 2004 (2003: -12.1 billion ringgit) on account of mainly higher inflows of FDI and portfolio funds following stronger economic growth and improved corporate earnings. FDI was mainly channeled into services, manufacturing and oil and gas sectors. Net international reserves stood at a record high of 253.5 billion ringgit or US$66.7 billion as of the end of 2004. The reserves increased further, to 280.2 billion ringgit or US$73.7 billion by 30 April 2005. They are sufficient to finance 8.7 months of retained imports and equal 6.8 times the short-term external debt. As of the end of 2004, total external debt increased moderately to 197.3 billion ringgit or US$51.9 million (2003: US$49.1 billion), attributable to higher short-term borrowings by the banking sector, which was largely due to hedging activities for trade-related transactions and treasury activities. The share of short-term debt in total debt remained low at 21.8 percent. Given the prudent debt management policy, Malaysia's share of external debt to GNP improved to 46.6 percent (2003: 50.2 percent), while the debt service ratio improved to 4.3 percent (2003: 6.2 percent).

Table 2.6 Current Account Balances (percent of GDP)

	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	0.3	2.7	2.3	2.0	2.0	2.2
Chile	0.1	-1.2	-1.6	-1.3	-0.8	
Mexico	-2.9	-3.2	-2.9	-2.1	-1.3	-1.3
Peru	-2.8	-2.9	-2.2	-2.0	-1.8	-0.1
The United States	-3.2	-4.2	-3.8	-4.5	-4.8	-5.4
Northeast Asia						
China	1.1	1.9	1.5	2.9	3.3	4.16
Hong Kong, China	6.3	4.1	5.9	7.6	10.4	9.9
Japan	2.6	2.5	2.1	2.8	3.2	3.7
Korea	5.5	2.3	1.6	0.9	2.0	
Chinese Taipei	2.8	2.9	6.4	9.1	10.0	6.23
Southeast Asia						
Brunei Darussalam	62.6	92.8	91.6	86.5	N.A	
Indonesia	4.1	3.4	4.7	4.5	3.5	1.1
Malaysia	15.9	9.4	8.3	8.4	12.9	13.4
The Philippines	9.5	8.4	1.9	5.7	4.2	2.4
Singapore	17.9	12.9	16.8	17.7	29.2	26.1
Thailand	12.4	9.3	6.2	6.1	5.6	6.3
Viet Nam	4.1	3.5	2.2	-2.4	-5.7	
Oceania						
Australia	-5.7	-4.1	-2.4	-4.3	-6.0	-6.4
New Zealand	-6.4	-4.9	-2.6	-3.7	-4.5	-6.4
Papua New Guinea	4.3	10.1	9.4	4.5	4.3	
Russia	12.6	18.0	11.3	8.5	8.3	10.3

Sources: Individual Economy Reports
ADB, *Asian Development Outlook*, May 2005.
IMF, *International Financial Statistics*, July 2005

Figure 2.5 Current Account Balances (percent of GDP)



The Philippines' overall BOP position for 2004 registered a deficit of US$280 million, a dramatic change compared to the surplus of US$115 million realized during the previous year. However, this deficit was lower than the expected deficit of US$516 million for the year. The current account registered a surplus of US$2.1 billion. Contributing to this surplus was the continued rise in overseas Filipino workers' (OFW) remittances due to the growing demand for Filipino workers abroad, particularly for highly skilled, educated workers and professionals. The services account registered a net deficit of US$1.3 billion in 2004, but this was an improvement compared to the US$1.7 billion deficit in 2003. The improvement in the services account was due mainly to the increase in tourism receipts. The capital account balance likewise worsened from US$1.5 billion in 2003 to US$1.7 billion in 2004. Gross international reserves (GIR) reached a level of US$16.2 billion at the end of 2004. This is 5.0 percent lower than the level in 2003, but exceeded the US$14 billion to $15 billion target for the year. At the end of the first quarter of 2005, the Philippines' overall BOP position stood at a US$98 million surplus. The balance of trade improved from a deficit to a surplus and OFW remittances continued to grow due to the ongoing deployment of higher-paid workers and sustained demand for Filipino mariners.

Meanwhile, as of the end of April 2005, the Philippines' GIR stood at US$16.7 billion. This is adequate to cover about 3.8 months' worth of imports of goods and payments of services and income, or 3.5 times the economy's short-term debt based on original maturity (1.7 times based on residual maturity). Total external liabilities dropped by 4.4 percent from US$57.4 billion in 2003 to US$54.8 billion in 2004, due largely to the net transfer of credit exposures from non-residents to residents.

Singapore's overall balance of payments registered a larger surplus of S$20 billion in 2004, compared to S$12 billion in the preceding year. This largely reflected the decline in outflows from the capital and financial account and the slight improvement in the current account surplus. Consequently, Singapore's official foreign reserves rose by S$21 billion to reach S$184 billion as at end 2004 (equivalent to 8.0 months of current imports).

Thailand's trade balance has remained in surplus since the crisis year of 1997. But its trend is to lessen the extent of surplus following strong internal demand from economic expansion. In 2004, trade surplus registers a surplus of US$1.7 billion. In 2005, the Ministry of Finance expects that exports value will grow by 11.8 percent to US$107.5 billion, while imports will increase by 15.6 percent to US$109.1 billion. The main factor in the acceleration of imports is upward demand for raw materials, capital goods, and energy to support new investment as well as a rise in commodity prices.

Viet Nam's trade deficit in 2005 is about US$1.4 billion (FOB price). The services balance will continue to decrease, to US$1.1 billion. The deficit of net income investment increased by US$100 million compared with that of last year and the estimated income from money transfers (of both private and state-owned enterprises) is US$2.6 billion. The capital balance is forecast to achieve a considerable surplus and the disbursement of foreign direct investment is estimated to reach US$2 billion. The net long- and medium-term debt could be around US$500 million, in which the long- and medium-term debt in 2005 could be US$1.6 billion, and the payment is estimated to be US$1.1 billion. The total balance of payments in 2005 is forecast to have the surplus of US$1 billion. At the end of 2005, the total foreign debt is estimated to be US$16.7 billion, increasing by 10.4 percent compared with that of 2004. The structure between foreign debt of government and private enterprises continues to be stable with the gradual decrease in the proportion of the government new debt and the increase in the commercial debt of enterprises. In 2005, new debt will be US$2.57 billion including US$1.57 billion new government debt and US$1 billion debt. The proportion of government debt in 2005 decreases to 61.1 percent and the proportion of new enterprises' debt increases to 38.9 percent. The debt payment accounts for 5.5 percent of the exports value in 2005, increasing by 0.5 percent compared with 2004 (5.0 percent in 2004). The government payment service accounts for 9.1 percent of the total government budget in 2005, a dramatic change in comparison to the 7.1 percent of 2004. However, if the debt is subtracted from debt capital via foreign accumulated debt budget (this was not included in the balance of the government budget), the government debt payment from government budget only accounts for 4.0 to –5.0 percent of the total government budget.

Oceania and Russia

Australia's current account deficit increased to $53.9 billion or 6.4 per cent of GDP in 2004, up from $46.9 billion or 6.0 per cent of GDP in 2003. Australia's gross external debt was $699.2 billion in December 2004, an increase from $611.4 billion in 2003.

New Zealand's current account deficit is expected to continue to increase, peaking at 7.0 percent of nominal GDP in late 2006–early 2007. After that, it will decline gradually to around 6.0 percent of GDP in June 2009. The increase in the deficit is expected to be driven initially by an increase in the deficit on goods as a result of the continuing momentum in the domestic economy maintaining import growth, while export growth slows as a result of the high exchange rate and slower trading partner growth. Subsequently, import prices are expected to increase more than export prices as the terms of trade deteriorate, further contributing to the deficit on goods. The balance on investment income remains negative throughout the forecast period, as the profits that accrue to foreign investors in New Zealand continue to exceed returns from New Zealand's overseas investments, but this component of the current account deficit decreases in the forecast period as business profitability declines. New Zealand's total external debt for the year to December 2004 was $152 billion, up from $137 billion in December 2003. The net international asset position saw liabilities exceed assets by $124 billion in December 2004, compared with $106 billion in December 2003.

The current account of Papua New Guinea recorded a surplus of 237 million kina or 1.7 per cent of GDP in 2004. This reflects a trade surplus of 1,058 million kina, a transfer surplus of 585 million kina largely offset by an income deficit of 1,406 million kina. The current account balance for March 2005 recorded a deficit of 211 million kina. This is attributed to the deficit in the balance of income more than offsetting the surplus in the balance of trade and the balance of transfers.

Russia's current account in 2004 has grown by 1.7 times since 2003 mainly due to increasing trade surplus. Russia's gold and foreign exchange reserve assets increased by US$47.6 billion over 2004 and reached US$120.8 billion by 1 January 2005 (US$143.7 billion by 1 June 2005). As Russia's official reserve assets depend on fluctuations of the world markets for oil, oil products and natural gas, etc., they increased greatly in 2005: to US$147.4 billion by 1 June 2005 from US$76.9 billion on 1 January 2004. Russia's foreign exchange reserves accumulated by 1 January 2005 were sufficient to finance 11.5 months' worth of imports of goods and services (8.9 months' a year before).

2.6. Foreign Exchange Markets

Western Hemisphere

The Canadian dollar has appreciated about 30 percent against the US dollar since 31 December 2002. Stronger global growth and increased demand for commodities has driven part of the rise in the value of the Canadian dollar over the past two years. Since Canada is a net exporter of commodities, the Canadian dollar often rises against the US dollar when global commodity prices increase. However, the appreciation of the Canadian dollar also reflects global portfolio adjustments in response to persistent US current account imbalances. All major floating currencies have climbed sharply against the US dollar over the past two years.

In 2004, Peru's free-floating exchange rate regime was maintained. As of December 2004, the exchange rate decreased 5.5 percent to S/. 3.282 from a year ago in line with most of Peru's main trade partners' currency appreciation against the US dollar. In real terms, the nuevo sol appreciated by 1.5 percent.

Northeast Asia

As of 21 July 2005, China adopted a managed floating exchange rate system. At the same time, the renminbi was revalued to 8.11 renminbi per US dollar from 8.28, or a 2.1 percent appreciation. The new system will allow fluctuation of the renminbi within the range of ± 0.3 percent depending on the movements of major currencies. Also, the fluctuation limits can be adjusted if necessary considering economic and financial market conditions.

The Hong Kong dollar exchange rate stayed close to the convertibility rate of HK$7.8/US$1 between April and September 2004, before strengthening from October 2004 to reach a level of 7.7703 on 8 December 2004. In response, the Hong Kong Monetary Authority (HKMA) conducted numerous strong-side operations. The market exchange rate gradually returned to close to the convertibility rate towards the end of 2004. In the first four months of 2005, the Hong Kong dollar exchange rate stayed close to the weak-side convertibility rate, with the weak-side Convertibility Undertaking being triggered occasionally. In order to further enhance the effectiveness of interest rate and exchange rate adjustments, the HKMA introduced three refinements to the Linked Exchange Rate System on 18 May (for details, see the "exchange rate" section of the Individual Economy Report on Hong Kong, China). Financial markets reacted favorably to these measures, with Hong Kong dollar Interbank interest rates rising to track US dollar interest rates more closely, and discounts in the Hong Kong dollar forward market narrowing. Thereafter, the Hong Kong dollar exchange rate strengthened slightly, reportedly attributed to increased demand for the Hong Kong dollar associated with equity initial public offerings in June and expectations of further renminbi appreciation following the change in the renminbi exchange rate regime in late July. The overall exchange value of the Hong Kong dollar, as measured by the trade-weighted Nominal Effective Exchange Rate Index, rose from 96.0 at end-2004 to 97.4 at end-August 2005.

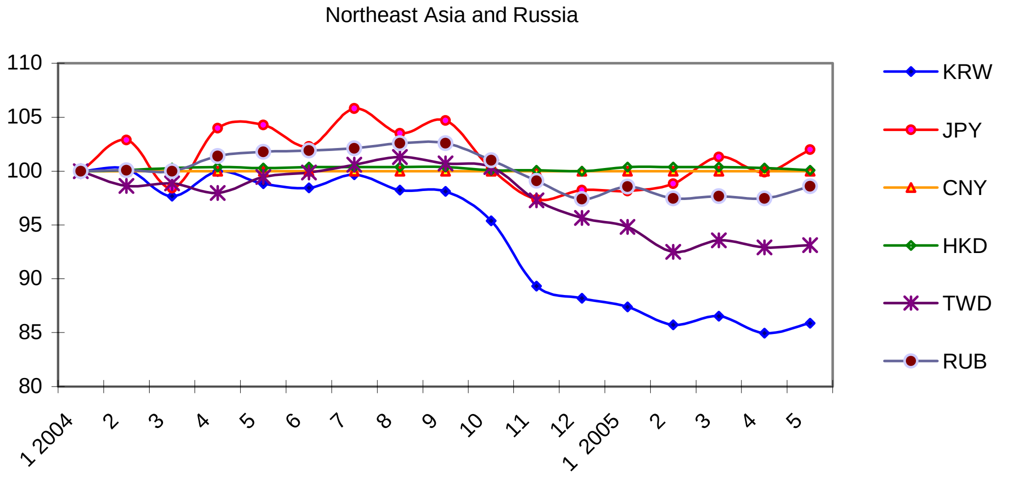
At the end of 2004, the US dollar and the Korean won exchange rate stood at 1,035.1 won (a 15.2 percent appreciation), which was a drop of 157.5 won, compared to the end of the previous year (1,192.6 won). The annual average of the dollar-won exchange rate was 1,144.7 won in 2004, a 4.1 percent appreciation in the value of the won compared to the 1191.9 won on average in the previous year. With expectation of broad-based dollar weakness and appreciation of the Korean won, domestic exporters had sold a significant amount of dollars which resulted in a drop of 100 won in Q4. During Q1 of 2005, the won-dollar exchange rate was back to a moderate pace, however, factors such as continued selling of the US dollars by exporters and revaluation of the Chinese renminbi have since weakened the dollar to a 1000 won range. In contrast, the dollar is on the back of a rising trend due to an interest rate hike by US Federal Reserve, recording an exchange rate of 1025.4 won as of June 2005, down by 0.9 percent from the same quarter of 2004.

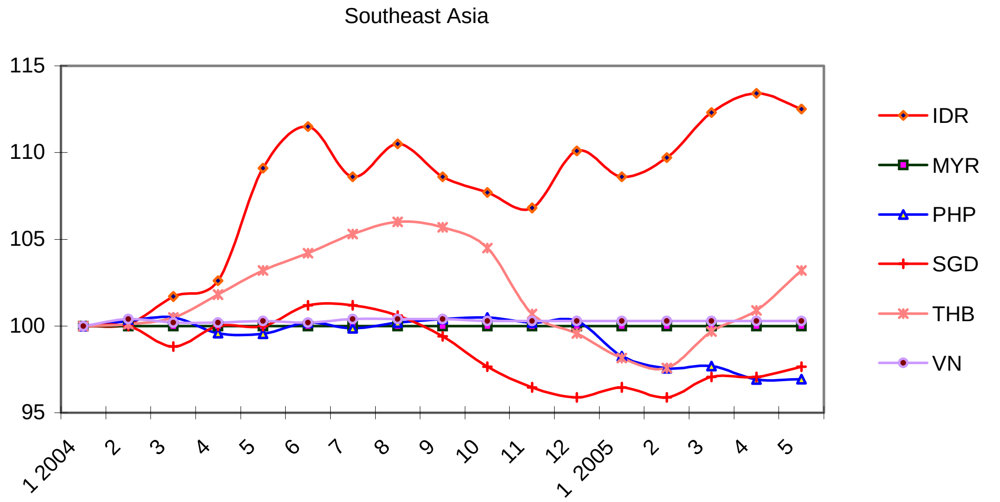
Due to an increase in the US trade deficit and a recovery in the Japanese economy, coupled with foreign capital inflows to the Chinese Taipei stock market, the New Taiwan dollar (NT dollar) appreciated from 33.976 to the US dollar at the beginning of 2004 to 32.798 in mid-April. In late April, the NT dollar started to depreciate under the impact of China's macroeconomic adjustments to slow its economy, expectations of rising US interest rates, and higher oil prices. The NT dollar declined to 34.199 against the US dollar on 28 July, the lowest level of the year. With the inflows of foreign funds, the NT dollar appreciated. In December, due to further weakness in the US dollar, and the devastating tsunami in South and Southeast Asia on 26 December 2004, funds flowed to Northeast Asia. Therefore, the NT dollar finished 2004 at its yearly high of 31.917. Compared with the rate of 33.978 registered at the end of 2003, the NT dollar appreciated by 6.46 percent against the US dollar in 2004.

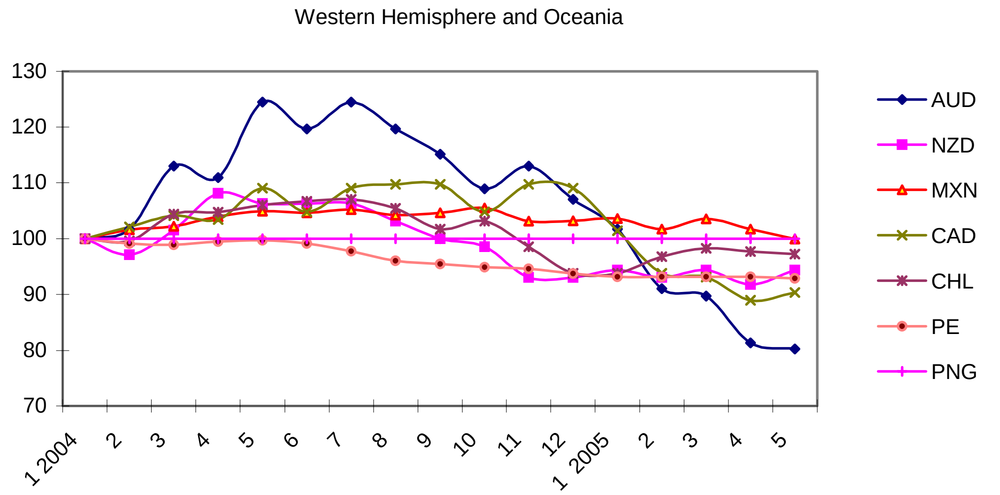
Table 2.7 Foreign Exchange Rates* (Local Currency Unit/USD)						
	2000	**2001**	**2002**	**2003**	**2004**	**May 2005**
Western Hemisphere						
Canada	1.50	1.59	1.58	1.29	1.34	1.25
Chile	572.6	656.20	712.38	599.42	636.59	580.22
Mexico	9.57	9.14	10.31	11.24	11.51	10.903
Peru	3.53	3.44	3.51	3.46	3.49	3.25
The United States**	0.94	0.88	1.05	1.26	1.22	1.24
Northeast Asia						
China	8.28	8.28	8.28	8.28	8.28	8.28
Hong Kong, China	7.80	7.80	7.80	7.76	7.77	7.78
Japan*	114.9	131.80	119.90	107.10	104.12	108.08
Korea	1,265	1,314	1,186	1,193	1,156	1,007
Chinese Taipei	33.07	34.95	34.60	33.93	33.52	31.92
Southeast Asia						
Indonesia	9,595	10,400	8,940	8,465	9,415	9,450
Malaysia	3.80	3.80	3.80	3.80	3.80	3.80
The Philippines	44.19	50.99	51.60	54.20	55.94	53.36
Singapore	1.73	1.85	1.74	1.70	1.63	1.66
Thailand	43.27	44.22	43.15	39.59	40.89	40.47
Viet Nam	14,51	15,084	15,403	15,646	15,745	
Oceania						
Australia	1.82	1.96	1.75	1.33	1.30	1.322
New Zealand	2.27	2.38	1.89	1.51	1.59	2.073
Papua New Guinea	3.03	3.07	4.00	3.33	3.23	
Russia	28.16	30.14	31.78	29.45	29.03	27.95

Note: * end of period
** US Dollar/Euro
Source: IMF*, International Financial Statistics, July* 2005

Figure 2.6 Trends of Exchange Rates of APEC Currencies against the US Dollar







Southeast Asia

Indonesia’s rupiah exchange rate in 2004 was largely stable, especially in the second half of 2004. The rupiah exchange rate closed at Rp. 9,283 per US dollar at the end of December 2004. During 2004, the exchange rate averaged at Rp. 8,940/US$, representing a 3.9 percent depreciation from the previous year. The rupiah exchange rate stability benefited from measures pursued by the government and the monetary authority to improve macroeconomic stability, strengthen coordination and consistency in policy measures, build a more resilient banking system and foster positive expectations. During the first quarter of 2005, the rupiah exchange rate experienced gradual depreciation with relatively low volatility. During the quarter, the rupiah/US$ rate averaged Rp. 9,279 and closed at Rp. 9,465 by end-March 2005. This depreciation trend was attributable to the increase of domestic foreign exchange demand that was not supported by a sufficient foreign exchange supply. Later in 2005, the rupiah exchange rate is predicted to stabilize and the rupiah will tend to appreciate, supported by encouraging internal and external factors and an effective rupiah stabilization policy package announced in 2004. The stable rupiah exchange rate in 2005 would also be supported by an improving supply and demand of foreign exchange coupled with the improved balance of payments performance in the same year. The current account is expected to record a surplus and will support the supply of foreign exchange in the economy. Meanwhile, the projected deficit in the capital account is not expected to cause a deficit in the overall balance of payment, thus avoiding pressure on the rupiah exchange rate. This is because: (i) the deficit capital account is mainly caused by the increase of official debt repayment, (ii) the rupiah exchange rate is more sensitive to the flow of portfolio investment than to overall deficit capital account, and (iii) FDI is expected to increase in 2005.

The pegged exchange rate arrangement continues to accord benefits to the Malaysian economy by providing predictability and stability for international trade and investment. The exchange rate regime would only be reviewed in the event the ringgit is headed for sustained misalignment arising from major structural changes within the international and regional financial system, or if fundamentals warranted a change in the system.

The Filipino peso-dollar exchange rate averaged 56.04 pesos/US$ in 2004, a 3.4 percent depreciation from the average exchange of 52.20 pesos/US$ in 2003. Corporate demand for US dollars rose due to higher import requirements brought about mainly by the hike in world oil prices and hedging against future dollar requirements in light of volatile energy prices. Concerns over the economy’s fiscal situation, the surge in world oil prices, and credit rating downgrades by international agencies also exerted downward pressure on the peso. Higher OFW remittances tempered the depreciation, as did: positive market sentiments following the decision of the California Public Employees' Retirement System, a large US pension fund, to continue investing in the Philippines; the conclusion of the elections; and the announcement of the Arroyo administration’s 10-point agenda, which would implement structural reforms to achieve fiscal balance by 2010, combat corruption and reduce poverty. The peso rebounded in the first quarter of 2005 to register an average exchange rate of 55.01 peso/US dollar for the period. This was due to sustained dollar inflows from OFW remittances and portfolio investments owing to a positive outlook on the economy. The peso also benefited from the continued weakness of the US dollar and the trend toward appreciation among regional currencies.

After changing the exchange rate regime from a currency basket system to a managed floating exchange rate regime within a pre-determined band, the Thai baht had continuously depreciated, which helped promote high growth exports from 1997 to 2001. With successful exports performance and a continuous balance of payments surplus, the Thai baht has directly appreciated along with Asian currencies led by the Japanese yen, and averaged 41.53 baht/US dollar in 2003 and 40.27 baht/US dollar. In addition, another key factor fuelling the Thai baht appreciation is the falling value of the US dollar, which has been pressed by its fundamental problem of a long period of current account deficit.

The general decline of the US dollar in the second half of 2004 was the main factor affecting bilateral exchange rates between the Singapore dollar and the currencies of its major trading partners. The Singapore dollar appreciated by 4.1 percent against the US dollar over the year. Currencies pegged to the greenback also weakened against the Singapore dollar. The Singapore dollar rose 4.1 percent against the Malaysian ringgit and 4.2 percent against the Hong Kong dollar. It also appreciated by a marginal 0.3 percent against the Australian dollar and was virtually unchanged against the Japanese yen. With the S$ nominal effective exchange rate (NEER) only slightly up over the year, the Singapore dollar weakened against most other major currencies in 2004. It weakened by 2.7 percent against the New Taiwan dollar, 3.7 percent against the pound sterling, 3.8 percent against the euro and 9.8 percent against the Korean won.

Oceania and Russia

Australia has had a floating exchange rate since 1983. The Reserve Bank of Australia (RBA) undertakes foreign exchange market operations for its clients (mainly the Australian Government) and on its own account. During 2004, the RBA did not intervene to influence the exchange rate of the Australian dollar. However, the RBA continued to add to its holding of foreign reserves, doing so during periods of strength in the exchange rate. The Australian dollar was relatively stable in 2004, appreciating (in nominal terms) by around 4.0 percent against the US dollar and depreciating by 3.5 percent against the euro and by around 0.7 percent against the Japanese yen. The movements of the Australian dollar against those currencies contributed to a 0.5 percent decrease in the trade-weighted index.

Papua New Guinea’s kina has remained stable against the US dollar and Australian dollar in 2005. Over the course of 2005, the kina has appreciated from 32 US cents to 32.1 US cents, an increase of 0.3 percent and from 41.06 cents to 42.03 cents against the Australian dollar, an increase of 2.4 percent. The stability of the currency reflects the government’s sound economic management and continued high international prices of major commodity exports. Foreign exchange reserves have also remained high and around near record levels.

In 2004, Russia continued to pursue the policy of floating exchange rate of the ruble. Over the year the exchange rate of the ruble remained relatively stable. On the whole, the supply of foreign exchange on the market prevailed over the demand. For most of the year the dynamics of the exchange rate of the ruble was characterized by a growth trend. During 2004 the official ruble/US$ exchange rate fixed by the Bank of Russia (CBR) went up by 5.8 percent or from 29.45 rubles per US$ on 31 December 2003 to 27.75 rubles per US$ as on 31 December 2004. In 2004 the official ruble/euro exchange rate went down by 2.7 (or from 36.82 rubles per euro as on 31 December 2003) up to 37.81 rubles per euro as on 31 December 2004. On the whole, the real ruble appreciation against the US dollar amounted to 15.0 percent in 2004 as compared with 2003, while the real ruble appreciation against the euro was 5.6 percent in the same period. The real ruble effective exchange rate (as compared with the basket of foreign currencies used in Russia's foreign trade) rose by 6.1 percent in 2004 as against 2003 y-o-y and by 4.6 percent compared to December 2003.

3. POLICY RESPONSE AND ECONOMIC PROSPECTS

3.1 Mixed Fiscal Policy Directions

Western Hemisphere

Canada has recorded seven consecutive budgetary surpluses—and is expected to record its eighth in fiscal year 2004–05, thanks to sound fiscal management. Canada’s fiscal performance over the past 10 years is unmatched among G-7 economies. In 1995 Canada’s total government deficit was well above the G-7 average. However, significant fiscal improvements at all levels of government enabled Canada's total government to post a surplus in 1997. Since then Canada has recorded a total government surplus every year, while the average deficit among G-7 economies has deteriorated rapidly since 2000. Indeed, Canada has been the only G-7 economy to record a total government budget surplus in each of the past three years. This strong overall fiscal performance, together with sustained economic growth, has given Canada a net debt-to-GDP ratio of under 39.0 percent in 2004, the lowest in the G-7.

Chile's budget surplus reached 2.9 percent of GDP due to a large increase in revenues (23.3 percent) while spending growth increased (5.1 percent). With the large surplus, the government made prepayments and deposits to the copper compensation fund (*Fondo de Compensación del Cobre*). The central bank's net debt, meanwhile, went from 0.5 to –0.2 percent of GDP by June 2004. The consolidated net debt of the central government and central bank fell from 7.4 percent to 5.7 percent of GDP, respectively, in the same period, and it had reached about 5.0 percent of GDP by the end of 2004. The consolidated gross debt fell from 34.3 percent in December 2003 to 32.3 percent of GDP in June 2004.

Peru's overall public sector deficit fell to 1.1 percent of GDP in 2004 from 1.8 percent in 2003. This reduction was mainly due to the decrease in non-financial expenditure of the central government from 14.9 to 14.6 percent of GDP and the increase in central government current revenues, from 15.0 to 15.2 percent of GDP. The surplus in the primary balance, which excludes interest payments from the overall balance, improved from a 0.4 percent of GDP in 2003 to 1.0 percent in 2004. The improvement of current revenues reflected the effect of a higher rate of economic activity, the extension of administrative measures oriented to enhance tax collection, the creation of the financial transaction tax that was established in March 2004, and the effect of a 1.0 percent increase in the rate of the IGV (value added tax) since August 2003. Specifically, the IGV collection increased from 6.7 percent of GDP in 2003 to 6.9 percent of GDP in 2004.

The US administration proposed, and Congress enacted, significant tax relief in each of the past four years which were designed to overcome the shocks that were restraining the economy and restore strong growth of output, income, and jobs. In addition to providing much needed near-term stimulus, the 2001 and 2003 acts also were designed to raise long-term growth by reducing the disincentives and distortions in the tax system. These acts reduced marginal tax rates on income, dividends, and capital gains. Lower tax rates encourage individuals and businesses to produce more, save more, and invest more. More saving and investment create capital, add to economic growth, and raise the standard of living

Northeast Asia

China's budget deficit contracted in 2004. China's domestic revenues rose to US$318.4 billion (excluding revenue from generation of debt, both here and below) from US$241.6 billion in 2003. National expenditures totaled US$342.7 billion, an increase of 15.1 percent year-on-year. Expenditures exceeded revenue by US$24.2 billion. Total revenue in the central budget amounted to US$182.2 billion, up US$26.0 billion (after deducting the additional US$15.4 billion used for export tax rebates), or 16.6 percent over the previous year and representing 109.1 percent of the budgeted figure. Total expenditures in the central budget came to US$220.8 billion (including US$125.4 billion in tax rebates and subsidies for local authorities), US$25.9 billion or 13.3 percent more than the previous year and representing 107.4 percent of the budgeted figure. The deficit in the central budget was US$38.6 billion, less than that approved at the Second Session of the Tenth NPC.

Hong Kong, China's unaudited financial results for 2004–05 (ending on March 31) showed a surplus of HK$21.4 billion or 1.7 percent of GDP in 2004 as compared with the original budget deficit of HK$42.6 billion. As of the end of March 2005, fiscal reserves stood at HK$296 billion, HK$20.7 billion more than the balance of HK$275.3 billion at the end of March 2004. The increase is due to the surplus of HK$21.4 billion for the year ending 31 March 2005, offset partly by a provision of HK$0.7 billion for the diminution in market value of investments with the Exchange

Fund during January to March 2005. The fiscal reserves at end of March 2005 represented 15 months of government expenditure in 2004–2005. The 2005–2006 budget forecasts a deficit of HK$10.5 billion, equivalent to 0.8 percent of the forecast GDP for 2005. The budgeted government expenditure represents a growth of some 4.9 percent in money terms over 2004–05. In the remaining years of the Medium-Range Forecast (from 2006–2007 to 2009–2010), government expenditure is planned to fall at an average annual rate of 0.2 percent in money terms.

Japanese public finance is confronted with a considerably severe situation with the national and regional long-term debts amounting to approximately 750 trillion yen at the end of 2004, which is about 150 percent of the nominal GDP. The government, in promoting the public expenditure reform, has maintained stable fiscal management since the FY2002 budget by holding general account expenditures and general expenditures at levels lower than those of the previous fiscal year, in real terms. Local government expenditures have also been under intensive review in accordance with the national policy. Meanwhile, tax revenue has been on the increase against a background of rising corporate profits. As for the FY2006 budget, based on the Basic Policies for Economic and Fiscal Management and Structural Reform 2005, central and local government will keep in line with each other to maintain and strengthen the expenditure reform. Government bond issuance will be restrained as much as possible. However, fiscal soundness should be pursued in balance with economic vitality.

Korea’s fiscal expansion continued in 2004. It sped up budgetary expenditures (55.0 percent of the total) for pertinent projects (including Korean funds and state-owned companies) during the first half of 2004 in order to facilitate economic recovery. During the second half of 2004, the government expanded fiscal spending to support low-income families and small and medium-sized enterprises (SMEs) that were struggling from the attenuated domestic demand (supplementary budget bill 1.8 trillion won, additional spending 2.7 trillion won). In this process, it is evident that fiscal spending was expanded in 2004 compared to 2003. Considering the integrated fiscal balance, however, national debt was recorded at a mere 203.1 trillion won (26.1 percent of GDP) while the proportion of debts in deficit was quite low, indicating the soundness of Korea’s fiscal status. During the first half of 2005, the economy has shown visible signs of recovery through the early execution of fiscal resources, namely an expansion in public construction investments. On the other hand, there are concerns about the austere management of budgetary expenditures in the second half of 2005. To prevent such problems, the government seeks to expand public spending of 3.1 trillion won in national funds and state-owned companies and will review the feasibility of additional spending plans, including the supplementary budget bill, according to the economic and financial situations. In addition, the government aims to implement the comprehensive investment plan and private capital project successfully during the second half of this year to manage economic conditions. This will set an efficient example for the new investment method by funneling additional financial resources from the private sector into public investments.

Chinese Taipei has implemented various tax-exemption measures in order to stimulate economic development. Also, fiscal consolidation measures were introduced to reduce budget deficits. The tax-exemptions caused the ratio of tax revenue to GDP to decline year by year, to just 13.6 percent in 2004. As government expenditure has not been reduced proportionally, a growing fiscal deficit has occurred. To improve the fiscal situation, measures have been taken to tap new sources of revenue and cut unnecessary expenditure. In September 2001, a Fiscal Reform Committee was established, to actively review tax revenue, non-tax revenue and expenditures. According to the Committee’s plan, all government authorities have been required to take appropriate measures to put the plan into effect with the aim of achieving a balanced budget within five to ten years. To this point, the Fiscal Reform Plan has attained certain preliminary results. Moreover, with the steadying and continued recovery of the domestic economy, the government tax revenue as realized in 2004 exceeded the estimated figure by NT$53.2 billion, the first time in six years that such a budget goal had been attained. To sum up, although the government still had a fiscal deficit in 2004 (excluding local government), the ratios of fiscal deficit to expenditure and fiscal deficit to GDP were 12.6 percent and 1.9 percent, respectively, which is an improvement compared to the figures of 15.3 percent and 2.5 percent for 2002, and 18.6 percent and 3.0 percent for 2003, all respectively. At present, Chinese Taipei is placing emphasis on tax reform to properly adjust the tax structure and achieve tax equality and efficiency.

Table 3.1 Budget Balances (percent of GDP)

	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	1.6	2.9	1.1	0.3	0.6	1.4
Chile	-1.4	0.1	-0.3	-0.8	-0.8	
Mexico	-1.2	-1.1	-0.7	-1.2	-0.7	-0.3
Peru	-3.2	-3.3	-2.6	-2.3	-1.8	-1.1
The United States	1.4	2.3	1.3	-1.5	-3.5	-3.6
Northeast Asia						
China	-2.1	-2.8	-2.6	-3.0	-2.7	-2.3
Hong Kong, China	0.8	-0.6	-4.9	-4.8	-3.3	1.7
Japan*	-8.6	-7.0	-6.6	-7.9	-7.7	
Korea	-2.7	1.3	1.3	3.8	1.3	
Chinese Taipei	-0.5	-2.4	-3.9	-3.6	-3.5	-3.9
Southeast Asia						
Brunei Darussalam	0.7	17.4	6.0	-4.2	N.A	
Indonesia	-3.7	-1.6	-2.8	-1.5	-2.1	-1.1
Malaysia	-3.2	-5.8	-5.5	-5.6	-5.3	-4.3
The Philippines	-3.8	-4.1	-4.1	-5.3	-4.6	-3.9
Singapore	3.4	2.5	-1.8	0.1	-1.1	-0.2
Thailand	-2.8	-2.3	-2.6	-2.9	-2.1	0
Viet Nam	5.0	5.0	5.0	5.0	5.0	
Oceania						
Australia**	0.7	2.1	0.9	-0.1	1.0	1.0
New Zealand	0.2	0.8	1.8	2.2	4.3	4.7
Papua New Guinea	-2.6	-2.0	-3.6	-4.2	-1.3	
Russia	-0.9	1.1	2.7	1.3	1.7	4.5

Note: * Refers to fiscal year (April to March)
**Refers to financial year eg 2004 is the financial year 2003–2004

Southeast Asia

In 2004, Indonesia has significantly reduced its budget deficit to -1.1 percent of GDP and the debt-GDP ratio was lowered to below 53.0 percent. Indonesia is currently targeting a deficit of 0.7 percent of GDP, down from 1.1 percent in 2004. This should lead to a government debt to GDP ratio of below 50.0 percent by the end of 2005. In 2005, fiscal policies aim at maintaining fiscal sustainability by lowering the budget deficit below 1.0 percent of GDP. The key fiscal challenges facing Indonesia in 2005 are the cost of reconstruction in Aceh and north Sumatra in the wake of the tsunami in December 2004, and the need to replace US$3 billion in budget financing previously available to Indonesia under the Paris Club rescheduling. In the absence of Paris Club debt rescheduling, net external debt repayments are projected to reach US$2.3 billion in 2005 (0.8 percent of GDP). The 2005 budget assumes foreign loans of US$3.1 billion against projected principal repayments of US$5.4 billion. The resulting net financing requirement is expected to be met partly through sales of government bonds (net issues of 0.9 percent of GDP), privatization and asset sales (0.3 percent of GDP) and a draw down of government deposits with bank Indonesia (0.6 percent of GDP).

Malaysia recorded a smaller fiscal deficit of 4.3 percent of GDP in 2004 (2003: -5.3 percent). The improvement in the fiscal position was due to better revenue collection and lower disbursements of development expenditure. The fiscal deficit was financed mainly from domestic sources.

The Government of the Philippines recorded a deficit of 186.1 billion pesos for 2004, 11.7 billion pesos lower than the full-year target of 197.8 billion pesos. Revenue collection increased by 11.4 percent to 698.3 billion pesos as the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) strengthened implementation of administrative reforms that began in 2002. The BIR fully harnessed its IT capabilities in detecting patterns of tax evasion and continued its tax compliance verification drive and other programs that enhance tax compliance. The BOC, on the other hand, improved its human resource management and overhauled the customs processing system and warehousing procedures. Total disbursements reached 884.4 billion pesos, a 7.0 percent increase from the previous year's level and one percentage point higher than the full-year program. The biggest increase in spending went to government infrastructures and capital outlays, which went up by 17.7 percent. This improved the share of government investment to 14.7 percent from last year's 13.5 percent. For the first four months of 2005, the government posted a deficit of 60.1 billion pesos with the total revenue collection reaching 255.4 billion pesos, an 11.8 percent increase from the first four-month level in 2004. The April 2005 collection was by far the highest recorded in the bureau's history. Likewise, customs collections increased by 9.6 percent and BIR's income grew by 22.4 percent for the same period reflecting continuing efforts to implement administrative reforms, enforce tax laws, and generate revenues from privatization of government assets. Total disbursements grew by 7.7 percent to 315.55 billion pesos for the first four months of 2005. The increase was mainly due to interest payments, personal services and the local governments' internal revenue allotment.

Thailand's past accommodative fiscal policy successfully stimulated domestic demand and set the economy on a sustainable growth track. Therefore, Thailand's fiscal stimuli will be reduced. For the entire FY2004, the total revenue collected was 1,127,153 million baht (17.6 percent of GDP) which exceeds the expected revenue outturn of 1,063,600 million baht, including the supplementary budget. Expenditure on the current fiscal year excluding carry-overs budget for FY2004 was 1,052,660 million baht, equivalent to 16.5 percent of GDP, out of the total budgeted expenditure of 1,163,500 million baht or 90.5 percent disbursement rate. This is a substantial improvement from the previous fiscal year, FY2003, when disbursement was 87.4 percent. The carry-overs disbursement was 87,450 million baht. The budget balance showed a deficit of 12,957 million baht or 0.2 percent of GDP, much lower than the expected deficit amount of 99,900 million baht. Including the extra-budgetary deficit of 55,018 million baht, the fiscal balance went into deficit by 67,974 million baht. The government plans that FY2005 budget should be the first balanced budget since the economic crisis in 1997. As of December 2004, outstanding public debt was at 3.1 trillion baht or 48.2 percent of GDP, lower than 50.6 percent of GDP at the end of

FY2003 or October 2003. However, with the fiscal sustainability framework, it is expected that public debt will be reduced along with the balanced budget starting in FY2005.

Singapore's fiscal policy was slightly expansionary in 2004. Total operating revenue was up by 6.9 percent to S$26.3 billion in 2004 due to the strong economic recovery. Total expenditure rose by 4.5 percent to S$28.4 billion. The government seeks to run a balanced budget, or achieve a modest surplus, over the medium- and long-term.

Thanks to the development of the economy and the comprehensive tax collection method, Viet Nam's budget income of 2005 is forecast to be high despite the reduction in some taxes in accordance with the integration route and the policy of promoting investment. The total budget income in 2005 will be VN$198 thousand billion, or an increase of 9.8 percent. The Budget Law of 2003 increased both independence and responsibility. This policy direction will continue in 2005.

Oceania and Russia

Australia's medium-term fiscal strategy has the primary objective of maintaining a budget balance, on average, over the course of the economic cycle. The 2004–05 underlying cash balance (data are not available on a calendar year basis) is expected to be in surplus of 1.1 percent of GDP (or 0.8 percent on an accruals basis). Further, over the eight years to 2004–05, the government has achieved cumulative underlying cash surpluses estimated at around $48 billion. These surpluses, combined with the proceeds from the sale of financial assets, have enabled the government to reduce Australian Government general government sector net debt from 19.1 percent of GDP in 1995–96 to an estimated 1.9 percent of GDP at the end of 2004–05. Consistent with the fiscal strategy, the government introduced its eighth budget surplus in the 2005-06 Budget. In the 2005–06 financial year, the Australian Government is expected to be in an underlying cash surplus of 1.0 percent of GDP (or 0.8 percent measured on an accruals basis).

New Zealand's operating balance before revaluations and accounting changes (OBERAC) is estimated to be 4.9 percent of GDP in June 2005, before declining to 4.3 percent of GDP in 2006 and 3.0 percent of GDP in 2009. Core Crown net debt is estimated to be 7.7 percent of GDP in 2006, compared with 15.4 percent in 2002, and is forecast to be 7.5 percent of GDP in 2009. Gross debt is forecast to fall from 22.6 percent in 2005 to 20.2 percent in 2009. Throughout the forecast period the accumulated assets of the New Zealand Superannuation Fund will grow from an estimated 4.3 percent of GDP in 2005 to 10.9 percent of GDP in 2009. Current fiscal policy in New Zealand is geared towards running operating surpluses sufficient to meet the contributions to the New Zealand Superannuation Fund and to slowly reducing gross debt as a percentage of GDP over the longer term, passing through 20 percent of GDP before 2015.

At the end of 2004, Papua New Guinea's public debt was 7.5 billion kina or 54.3 percent of GDP, with 4.3 billion kina (or 57.0 percent) external debt and 3.2 billion kina (or 43 percent) domestic debt.

Russia's federal budget revenue in 2004 increased 1.3 times in absolute terms year-on-year and aggregated 3,426.3 billion rubles, or 20.4 percent of GDP as against 19.6 percent in 2003. The Federal Tax Service accounted for 57.3 percent of total federal budget revenue and the Federal Customs Service contributed 35.6 percent (in 2003, the respective percentages were 64.8 percent and 29.3 percent). Year-on-year growth in federal budget revenue in 2004 was due to the increase in tax revenues, which accounted for 79.2 percent of total budget revenue as against 78.5 percent in 2003. The taxes on foreign trade and foreign economic operations accounted for almost half of overall revenue growth owing to high oil prices and the expansion of foreign trade turnover in 2004. The ratio of non-tax revenues contracted to 6.5 percent in 2004 as against 6.8 percent in 2003, mainly as a result of a fall in revenues from foreign economic operations (which decreased by one-third in absolute terms), which in turn was mainly due to interest on government loans. The structure of the federal budget revenues changed significantly in 2004 as compared with 2003. The taxes on foreign trade and foreign economic operations accounted for

25.1 percent of federal budget revenue as against 17.5 percent in 2003 and the severance tax accounted for 12.7 percent as against 9.6 percent a year earlier due to the increase in the tax rate. At the same time, the ratio of value added tax in the federal revenues contracted from 34.1 percent to 31.2 percent owing to a cut in the VAT rate. The ratio of excise duties decreased from 9.8 percent to 3.4 percent as a result of the lifting of the excise duty on natural gas.

3.2 Leaving Accommodative Monetary Policy

Western Hemisphere

Low and stable inflation, together with a strong fiscal position, has given the Bank of Canada the flexibility to respond quickly and decisively to domestic or external shocks. Since 1991, the Federal Government and Bank of Canada have maintained an official target range for the inflation rate, which was gradually lowered to between 1.0 to 3.0 percent by 1993. The commitment to keep inflation within that target range was renewed in February 1998 and again in May 2001, with the latter commitment in effect until the end of 2006. The commitment to a low and stable inflation environment enables policy to best contribute to a sustained economic expansion in Canada, thereby leading to the likelihood of lower unemployment and improved productivity. Since 1993, inflation in Canada has averaged 1.9 percent, which is very close to the mid-point of the current inflation targeting range.

Chile's monetary policy remains expansionary although it has been reducing monetary expansion since mid 2004. Since September 2004, the Central Bank's Board has applied a steady reduction to the strong monetary stimulus in order to keep inflation at about 3.0 percent annually over the usual policy horizon. Since then, the monetary policy rate (MPR) has been increased by 75 basis points to 2.5 percent. After a strong rise in September, interest rates on central bank instruments fell and in general they now stand at moderately higher levels than those prevailing in 2003, especially nominal short-term and indexed instruments. Since 2003, interest rates on indexed instruments (BCU) have risen by about 20 to 60 basis points, reaching from 2.6 percent to 3.2 percent for five- and ten-year maturities. Interest rates on two- and five-year nominal bonds (BCP) have risen by 40 and 90 basis points to reach 3.9 percent and 5.0 percent, respectively. Only interest rates on ten-year peso bonds have not changed, remaining at 5.9 percent, while interest rates on PDBC-90s remain at around the MPR.

Peru's Central Bank monetary policy is conducted under an inflation target of 2.5 percent with a margin of 1 percent. During 2004, the economy was affected by successive inflationary supply shocks. Given the temporary nature of these shocks, the central bank decided to maintain their monetary stance. However, by mid-year and due to the persistence of the inflation rate's deviation from the target, the central bank increased its reference interest rate twice (August 2004 and October 2004) to prevent these increases from affecting the other components of the retail prices index. This decision was consistent with the need to gradually reduce monetary stimulus. As a result, the Interbank interest rate came up from 2.5 percent in December 2003 to 3.0 percent in December 2004. During 2004, an upward trend was observed in the annual rates of growth of the monetary aggregates, particularly in domestic currency. This increase was associated with the greater public demand for domestic currency as well as growth in economic activity. Credit of the financial system to the private sector in nuevo sols expanded 11.0 percent in 2004, especially in the small business segment (15.2 percent). The credit dollarization coefficient decreased from 73.0 to 71.0 percent. In terms of broad money of the financial system, the dollarization coefficient fell from 47.0 to 42.0 percent, due to the 23.6 percent increase for sol-denominated broad money.

The United States' monetary policy has been focused on overcoming negative shocks and restoring strong sustained growth for the past four years. From the beginning of 2001 through mid-2003, the Federal Reserve lowered the target federal funds rate 13 times, from 6.5 percent to 1.0 percent. That low rate was maintained until June 2004 when the Federal Reserve began to increase the rate gradually. Over the course of 2004, it became increasingly evident that the economy was once again growing strongly and labor markets were improving. This reduced the need for monetary stimulus. By May 2005, the Federal Reserve had raised the funds rate to 3.0 percent, a level that it believed was still accommodative. In its statement accompanying the May increase, the Federal Reserve indicated that it intended to move at a measured pace to reduce further the accommodative stance of monetary policy.

Northeast Asia

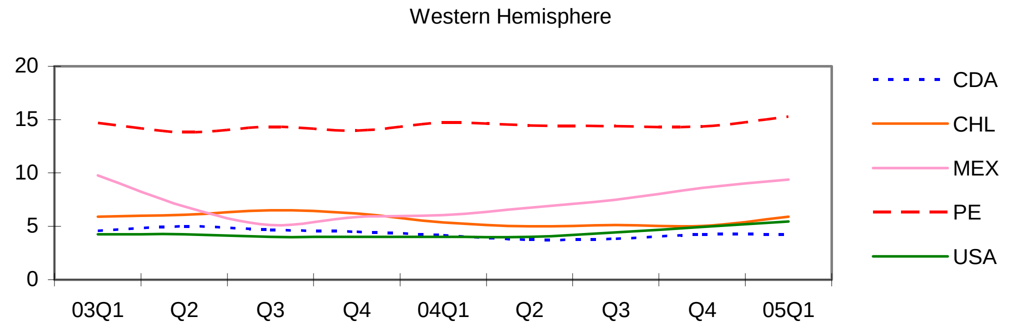
In China, by the end of 2004, the money supply in terms of M2 was US$3.05 trillion, reflecting a year-on-year increase of 14.6 percent. Narrow money supply (M1) was US$1.16 trillion, up 13.6 percent. Cash in circulation (M0) was US$253.7 billion, up 8.7 percent. Savings deposit in renminbi and foreign currencies in all financial institutions totaled US$3.06 trillion at the end of 2004, up 15.3 percent. Loans in renminbi and foreign currencies by all financial institutions reached US$2.28 trillion, up 14.4 percent.

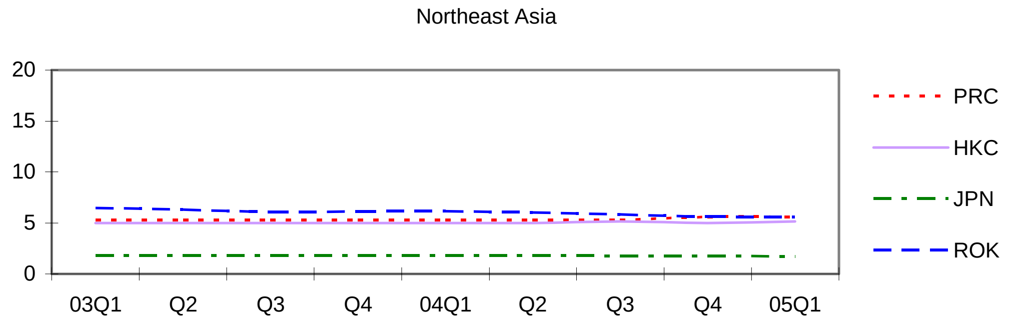
Table 3.2 Short-term Interest Rate (percent, per annum)

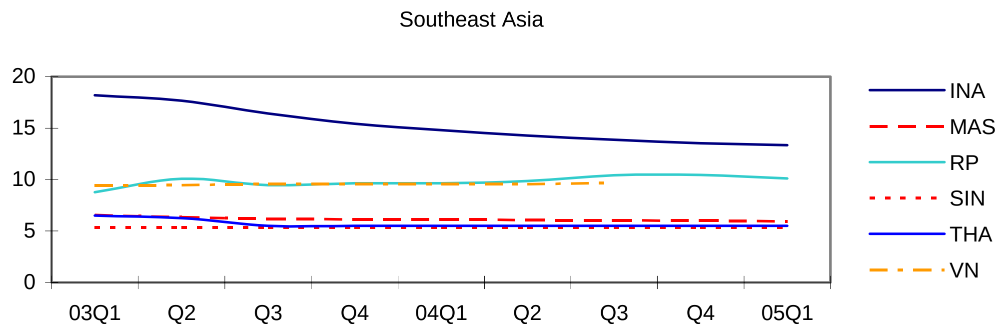
	1999	2000	2001	2002	2003	2004
Western Hemisphere						
Canada	4.7	5.5	3.8	2.6	2.9	2.31
Chile	11.0	10.8	7.2	3.9	2.8	5.0
Mexico	21.4	15.2	11.3	7.1	6.2	6.8
Peru	14.9	12.7	8.6	3.2	3.4	2.7
The United States	5.0	6.2	3.9	1.7	1.1	1.6
Northeast Asia						
China	5.6	5.6	5.6	5.6	5.6	1.78
Hong Kong, China	5.8	6.1	3.6	1.8	1.0	0.39
Japan	0.12	0.17	0.07	0.02	0.01	0.01
Korea	4.9	5.1	4.6	4.2	4.0	3.61
Chinese Taipei	4.8	4.7	3.7	2.0	1.0	1.06
Southeast Asia						
Brunei Darussalam	1.25	1.25	0.5	0.4	0.225	0.225
Indonesia	26.0	12.5	17.6	13.0	8.3	6.4
Malaysia	3.18	3.25	3.27	3.13	2.87	2.8
The Philippines	10.2	9.9	9.9	5.4	6.0	6.0
Singapore	2.8	2.8	1.3	0.8	0.8	1.4
Thailand	1.5	1.8	2.1	2.0	1.4	1.3
Viet Nam	1.1	0.9	0.8	0.8	N.A	N.A
Oceania and Russia						
Australia	5.0	6.2	4.9	4.7	4.9	5.5
New Zealand	5.4	6.7	5.0	5.9	5.3	6.7
Papua New Guinea	22.7	15.7	10.2	15.5	16.1	
Russia	39.7	24.4	17.9	15.7	3.8	11.4
LIBOR* (3-months US $)	5.4	6.5	3.8	1.8	1.2	1.8

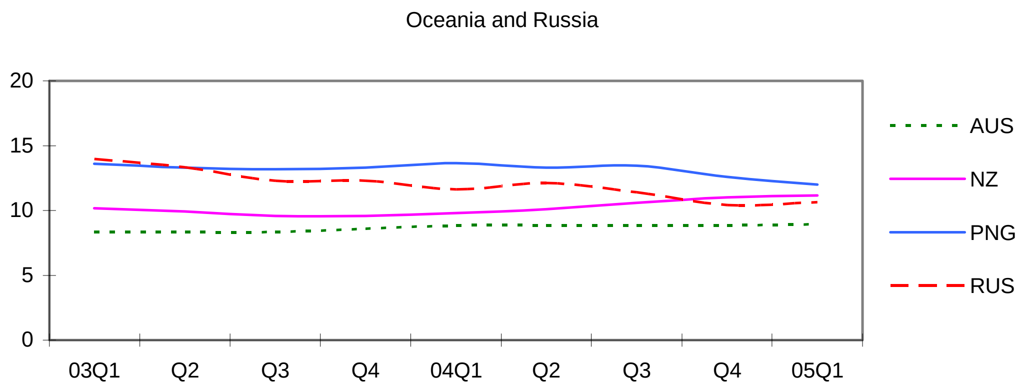
Note: * London Inter-bank Offer Rates on US Dollar Deposits.
Sources: Individual Economy Reports.
IMF, *International Financial Statistics*, July 2005

Figure 3.1 Trends of Short-term Lending Rates









Hong Kong dollar Interbank interest rates increased during the first nine months of 2004, upon continued increase in the US federal funds target rate. Interest rates then started to ease, attributable to increased liquidity inflows. For 2004 as a whole, the three-month Interbank interest rate rose by 22 basis points, significantly less than the 125 basis points rise in the US federal funds rates. Meanwhile, the best lending rate of banks in Hong Kong was unchanged at 5.0 percent at the end of 2004. Marching into 2005, reflecting a cumulative hike of 125 basis points in the US federal funds target rate as well as outflow of funds after the introduction of the three refinements to the Linked Exchange Rate System, Hong Kong dollar Interbank interest rates increased notably during the first eight months. Specifically, the three-month Interbank interest rate rose by 347 basis points to 3.75 percent at end-August 2005. Meanwhile, the best lending rate of banks in Hong Kong rose by 175 basis points to 6.75 percent. As to money supply, Hong Kong dollar narrow money [HK$(M1)] declined by 4.0 percent in July 2005 amidst a fall in demand deposits, while Hong Kong dollar broad money [HK$(M3)] grew strongly by 9.3 percent, in line with the pace of economic growth. Domestic credit increased further upon buoyant economic activity, with loans for use in Hong Kong, China, rising by 9.8 percent in July 2005 from a year earlier. The overall quality of the loan portfolio of banks continued to improve. Specifically, the ratio of overdue and rescheduled loans to total loans for retail banks declined from 1.48 percent at end-2004 to 1.13 percent at end-June 2005. Banks remained well-capitalized, with a 15.3 percent consolidated capital adequacy ratio for all locally incorporated authorized institutions at end-June 2005, well above the standard set by the Bank for International Settlements.

The Bank of Japan (BOJ) adopted the quantitative easing policy in March 2001. Since January 2004, the target balance of current accounts held at the Bank remains “around 30 to 35 trillion yen”. With the target amount of the banks’ current accounts at the BOJ left unchanged, the growth of the monetary base has decelerated from 4.0 percent at the beginning of 2005 to 1.0 percent or 2.0 percent in the middle of 2005. The growth of M2+CD (certificates of deposit) has remained at around 2.0 percent. Should there be a risk of financial market instability, such as a surge in liquidity demand, the BOJ will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank’s funds-supplying operations, there may be cases where the balance of current accounts falls short of the target. The government expects that, considering market trends and expectations, the BOJ will exercise effective monetary policy management, which will be consistent with the government's efforts for emergence from deflation.

Korea adopted monetary policies that were conducive to recovery in domestic demand while stabilizing domestic prices in 2004. Although domestic demand in private consumption, facility investments and so forth tended to fall, as industrial production made headway due to a hike in exports along with the volatile status of inflation due to high prices of raw materials, the government was urged to maintain target call rates of 3.75 percent until July. However, as unfavorable economic conditions were expected with the oil price unexpectedly maintaining its upward trend and a stagnant information communication industry, the government has lowered, by 0.25 percent, its target call rates for July and November, respectively.

The Central Bank of Chinese Taipei, in the wake of sustained economic expansion, rising prices and negative real interest rates, changed its low interest rate policy which had been adopted since the end of 2000, into a neutral monetary stance in October 2004. By the end of March 2005, the central bank had raised the discount rate in three successive quarters, to 1.875 percent, with a total increase of 50 basis points, guiding market rates gradually upwards. Furthermore, to enhance the transparency of financial institutions’ pricing process, the central bank has urged banks and community financial institutions to implement adjustable rate mortgages (ARMs) and the base rate system. At the end of March 2005, all domestic banks and around half of the community financial institutions had adopted ARMs and the base rate system. Given a combination of the increase in demand for funds driven by economic expansion and banks’ active promotion of consumer finance business, loans and investments by major financial institutions grew by 8.65 percent in 2004. The expansion of bank credit, together with net capital inflows, led to an annual increase of 7.45 percent in the M2 monetary aggregate in 2004. To foster sound development of financial markets, the central bank helped set up the Bills Depository and Clearing System and promoted the electronic processing of check payments by the Taiwan Clearing House, greatly improving payment efficiency. The central bank also continued its efforts in financial liberalization and globalization. It introduced more foreign exchange products, streamlined foreign investment application procedures, and eased restrictions on direct financial transactions across the Taiwan Strait.

Southeast Asia

Indonesia's monetary policy is aimed at meeting the medium-term inflation target while maintaining support for economic growth. Rates on monetary instruments had trended downward for the whole year, at a much slower pace than in 2003, partly because of the shift in policy stance near mid-year from the cautious accommodative policy to a tight-bias policy. During the first five months in 2004, well-contained inflationary pressure allowed he monetary policy stance to be relatively accommodative by edging-down the interest rate on monetary instruments. Toward the second half of 2004, inflationary pressures started to emerge, owing to rapid expansion in domestic demand and depreciation of the rupiah. Since June 2004, Bank Indonesia started to raise the interest rate on Sertifikat Bank Indonesia (SBI) gradually to keep inflation under control. In order to maintain exchange rate stability, Bank Indonesia issued the Rupiah Stabilization Policy Package in June 2004, aimed at mopping up excess liquidity and arresting further weakening of the rupiah. In addition, Bank Indonesia attempted to improve the effectiveness in the implementation of monetary policy by realigning interest rate structure; reducing the frequency of SBI auctions; and easing SBI repo regulation. In April 2005, in the effort to curb further deprecation of the rupiah, Bank Indonesia issued a few short-term regulations, i.e., lowering the net open position limit for banks and activating the fine tuning operation (FTO) instrument for the first time. This regulation was aimed at absorbing domestic excess liquidity so as to restrain speculative activities that have brought the rupiah exchange rate down lately. Taking into account factors that are likely to affect inflation in the period ahead, Bank Indonesia will continue implementing its tight-bias monetary policy in 2005. Operationally, this would be achieved through optimal liquidity absorption to balance between liquidity and economic needs. This is done by directing base money at its average growth target range of 11.5 percent to 12.5 percent. Bank Indonesia will seek to manage inflation expectations by building a track record so as to enhance credibility. In order to increase effectiveness and send a clearer signal of its monetary policy stance, Bank Indonesia will use interest rates as the operational target beginning in mid-2005. In operational implementation of monetary policy, open market operations (OMOs) would still be the main instrument. Further, in the medium term, monetary policy will continue to focus on the achievement of a gradual downward path over the medium-term inflation target while sustaining the momentum for growth. To achieve the inflation target, the focus would be on controlling factors that influence inflation, notably the output gap, the exchange rate, and inflation expectations. Indonesia's inflation targets for 2005, 2006, and 2007 are 6 percent, 5.5 percent, and 5.0 percent respectively, with a deviation of +/- 1.0 percent.

Malaysia's macroeconomic policy was focused on maintaining stability and improving the risk bearing capacity of the economy in 2004. While the government continued to pursue gradual fiscal consolidation to strengthen its fiscal position, the monetary policy stance remained accommodative to support domestic economic activities. Interest rates remained consistent with domestic economic activity and were supportive of growth. The financially sound positions of the corporate, household and banking sectors were instrumental in ensuring the effectiveness of the accommodative monetary policy. The effectiveness and efficiency of the conduct of monetary policy was further improved when the central bank introduced a new interest rate framework in April 2004 whereby the overnight policy rate (OPR) replaced the 3-month intervention rate as the indicator of the monetary policy stance. The OPR was set at the prevailing Interbank overnight rate of 2.70 percent and allowed to fluctuate within a margin +/-25 basis points (bps) so as to minimize excessive volatility in the corresponding market rate. The new interest rate framework also allowed for greater efficiency in the operation of the banking system, thereby facilitating an effective and efficient pricing of financial products. For example, banking institutions were allowed to set their own base lending rate (BLR) taking into account their institutional cost structure and strategies. The banking sector continued to remain robust with a high level of capitalization, and marked improvement in profitability. Loan growth expanded at 8.5 percent, while net non-performing loans (NPLs) fell to 7.6 percent (based on 3-month classification), the lowest since the Asian financial crisis. The risk-weighted capital ratio (RWSR) of the banking system stood at 13.8 percent while the core capital ratio (CCR) was at 10.8 percent as of the end of December 2004.

In the Philippines, the Bangko Sentral ng Pilipinas (BSP) maintained policy rates in 2004 under the consideration that the rise in inflation was supply-side-driven and could be addressed only by non-monetary measures. The overnight borrowing or reverse repurchase rate (RRP) remained at 6.75 percent and the overnight lending or repurchase rate (RP) at 9.0 percent. However, in order to pre-empt inflation-caused volatility in the foreign exchange market, the BSP raised the liquidity reserve requirement from 8.0 percent to 10.0 percent in February 2004 while maintaining the regular reserve requirement at 9.0 percent. Domestic interest rates rose during the year, reflecting concerns over rising inflation, fiscal sustainability and the status of the economy's credit ratings. The average bank lending rate increased from 9.5 percent in 2003 to almost 10.0 percent in 2004. The average 91-day T-bill (treasury bill) rate likewise increased from 6.0 percent to 7.3 percent during that period. The average savings deposit rate remained unchanged at 4.2 percent. In April 2005, the BSP raised key policy rates for the first time since October 2000, increasing the RRP and RP rates by 0.25 percentage points to 7.0 percent and 9.25 percent, respectively. Demand-driven inflationary pressures remain limited, but increasing oil prices both local and international and other potential supply-side factors are affecting public expectations of future inflation. The increase aims to keep these expectations from spreading and prevent supply shocks from generating second-round effects.

The Monetary Authority of Singapore (MAS) shifted its policy stance in April 2004 in view of the general improvement in economic conditions and rising inflationary pressures. The S$ nominal effective exchange rate (NEER), which had been allowed to follow a zero percent appreciation path prior to this change, began to be guided to permit a modest and gradual appreciation. Nevertheless, until the middle of August 2004, the S$NEER remained actually lower within the MAS' policy band. Soon after its return to an appreciating trend, the MAS announced in October 2004 the continuation of the policy to allow the appreciation of the S$NEER.

Thailand's monetary policy formulation is set by the Monetary Policy Committee in order to attain price stability conductive to sustainable economic growth by utilizing the 14-day repurchase rate as the key policy rate. Its target is core inflation within a designated range. With weak internal demand and low inflation rate environment before 2003, Thailand adopted an accommodative monetary policy in order to maintain a supportive economic condition. The Bank of Thailand (BOT) reduced its 14-day repurchase rate, a policy instrument, from 2.25 percent per annum in 2002 to 1.25 percent per annum in June 2003. As the inflation rate still remained low, there was no negative effect from the further easing of its monetary policy to safeguard against uncertainties in economic conditions and support the growth process. Although the economic environment has been changed alongside with the economic expansion, the rising oil and farm prices led to headline inflation to take off by increasing to 3.1 percent year-on-year in August 2004. This signaled an inflationary pressure for the Thai economy due to continuously increasing capacity utilization, rising domestic oil prices, and a tightening labor market, and one that would exert pressure on core inflation, the monetary policy's target. Therefore, the Bank of Thailand (BOT) started to raise the 14-day repurchase rate, by 25 basis points from 1.25 to 1.50 percent per annum, in August 2004. Later, the 14-day repurchase rate was raised twice by 25 basis points, in October 2004 and December 2004. In addition, on March 2005, the BOT made the decision to further raise the policy rate from 2.00 to 2.25 percent per annum in order to strengthen economic stability and sustain growth in the long term.

In 2005, Viet Nam's central bank continues to execute the floating exchange rate policy priority of controlling the spread of price increases, and in alignment with assisting economic growth. The money supply increased by 22.0 percent. The overall mobilized deposits and total credit increased by 20.0 to –21.0 percent and 23.0 percent, respectively. Although the credit to debt ratio is quite high compared to the consumer price index of 2004 (the average was 9.5 percent in 2004 and 4.3 percent in the first 4 months of 2004), it still does not create a considerable change in the monetary market. The interest rate still increased only slightly in 2005, despite the continuation of the unsecured credit policy and decrease of inflation. Therefore, the monetary policy of 2005 is likely to stabilize the Vietnamese macro-economy and assist economic development. In particular, the stable exchange rate and the increase in the interest rate of the Viet Nam dong enabled the Vietnamese State Bank to build up foreign reserves and thus increase stabilization of the foreign exchange market. The consumer price index in 2005 is forecast to be 6.5 percent.

Oceania and Russia

The Board of the Reserve Bank of Australia has the primary responsibility for the conduct of monetary policy. The independence of the Reserve Bank Board in conducting monetary policy was formalized in the Statement on the Conduct of Monetary Policy agreed between the Treasurer and the Reserve Bank Governor in August 1996 and reaffirmed and updated for current practice in July 2003. This Statement includes a commitment by the Reserve Bank Board to hold consumer price inflation to between 2.0 and 3.0 percent, on average, over the course of the economic cycle. The medium-term focus of the inflation target allows for the natural short run variation in inflation over the cycle. The instrument of monetary policy is the ‘cash rate’, which is the market interest rate on overnight funds. The target cash rate remained unchanged at 5.25 percent throughout 2004.

The Reserve Bank of New Zealand is an independent central bank and through the Reserve Bank Act (1989) it is charged with maintaining price stability in New Zealand. The act requires that there be a Policy Targets Agreement between the Minister of Finance and the Governor of the Reserve Bank. The most recent Policy Targets Agreement was signed in September 2002, and it requires the bank to maintain inflation in the range of 1.0 percent to 3.0 percent on average over the medium term. The agreement also states that in pursing its primary objective of price stability, the bank shall seek to avoid “unnecessary instability in output, interest rates, and the exchange rate”. Short-term interest rates are expected to remain around current levels of 7.0 percent until the first quarter of 2006 in order to lean against current inflation pressures. Interest rates are then forecast to decline towards their assumed neutral level of around 5.8 percent by June 2009.

The priority of the Russian Federation’s financial policy is to slow down inflation. The target inflation growth rate in 2004 was 8.0 percent to –10.0 percent. To neutralize excessive amounts of rubles held by commercial banks, the Ministry of Finance of Russia (Minfin of Russia) together with the Central Bank of Russia (CBR) was holding discounted auctions of state short term obligations (GKO) and federal official bonds (OFZ). The total size of sales of federal securities by the Minfin of Russia amounted to 184.5 billion rubles in 2004 compared to 135.9 billion rubles in 2003, while the total size of repaying these securities from the federal budget reached 108.5 billion rubles in 2004 against 134.6 billion rubles in 2003. The size of net sale of the mentioned state securities by the CBR equaled 6.3 billion rubles in Q4 2004 as compared with 2.6 billion rubles in Q3 2004.

3.3 Structural Reform

Financial System

The Japanese government has aggressively carried out the measures included in the “Financial Revival Program” formulated in 2002, such as tightening banks’ assessment of assets, improving banks’ capital, strengthening banks’ governance, and promoting simultaneous revival of industrial and financial sectors. As a result, the major banks’ NPL ratio has dropped from 8.4 percent in March 2002 to 2.9 percent in March 2005. In order to create a “financial services nation” in which the level of users’ satisfaction is high, which is evaluated well internationally, and which contributes to regional economies, the financial administration will enact measures in accordance with the work schedule of the “Program for Further Financial Reform”, which was formulated in 2004 as a guideline of the financial administration during the “Concentrated Consolidation Period”.

China is accelerating its reform of the financial system. It plans to reform state-owned commercial banks by carrying forward the successful pilot program to turn them into stock companies. Also, China will vigorously yet steadily develop financial institutions with various forms of ownership. Gradually, interest rates will be left to market forces. China plans to reform the mechanism for setting the exchange rate for the renminbi and keep it basically stable at a proper and balanced level.

Since the financial crisis, Korea has vigorously carried out financial restructuring to restore the financial market function. In this process, 809 financial institutions were either merged or liquidated while 1661.1 trillion won worth of public funds was injected to enhance the soundness of financial institutions. Consequently, the soundness of the financial institutions recovered is evidenced by the amount of non-performing loans in financial institutions, which decreased to 40.2 trillion won (4.2 percent of the total loans) as of the end of September 2003 from 88 trillion won (14.9 percent of the total loans) in 1999. Profitability of financial institutions such as banks has significantly improved. The government plans to steadily implement financial restructuring based on market principles to prevent a delay in restructuring from turning into a destabilizing factor in the financial market. The remaining banks that received public funds will be privatized without delay and the plan to implement restructuring of the non-banking sector including investment trust companies on a continual basis will be carried out.

Chinese Taipei established a Financial Supervisory Commission (FSC) on 1 July 2004 as part of its efforts to speed up the liberalization and internationalization of its financial markets. The FSC’s major goals and functions are to consolidate the supervision and examination of the banking, insurance, and securities and futures industries, including financial holding companies, under a single supervisory authority with greater independent power. The Chinese Taipei government is targeting the reduction of its shareholdings in six financial institutions to no more than 20 percent of their total shares by August 2006, and the completion of the privatization of the remaining four state-owned financial institutions by the end of 2006. It has also been taking active measures to help financial institutions dispose of non-performing loans. As a result, the non-performing loan ratio of domestic banks declined sharply from its peak of 8.04 percent in March 2002 to 2.79 percent in February 2005. To improve the efficiency of its financial market, Chinese Taipei launched the Second Phase of Financial Reform. The key targets are as follows: First, the market shares of the top three banks will be over 10.0 percent by the end of 2005. Second, the number of state-owned banks will be reduced to six or fewer by the end of 2005. Third, at least one financial institution will be run by a foreign company or listed on an overseas market by the end of 2006. And fourth, the current 14 financial holding companies will be reduced to seven by the end of 2006.

Malaysia achieved significant progress in further strengthening its financial system. The national asset management company, Danaharta had successfully redeemed all 15 branches of its bonds worth 11.1 billion ringgit by March 2005. The bonds had been issued to finance Danaharta’s acquisition of non-performing loans. In addition, the ongoing mergers between finance companies and commercial banks have also helped strengthen the capacity and capability of domestic banking institutions. The Financial Sector Masterplan (FSMP), a blueprint for the financial sector launched in 2001, is on track and pursues progressive liberalization. They include: the approval of three foreign financial institutions to operate Islamic banking in Malaysia; allowing up to 49.0 percent foreign equity in the Islamic subsidiary of commercial banks; allowing up to 49.0 percent foreign ownership of investment banks; and according greater operational flexibility to incumbent foreign banks.

Indonesia introduced the program, Indonesian Banking Architecture (API) and as part of its implementation in January 2005, Bank Indonesia issued a new banking regulation package. This package is expected to facilitate the consolidation process in the banking industry and support investment in infrastructure as well as economic activities, including infrastructure investment in Aceh. At the same time, the regulations tightened the provisions regarding overall asset quality, consolidated banking supervision, and transparency. In particular, the policy package covers eight regulations to affect: (i) changes in the legal lending limits, (ii) the policies of commercial banks regarding assets quality, (iii) information transparency of banks' products and use of bank personal data, (iv) prudential principles for asset backed securitizations, (v) special treatment of bank's foreign debts, (vii) resolution of customers' complains and (viii) creation of a debtor information system. With regard to the financial safety net, a new law establishing a deposit insurance agency, the Indonesia Deposit Insurance Corporation, was adopted to protect bank depositors by guaranteeing all commercial bank payment.

In the Philippines, with regard to the banking sector, the central bank (BSP) issued guidelines in June 2004 governing the development and implementation of banks; including internal credit risk rating systems to ensure that banks' credit management processes are sound and effective. The BSP is also pushing for the formation of a central credit bureau, which would hold a central data bank of borrowers' history of transactions that would support banks' access to credit information. On the non-bank financing sector, the Securities and Exchange Commission laid out the guidelines for the eventual shift to a risk based capital adequacy framework among its regulated and monitored entities.

Fiscal Reform

China promotes reform of fiscal and tax systems and the investment system. The public finance system will be strengthened and the system of transfer payments from the central government will be improved and standardized. Value added tax reform will be carefully carried out on a trial basis in selected areas. The mechanism for granting export tax rebates will be improved. The scope and procedures for government investment will be standardized, the monitoring system improved, and a responsibility system for investments made by government bodies and state-owned enterprises formulated as will a system for assigning responsibility for bad investment decisions in order to eradicate the problem of irresponsibility.

Chinese Taipei will abolish exemption from personal income tax of military personnel and elementary and junior high school teachers and push for the implementation of an Alternative Minimum Tax. The business tax will be raised by 1.0 to –2.0 percentage points, and there will be a push for the adjustment of commodity tax toward a green-oriented system. To attract foreign investment, Chinese Taipei plans to decrease the marginal rates of estate and gift taxes from their current 50.0 percent to 40.0 percent.

Indonesia's fiscal policy in 2004 was set to comply with the medium-term development plan framework for 1999-2004. In general, the fiscal policy was aimed to improve fiscal sustainability through the reduction of fiscal deficit and to balance the budget in 2006. In order to reduce the fiscal deficit, several policies were undertaken, such as: improvement of fiscal discipline; gradual reduction of subsidy and foreign debt; improvement of progressive tax revenue; and reforms in the government expenditure. In general, these efforts were taken through fiscal consolidation. Despite some challenges faced in 2004, such as the increase of oil prices and the tsunami in December 2004, the government continued its commitment to reduce the budget deficit and maintained fiscal sustainability. Recognizing the need to improve its budget management and processes, the Ministry of Finance in 2004 established a single treasury unit responsible for both foreign and domestic debt financing, and introduced an improved computer support system to promote better transparency and accountability in financial management. In 2005, the government plans to launch an integrated budgetary system to clarify and focus government spending decisions and improve efficiency.

The Philippines enacted the indexation of excise taxes on alcohol and cigarettes, one of the measures aimed at addressing the weakness of the current excise tax system. The law took effect on 1 January 2005. Meanwhile, the President signed RA 9337 into law on 24 May 2005, which further expands the value added tax (VAT) base as well as provide for rate adjustment in 2006 towards a more efficient and productive VAT system. To improve efficiency in collecting revenues, the BOC and BIR continued their automation drive and simplified their procedures, which allowed them to better detect leakages and recover revenue losses. In managing its expenditures, the government is guided by the 2004-2010 Medium-Term Public Investment Program in order to ensure that the programs and projects to be implemented will address key developmental concerns.

Privatization

In order to regenerate the dynamism of the Japanese economy, Japan continues to carry out the structural reforms under the principles of "No Growth without Reform", "Leave to the private sector what can be done by the private sector", and "Leave to local governments what can be done by local governments". One of the key reforms is the privatization of Japan Post. The government will make efforts towards enactment of related bills in order to realize the privatization of Japan Post from FY2007. Also, to improve the efficiency of public services, it will develop a system aiming towards the full-scale introduction of "Market Testing". For this system, based on the "Three year Program for Promoting Regulatory Reform (revision)", a draft proposal of the "Improvement of Public Services Efficiency Bill (or Market Testing Bill) (provisional title)" will be quickly prepared in order to be submitted to the Diet within FY2005.

China regards deepening the reform of state-owned enterprises as the central link in economic restructuring, and therefore it must proceed unwaveringly in accordance with the principles and policies set by the Central Committee and the State Council: 1) readjust the distribution and structure of the state-owned sector and improve the mechanism for ensuring rational distribution of state; 2) speed up the transformation of large state-owned enterprises into stock companies; 3) accelerate the process of relieving state-owned enterprises of social obligations; and 4) reform the government, telecommunications and civil aviation industries, postal and railway systems and urban public utilities by liberalizing market access and instituting competitive mechanisms.

Capital Market

China will strengthen the infrastructure of the capital market and formulate sound regulations to protect the legitimate rights and interests of investors, particularly non-government investors, thereby creating a favorable environment for its steady and sound development. Reform of the insurance industry will be deepened and order in the insurance market standardized.

Malaysia implemented several initiatives under the Capital Market Masterplan (CMP) during 2004, aimed at further enhancing market liquidity and efficiency as well as investor protection and corporate governance. Among others, the key initiatives include: de-mutualizing the Kuala Lumpur Stock Exchange by converting it into a public company limited by shares from a company limited by guarantee; liberalizing the foreign exchange administration rules to allow multilateral development banks (MDBs), multilateral financial institutions (MFIs) and multinational corporations (MNCs) to issue ringgit-denominated bonds in Malaysia; allowing five foreign stockbrokers and five global fund managers to establish fully-owned operations in Malaysia; and allowing 100 percent foreign ownership in futures broking companies and venture capital companies.

Other Reform Initiatives

In Japan, during the Concentrated Consolidation Period (FY2005–FY2006), the following three issues require particular emphasis during the next two crucial years. The first task is to establish a "small and efficient government." The second task, with an eye to future growth, is to establish a foundation that will allow Japan to overcome the two most important environmental changes for the Japanese economy in the 21st century: the trend of declining birth rate and aging society; and the trend of globalization. The third task is to overcome deflation and revitalize the Japanese economy to secure private demand-led economic growth.

China’s structural reform continued in various areas. First, it continued rural reforms. The reform of rural taxes and administrative charges constitutes a profound transformation of the rural economic and social framework. China aims to strengthen the market system and will energetically develop the market for factors of production. The equity exchange market will be standardized and developed. The reform of the distribution system will be continued, and modern distribution methods will be vigorously developed. Price reforms will be deepened to better balance price relationships. A campaign to protect intellectual property rights will be launched. The government will severely crack down on pyramid schemes and all other types of fraudulent commercial activities, as economic crimes such as smuggling, tax evasion and fraud, and money laundering. The establishment of a credit system for the general public will be accelerated. This year the government is faced with many new situations as the economy opens up to the outside world. Tariffs need to be reduced to the level promised when China joined the WTO, most non-tariff measures need to be eliminated, and the service sector needs to be opened wider to foreign competition.

In Korea, corporate restructuring implemented in the aftermath of the financial crisis has remarkably enhanced corporate financial status. The debt-to-equity-ratio in the manufacturing sector dropped to 123 percent as of 2003, from the pre-crisis level of about 400 percent. This ratio is lower than that of developed economies such as the United States and Japan. Concerning the restructuring of non-viable companies, a total of 83 firms have undergone restructuring through the workout program since the financial crisis. In accordance with the workout procedure, 57 companies took the path to management normalization, 19 firms completed an early liquidation process and 7 firms are currently in the workout program. Along with such efforts, a basis for constant corporate restructuring based on market principles has been laid. The constant assessment system of the credit risk of companies was introduced (in February 2003) with creditor banks taking on a leading role. The Corporate Restructuring Promotion Act (enacted in September 2002) established the laws and institutions under which companies that prove problematic according to evaluation results will undergo swift restructuring based on market principles. In accordance with the pre-prepared guidelines of corporate restructuring, further restructuring will be implemented in a drastic and swift manner. In addition, to ensure a level playing field, the government aims to establish a fair and transparent economic system based on the "Three-year Market Reform Action Plan" announced in October 2003.

Chinese Taipei is stepping up efforts to promote the development of the service sector. To this end, it has launched the Guidelines and Action Plans for Service Industry Development, targeting a compound annual growth rate of 6.1 percent for the whole of the services sector and of 8.0 percent for knowledge-intensive services during the period 2004 to 2008. The basic strategies for carrying out this initiative are deregulation, pushing for modernization of services, adopting a negative-list approach, and improving the legal and regulatory system. Its anticipated benefits include creating a large number of jobs to lower the unemployment rate, improving quality of life, and speeding up knowledge-based economic development.

Indonesia was removed from the NCCT list as a result of its continuing efforts to eradicate money laundering, on 11 February 2005. As an effort to combat money laundering activities, the authorities have taken some policy measures, namely, ‘Know Your Customer’ regulations, an anti-money laundering law which was amended in 2003, and the establishment of a financial intelligent unit, the Center for Financial Transaction Analysis and Reporting (PPATK). The new government has put anti-corruption efforts as another top priority. The Anti-Corruption Commission is fully operational, with the installation of judges for the Anti-Corruption Court, and a number of cases are currently being processed. In this connection, a presidential decree was issued in 2004 to enhance transparency, efficiency, and accountability of public management. All government officials are required to report their wealth to the Anti-Corruption Commission annually. With regard to external trade policies, ensuring consistency in regulations and taxes introduced at different levels of the government is a high priority for improving the investment environment. In this respect, some measures have been taken to improve competitiveness and reduce trade distortions. Overall program design and schedule, including exceptions, and implementation of the harmonized tariff system with a flat tariff of 5.0 percent are being developed, with initial implementation scheduled for 2005. The effort toward reducing export and import impediments has also been strengthened and bilateral and regional cooperation enhanced. In addition, 21 regulations related to labor rigidity issued by local governments have been revoked.

In the Philippines, a fixed income exchange was created in 2004 to serve as a secondary market for government securities and alternative funds from the traditional banking system. It is expected to be fully operational in 2005. With regard to foreign investments liberalization, the 6th Regular Foreign Investment Negative List was issued in 2004. The list specifies the few areas in which investment is limited to Filipinos as provided for in the Philippine Constitution and other laws. Foreigners may invest as much as 100 percent equity in export enterprises and certain domestic activities, including retail trade enterprises. The Supreme Court's decision in December 2004 on the constitutionality of foreign ownership in the Philippine Mining Act is expected to revive the under-performing mining industry with the projected investments in large-scale metallic and mineral exploration activities.

Singapore pursues the restructuring of its economy towards to a more diversified, globalized, and entrepreneurial spirit to meet the challenges of technological advances and globalization which have intensified competitive pressure in the global economy. Manufacturing and services will continue to be the twin engines propelling Singapore's growth, supported by a strong base in science and technology, and cost competitiveness. As a major trading economy, Singapore is also committed to globalization. Expanding external ties through the multilateral framework of the WTO, regional co-operation and bilateral free trade agreements will link Singapore to foreign markets and investment opportunities. There will be further encouraging of entrepreneurship, creativity, and innovation, since these will be key in the knowledge-based, innovation-driven economy.

Viet Nam's economic structural reform aims at a full-scale transformation of its economic structure to a modern and industrialized one. For rural economies, Viet Nam has continued to speed up agricultural and rural industrialization and modernization geared toward forming a large-scale concentrated commodity agriculture by constructing high-tech zones applying modern technology. In 2005, Viet Nam will concentrate on industries capable of promoting their competitive advantages, taking hold of domestic markets and pushing ahead exports, along with reducing cost. Viet Nam will pursue the development of high-tech industrial products as well as agro-supporting industries, especially its processing industry. It continues to organize the trading system of certain essential products, to ensure price stability, and to prevent a monopoly in distribution of products such as steel.

The macroeconomic reforms taken over the last decade have enabled the Canadian economy to weather economic shocks better than in the past. The Organization for Economic Cooperation and Development (OECD) recently acknowledged this benefit, stating: "the Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well designed macroeconomic framework and the pay off from a range of structural reforms implemented since the late 1980s."

In Papua New Guinea, there are a number of critical cross-cutting structural issues that are consistently raised by the private sector as impeding business, namely, poor road maintenance, inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs, and a range of issues around land tenure, access and utilization and the aspects of the taxation system which are internationally uncompetitive. To increase economic growth, the government intends to introduce a number of measures to address ongoing problems of inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs, a range of issues concerning land, and poor service delivery by the public sector.

3.4 Summary and Medium-Term Forecasts

Summary

The APEC economies have enjoyed overall economic expansion following the growth peak in 2004. The strong growth trend has been supported by both buoyant domestic and external demands. The US and Chinese economies continue to be the engines leading the APEC economies as well as the global economy. Most Asian emerging economies also showed remarkable growth thanks mostly to the highest pick up of investments since the 1997 financial crisis. Economies in the Oceania and Western Hemisphere regions also showed robust growth in 2004. The fuel price increases have boosted the Russian economy significantly. As the pace of world economic growth starts to slow down at the end of 2004, the growth performance of APEC economies is expected to moderate but remain robust in 2005. Trade performances of APEC economies are well matched with the global trend. Particularly, import demands of APEC economies have been strong due to increasing domestic demands. High intra-APEC trade also continued. However, the current account imbalance among APEC regions remains a serious problem. In order to prevent the negative effects of the persistent current account imbalance on global and APEC economies, closer macroeconomic policy coordination is desired, including in exchange rate arrangements and fiscal policy coordination. In spite of the strong overall APEC economy, inflation has been held at manageable levels allowing many economies flexibility in their macroeconomic policies. Nevertheless the recent hikes in oil prices, coupled with geo-political uncertainties and natural disasters, raise the risks of a new upward trend of inflation, considering that the fastest growing APEC economies are net-oil importers.

Major APEC economies' medium-term forecasts on economic growth are basically optimistic. The US projects that GDP will expand strongly through 2010, inflation will be contained, and labor markets will continue to strengthen. Real GDP will grow at an average annual rate of 3.3 percent during the four years of 2005 to 2008. Japan expects the long-standing deflationary pressure to decrease gradually through the combined efforts of the government and Bank of Japan. In FY2006 and thereafter, Japan expects that the economy will go on a growth path of around 1.5 percent or higher in real terms and around 2.0 percent or higher in nominal terms. For China, 2005 is crucial for accomplishing all the tasks of the Tenth Five-Year Plan (2001-2005) and for laying a solid foundation for development during the Eleventh Five-Year Plan (2006-2010). China's mid-term economic growth forecast is around 8 percent for this period. Other economies in the Northeast Asian region have optimistic expectation on economic growth in the medium term. Korea's growth forecast is 5.2 percent annually, which is higher than recent economic performance. Chinese Taipei's economy is expected to improve steadily in line with the favorable outlook for the global economy. During 2005-08, Chinese Taipei's potential average growth rate of GDP is projected to be 4.9 percent. Nominal per capita GDP will increase to US$18,000 in 2008. The medium-term prospect for the Hong Kong, China, economy is bright, as it will continue to reinforce its existing strengths and identify new areas for development. Hong Kong, China, expects to attain a 4.0 percent GDP growth over the next four years (2006-2009).

In Southeast Asia, economies expressed moderately favorable expectations of economic growth thanks partly to favorable external environments and continued strong domestic demand, and partly from industrial and macroeconomic policies. Indonesia's macroeconomic condition during 2004-2009 is expected to be favorable as a response to its development strategy and policies, as well as reforms, in the domestic market. The growth rate is forecasted to increase from 5.5 percent in 2005 to 7.6 percent in 2009, or on average by 6.6 percent per year. Malaysia's prospects in 2005 remain sound, driven largely by strong private sector demand, despite moderating world economy and trade. Real GDP in 2005 is expected to continue to register a strong, albeit lower, growth of 5.0 percent to 6.0 percent. The Philippines's real GDP and GNP are projected to grow by 5.3 percent in 2005, respectively. For 2006-2010, GDP and GNP growths are expected to be within the growth targets set in the 2004–2010 Medium-term Philippine Development Plan (MTPDP). Singapore expects moderated economic growth between 3.0 to 5.0 percent in 2005 due to concerns over external demand from key trading partners, the pace of recovery of the global electronics cycle, and lingering high oil prices. Thailand forecasts that real economic growth rate will reach 5.9 percent per annum with an inflation rate of 3.2 percent per annum. Economic growth in 2005–2009 will be supported by steady growth in private consumption, improvement in exports, and a surge in investment from both public and private sectors that will improve productivity. Viet Nam expects that its per capita GDP will be 2.1 times bigger in 2010 than 2000 due to its accelerating the industrialization and modernization process.

In other APEC regions, economies expected moderate growth in the medium term. Canada's latest survey of private sector forecasters conducted in June 2005 projected economic growth of 2.7 percent in 2005 and 2.9 percent in 2006. Also, forecasters expected growth to average about 3.0 percent per year over 2007-2009. New Zealand's GDP growth is forecast to pick up to 3.5 percent in the period 2005 to March 2008 as the lagged impact of an expected depreciation of the exchange rate boosts exports. By March 2009 the economic growth is projected to be 3.0 percent. Russia's GDP growth in 2005 is forecast to be 5.9 percent. Thanks to strong growth of investments in fixed assets, the medium-term growth prospect remains robust at 5.8 percent to 6.0 percent. During 2005, both real GDP and the domestic demand of Peru are expected to grow 4.5 percent.

Medium-Term Outlook of Individual Economies

Western Hemisphere

Canada expects its recent healthy growth to continue in the medium term. Based on the latest survey that private sector forecasters conducted in June, Canada projected economic growth of 2.7 percent in 2005 and 2.9 percent in 2006. Over 2007–2009, average growth is expected be about 3.0 percent.

Toward the medium term, the inflation forecast for the end of the projection horizon is not materially different from what was expected from mid-2004. Thus, and—among other factors—as a result from the gradual normalization of the monetary impulse, CPI inflation will expectedly reach an average of 2.9 percent per annum during 2006, and 3.2 percent at the end of the projection horizon, due to the fact that core inflation will continue on a similar upward trend as it showed in 2004 (after the deceleration of late 2003), and barely above 3.0 percent toward 2006.

During 2005, both real GDP and the domestic demands of Peru are expected to grow 4.5 percent. The balance of payments current account is expected to show a surplus of 0.5 percent of GDP, due to a trade surplus for the fourth consecutive year mainly thanks to the expansion of exports (8.8 percent). The central bank's international reserves should remain close to US$13 billion during 2005. The fiscal deficit should continue decreasing to 1.0 percent of GDP in 2005 as stated in the Fiscal Responsibility and Transparency Law. Monetary policy will continue to be conducted under the inflation targeting regime with a target of 2.5 percent with a 1.0 percent margin up or down.

The US economy continues to be well positioned for long-term growth. It projects that its GDP will expand strongly through 2010, inflation will remain contained, and labor markets will continue to strengthen. Real GDP will grow at an average annual rate of 3.3 percent during the four years 2005 to 2008. This pace is slightly above the expected 3.2 percent annual potential growth, so the unemployment rate is projected to edge lower, from 5.4 percent at the end of 2004 to 5.1 percent by the end of 2006. The unemployment rate is expected to remain flat thereafter as the economy grows at its potential rate of 3.2 percent in 2007 and 2008 and 3.1 percent in 2009 and 2010. Potential GDP growth is expected to slow somewhat after 2008, as labor force growth declines. It is expected that real GDP will grow 3.5 percent during the four quarters of 2005. This growth will be driven by continued gains in consumer spending, investment growth (although slower than in

2004), and stronger net exports. In 2005 and 2006, the overall CPI is projected to be held down by anticipated declines in energy prices consistent with the declines implicit in the futures market for crude oil. Employment will increase at a rate of about 175,000 jobs per month on average during the 12 months of 2005—a projection that is in line with the consensus of private forecasters. The unemployment rate is projected to edge down from its December 2004 level of 5.4 percent to 5.3 percent by the fourth quarter of 2005. Employment growth is not expected to slow by as much as output growth because productivity (output per hour) is projected to increase at a slower pace than in 2004, and more of the projected output growth may be translated into labor demand and employment in 2005 than in 2004. Looking ahead, stronger growth in US trading partners appears to favor continued gains in export growth. Growth among the non-US members of the OECD is projected to increase from 2.7 percent during the four quarters of 2004 to 3.0 percent during the four quarters of 2005. This growth should support growth in US exports, augmented by a rise in the US share of world exports, owing in part to recent declines in the value of the dollar against other major currencies. Overall, the US projects real exports to grow substantially faster than GDP in 2005. The projected moderation of US GDP growth in 2005 and 2006 together with the recent change in the exchange value of the dollar suggest that growth in real imports will slow in the future.

Northeast Asia

For China, 2005 is crucial for accomplishing all the tasks of the Tenth Five-Year Plan (2001–2005) and for laying a solid foundation for development during the Eleventh Five-Year Plan (2006–2010). The government has set main targets for this year's economic and social development as follows: GDP growth around 8.0 percent, 9 million new jobs for urban residents, registered urban unemployment rate below 4.6 percent, a rise in the CPI of no more than 4.0 percent, and basically a balance in international payments.

The medium-term prospect for the Hong Kong, China economy is bright, as Hong Kong, China will continue to reinforce its existing strengths and identify new areas for development. Hong Kong, China will continue to serve as an eminent foothold and conduit for business between China and the rest of the world. Also, the closer business links between Hong Kong, China; and other economies in East Asia render added scope. This, coupled with envisaged benefits derived from further integration and co-ordination with China’s economy, will help Hong Kong, China speed up the process of economic restructuring towards higher value-added services and knowledge-based economy in the coming years. The productivity growth achieved in the process will help the economy of Hong Kong, China attain a 4.0 percent trend in GDP growth over the next four years (2006–2009).

According to Japan’s “Structural Reform and Medium-Term Economic and Fiscal Perspectives–FY2004 Revision” decided by the Cabinet in January 2005, a steady progress toward overcoming deflation can be expected through the combined efforts of the government and the Bank of Japan. In addition, with the recovering productivity of the corporate sector on the one hand and the decreasing working population on the other, promoting structural reforms to maintain and improve Japanese economic vitality will enhance the potential for medium-term growth. In view of these factors, in FY2006 and thereafter, the economy will go on a growth path of around 1.5 percent or higher in real terms and around 2.0 percent or higher in nominal terms.

As the upswing in domestic demand gains strength, Chinese Taipei’s GDP growth rate is projected to rise to 3.65 percent in 2005. The value of merchandise exports is expected to grow by 6.9 percent, slower than the 20.7 percent in 2004 because of weak global demand. The value of merchandise imports is forecast to grow 9.5 percent, mainly driven by a steady growth of domestic demand. The balance of trade is likely to show a trade surplus of US$2.2 billion in 2005. The positive wealth effect from the warming-up of the stock and real-estate markets, together with the lowering of the unemployment rate, will give a boost to business and consumer confidence, and is likely to result in a strong rebound in consumer spending in the near future. Therefore, private consumption is projected to show a real growth rate of 3.1 percent for the year. Rising investor confidence, combined with a wave of expansion in the opto-electronic and semiconductor industries and the implementation of large-scale projects such as the high-speed railway, 12-inch wafer plants and the sixth naphtha cracker plant, will push up private investment sharply. As a result, the real growth rate of private investment is projected to reach 9.9 percent for the year. In the medium term, Chinese Taipei's economy is forecast to improve steadily in line with the favorable outlook for the global economy. During 2005–08, Chinese Taipei's potential average growth rate of GDP is projected to be 4.9 percent. Nominal per capita GDP will increase to US$18,000 in 2008.

Southeast Asia

Indonesia's macroeconomic condition during 2004-2009 is expected to be favorable as a response to the development strategy and policies, as well as their reforms, in the domestic market. The growth rate is forecast to increase from 5.5 percent in 2005 to 7.6 percent in 2009, or an average of 6.6 percent per year. Higher economic growth will bring about wider job opportunities for the labor force. The unemployment rate is expected to decline from 9.7 percent in 2005 to 5.1 percent in 2009. The poverty rate is expected to decline to 8.2 percent of total population in 2009. However, maintaining macroeconomic stability is one of the main prerequisites to achieving these targets. The maintenance of macroeconomic stability in 2004 provides a solid foundation for the further acceleration of economic activity. Entering 2005, continuing efforts to maintain macroeconomic stability include the government's determination to maintain fiscal sustainability through the projection of a small deficit in the 2005 state budget and Bank Indonesia's commitment to a stable value of the rupiah and a stronger banking system. Meanwhile, to achieve the economic growth target, the government emphasizes structural reforms, which lays the foundations for medium-term development. In this regard, one of the government's important steps is to boost investment through the creation of a business climate conducive to growth, which includes the acceleration of infrastructure development. These various aspects of economic policy have fostered optimism in the Indonesian economy, which is projected to grow in the range of 5.0 percent to 6.0 percent in 2005.

Prospects for the Malaysian economy in 2005 remain sound, driven largely by strong private sector demand, despite moderating world economic and trade activities. Real GDP in 2005 is expected to continue to register strong albeit lower growth of 5.0 percent to 6.0 percent. Economic growth will continue to be supported by all sectors, except construction. The overall deficit as a percentage of GDP is expected to fall to 3.8 percent of GDP in 2005, reflecting continued fiscal prudence and consolidation efforts. The current account surplus of the BOP is likely to remain large at 14.9 percent of GNP, following the continued build-up in the trade account surplus as the moderation in export growth (7.0 percent) to be offset by slower growth in imports (6.3 percent). In addition, the services account is expected to register a smaller deficit with the continuing growth in tourist arrivals. The on-going improvements in productivity and the capacity expansion that have been taking place over the years are likely to mitigate any build-up of inflationary pressures in 2005. The inflation rate is expected to register an increase of 2.5 percent, taking into account the edging up of the CPI in the first half of this year due to the one-off impact of price adjustments to retail prices of petroleum products as well as higher taxes on cigarettes and tobacco. The favorable economic growth environment will provide greater job opportunities across major sectors of the economy, with the unemployment rate projected to remain low at 3.5 percent in 2005.

The Philippines' real GDP and GNP are projected to grow by 5.3 percent in 2005. For 2006–2010, GDP and GNP growths are expected to be within the growth targets under the 2004–2010 Medium-term Philippine Development Plan (MTPDP). Merchandise exports in dollar terms are expected to grow by 6.0 percent in 2005 due to the projected modest growth in world trade. Merchandise imports in dollar terms are expected to grow by 8.0 percent. The inflation rate is expected to reach 7.8 percent in 2005 due to expectations that world oil prices will remain high given the continuing tight supply situation. Exerting additional upward pressure are possible increases in transport fares, and adjustments in power rates. The government will continue to be guided by the strategies laid out in the Medium-Term Philippine Development Plan for 2004–2010.

The Singapore economy registered high growth in 2004 on the back of a recovery from a SARS-afflicted 2003. However, as it rebounded from a low base, there had already been early indications towards the end of 2004 of an expected moderation in 2005. Moving forward, there are a number of factors that will influence the extent of moderation in 2005. These include concerns over external demand from key trading partners, the pace of recovery of the global electronics cycle, and lingering high oil prices. The Singapore economy is expected to grow between 3.5 and 4.5 percent in 2005.

Thailand forecasts that its real economic growth rate will reach 5.9 percent per annum with an inflation rate of 3.2 percent per annum in 2005–2009. It will be supported by steady growth in private consumption, improvement in exports, and a surge in investment from both public and private sectors that will improve productivity. Meanwhile, the external front will perform well due to its diversified strategy. In turn, private investment would pick up more firmly after a high rate of capacity utilization. One crucial factor supporting growth will be an improvement in productivity, which will enhance the economy’s competitiveness and increase investment efficiency. In the next five years, public investment in infrastructure is in the pipeline, which could contribute to maintaining their above standard economic performance. Inflation will pick up to average 3.2 percent driven by the high commodity prices of crude oil, metal, and agricultural products due to higher global demand, especially from developing economies with strong growth such as China and India.

The vision of development until 2010 is under consideration by Viet Nam’s authorities and will be submitted to the leadership. The major task in the next five years is to further accelerate the industrialization and modernization process, to reduce the risk of backwardness, and to gradually achieve the global millennium goal. GDP in 2010 is expected to be 2.1 times higher than in 2000. GDP in 2010 will reach VN$1,530 billion to VN$1,600 billion (at current prices), equivalent to US$85 billion to US$89 billion with the GDP per person an average of US$950 to US$1000. It will achieve the popularization of secondary schooling. Also, in 2010, higher education will reach 200 students/1000 people. The ratio of educated labor is expected to be 40.0 percent of the social labor force in 2010. Viet Nam seeks to create 8 million jobs and reduce the unemployment rate in urban areas to under 5.0 percent.

Oceania and Russia

The Australian economy is expected to record solid growth in 2005–06, after a period of modest growth in 2004–05. The rebalancing of growth towards the external sector is expected to continue, reflecting strong world demand for Australian exports and an easing of consumption and dwelling investment to more moderate rates of growth. Real GDP grew by 2.3 percent in 2004–05 and is expected to grow by 3.0 percent in 2005-06.

New Zealand’s GDP growth is forecast to pick up to 3.5 percent in the year to March 2008 as the lagged impact of an expected depreciation of the exchange rate boosts exports. By the end of the forecast period in March 2009 growth of 3.0 percent is forecast. Nominal GDP will be rising at a rate of approximately 5.0 percent per annum.

Papua New Guinea’s outlook for 2006 is for continued solid economic conditions, with economic growth increasing to 3.4 percent. This will be the fourth successive year of economic growth equal to or above population growth of 2.7 percent, a significant improvement from the first part of the decade and an indication that GDP per capita is slowly improving.

Russia’s main priorities of economic policy for 2005 are to increase the income level of the population, work out and realize measures to support economic growth, and form the potential of the economy for stable development. According to the last government assessment (as of August

2005), the growth rate of GDP in 2005 will amount to 5.9 percent (5.8 to 6.0 percent in 2006–2008); of industrial production, 4.5 percent (with growth up to 5.0 to 5.5 percent in 2008); of investments average in fixed capital, 9.0 to 10.0 percent in 2006–2008; and inflation (in terms of CPI) will be reduced from 8.5 percent in 2006 to 5.5 percent by the end of 2007.

Table 3.3 Forecasts of GDP Growth (percent)

	2004	2005				2006				Medium-term	
		Official	IMF	OECD	ADB	Official	IMF	OECD	ADB	Official	GI*
Western Hemisphere											
Canada	2.9	3.3	2.9	2.8		2.9	3.2	3.1		3.1	2.8
Chile	6.1		5.9				5.8			3.4-4.0	5.1
Mexico	4.4	3.8	3.0	4.0	5.0	3.6	3.5	4.2		4.1	3.9
Peru	4.8	4.5	5.5				4.5			4.5	4.4
The United States	4.4	3.5	3.5	3.6			3.6	3.3		3.3	3.1
Northeast Asia											
China	9.5	8	9.0		8.5		8.2		8.7	7.0	7.0
Hong Kong, China	8.2	4.5-5.5	6.3		5.7		4.5		4.1	4.0	4.7
Japan	2.7	1.6	2.0	1.5	1.6		2.0	1.7	1.5	1.5	1.5
Korea	4.6		3.8	4.6	4.1		5.0	5.0	5.1	5.2	5.6
Chinese Taipei	5.7	3.65	3.4		4.2		4.3		4.5	4.9	4.3
Southeast Asia											
Brunei Darussalam	1.7		3.0				2.2				1.3
Indonesia	5.1	5.0	5.8		5.5		5.8		6.0	5.5-6.0	4.8
Malaysia	7.1	5.0-6.0	5.5		5.7		6.0		5.3	4.2	5.2
The Philippines	6.0	5.3	4.7		5.0		4.8		5.0		4.5
Singapore	8.4	3.5-4.5	3.9		4.0		4.5		4.7	3.0-5.0	4.3
Thailand	6.1	6.0	3.5		5.6		5.0		5.8	5.9	5.2
Viet Nam	7.7		7.5		7.6		7.0		7.6	7.5	6.9
Oceania											
Australia**	3.2	2.0	2.2	2.5		3.0	3.2	3.4		3.5	2.5
New Zealand	4.8	2.2	2.5	2.4		2.2	2.5	2.4		3.0	2.5
Papua New Guinea	2.5		2.8		2.5		2.8		3.0		4.2
Russia	7.2		5.5	5.8			5.3				4.5
APEC	4.3										
World	4.1		3.4	3.3							3.1

Note: *GI stands for Global Insight. 5 year average of GDP growth (2006-10)
**Official forecasts are based on financial years (beginning July 1 previous year)

Sources: Individual Economy Reports.
ADB, *Asian Development Outlook, August* 2005
Global Insight Inc., *World Outlook*, June 2005
IMF, *World Economic Outlook*, May 2005.
OECD, *OECD Economic Outlook*, May 2005

Table 3.4 Forecasts of Consumer Price Inflation (percent)

	2004	2005				2006				Medium-Term	
		Official	IMF	OECD	ADB	Official	IMF	OECD	ADB	Official	GI*
Western Hemisphere											
Canada	1.8	1.8	7.2	1.9		2.0	2.5	1.9			1.8
Chile	2.4		2.9				3.3				3.2
Mexico	5.19	3.0	4.3	4.4		3.0	3.6	3.7			3.9
Peru	3.5	2.3	1.8				2.6				3.0
The United States	3.3	2.7	3.1	2.8			2.8	2.6			2.1
Northeast Asia											
China	3.9	4.0	3.0	2.0	3.6		3.8		3.3		3.1
Hong Kong, China	-0.4	1.5	1.1		1.5		1.1		1.6	3.0	1.6
Japan	0	0.1	-0.4	-0.2			-0.1	0.1		2.1	1.8
Korea	3.6			4.3	3.0				3.3		3.3
Chinese Taipei	1.6	1.97		3.2	1.7			3.0	1.5		2.1
Southeast Asia											
Brunei Darussalam		3.6	1.0				1.0				0.3
Indonesia	6.4	4.0-6.0	8.2		5.9		6.5		5.4	6.0-7.0	4.7
Malaysia	1.4	2.5	3.0		2.4		2.5		2.0		1.8
The Philippines	5.5	7.8	8.2		6.5		7.5		6.0		5.4
Singapore	1.7	0.0-1.0	0.7		0.8		1.7		1.5		1.4
Thailand	2.7	2.7	4.2		3.5		2.7		3.0	3.0	2.8
Viet Nam	7.7		8.0		5.7		5.5		5.2		3.9
Oceania and Russia											
Australia**	2.3	2.5	2.7	2.6		2.75		2.8		2.5	2.8
New Zealand	2.3	2.5		3.2		2.6		2.8			2.9
Papua New Guinea			2.4		3.8		2.5		4.8		6.1
Russia		5.9	12.8				10.7			5.8	7.6

Note: *GI stands for Global Insight. 5 year average of GDP growth(2006-10)
**Official forecasts are based on financial years (beginning July 1 previous year)

Sources: Individual Economy Reports.
ADB, *Asian Development Outlook, August* 2005
Global Insight Inc., *World Outlook*, Second Quarter 2005
IMF, *World Economic Outlook*, May 2005.
OECD, *OECD Economic Outlook*, May 2005

Table 3.5 Forecasts of Budget Balances (percent of GDP)

	2004	2005		2006	
		OECD	ADB	OECD	ADB
Western Hemisphere					
Canada	1.4	1.2		0.8	
Chile					
Mexico	-0.3				
Peru	-1.1				
The United States	-3.6	-4.1		-3.9	
Northeast Asia					
China	2.3	-2.5	-0.9		-0.7
Hong Kong, China	1.7		-1.2		0.1
Japan		-6.1		-5.3	
Korea		2.8	-2.8	2.9	
Chinese Taipei	-3.9		-4.9		-4.5
Southeast Asia					
Brunei Darussalam					
Indonesia	-1.1		-0.8		
Malaysia	-4.3		-3.1		-1.0
The Philippines	-3.9		-3.6		-2.2
Singapore	-0.2				
Thailand	0		0.0		3.2
Viet Nam			-4.9		0.2
Oceania and Russia					-5.0
Australia	1.0	0.9		0.8	
New Zealand	4.7	3.2		2.8	
Papua New Guinea			-1.0		-0.6
Russia		0.5			

Sources: Individual Economy Reports.
ADB, *Asian Development Outlook*, August 2005.
OECD, *OECD Economic Outlook*, May 2005

Table 3.6 Forecasts of Export Growth (percent)

	2004	2005			2006		
		Official	OECD	ADB*	Official	OECD	ADB*
Western Hemisphere							
Canada		5.6	7.1		4.7		
Chile							
Mexico	11.5	6.8					
Peru	15.2	8.8					
The United States	8.6	12.3	5.2				
Northeast Asia							
China*	35.4			20.4			14.8
Hong Kong, China	15.3			12.2		12.8	12.3
Japan	14.4	7.1	7.2			7.6	
Korea	31.0		9.8	11.8			9.6
Chinese Taipei	16.57	3.05		12.1			8.2
Southeast Asia							
Brunei Darussalam	11.1	7.0					
Indonesia	8.47	8.6-9.1		6.0			7.0
Malaysia	20.6	7.0		12.0			10.2
The Philippines	14.0	7.6		8.0			8.0
Singapore*	24.5			8.0			8.0
Thailand	7.8	4.5		10.0			5.0
Viet Nam				12.0			
Oceania and Russia							
Australia**	4.2	2.0	4.6		7.0	8.1	
New Zealand	5.2	4.1	8.3		4.1	8.3	
Papua New Guinea				-3.9			
Russia	350.	22.0					

Note: * Based on merchandise exports.
**Official forecasts are based on financial years (beginning July 1 previous year)
Sources: Individual Economy Reports.
ADB, *Asian Development Outlook*, August 2005.
OECD, *OECD Economic Outlook*, May 2005

Table 3.7 Forecasts of Import Growth (percent)							
	2004	2005			2006		
		Official	OECD	ADB*	Official	OECD	ADB*
Western Hemisphere							
Canada		8.2	7.9		5.3		
Chile							
Mexico	10.2	6.2					
Peru	9.5	8.4					
The United States	9.9	9.2	7.7				
Northeast Asia							
China*	36.0			22.1			19.6
Hong Kong, China	13.8			12.6		5.9	12.1
Japan	8.9	5.6	6.2			5.3	
Korea	25.5		8.7	13.5			10.6
Chinese Taipei*	18.56	2.44		18.2			12.6
Southeast Asia							
Brunei Darussalam	4.4						
Indonesia	24.95	18.0-18.5		9.6			11.0
Malaysia	25.1	6.2		15.8			13.5
The Philippines	6.3	7.8		5.5			6.0
Singapore*	27.5			7.6			8.5
Thailand	12.1	6.2		13.5			6.0
Viet Nam				11.0			
Oceania							
Australia**	14.3	10.0	9.0		8.0		
New Zealand	15.7	6.7	6.3		6.7	6.3	
Papua New Guinea				6.2			-2.9
Russia	26.6	23.6					

Note: * Based on merchandise imports.
**Official forecasts are based on financial years (beginning July 1 previous year)
Sources: Individual Economy Reports.
ADB, *Asian Development Outlook*, August 2005.
OECD, *OECD Economic Outlook*, May 2005

Table 3.8 Forecasts of Current Account Balances (percent of GDP)							
	2004	2005			2006		
		OECD	IMF	ADB	OECD	IMF	ADB
Western Hemisphere							
Canada	2.2	1.7	1.5		2.5	1.7	
Chile	1.5		0.3			-0.7	
Mexico	-1.3	-1.9	-1.1		-2.0	-0.8	
Peru			0.3			0.3	
The United States	-5.7	-6.4	-6.1		-6.7	-6.1	
Northeast Asia							
China	4.2	1.5	6.1	1.2		5.6	0.4
Hong Kong, China	9.9		10.3	7.7		10.2	7.3
Japan	3.7	3.6	3.3	3.9	4.1	3.0	3.5
Korea	4.1	3.0	2.0	3.1	1.7	1.5	
Chinese Taipei	6.1		4.3	6.8		4.6	6.7
Southeast Asia							
Brunei Darussalam	68.2		72.8			67.0	
Indonesia	1.2		-0.4	2.1		0.7	1.5
Malaysia	12.6		13.5	10.2		12.4	8.3
The Philippines	2.7		2.1	3.0		1.9	2.2
Singapore	26.1		25.7	26.7		22.7	25.7
Thailand	4.5		-2.5	2.3		-2.5	1.3
Viet Nam	-3.8		-4.7	-5.6		-4.7	-5.8
Oceania and Russia							
Australia	-6.4	-5.4	-5.7		-4.9	-5.0	
New Zealand	-6.4	-6.1	-7.4		-6.3	-7.7	
Papua New Guinea	8.1		10.6	0.5		5.9	-0.8
Russia	10.3	6.5	13.2			13.0	

Sources: Individual Economy Reports.
ADB, *Asian Development Outlook*, August 2005.
IMF, *World Economic Outlook*, September 2005.
OECD, *OECD Economic Outlook*, May 2005

CHAPTER TWO
THE ECONOMIC IMPACT OF TERRORISM AND COUNTER-TERRORISM IN THE APEC REGION

TWO PAPERS:

1. **THE ECONOMIC IMPACT OF TERRORISM: AN APPLICATION TO 9/11**
2. **TERRORISM AND FDI FLOWS: CROSS-COUNTRY DYNAMIC PANEL ESTIMATION**

THE ECONOMIC IMPACT OF TERRORISM: AN APPLICATION TO 9/11

EXECUTIVE SUMMARY

This study sets up a framework for thinking about the economic costs of terrorism, and applies that framework to 9/11. The five types of costs detailed in the study include:

- Direct damage from the attacks. This includes the physical damage and loss of life. In some cases this might be a small part of the total economic cost. However, with the disruption of critical infrastructure, economic damage that far exceeds the direct destruction might result.

- The macro-economic impact results from the loss of business and consumer confidence, which reduces investment and consumption expenditures. These impacts can be offset by a rapid easing of fiscal and monetary policy. This was done in the wake of 9/11.

- Sectoral impacts are those that accrue to a particular sector of the economy, such as the tourist sector. In a large, diversified economy, such as that of the United States, overall these costs are small because there are expanding sectors that offset the declining sectors, as long as overall spending remains relatively stable. In less diversified economies, however, these costs can be large if the declining sector is large relative to the expanding sectors.

- Frictional shocks are those that arise as a result of the time costs of various security measures set up in the wake of terrorist attacks. While there is some debate over the scale of these costs arising from 9/11, the rapid growth in productivity in the US after 9/11 would, on the face of it, appear to suggest they might have been small.

- Security and defence expenditures often rise as a result of terrorist attacks, and they certainly did in the US after 9/11. These costs might be thought of as the overhead costs of doing business, but in the public mind they should "buy" a greater sense of security, and this spending might allow the public to go about its business.

Overall, the costs of 9/11 to the United States were substantial. In this paper, which makes a rough stab at estimating these costs, they were suggested to be about $660 billion over four years, or between 1.0 and 2.0 percent of GDP per year over that period.

1. INTRODUCTION[1]

Terrorist actions exact a level of destruction upon the target nation, not the least of which is the economic cost.[2] It is axiomatic that terrorist actions create economic costs, however, questions remain unanswered.[3] What are those costs, and how large are they? Not only are these questions in their own right significant, such an understanding may contribute to the context for the analysis of counter-terrorism.

This study has two goals. The first is to attempt to conceptually disentangle the costs of terrorism, and the second is to apply this framework to assess the costs of one of the most significant terrorist actions of our time, the attacks on the United States on 11 September 2001 (hereafter referred to as 9/11).[4]

What are the major categories of cost that result from a terrorist attack? First, there is the immediate destruction of life and property. This is the destruction of an economy's productive capacity, so there is a reduction in aggregate supply. However, most of the destruction caused by most terrorist attacks, even 9/11, is small relative to the economy's total stock of productive resources. The one *caveat* here is that the destruction of critical infrastructure or personnel could impair an economy's productive capacity in a way that is out of proportion to the scale of the attack. Second, there is the macro-economic effect resulting from a perception of increased uncertainty and risk causing firms to delay, abandon or relocate planned investments. Moreover, consumers might delay some consumption expenditures. Thus, a lack of aggregate demand could cause a slowing of growth, or even a recession. Third, there are the sectoral shocks as consumers change their spending patterns. However, these shocks relate to the changing pattern of spending, not the overall quantity of spending, so these costs tend to be small from a macro-economic perspective. When there is heightened awareness of the threat of terrorist attack, the security authorities normally enact a variety of extra security measures. The fourth set of costs is the frictional costs that many of these security measures impose upon the economy. The fifth and final set of costs, is the direct costs of extra security and defence spending.[5] In each of the following five sections of this paper we examine the nature of each cost in turn, and develop an estimate of what the cost might have been arising from 9/11. In the conclusion we consider the sum of the costs from 9/11, and how these costs have evolved in the years following. In addition, there are a number of areas where further research is called for, and we outline those.

[1] There are a number of compelling reasons why Canada should be interested in the economic costs of terrorism. Terrorism is not unknown in Canada, which suffered the FLQ attacks in 1970 and the Air India bombings in 1985. Moreover, with the rise in global terrorism, no Western economy should feel immune to potential attack. Furthermore, it is important for Canada to understand Americans in order to work with them better in the pursuit of our mutual interests. Contributing to an important policy discussion with the US, and other economies, is also worthwhile.

[2] In this paper we do not propose a precise definition of "terrorism". Suffice it to say that "terrorism" occupies a space along the continuum between civil disobedience and armed insurrection. It is not necessary in this exercise to define the borders very precisely.

[3] Nevertheless it is worth testing this proposition empirically. Blomberg, Hess and Orphanides (2004), using the international ITERATE data set find that terrorism has a larger, and statistically significant impact on economic growth in developing economies, but that the effect is not significant in OECD economies. Eckstein and Tsiddon (2003) find that terrorism in Israel over the 2000-2003 period has caused per capita output in that economy to be about 5.0 percent lower than if there were no terrorist acts.

[4] While many of the costs of 9/11 were borne by the international community, the vast majority of the costs were felt in the US. Where we estimate the costs, they are to the US only, but we do mention where some of the costs could spill across borders.

[5] A table summarizing this taxonomy appears as Annex 1.

2. DIRECT COSTS AND IMMEDIATE IMPACTS

The most immediate impact of 9/11 was on human life with 2,973 fatalities resulting from the attack.[6] The human capital embodied in those lives could possibly be estimated as the lost lifetime incomes of those individuals. However, to maintain perspective, the number killed is small relative to the total US population, or even the US workforce, or the highly skilled segment of the workforce, and this cost is unlikely to be large relative to GDP.[7]

The other immediate impact of 9/11 was the destruction of physical infrastructure. The destruction of physical assets was estimated between $10 billion and $13 billion and included the following:[8]

- The destruction of the World Trade Center complex ($3.0 billion to $4.5 billion);
- Pentagon damage ($250 million to $1 billion);
- Clean up of rubble from crash sites ($1.3 billion);
- Four passenger jets ($385 million);
- Fire trucks, ambulances and police cars ($35 million);
- Infrastructure such as streets, sewers, utility lines and subways ($2 billion); and
- Office equipment and software ($3.2 billion).

The costs borne by the insurance industry have been estimated at between $30 billion and $58 billion.[9] These numbers include claims related to physical damage, but also life insurance, workers' compensation and business interruption insurance, and since they include the human cost, they are likely to be a more appropriate estimate of the total immediate damage inflicted.[10]

As Table 1.1 indicates, the New York Stock Exchange and the NASDAQ, which list most large publicly traded corporations, suffered double digit percentage point losses in the days following the attack. The loss of stockholder wealth, as measured by the reduction in market capitalization, was $1.7 trillion.[11]

---

[6] According to the number of death certificates issued by the New York City Medical Examiner's Office, the WTC attacks killed 2,749 non-terrorists, including non-terrorist occupants of the hijacked aircraft. The Pentagon attack killed 184 non-terrorists, including the occupants of the hijacked aircraft. In the crash of United Airlines Flight 93 in Pennsylvania, 40 non-terrorists died. *The 9/11 Commission Report*, 22 July 2004. Although the vast majority of the victims were Americans, the citizens of many other economies were also killed.

[7] However, it may well be true that there were no other buildings on the planet that contained more human capital.

[8] Navarro, Peter & Spencer, Aron, "September 11, 2001: Assessing the Cost of Terrorism", The Milken Institute Review, 2001. pp.19. By contrast the Comptroller of the City of New York estimated the property losses to be $21.8 billion.

[9] OECD- Economic Consequences of Terrorism, September 11 attacks have led to claims on a variety of types of policies: life, property, auto, airplane, workers compensation and business interruption insurance. pp. 124

[10] The Comptroller of the City of New York estimated the human costs of the attacks to be just under $10 billion, which puts their estimate of the total cost at the lower end of this scale.

[11] Navarro, Peter & Spencer, Aron, "September 11, 2001: Assessing the Cost of Terrorism", The Milken Institute Review, 2001, pp. 22

Table 1.1: Loss of Stock Market Wealth

	Drop in Index as of September 21	Loss in Market Capitalization
NYSE	-11.24 percent	-1.3 trillion
NASDAQ	-16.05 percent	-407 billion

However, as Table 1.2 indicates, most of the stock market losses were on paper only, as most pre-9/11 levels were reached again by the first quarter of 2002.[12]

Table 1.2: Common Stock Price Indices[13]

Period	DJIA	S&P 500	NASDAQ
2001- August	10,314.68	1,178.51	1,929.71
September	9,042.56	1,044.64	1,573.31
October	9,220.75	1,076.59	1,656.43
November	9,721.82	1,129.68	1,870.06
December	9,979.88	1,144.93	1,977.71
2002- January	9,923.80	1,140.21	1,976.77
February	9,891.05	1,100.67	1,799.72
March	10,500.95	1,153.79	1,863.05

2.1 Critical Infrastructure: The Financial System

All human and physical capital is not equal. Some have specialized functions which, if disrupted, could cause economic damage that is significantly out of proportion to the initial disruption. Although the financial sector was not severely impaired by the 9/11 attack, it did suffer serious damage, and some components of this sector have critical infrastructure properties.

In any developed economy the financial system has a number of key functions that are essential to the continuing good health of that economy. The fundamental operation of the financial system is the transformation of savings into productive investments. An important part of this function is the continuous pricing of assets and risks, as this is essential to the efficient allocation of capital. Equally important is the clearing and settlement of payments, which is fundamental to transactions that occur through financial institutions, as these are the vast majority of all transactions. In order to fulfill these functions, there are three pillars of the financial system that include (i) clearing and settlement systems, (ii) financial institutions and (iii) financial markets.

In a sense the clearing and settlement systems are at the heart of the financial system. They are the means by which transactions are completed and funds transferred between major financial intermediaries, thus facilitating almost all transactions involving financial and real assets as well as goods and services. Financial institutions include banks and other deposit taking institutions as well as insurance companies and securities firms. These firms provide financial intermediation services, thus creating a flow of funds between savers and investors and other borrowers. Financial markets also provide the flow of funds between savers and borrowers, but with less in the way of intermediation. Moreover, financial markets provide a public price discovery process that facilitates the efficient allocation of capital.

There are a number of types of financial system risks that have been considered, and a number of safeguards have been put into place to support financial stability.[14] The direct disruption of one or

[12] An investor would only have realized the loss if they sold in the immediate aftermath of the attack.
[13] National Bureau of Economic Research- http://www.nber.org/
[14] See: Chant, John; Lai, Alexandra; IIling, Mark & Daniel, Fred, "Essays on Financial Stability", Bank of Canada. Technical Report No. 5. Bank of Canada, September 2003. pp. 22

more elements of the financial system by terrorist attack is often considered to be a part of operational risk. As with many other types of critical infrastructure, measures can be taken to protect existing infrastructure, or redundant infrastructure can be maintained as a back-up.[15] Hardening existing infrastructure and maintaining redundant capacity are costly undertakings. It is uncertain what the optimal level of infrastructure protection would be. This problem is similar to that faced by the insurance industry, in that when a new and significant risk is suddenly imposed, the lack of data makes pricing that risk very difficult. Moreover, if the estimates of the magnitude and probability of the risk evolve over time, that makes the emplacement of the correct amount of infrastructure enhancement very difficult. A second issue is that while there is significant incentive for private firms to make these investments, it is not clear that the private sector incentives would yield an optimal outcome. Given that these shocks so easily spill over across firms, there is clearly a significant public good aspect to these infrastructure enhancements.

In the financial sector, where one major shock can lead to others, possibly of even greater severity, measures such as the emergency provision of monetary liquidity by central banks can help to contain a potential crisis. It is also important that participants in the financial system remain confident in the essential integrity of the financial system as a whole, despite an attack.

When the World Trade Towers were destroyed, a key market-maker[16] in the US treasury market, Cantor Fitzgerald, lost a significant operation, and an important element in the settlement system for US treasuries, the Bank of New York (BoNY) also suffered significantly. Cantor Fitzgerald lost nearly 700 of its staff. Fortunately, within days, Cantor Fitzgerald's London office and other market makers were able to fill the gap on the market-making side, and the settlement system was still usable.[17]

The swift and effective response by the Federal Reserve Bank (Fed) during the terrorist attacks of 9/11, demonstrated the ability of the US financial system to manage a crisis of such a magnitude.[18] Yet, since 9/11, there have been many discussions and debates in the US about the vulnerability of the financial system, and its ability to respond to a crisis, especially if there are multiple attacks at the same time.

[15] It is important to note that back-up human resources are needed as well.

[16] A market-maker, sometimes called a dealer, is an intermediary in a financial market that buys financial products from sellers and sells them to buyers, who eliminate the otherwise costly requirement of matching sellers to buyers. Market-makers are prominent in foreign exchange and fixed income (bond) markets and can also be found in some equity markets.

[17] Chen and Siems (2004) find the financial sector to have been more resilient after 9/11 than after major shocks in preceding decades. They attribute this to the greater stability of the financial sector generally, and also to the adequate provision of monetary liquidity in the immediate aftermath.

[18] Some of the steps taken by the Federal Reserve Bank were:

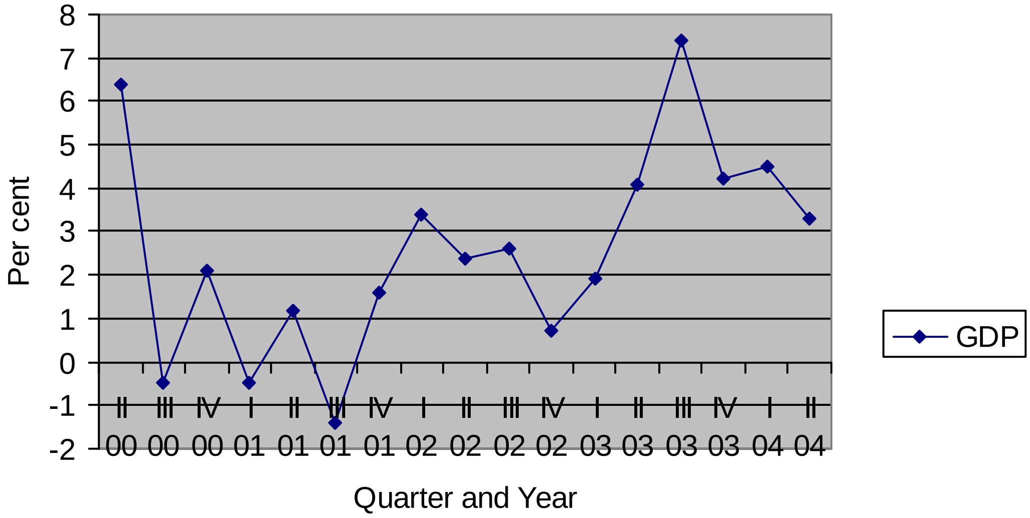
- On 5 September, System discount window borrowing totalled $195 million before the attacks. On 12 September, the day after the attack, it peaked at a record $45.6 billion.
- Also on 12 September, the Open Market Desk at the Federal Reserve Bank of New York injected $38 billion in liquidity into the financial system.
- To facilitate the functioning of financial markets and provide liquidity in US dollars, the Federal Reserve established or expanded swap lines totalling $90 billion with the European Central Bank, the Bank of Canada, and the Bank of England.
- The Open Market Desk facilitated the clearing process in the government securities markets by liberalizing its rules for securities lending. In the strained, post-crisis marketplace, the Open Market Desk's lending expanded from a pre-September daily average of approximately $1.5 billion to over $8 billion a day in the week following the attacks.
- To further help the US economy the Fed eased monetary policy four times during the reminder of 2001 for a total of 175 basis points, bringing the federal funds rate to a 40-year low of 1.75 percent.

Each of these measures was announced through press releases shortly after the attack. See www.federalreserve.gov.

3. MACRO-ECONOMIC IMPACT

Before analyzing the macro-economic impact of the 9/11 attacks, it is useful to review the economic context in which the terrorist attacks occurred. The National Bureau of Economic Research (NBER), the body which officially dates business cycles in the US, has determined that a recession began in March 2001 and lasted until November of that year.[19] Chart 1 below shows real US GDP growth, which had been growing very slowly (below potential) since the downturn in 2000 Q3, dropped again in 2001 Q3.[20] Thereafter, growth remained relatively tepid through to mid-2003.

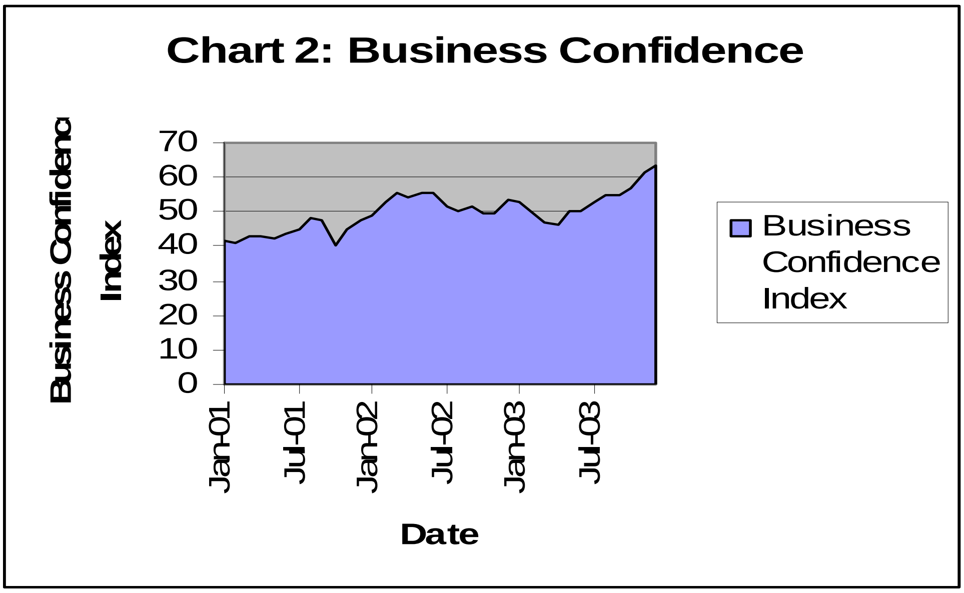
Chart 1: US Real Gross Domestic Product Growth 2000–2004



Source: US Department of Commerce, Bureau of Economic Analysis, National Accounts

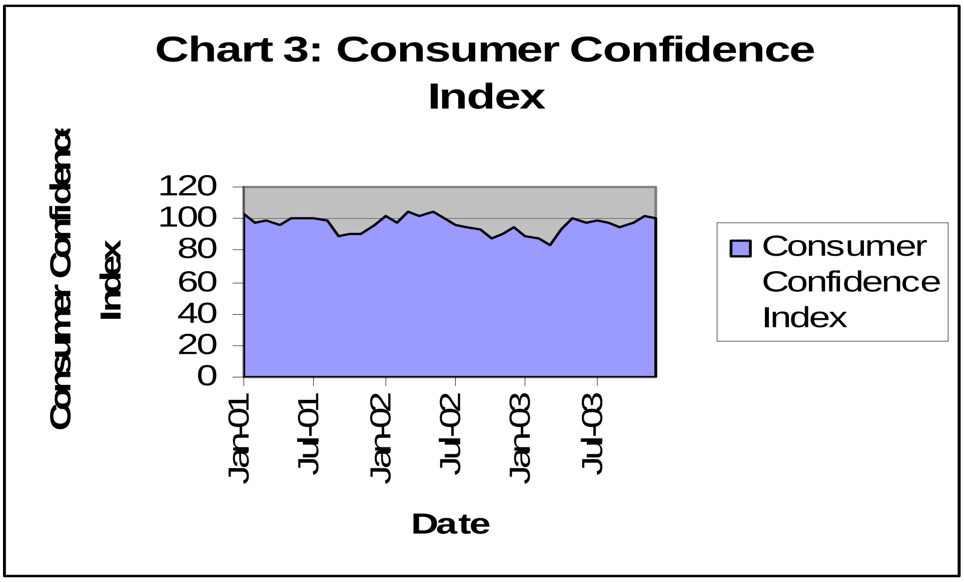
The shock of the attacks of 9/11 created a sense of uncertainty about the future. Large numbers of Americans realized that a new and unknown risk had entered the calculus for the future. As can be seen in Charts 2 and 3, this jolted business and consumer confidence measures fairly sharply. However, both of these measures had recovered by the first quarter of 2002. Business confidence did not convincingly rise above the neutral point of 50 until the second half of 2003. Consumer confidence did not rise appreciably above its neutral point of 100 at all during this period.[21] The dearth of new jobs created during the recovery is probably behind that phenomenon. Nevertheless, consumer spending held up throughout the period.

[19] The popular definition of a recession, two or more back-to-back quarters of real GDP decline does not apply to the official NBER definition.
[20] Potential GDP growth refers to the underlying growth in overall American productive capacity, which in this period is estimated at about 3.0 per cent. Growth at less than this rate creates slack in the economy.
[21] Garner (2002) discusses consumer confidence during this period in greater detail.



Source: Institute for Supply Management, ISM Manufacturing "Report on Business," PMI - History, 1948 - present

In the final analysis, the risk of further terrorist attacks, together with the continuing concerns about technology sector over-investment during the bubble years, and corporate scandals, probably became a significant part of the background residual nervousness that lingered several years after the 9/11 attacks.



Source: OECD, "Main Economic Indicators," December 2001; Volume 2002/12 December; Volume 2003/12 December; Volume 2004/3 March

Table 1.3 outlines the growth rates of a number of key components of aggregate demand, as well as the monetary policy instrument, the federal funds rate. It is evident that investment and international trade were weak through 2001 without any reference to 9/11. However, the impact of 9/11 is probably present in the very severe decline in investment in 2001 Q4. The macro-economic impact of this was significantly offset by the surge in consumption expenditures in that quarter, primarily of durable goods. Boosting government expenditures also offset the weakness in investment. Thereafter, except for a partial recovery in 2002 Q1, investment remained weak until it convincingly took off in 2003 Q3. During the period of 2002 and the first half of 2003, consumption and government expenditures remained robust.

An important explanation as to why the decline in investment expenditures was arrested and consumption expenditures held on, is the rapid easing of monetary policy. The Fed funds rate fell by 375 basis points between the end of 2001 Q1 and 2001 Q3, and then over the course of the next two years the Fed further reduced interest rates by 75 basis points. By aggressively easing the stance of monetary policy the Fed prevented a significantly worse economic outcome from resulting.

Table 1.3: Key Macro-Economic Indicators (percent change from preceding period)

	2001 I	**2001 II**	**2001 III**	**2001 IV**	**2002 I**	**2002 II**	**2002 III**	**2002 IV**	**2003 I**	**2003 II**	**2003 III**	**2003 IV**
Real GDP	-0.5	1.2	-1.4	1.6	3.4	2.4	2.6	0.7	1.9	4.1	7.4	4.2
Investment	-13.6	-7.6	-10.5	-22.7	16.8	0.3	4.1	-0.5	-0.8	3.5	22.4	13.9
Consumption	1.7	1.0	1.8	7.0	1.8	2.8	2.9	2.5	2.7	3.9	5.9	3.6
Imports	-3.7	-12.6	-10.3	-3.4	12.5	11.4	5.4	9.6	-2.0	2.5	2.8	17.1
Exports	-5.3	-12.7	-18.2	-10.8	4.7	11.0	3.1	-4.2	-1.5	-1.6	11.3	17.5
Government Expenditures	5.3	7.9	-1.5	8.5	4.7	4.4	2.1	4.0	0.3	7.2	0.1	1.6
Fed Funds Rate	5.5	4.5	3.0	1.75	1.75	1.75	1.75	1.25	1.25	1.25	1.00	1.00

Source: US Department of Commerce, Bureau of Economic Analysis, National Accounts

This raises an issue with respect to the determination of the macro-economic cost associated with the 9/11 attacks. While the terrorist attack was a significant shock, it was far from the only shock to affect the US. Moreover, there were powerful mitigating influences stemming from the easing of monetary and fiscal policy. If one wanted to estimate the economic costs inflicted by the 9/11 attacks, one would have to do so within the context of an empirical macro-economic model. To the best of our knowledge this has not been done.

When assessing the macro-economic cost there is the important question of whether the loss in output is temporary, or whether it is permanent. For example, if uncertainty about the future causes a household to postpone the purchase of a new vehicle, but when the uncertainty is resolved the purchase is made, this is only a temporary loss. Nevertheless, it is a real loss that is never made up. However, if that same uncertainty causes a firm to abandon an investment plan altogether or to locate that investment abroad, then the loss is permanent.[22] The major cause of the period of slow growth from 9/11 until mid-2003 was weak investment. It is clear that businesses were reluctant to make investments during this period through a combination of having over-built during the technology bubble, and uncertainties related to the terrorist attacks and corporate scandals. Moreover, the surge in investment spending in mid-2003, suggests that there might have been some pent-up intentions to spend. Thus, when estimating the macro-economic costs of the attack it is probably wise to be conservative.

While the most severe macro-economic impact of 9/11 was on the US economy, it was also felt in other economies through two mechanisms. First, many people outside of the US displayed a heightened awareness of, and concern about, the potential of further terrorist attacks both inside and outside the US. Thus, the raised sense of risk and uncertainty, with the accompanying

[22] In fact, with the investment example, in a sense there is a double loss. First there is the loss from forgone investment spending, and second, over the long term there is a smaller capital stock than would have otherwise been in place, leading to reduced productive capacity.

negative impact on investment, affected many economies. Second, a slowdown in the US affected its major trading partners through the operation of the standard trade channel.

4. SECTORAL IMPACTS

A number of sectors were subjected to particularly severe shocks by 9/11, including the tourism, travel, airline manufacturing and insurance sectors. These impacts were not macroeconomic in nature as they largely reflect simple transfers within the economy. That is, although there may be less spending on these sectors or they may have been subjected to a significant shock, these shocks would benefit some other sector. For example, if a certain household decided not to take a family vacation because their perception of the risk involved with that activity had risen, they instead chose some other form of consumption. (Overall consumption expenditures did not decline). Thus, there are two types of costs that resulted from this; the loss in consumer surplus and the adjustment costs which, however, are not large from a macroeconomic perspective.

The concept of consumer surplus refers to the benefit a consumer receives from the consumption of a product above and beyond the price he or she paid for the product. It is the psychic net benefit of purchasing a product. In the case of tourism and travel, the increased perception of risk associated with the consumption of that product made it less attractive, and consumers shifted away from that product and towards others. When one switches from one's first choice to a second choice there is a loss in consumer surplus, and this was one of the costs that 9/11 imposed on seemingly uninvolved people.

The fact that consumption spiked sharply upward in 2001 Q4, driven by a surge in spending on consumer durables, supports the notion that households made this substitution. The surge in spending on consumer durables would also have been supported by the sharp decline in interest rates. Given the extraordinarily low interest rate regime at the time, here was considerable evidence that households started to withdraw housing equity, further driving consumption.

One sign of a healthy economy is the constant creation and destruction of jobs, businesses and industries as technologies and tastes constantly change. This is an indication that the economy is adjusting to changing conditions. However, the adjustment of the economy is not costless. Whenever a worker is laid off, there are the inevitable costs associated with the job search and the forgone production and wages (which are different ways of measuring the same thing), for the period while they are unemployed.

It is misleading to focus entirely on those industries where output and employment fell in the wake of 9/11, since, as indicated above, output shifted to other industries and in many cases employment followed. While the lost consumer surplus and adjustment costs were very real costs, they were temporary, and their existence indicated that the economy was adjusting appropriately to the shock.

There is one *caveat* to the suggestion that the net cost of sectoral shocks is small. Some smaller economies are not well diversified and are particularly dependent on certain industries, such as tourism. In such a case, a sectoral shock may be indistinguishable from a macro-economic shock and could be very large.

4.1 The Insurance Problem

A particular problem arose with respect to insurance. While the cost borne by the insurance industry was somewhat larger than that associated with most natural disasters, the real concern was with the arrival of a new and unknown risk. Before 9/11, insurance coverage specifically for terrorism was close to nil as the probability of an attack in the US was considered to be very low. Insurance companies considered the risk to be so low that they did not identify or price potential losses from terrorist activity separately from the general property and liability coverage provided to businesses. However, after the attacks, insurance companies recognized that their risk exposure was both real and potentially enormous. Their previous experience with major terrorist events was minimal at best. So the question was how to price this risk?[23] In particular, the problem was to estimate the probability and costs of future events, based upon a single occurrence.

One possible outcome of this situation was for the market for terrorism insurance to vanish, at least temporarily, until the accumulation of more experience and data would allow the appropriate pricing of this risk. To some degree this occurred with the property and casualty reinsurers, who bore the burden of paying $50 billion or more in claims resulting from 9/11, announcing that they would no longer sell coverage for acts of terrorism.[24]

As a result, a debate arose over government involvement in terrorism insurance. On 21 September 2001 Congress passed quite comprehensive terrorism risk insurance legislation that obligated the US government to pay terrorism-related losses over $100 million for the subsequent 180 days. The government has renewed the program several times since the initial expiration of the legislation in March 2002.[25]

The argument was made that the government would act as a bridge while the private sector built the capacity and expertise necessary to satisfy the demand for terrorism insurance.[26] Yet, the issue of pricing terrorism risk remains. The Organization for Economic Cooperation and Development (OECD) argues that as limited as the data is for natural catastrophes, there is much less information available on terrorist attacks for risk estimation purposes. "To the extent that data do exist and are available from government sources, they may not be representative of current threats. Even more important, unlike earthquakes and other natural disasters, whose occurrence has a physical basis that can be understood by scientists, terrorist attacks are a function of the malicious intent of groups of individuals of varying sizes and varying agendas." Nevertheless, the report indicates that, "Although none of the terrorist models currently provides well-specified distributions of expected loss in the statistical sense, they can be helpful in enabling insurers to understand the degree of their exposure under a specific attack scenario."[27]

5. TRADE AND FRICTIONAL COSTS

An important factor that spurred rapid world economic growth during the 1990s was an increasingly liberal global trading system. Economies in the Asia-Pacific region, Europe, North America and elsewhere were easing tariff and non-tariff barriers and increasingly engaging in trade facilitation measures. Increasing specialization and competition led to falling unit costs, and, together with growing international investment flows, led to rapid non-inflationary economic growth in many economies. Indeed by 2004, over 15 million containers were moving at sea or on land, or standing in yards waiting to be delivered on any given day, transporting about 90 percent of the world's cargo.[28]

In the post-9/11 environment it was evident that the maritime transportation system could be used as a means of smuggling terrorists or their weapons across borders, or more seriously, as a platform of attack, particularly with weapons of mass destruction (WMD). Many called for substantial tightening of security in maritime trade, and yet to a significant degree, continuing

[23] Reinsurers—companies that routinely take on some of the risk that direct primary insurers face in return for a share of the premiums—were now unwilling to participate in terrorism coverage because of the enormous losses they suffered after 11 September and the newly recognized difficulties of pricing terrorism insurance.
[24] A Call for US to Get out of Terror Insurance for Airlines, "New York Times, February 26th, 2002", Section C, p.8
[25] Hartwig, Robert. "One hundred Minutes of Terror that changed the Global Insurance Industry Forever", Insurance Information Institute, January 2003. pp. 12
[26] Brown, Jeffrey & Kroszner, Brian "Federal Terrorism Risk Insurance". NBER Working Paper. October 2002, pp. 1
[27] OECD–"Insurability of Mega Terrorism Risk: Challenges and Perspectives", October 2004. pp. 2-7
[28] The Economist, "Container Trade: When Trade and Security Clash", April 2004, pp. 1.

world economic growth depends on the continued smooth functioning of maritime transportation. The stakes involved in securing maritime trade are very high, as an important breakdown in the maritime transport system would fundamentally cripple the world economy.[29]

Since 9/11 and even earlier, the US has been a driving force behind maritime security, having initiated a number of measures including the Automated Commercial Environment (ACE), Container Security Initiative (CSI), International Trade Date System (ITDS) and the Customs-Trade Partnership against Terrorism (C-TPAT). In addition, the International Maritime Organization (IMO) initiated the International Ship and Port Facility Code (ISPS). The cost of implementing these initiatives would be several billion dollars.[30]

Security at a number of land border crossing points has also been tightened. The land border with the greatest volume of trade passing over it is that between Canada and the US. The wait times at this border have increased.

A number of researchers have investigated the effect of terrorism on trade and find empirical evidence that corroborates the expected negative effect. For example, Nitsch and Schumacher (2002), estimating a gravity model of trade find that terrorism significantly impedes bilateral trade. Blomberg and Hess (2004) find the presence of terrorism, along with internal and external conflict, to be the equivalent of a 30 percent tariff on trade. Moreover, Walkenhorst and Dihel (2002), using a CGE model, find that 9/11 increased the frictional trading costs by 1.0 percent of the total value of traded goods.

Bernasek (2002) has pointed to an increase in economic frictions as being a significant cost imposed by the myriad of security measures.[31] These frictions include anything from airport and border point waiting times to the costs of slower production supply chains and larger inventory stocks. The author estimated that these frictions could be costing the US economy 1.5 per cent of GDP. However, this estimate is probably exaggerated. The impact of these frictional costs should be to reduce productivity growth. However, on the face of it, there is no strong evidence supporting this, as productivity growth accelerated from 2.5 percent in 2001 to 4.4 percent in 2002, 4.4 percent in 2003 and 4.1 percent in 2004.[32] Nevertheless, rigorous testing using a state-of-the-art productivity model should be done.

6. SECURITY AND DEFENCE EXPENDITURES

Security and defence expenditures pose a conceptual problem in that increases in these expenditures are often cited as a cost of terrorism.[33] However, such expenditures (and indeed any increase in government spending) are stimulative from a macro-economic standpoint, and therefore it is difficult to see them as a cost. The point is that these expenditures are not a cost *per se*, but a symptom of the cost. That is, the terrorist attack creates the perception of insecurity and risk, and this, strictly speaking, is the cost. The perception of insecurity then creates the demand for increased security and defence spending. While the latter is not the cost, it does give a useful gauge of the magnitude of insecurity created. Moreover, the financing of the increased spending can create further costs and risks. In a sense, security spending is a societal overhead, and therefore one can think of this cost as being a supply-side shock. This section is divided into two parts. The first part will discuss the federal funding for homeland security. The second will

[29] OECD, Maritime Transport Committee, "Security in Maritime Transport: Risk Factors and Economic Impact", July 2003, pp. 1-5.
[30] For details on these measures see http://www.imo.org
[31] See, for example, Anna Bernasek, "The Friction Economy", *Fortune*, February 18, 2002. In this article the author estimates frictional costs to be 1.5 percent of GDP. This is probably too high an estimate as productivity growth would be expected to fall if this were the case, but it seemed to materially accelerate in the US in 2002 and 2003.
[32] Bureau of Labor Statistics, US Department of Labor.
[33] For example, see Krugman (2004).

discuss the issue of an elevated budget deficit due to increased security spending in the US, and its implications for the US economy.

6.1 Increased Security and Defence Expenditures

Table 1.4 provides some of the more significant elements of recent changes in fiscal policy. With discretionary and supplemental spending combined together, homeland security spending rose from $13 billion in 2001 to $28 billion in 2004, and defence spending rose from $317 billion in 2001 to $490 billion in 2004. Over that same period, the government fiscal balance shifted from a surplus of $128 billion to a deficit of $412 billion, representing a net change of -$540 billion. Of this, $272 billion is due to increases in defence and homeland security spending,[34] $57 billion is due to other spending increases and $11 billion is due to reductions in revenues collected.[35] Thus, even if one includes Department of Defence spending, counter-terrorist activities are not a complete explanation of the government budget deficit.[36] Moreover, a deficit-to-GDP ratio of 3.6 percent and a debt-to-GDP ratio of 37.2 percent in 2004 are not extraordinary. Nevertheless, security spending does add significantly to the deficit, and it is worthwhile reviewing the economic impact of a government deficit.

Table 1.4: Government Financial Balance ($ billions)

	2001	2002	2003	2004
Total Outlays	1,863	2,011	2,160	2,292
Of which:				
Discretionary Defence	303	328	365	376
Supplemental Defence	14	18	80	114
Discretionary Homeland Security	10	13	24	28
Supplemental Homeland Security	3	12	6	*
Total Receipts	1,991	1,853	1,782	1,880
Surplus/Deficit	128	-158	-378	-412
Surplus/Deficit as percent of GDP	1.3	-1.5	-3.5	-3.6

Source: The White House, Office of Management and Budget, “The Budget for the Fiscal Year, 2006”
* Indicates $500 million or less.

7. IMPLICATIONS OF DEFICIT SPENDING

The impact of a government deficit on an economy depends fundamentally on how it is financed. Here we simply assume that new government bonds are sold to the private sector.[37] The increase in the supply of bonds would be expected to put downward pressure on the price of this new debt, which would put upward pressure on longer-term interest rates. Higher long-term interest rates, in turn, make it more costly for private sector borrowers to raise funds, and one would normally expect some diminution of long-term borrowing, and in the investment and residential housing expenditures that would have been supported by this borrowing. This is sometimes referred to as

---

[34] It is assumed that all increases in homeland security and defence spending have been due to 9/11, which some would debate. This is undoubtedly an overestimate, but perhaps a useful starting point.
[35] This is not the same as saying $11 billion is due to tax cuts. Given economic growth, an unchanged tax regime would have yielded increasing revenues. Therefore, tax cuts are a more significant factor.
[36] Here we simply assume that all supplemental defence and homeland security spending and all increases in discretionary defence and homeland security spending are a result of the sense of insecurity brought on by 9/11.
[37] In principle it is possible to sell the new bonds to the central bank. This, however, can imply a significant increase in monetary creation, which can be quite inflationary. That would suggest that the current holders of nominal debt would bear the cost of this “inflation tax”. The Federal Reserve System is aware of this and is not about to let inflation run out of control.

"crowding out" since public sector borrowing is crowding out private sector investment. Over the long term this can have a negative economic impact, as the productive capacity of the economy grows more slowly than might otherwise have been possible with greater private investment.

The situation at this time in the US, however, is more complex. The United States as a whole spends more than it earns. In particular, investment and government expenditures are greater than domestic savings and tax revenues; which is equivalent to saying that imports exceed exports (which is approximately equal to saying that there is a current account deficit). The current account deficit in the US was $531 billion in 2003, and continues to grow. This implies that unless there are substantial capital inflows into the US, there would be significant downward pressure on the external value of the US dollar. A significant part of this capital inflow has been from Asian central banks, as they attempt to maintain their fixed exchange rates or otherwise intervene in foreign exchange markets to keep their currencies low. The US dollar has declined by 39 percent against the euro between 2001 and 2004,[38] and also declined against many other currencies. The real issue here is that with the continuing possibility of a sharp US dollar depreciation, there is a risk that those who have investments in US dollar denominated assets could abruptly withdraw those investments, thereby precipitating a sharp fall in US asset prices and in the value of the US dollar. The concern is that the ensuing loss in wealth and confidence could trigger another economic downturn.[39]

While a reduction in the federal deficit would not automatically reduce the current account deficit, it would reduce the ongoing American need for foreign capital, which would reduce the risk of severe financial market fluctuations. The US administration is aware of this, and is planning a reduction in deficit spending over the medium-term. However, there are other developments that could also alleviate this risk. Recently China has abandoned its exchange rate peg to the US dollar, in favour of a slightly more flexible exchange rate regime. This, and further flexibility would help to create a global pattern of exchange rate adjustment which is more balanced and appropriate. Moreover, particularly if the large continental European economies were to engage in more active structural reform policies, their economic growth rates could accelerate. More balanced global growth could alleviate the US current account deficit and thereby mitigate the risks of financial market volatility.

Thus, one of the implications of the terrorist attacks is an elevation of the level of global financial imbalances, which in turn increases the risk of a financial market downturn commencing in the US, and potentially having negative macroeconomic implications.

8. CONCLUSIONS

What was the economic cost of 9/11? All we can do at this point is a very rough calculation, which appears in Table 1.5. The direct costs, which have been absorbed by the insurance industry, have been estimated in the $30 to $60 billion range. We take the mid-point. The macroeconomic costs, caused by increased uncertainty, are particularly difficult to estimate without the use of an empirical macro-economic model. As a rough guess, we assume that a 0.25 per cent loss of GDP starting in 2001 Q3 and running through to 2003 Q1 could be attributable to 9/11. Although this is a straight-line estimate, it does front-end load the cost somewhat because the attack came after most of Q3 was over. This effect would account for the uncertainty that spiked with the attack and lingered in the background until growth decisively rebounded in mid-2003. The sectoral and frictional costs, as explained above, are relatively minor as, for the most part, they entail a transfer of resources within the economy. These costs are probably small and the sectoral costs are temporary. Moreover, some of these costs could be reflected in the macro-economic costs.

[38] The Federal Reserve Board, Annual Foreign Exchange Rates, Release date 3 January 2005 (Average rates of exchange in 2004 with comparable figures for 2001 used. Averages based on daily noon buying rates.)
http://www.federalreserve.gov/releases/g5a/current/

[39] While it is quite probable that the Fed would prefer to head off this potential shock by easing monetary policy if it came to pass, such a move would only mitigate the shock.

Finally, there is the sense of insecurity, which is reflected in the increased security and defence spending. Supplemental defence and homeland security spending, plus all increases in discretionary defence and homeland security spending from 2001 to 2004 totalled $205 billion.

Table 1.5: The Economic Costs of 9/11 ($ billions)

	2001	**2002**	**2003**	**2004**	**Total to date**
Direct Costs	45				45 (7%)
Macro- Costs	50	100	25		175 (26%)
Security Costs	17	58	162	205	442 (67%)
Total Costs	**112**	**158**	**187**	**205**	**662**
Total as percent of GDP	1.1	1.5	1.7	1.8	

Added together these costs total $662 billion over four years, and ranged from 1.1 percent to 1.8 percent of GDP. Is this a large or small cost?[40] One could consider how many hospitals or universities that would buy, or what impact those funds could have on the developing world, or one could imagine that would be roughly equal to $100 for every man, woman and child on the planet.

There are two particular areas that require further investigation. The first area is to develop an estimate of the macro-economic impact of 9/11 which is based on little more than guesswork. This would involve the estimation of an empirical macro-economic model that would include the monetary and fiscal policy responses. The use of a vector autoregressive model appears to be particularly warranted. This would allow the researcher to examine the macro-economic impact of 9/11 with and without the active policy response that followed the actual event.[41] Second, a careful investigation of the frictional costs caused by the heightened security measures and its impact on the evolution of productivity growth would be warranted. Although there is already an empirical literature emerging that is focussed on determining the impact of terrorism on trade, it might be particularly interesting if the effects were decomposed to direct effects and the frictions resulting from new security measures.

[40] Paul Krugman arrives at a similar estimate, and implies that the number is small.
[41] A second question to test for is whether the macro-economic impact of 9/11 was consistent or not with the impacts of other terrorist attacks, with suitable adjustments made for scale. The sheer shock of 9/11 seems to be out of proportion with other events and it appears that 9/11 represented something of a turning point in terms of security. In general the economic impacts of terrorist actions are probably highly subject to non-linearities and this issue could be profitably investigated.

BIBLIOGRAPHY

American Society of Civil Engineers, 1996, “The Oklahoma City Bombing: Improving Building Performance through Multi-Hazard Mitigation”, Washington D.C.

Baily, M., 2001,,“Economic Policy Following the Terrorist Attacks”, Institute of International Economics, International Economic Policy Briefs, Washington D.C.

Bank of England – Financial Stability Review, December 2001.

Bernasek, A., 2002. *Fortune*, “The Friction Economy”, Volume 145, Issue: 4.

Blomberg, S. B., G.D. Hess, and A. Orphanides, 2004, “The Macroeconomic Consequences of Terrorism”, CESifo Working Paper No. 1151.

Blomberg, S. B. and G. D. Hess, 2004, “How much does violence tax trade?” CESifo Working Paper No. 1222.

Brown, J. and B. Kroszner, 2002, “Federal Terrorism Risk Insurance”, NBER Working Paper.

Bureau of Economic Research, US Department of Commerce, 2004.

Chant, J., A.Lai , M.IIling, and F. Daniel, 2003, “Essays on Financial Stability”, Technical Report No. 5, Bank of Canada.

Chen, A., and T. Siems, 2004. “The effects of terrorism on global capital markets”, *European Journal of Political Economy*, Vol. 20, 349-366.

Comptroller of the City of New York, 2002. “One Year Later; The Fiscal Impact of 9/11 on New York City”. Publisher???

Eckstein, Z. and D. Tsiddon, 2003. “Macroeconomic Consequences of Terror: Theory and the Case of Israel”, CEPR.

The Economist, 2004. “Container Trade: When Trade and Security Clash”. Issue info?

The Federal Reserve Board, Annual Foreign Exchange Rates, Release date January 3, 2005.

Garner, A. C., 2002. “Consumer Confidence after September 11”, Economic Review, Federal Reserve Bank of Kansas.

General Accounting Office, 2003 “Potential Terrorist Attacks—Additional Actions Needed to Better Prepare Critical Financial Market Participants.” Publisher?

Hartwig, R., 2003. “One Hundred Minutes of Terror that changed the Global Insurance Industry Forever”, Insurance Information Institute. Where?

Hograth, R., 2002, “Insurance and Safety after September 11, 2001: Coming to Grips with the Costs and Threats of Terrorism”, Working Paper at Universitat Pompeu Fabra, Barcelona, Spain.

Institute for Supply Management, ISM Manufacturing “Report on Business,” PMI - History, 1948 – present.

Krugman, P., 2004, “The Costs of Terrorism: What Do We Know?” Princeton University, *mimeo*.

Navarro, P., and A. Spencer, 2001, “September 11, 2001: Assessing the Cost of Terrorism”, The Milken Institute Review. Pages?

Nitsch, V., and D. Schumacher, 2002, “Terrorism and Trade”, Paper written for Workshop on “The Economic Consequences of Global Terrorism”, DIW, Berlin, 14-15 June 2002.

OECD, 2004. “Insurability of Mega Terrorism Risk: Challenges and Perspectives”.

OECD, 2001; Volume 2002/12 December; Volume 2003/12 December; Volume 2004/3 March, “Main Economic Indicators”.

OECD, 2003, “Security in Maritime Transport: Risk Factors and Economic Impact,” Maritime Transport Committee.

Oklahoma City bombing trial transcripts, 13 June 1997

Raby, G., 2003, “The Cost of Terrorism and the Benefits of Cooperating to Combat Terrorism”, Department of Foreign Affairs and Trade, Economic Analytical Unit, Government of Australia.

Stern, J., 2004, “Terror in the Name of God: Why Religious Militants Kill”, Harper Collins, New York.

The 9/11 Commission Report, 22 July2004.

Walkenhorst, P., and N. Dihel, 2002, “Trade impacts of the terrorist attacks of 11 September 2001: A quantitative assessment”, Paper written for Workshop on “The Economic Consequences of Global Terrorism”, DIW, Berlin, 14-15 June 2002.

ANNEX 1

A TAXONOMY OF TERRORISM'S COSTS

Categories of Costs	Aggregate Supply or Demand Shock	Temporary or Long-Term	Type of Cost	Caveats
Direct Damage	▪ Supply	▪ Long-Term	▪ Capitalized Value of Stock	▪ Critical Infrastructure
Macro-economic Costs	▪ Demand	▪ Temporary, could be up to several years	▪ Model-Based ▪ Forgone growth	▪ In long-run Supply can be affected ▪ Could be partially offset by macro policy ease
Sectoral Shocks	▪ Neither	▪ Short-Term	▪ Small loss of Consumer Surplus ▪ Adjustment Costs	▪ Costs are generally small in aggregate
Frictions	▪ Supply	▪ Long-Term	▪ Model-Based ▪ Forgone efficiency	
Security Costs	▪ "Overhead"	▪ Long-Term	▪ Increased Annual Spending	

TERRORISM AND FDI FLOWS: CROSS-COUNTRY DYNAMIC PANEL ESTIMATION

EXECUTIVE SUMMARY

After the 11 September 2001 terrorist attacks on the World Trade Towers (9/11), the economic impact of terrorist activities has attracted attention from policy makers and academics. The risks of possible future terrorist incidents, the huge cost associated with terrorist incidents and the significant redistribution of economic resources underscored the need for a better understanding of the economic consequences of terrorism.

Terrorism might aggravate economic performance through increases in costs, which include an increase in insurance premiums, disruptions of the transportation system, the severe tightening of border controls, and increase of public spending on homeland security and military operations. In particular, an increase of transactions costs might affect the flows of commodity trade as well as financial capital. While the impact of terrorism on trade and capital flows may vary across time and place, terrorism generally imposes additional costs for transactions so that, if anything, we would expect a negative association between terrorist activity and the volume of trade and capital flows.

This paper investigates the impact of terrorism on the flow of foreign direct investment (FDI), which is one of the recent features of the world economy. Most developing countries consider FDI inflows as one of the most important channels for economic development.

Using the generalized method of moments (GMM) for estimation, the empirical results show that all terrorist variables play a negative role in attracting FDI for all model specifications. Furthermore, all model specifications satisfied specification tests and the AR test. Looking at the specifications, we see that lagged FDI stock, GDP per capita and exports are assumed as endogenous variables and economic freedom index, average tariff rate and terrorist variables are assumed as strictly exogenous ones.

In sum, by using FDI and terrorist data between 1980 and 2002, this paper investigates the role of terrorism on FDI. Consistent with our hypothesis, the estimation results show that terrorism is negatively and significantly related with FDI flows. Estimates indicate that the terrorism variables decrease world FDI flows by 0.3 to 0.6 percent. In particular, terrorist activity in an economy reduces FDI flow to that economy by 0.5 percent. The decreases in FDI flows are estimated to decrease the world growth rates by 0.08 percent. This is because FDI is the most important channel of development to both developing counties and developed countries.

The specifications for possible endogeneity of control variables strengthen the significant role of terrorism variables. Furthermore other control variables that are shown as important factors in previous studies have proved to be significant in this study.

1. INTRODUCTION

After the terrorist attacks on 11 September 2001 (9/11), the economic impact of terrorist activities has attracted wide attention from policy makers and academics. The risks of possible future terrorist incidents, the huge cost associated with terrorist incidents and the significant redistribution of economic resources has motivated us to find a better understanding the economic consequences of terrorism.

Terrorism might aggravate economic performance through: increases in costs, including an increase in insurance premiums; the disruptions of the transportation system; the severe tightening of border controls; and increase of public spending on homeland security and military operations. Even with measurement problems such as aggregation issues, the definition of damage, and the causality of indirect effects etc. The Organization for Economic Cooperation and Development (OECD) estimated costs resulting from the 9/11 to be US$11 billion to US$14 billion for the private sector, US$1.5 billion for state and local government enterprises, US$0.7 billion for the US federal government, and US$11 billion for the rescue and clean-up operations (Lenain *et al*., 2002). An increase of transaction costs might affect the flows of commodity trade as well as financial capital. While the impact of terrorism on trade and capital flows may vary across time and place, terrorism generally implies additional costs for transactions so that, if anything, we would expect a negative association between terrorist activity and the volume of trade and capital flows.

The policy responses aimed to prevent and detect terrorism are enacted on borders and include closer inspections on people, vehicles and goods as well as more restrictive immigration regulations. There is the risk of a direct destruction of traded goods. Studying the empirical effects of terrorism on international trade, Nitsch and Schumacher (2004) find that conflicts, broadly defined, had significant effects on bilateral trade flows; a doubling in the number of terrorist incidents is associated with a decrease in bilateral trade of about 4.0 percent.

Furthermore, with the shrinkage of terrorism-related insurance coverage stemming from the perception of greater risks, higher transaction costs may have a detrimental impact on investment, as lenders become wary of greater potential risks, although there is no strong evidence yet of such a pattern.

This paper is to investigate the impact of terrorism on the flow of foreign direct investment (FDI), which is one of the recent features of the world economy. Most developing economies consider FDI inflows as one of the most important channels for economic development.

One of the important questions raised by FDI literature is: what are the determinants in the location of multinational enterprises. Potential determinants of FDI location have been extensively studied (Coughlin *et al*., 1991; Friedman et al., 1992, 1996; Wheeler and Mody, 1992; Head *et al*., 1995; Chen, 1996; Barrel, 1999; Cheng and Kwan, 2000). Main determinants of FDI location suggested by the studies above can be summarized into four categories: agglomeration effects, infrastructure effects, factor cost effects and market access effect.

Agglomeration effects might be due to positive linkages among projects. One incentive is the spillover effects created by research and development. The second is confidence and the possibility that firms cluster. For example, firms are not sure as to whether a particular economy (region) is a good location for FDI and thus take the success of one firm as a signal of the underlying economic (regional) characteristics. A third incentive arises from the supply of, and demands for intermediate goods (see Fujita *et al.*, 1999 for a general overview).

Second, most developing economies have tried to attract FDI through special economic policies such as the establishment of special economic zones and the construction of new roads. This results in FDI investors having decreased setup costs for new local establishments in host economies (Chen, 1996; Cheng and Kwan, 2000).

Third, a significant part of multinational activity tends to take the forms of firms shifting a stage of their production process to low-cost locations. The economic analysis of this shift is based on the idea that different parts of the production process have different input requirements. For example, it may be profitable to move production of labor-intensive goods to labor-abundant economies while the headquarter services are left in the home economy (Helpman, 1984, 1985; Helpman and Krugman, 1985).

Fourth, switching from direct exports to local production will bring cost savings. Obviously local production can save costs through avoiding transport costs, trade barriers such as tariffs and other, non-trade barriers. Furthermore, local production in collaboration with local firms through joint ventures can decrease the cost of dealing with foreign regulation, tax, and administration. Theoretical modeling based on distinct firms with increasing returns to scale predicts that FDI is more likely to replace exports the larger the market is, because the plant-specific fixed costs may be spread over more units of output as the market size increases. Also, larger markets will tend to have more local firms, and consequently more intense competition than smaller markets. This will lead to a lower price and be particularly damaging to the profitability of exports, tipping the firm's decision in favor of local production (Horstmann and Markusen, 1987; Markusen and Venables, 1998).

One possible issue is the possible endogeneity of the terrorist activities, i.e., economic conditions might cause terrorism. For example, Li and Schaub (2004) test the effect of economic globalization on the number of transnational incidents. Their empirical results show that trade, FDI, and portfolio investment have no direct effects on transnational incidents within economies. They further find that the economic development of an economy and its top trading partners is related to the number of terrorist incidents inside those economies. Supporting the findings, Hess and Orphanides (1995, 2001), and Blomberg and Hess (2002), and Blomberg, *et al*. (2004) explore the links between the incidence of terrorism and the state of the economy's economy. They find that economic activity and terrorism are not independent, showing that high income and democratic economies appear to have a higher incidence of terrorism, and a lower incidence of economic contractions. Furthermore, terrorism appears to be related to the economic business cycle: periods of economic weakness increase the likelihood of terrorist activities.

In order to consider possible issues raised in estimates, this paper uses Panel System GMM estimation (Holtz-Eakin *et al*., 1988; Arellano and Bond, 1991; Ahn and Schmidt, 1995, 1997; Arellano and Bover, 1995; Blundell and Bond, 1998). Then we find that terrorism and other economic activities such as: economic freedom, average tariff rate, income per capita and exports, play significant role in attracting FDI. They are economic freedom, average tariff rate, income per capita and exports.

The paper is organized as follows. Section 2 describes several indicators of terrorism. Sections 3 and 4 present the estimation methodology and the results and Section 5 the conclusion.

2. TERRORISM

The data on terrorist activities are from the latest update of the International Terrorism: Attributes of Terrorists Events (ITERATE) data set from Mickolous, *et al.* (2003). The ITERATE data set, which provides a detailed chronology of terrorist events around the world since 1968, attempts to standardize and quantify characteristics, activities, and impacts of international terrorist groups. The types of incidents included in the data are: kidnapping, barricade and hostage seizure, occupation of facilities without hostage seizure, letter or parcel bombing, incendiary bombing, arson, Molotov cocktail, explosive bombing, armed attack employing missiles, armed attack—other (including mortars and bazookas), aerial hijacking, takeover of non-aerial means of transportation, assassination or murder, sabotage not involving explosives or arson, toxic pollution, nuclear weapons threat, theft or break-in threat, conspiracy, hoax, sniping, shoot-out with police, arms smuggling, car bombing and suicide bombing.

The raw data consists of five categories. First, there are the incident characteristics of each event (timing, type of accident, location start, etc.). Second, there are the terrorist characteristics, which include the number of terrorists, their citizenship, etc. Third, victim characteristics describe the number, citizenship, and types of victims. Fourth, life and property losses are recorded. They are total individuals wounded and killed, and amount of damage, etc. Finally, the terrorists' logistical success or failure is recorded.

Since there is no consistent definition of terrorism, we use several measures of terrorism: the number of terrorists in attack force (terrorists), the number of incidents (incidents), the number of victims (victims), and the number of victims per incident (victims per incident). The next question is: how do we define the rate of terrorist activity. For example, the variable which might be assumed to affect FDI is the number of individuals wounded per year or the accumulated number of individuals wounded until the year before the FDI decision is made.

Figures 1-4 depict the number of each variable over years.

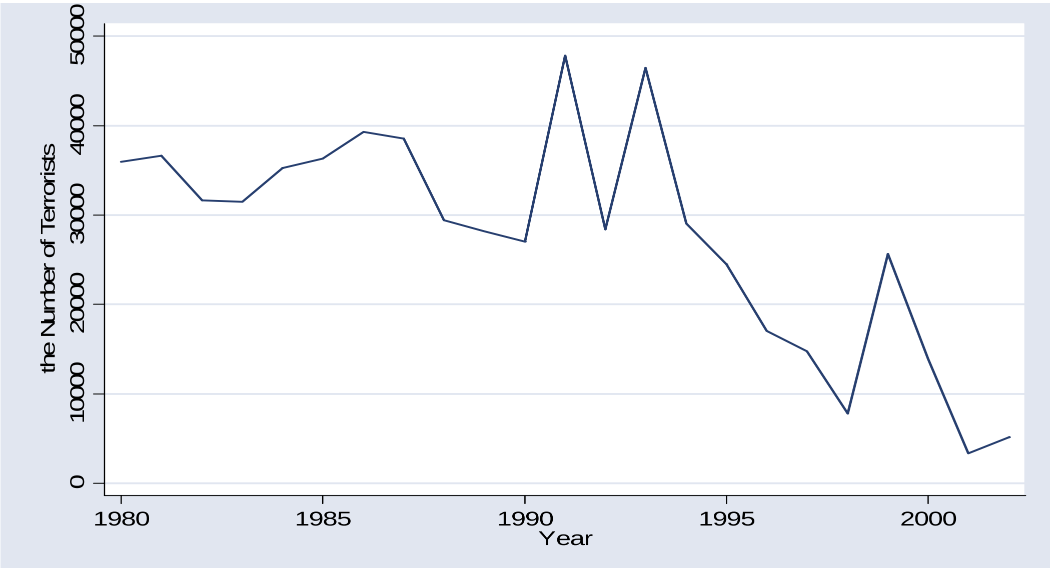


Figure 1: Annual Trend of the Number of Terrorists: 1980-2002

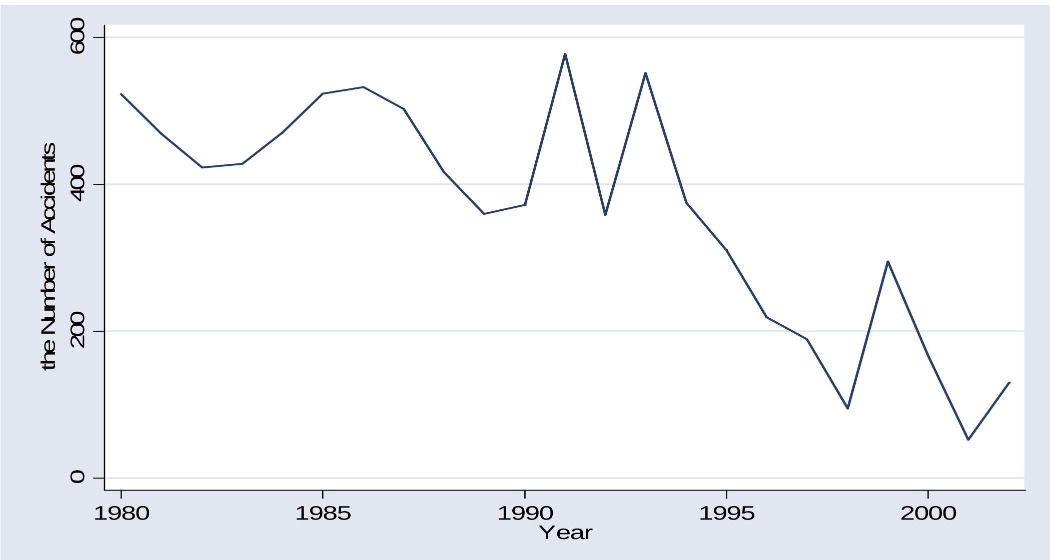


Figure 2: Annual Trend of the Number of Accidents: 1980-2002

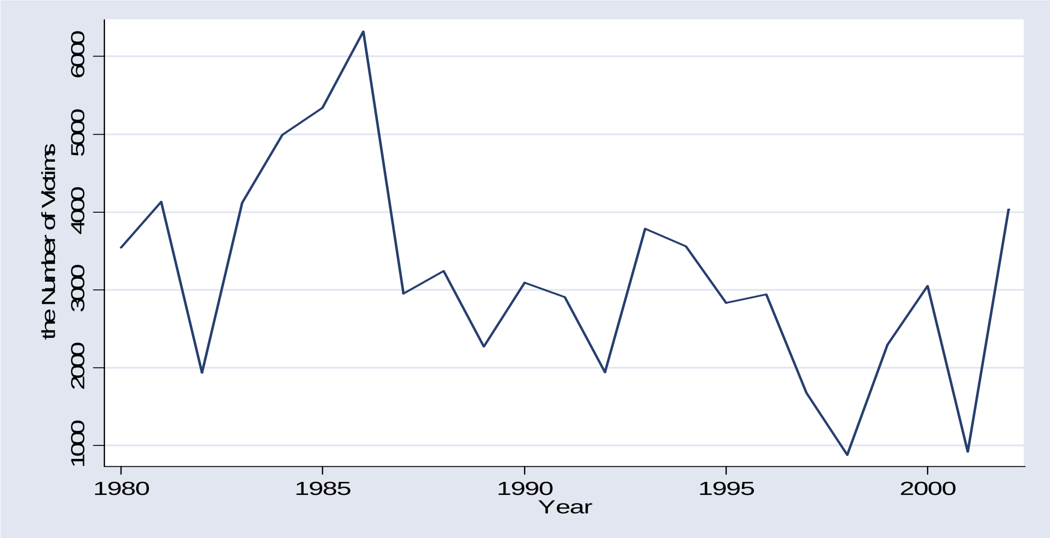


Figure 3: Annual Trend of Victims: 1980–2002

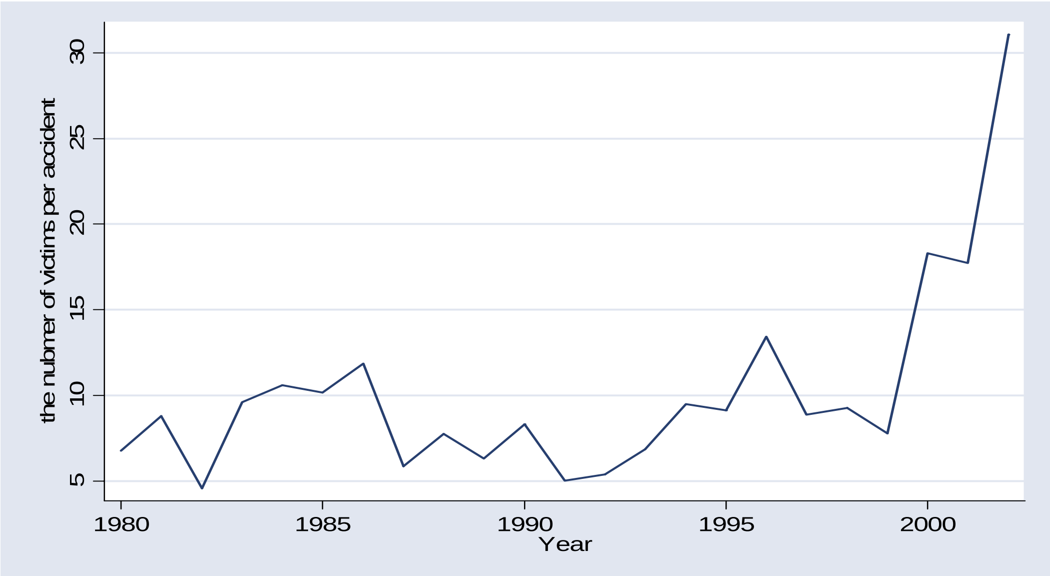


Figure 4: Annual Trend of Victims per Accidents per year: 1980–2002

Table 2.1 describes the summary statistics of terrorism variables that are used in the estimation.

Table 2.1: Summary Statistics of Terrorism Variables

	1980–84	1985–89	1990–94	1995–99	2000–02	Total
Terrorists	474.5	444.9	467.6	291.3	179.7	406.7
	(854.8)	(816.5)	(1143.2)	(650.1)	(260.3)	(867.4)
Accidents	6.4	6.1	5.8	3.6	2.8	5.4
	(10.8)	(10.3)	(12.5)	(6.9)	(2.9)	(10.2)
Victims	52.1	52.1	40.0	35.5	64.6	47.0
	(142.8)	(161.7)	(96.7)	(77.8)	(148.3)	(128.5)
Victims per Accident	10.5	9.1	9.0	14.3	23.4	11.5
	(25.5)	(25.5)	(23.6)	(51.3)	(56.3)	(32.3)

3. MODEL SPECIFICATION

Assume the following FDI determination equation in the economy in year t.

$$f_{it} = \alpha_1 + (1+\alpha_2)F_{it-1} + \beta' X_{it} + \eta_i + \omega_t + v_{it}, \quad (1)$$

where f_{it} is FDI flows into economy i in year t and F_{it-1} represents the accumulated stock of FDI flows until year $t-1$, which reflects the accumulation effect.

Since FDI flows f_{it} can be rewritten as $F_{it} - F_{it-1}$, equation (1) can be rewritten as a dynamic panel regression in the form:

$$\begin{aligned} F_{it} &= \alpha_1 + \alpha_2 F_{it-1} + \beta' X_{it} + u_{it}, \\ u_{it} &= \eta_i + \omega_t + v_{it}, \ i = 1,2,...,N, t = 1,2,...,T. \end{aligned} \quad (2)$$

This equation is a dynamic panel regression with a lagged dependent variable on the right hand side. We assume the time-specific effect, ω_t, as a fixed, unknown constant, which is equivalent to putting time dummies in the regression. The treatment of the economy-specific effect, η_i, requires extra care. It is known that, in a dynamic panel regression, the choice between a time-specific effect and a random-effect formulation has implications for estimation that are of a different nature than those associated with the static model (Anderson and Hsiao, 1981, 1982; Hsiao, 1986). Further, it is important to ascertain the serial correlation property of the disturbances in the context of our dynamic model, as that is crucial for formulating an appropriate estimation procedure. Finally, the issue of reverse causality will have to be addressed. We have to deal with the potential endogeneity of both the lagged dependent variable and the explanatory variables arising from the feedback effects of FDI on the local economy. These econometric issues will all have profound implications for specifying an appropriate model and its estimation.

Following Holtz-Eakin, *et al*. (1988), Arellano and Bond (1991), Ahn and Schmidt (1995, 1997), Arellano and Bover (1995), and Blundell and Bond (1998), we address the above-mentioned econometric issues under a generalized method of moments (GMM) framework.

The GMM approach starts with the first-differenced version of (2).

$$\Delta F_{it} = \alpha_2 \Delta F_{it-1} + \beta' \Delta X_{it} + \Delta u_{it}, \ i = 1,2,...,N, t = 1,2,...,T, \quad (3)$$

in which the economy-specific effects are eliminated by the difference and Δ represents the first difference of each variable.

Under the assumption of serially uncorrelated level residuals, values of F lagged two periods or more qualify as instruments in the first-differenced system, implying the following moment conditions:

$$E[F_{it-1}\Delta u_{it}] = 0 \quad for\, t = 3,...,T \text{ and } s \geq 2. \quad (4)$$

But GMM estimation based on (4) alone can be highly inefficient. In most cases, it is necessary to make use of the explanatory variables as additional instruments.

Here the issue of endogeneity due to reverse causality becomes critical. For strictly exogenous explanatory variables both past and future ΔX are valid instruments:

$$E[\Delta X_{it-s}\Delta u_{it}] = 0 \quad for\, t = 3,...,T \text{ and all } s. \quad (5)$$

But using (5) for $s < 2$ will lead to inconsistent estimates if reverse causality exists in the sense that $E[X_{ir}v_{it}] \neq 0$ for $r \geq t.$ To allow for this possibility, one may assume X to be weakly exogenous, ie, $E[X_{is}v_{it}] = 0$ for $s < t,$ which implies the following subset of (5):

$$E[\Delta X_{it-s}\Delta u_{it}] = 0 \quad t = 3,...,T \text{ and } s \geq 2. \quad (6)$$

Equations (4)-(6) imply a set of linear moment conditions to which the standard GMM methodology applies. The consistency of the GMM estimator hinges on the validity of these moment conditions, which in turn depends on maintained hypotheses on the level residuals being serially uncorrelated and the exogeneity of the explanatory variables. It is therefore essential to ensure that these assumptions are justified by conducting specification tests (Arellano and Bond, 1991).

The overall validity of the moment conditions is checked by the Sargan test. The null hypothesis of no misspecification is rejected if the minimized GMM criterion function registers a large value compared with a chi-squared distribution with the degree of freedom equal to the difference between the number of moment conditions and number of parameters. Another diagnostic is the Sargan-difference test that evaluates the validity of extra moment conditions over that of weak exogeneity (i.e., (6) is nested in (5)). The stronger assumption of strict exogeneity will be in doubt if these extra moment conditions are rejected by the Sargan-difference test.

To check the serial correlation property of the level residuals, we rely on the Arellano-Bond m_1 and m_2 statistics. If the level residuals were indeed serially uncorrelated, then, by construction, the first-differenced residuals in (3) would follow a MA(1) process which implies that autocorrelations of the first-order are non-zero but the second or higher-order ones are zero.[42] Based on the differenced residuals, the Arellano-Bond m_1 and m_2 statistics, both distributed as $N(0,1)$ in large sample, test the null hypotheses of zero first-order and second-order autocorrelation, respectively. An insignificant m_1 and/or significant m_2 will issue warnings against the likely presence of invalid moment conditions due to serial correlation in the level residuals.

Notice that the first-differencing operation not only eliminates unobserved economy-specific

[42]There should be an evidence of significant negative first-order serial correlation in differenced residuals and no evidence of second order serial correlation in the differenced residuals.

effects but also time-invariant explanatory variables for which only cross-sectional information is available. Moreover, as demonstrated by Ahn and Schmidt (1995, 1997) and Blundell and Bond (1998), under a random-effect model, the first-differenced GMM estimator can suffer from serious efficiency loss, for there are potentially informative moment conditions that are ignored in the first-difference approach. It motivates us to explore additional moment conditions that make use of information in the level equation (1).

Following Blundell and Bond (1998), we augment the first-differenced moment conditions (4)-(6) by the level moment conditions:

$$E[u_{it}\Delta F_{it-1}] = 0 \quad t = 3,...,T, \tag{7}$$

which amounts to using lagged differences of F as instruments in the level equation (1).

In addition, for strictly exogenous explanatory variables, the appropriate level moment conditions would be:

$$E[u_{it}\Delta X_{it-s}] = 0 \quad t = 3,...,T, \text{ and all } s. \tag{8}$$

For weakly exogenous explanatory variables, the appropriate level moment conditions would be:

$$E[u_{it}\Delta X_{it-s}] = 0 \quad t = 3,...,T, \text{ and all } s \geq 1. \tag{9}$$

The Blundell-Bond system GMM estimator is obtained by imposing the enlarged set of moment conditions (7)-(9). By exploiting more moment conditions, the system GMM estimator is more efficient than the first-differenced GMM estimator that uses only a subset (4)-(6). The validity of the level moment conditions (7)-(9) depends on a standard random effects specification of the level equation in (1), plus additional assumptions on the initial value generating process and the absence of correlation between region-specific effects and the explanatory variables in first-differences. The reader is referred to Blundell and Bond (1998) for details.

The efficiency gain from imposing the level moment conditions certainly does not come free; we need extra assumptions, the violation of which may lead to bias. For example, the presence of correlated economy-specific effects will invalidate some of the level moment conditions, leading to inconsistent system GMM estimates. The first-differenced estimator, in contrast, remains consistent in this case. Thus, it is important to conduct specification tests to justify the use of the additional level moment conditions. Since the first-differenced moment conditions are nested within the augmented set, the additional level moment conditions can be evaluated by the Sargan-difference test described above. In addition, invalid level moment conditions can also be detected by the Sargan over-identification test from the system GMM estimation.

4. DATA AND ESTIMATION RESULTS

FDI indicators are drawn from the United Nations Conference on Trade and Development (UNCTAD) website and other independent variables are from the World Bank. In addition to transaction advantage variables, the institutional environment has been shown to affect ownership strategies. As an institutional environment variable, economic freedom indices (EFI), constructed by the Fraser Institute, are used. The summary index is based on 23 components designed to identify the consistency of institutional arrangements and policies with economic freedom in seven major areas and the data were released on a scale of 1 to 10 covering five-year periods from 1970 to 1995, and released annually thereafter.[43] The core ingredients are personal choice, legal protection of property rights, freedom of exchange, reliance on markets, use of money and market

[43] The missing data of other years are generated by the linearly interpolated method.

allocation of capital. Individuals have economic freedom when: (a) the property they have acquired without the use of force, fraud, or theft is protected from physical invasions by others and (b) they are not forced to use, exchange, or give their property to another as long as their actions do not violate the identical rights of others. To see the effect of trade barriers, the mean tariff rate, which is a component of the EFI, is used as an indicator.

Table 2.2 shows the estimation results of equation (1) by panel estimation, while Table 2.3 shows those of a panel system GMM estimation of equation (2). Except for the number of terrorists, other terrorist variables do not show negative and significant coefficients. However, all other variables show negative ones even though they are not significant.

From Table 2.2, the positive and significant coefficient for the lagged FDI stock supports a strong agglomeration effect which implies that the economies with more FDI stock a year ago tend to attract more FDI during the current year. Income per capita shows a negative and significant coefficient showing that the economies with lower income per capita tend to attract more FDI flows. The economies with larger exports and lower tariff rates have higher values of FDI flows, which shows that trade is positively related with FDI flows. And the EFI has a positive correlation with FDI flows: FDI flows more to those economies with higher economic freedom, i.e., better property rights, good legal protection, etc.

Considering the possible endogeneity of independent variables, Table 2.3 shows the estimation results of panel system GMM estimation. All variables show consistent estimation results with those of Table 2.2. In particular, all terrorist variables play a negative role in attracting FDI for all model specifications. Furthermore all model specifications satisfied specification tests and AR test. Over the all specifications, we assume that lagged FDI stock, GDP per capita and exports are assumed as endogenous variables and economic freedom index, average tariff rate and terrorist variables are assumed as strictly exogenous ones.

5. Conclusion

By using data on FDI and terrorist activity between 1980 and 2002, this paper investigates the impact of terrorism on FDI. Consistent with our hypothesis, the estimation results show that terrorism is negatively and significantly related with FDI flows. The specifications under consideration as possible endogeneity control variables strengthen the significant role of terrorism variables. Furthermore, other control variables which are shown to be important factors in previous studies are shown to be significant.

Table 2.2: Panel Estimation

	Model 1		Model 2		Model 3		Model 4	
	Fixed	Random	Fixed	Random	Fixed	Random	Fixed	Random
Log (terrorist)	-0.047	-0.052						
	(2.16)*	(2.53)*						
Log (incidents)			-0.045	-0.064				
			(0.8)	(1.24)				
Log (victims)					-0.024	-0.02		
					(1.08)	(0.94)		
Log (victims per terror)							-0.022	-0.013
							(0.77)	(0.46)
Lagged FDI stock	0.434	0.541	0.427	0.538	0.428	0.542	0.432	0.543
	(5.25)**	(8.90)**	(5.10)**	(8.75)**	(5.13)**	(8.88)**	(5.18)**	(8.89)**
Log (per capita GDP)	-0.604	-0.318	-0.584	-0.321	-0.567	-0.333	-0.562	-0.334
	(1.42	(3.89)**	(1.37)	(3.84)**	(1.33)	(4.01)**	(1.32)	(3.98)**
Log (exports)	1.156	0.573	1.186	0.586	1.19	0.587	1.19	0.586
	(5.56)**	(6.11)**	(5.68)**	(6.20)**	(5.69)**	(6.20)**	(5.69)**	(6.20)**
Economic Freedom	0.323	0.347	0.323	0.351	0.329	0.362	0.333	0.366
	(4.19)**	(5.56)**	(4.14)**	(5.52)**	(4.27)**	(5.79)**	(4.31)**	(5.80)**
Log (mean tariff)	0.064	0.17	0.059	0.166	0.065	0.173	0.063	0.172
	(0.66)	(2.07)*	(0.6)	(2.00)*	(0.66)	(2.10)*	(0.64	(2.09)*
Constant	-21.623	-11.389	-22.583	-11.814	-22.886	-11.887	-22.988	-11.912
	(5.93)**	(7.48)**	(6.27)**	(7.74)**	(6.39)**	(7.79)**	(6.42)**	(7.81)**
Observations	811	811	811	811	811	811	811	811
Number of Economies	83	83	83	83	83	83	83	83
Overall R-squared	0.74	0.77	0.74	0.77	0.74	0.77	0.74	0.77
Sigma_u	1.303	0.767	1.331	0.779	1.348	0.778	1.355	0.784
Sigma_e	0.856	0.856	0.858	0.858	0.858	0.858	0.858	0.858
Rho	0.699	0.446	0.706	0.452	0.712	0.451	0.714	0.455
Hausman statistics (p-value)	23.55(0.001)		27.82(0.0001)		3.34(0.765)		25.84(0.0002)	

Note: Robust z statistics in parentheses; significant at 5 percent; ** significant at 1 percent

Table 2.3: Dynamic Panel System GMM Estimation

	Model 1	Model 2	Model 3	Model 4
Log (Lagged FDI stock)	0.909	0.909	0.907	0.908
	(522.05)**	(488.91)**	(304.59)**	(491.02)**
Log (per capita GDP)	-0.053	-0.053	-0.055	-0.056
	(16.88)**	(14.88)**	(20.08)**	(22.56)**
Log (exports)	0.114	0.114	0.117	0.116
	(48.48)**	(42.55)**	(25.18)**	(53.20)**
Economic Freedom	0.026	0.026	0.025	0.026
	(39.78)**	(29.58)**	(14.24)**	(17.92)**
Log (mean tariff)	0.04	0.039	0.041	0.043
	(16.25)**	(10.58)**	(16.53)**	(19.87)**
Log (terrorist)	-0.003			
	(14.47)**			
Log (incidents)		-0.003		
		(3.75)**		
Log (victims)			-0.004	
			(10.84)**	
Log (victims per terror)				-0.006
				(17.13)**
Constant	-1.576	-1.584	-1.628	-1.603
	(49.84)**	(45.93)**	(21.46)**	(55.39)**
Observations	870	870	870	870
Number of economies	83	83	83	83
Hansen Overiden. Test	77.89(0.9)	78.14(0.9)	76.66(0.9)	77.04(0.9)
AR(1)	-1.95(0.05)	-1.95(0.05)	-1.95(0.05)	-1.95(0.05)
AR(2)	-0.71(0.48)	-0.68(0.50)	-0.67(0.50)	-0.72(0.47)

REFERENCES

Arellano, M. and S. Bond, 1991, "Some Tests of Specification for Panel Data: Monte Carlo Evidence and an Application to Employment Equations," *The Review of Economic Studies, 58,* 277-297.

Arellano, M. and S. Bover, 1995, "Another Look at the Instrumental Variable Estimation of Error-components Models," *Journal of Econometrics*, 68, 29-51.

Blomberg, S.B. and G.D. Hess, 2002, "The Temporal Links between Conflict and Economic Activity," *Journal of Conflict Resolution,* 46, 74-90.

Blundell, R. and S. Bond, 1998, "Initial Conditions and Moment Restrictions in Dynamic Panel Data Models," *Journal of Econometrics,* 87, 115-43.

Hess, G.D. and A. Orphanides, 1995, "War politics: an Economic, Rational-voter Framework," *American Economic Review*, 85, 828-846.

Hess, G.D. and A. Orphanides, 2001, "Economic Conditions, Elections and the Magnitude of Foreign Conflicts," *Journal of Public Economics*, 80, 121-140.

Holtz-Eakin, D., W. Newey, and H.S. Rosen, 1988, "Estimating Vector Autoregressions with Panel Data," *Econometrica*, 56, 1371-1395.

Lenain, P., M. Bonturi, and V. Koen, 2002, "The Economic Consequences of Terrorism," *OECD Economic Department Working Papers*, No. 334, Paris.

Li, Q. and D. Schaub, 2004, "Economic Globalization and Transnational Terrorism," *Journal of Conflict Resolution*, 48(2), 230-258.

Windmeijer, F., 2005, "A finite sample correction for the variance of linear efficient two-step GMM estimators," *Journal of Econometrics,* 126, 25-51.

ANNEX 1

Indicators of a Knowledge-Based Economy 2005

ANNEX 1
INDICATORS OF A KNOWLEDGE-BASED ECONOMY

Building on work first presented in the 2000 APEC Economic Committee's report, *Towards Knowledge-Based Economies in APEC,* this statistical annex presents a comparison of APEC economies along 21 indicators relevant to knowledge-based economies (KBEs). That initial report defined a KBE as "an economy in which the production, distribution, and use of knowledge is the main driver of growth, wealth creation and employment across all industries." As originally anticipated, the composition of the Annex continues to evolve with each edition. In addition to some changes in indicators described below, the scope of this year's version of the Annex has been expanded to cover all APEC economies. Although available data for some economies is relatively sparse when considered against the data available for other economies, it is important that KBE development be considered in the context of APEC as a whole.

APEC continues to place a high priority on promoting KBE-driven growth throughout the region. Research has identified four key policy dimensions of KBEs: Innovation Systems, Human Resource Development, Information and Communication Technology (ICT), and Business Environment.[1] Economies must drive change in each of these dimensions in order to accomplish the total transformation of economic activity required to secure increased productivity and improve the economic well being of all citizens. Although the pace of improvement varies and some indicators may lag overall, the APEC economies are making progress in their efforts to become knowledge-based economies.

DATA NOTE

Within the four dimensions listed above, there are many possibilities for specific indicators. Most indicators included in this annex are the same as in previous years, providing continuity in analysis. However, some changes have been made and these are noted in the individual dimension sections that follow. Within each dimension there continues to be the attempt to represent the four phases of knowledge creation, acquisition, dissemination and use, so that the indicators complement rather than duplicate each other.

Details for the indicators used are given in Table A-3.These include a description of each indicator, reason for inclusion, source, reference year, and reference value. Reference year varies by indicator, and for some indicators, the reference year also varies by economy. The reference value is the value of the indicator averaged over the 30 OECD economies. This is a simple average, not weighted by population, GDP, or any other variable.

Figure A-4 presents the available individual indicators for each of the 21 APEC economies, providing a snapshot of each economy's position with respect to being a KBE. In order to provide a consistent basis for comparison across indicators, each economy indicator is divided by the reference value. Therefore in each chart, the value 1.0 represents the OECD average. This provides a basis for comparison that is relevant, but independent of the sample set. The reference value also provides the means by which values in the charts in Figure A-1 can be converted to their original values. For some purposes, the original values of the indicators may be useful.

[1] Organization for Economic Cooperation and Development, *The New Economy—Beyond the Hype*, Paris 2001.

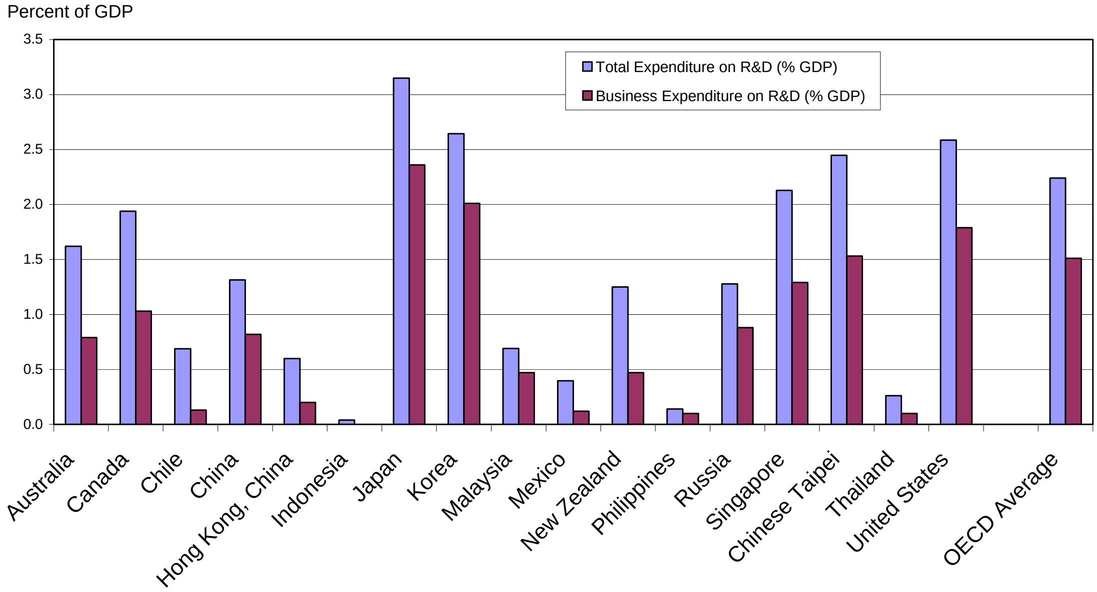
The most recent data for available KBE indicators are presented in Figure A-5. Following are brief observations highlighting some of the changes that have occurred in each of the four dimensions, including changes to the indicator set.

Innovation System:
A KBE is one where "innovation and technological change are pervasive and supported by an effective economy-wide innovation system (that is, a network of institutions in the public and private sector whose activities and interactions initiate, import, modify, and diffuse new technologies and practices)". (APEC 2000)

The Innovation System includes four objective measures (number of researchers, total R&D spending, business R&D spending, and number of US patents) and two opinion measures (degree of technology cooperation between companies and between companies and universities).

- There are not only significant differences among the APEC economies as to the amount of resources available to foster innovation, both in the number of researchers and investment in R&D, but there are also differences in the proportion of private versus government funds invested to spur innovation. As shown in Figure A-1, while R&D is funded primarily by the private sector in most APEC economies, government R&D accounts for over 50 percent of the total in others (Australia; Chile; Hong Kong, China; Mexico; New Zealand; and Thailand).

Figure A-1: R&D Expenditures as a Percentage of GDP



Sources: OECD Main Science and Technology Indicators, 2005 Tables 2 and 24 and World Competitiveness Year Book 2005 Tables 4.3.03 and 1.1.01.

- Even in those economies with relatively few US patents, significant growth in the number of patents issued over time has occurred. This reflects not only an increase in innovation, but also an increase in the perceived importance of intellectual property rights. (See Table A-1.)

Table A-1: Number of US Patents, 1994 and 2004

	1994	2004
CHILE	8	18
CHINA	48	597
MALAYSIA	16	93
MEXICO	52	102
RUSSIA	38	173
THAILAND	8	28

Sources: Patent Counts by Country/State and Year, All Patents, All Types: January 1, 1977—December 31, 2004 April 2005, US Patent and Trademark Office, Office of Electronic Information Products, April 2005

Human Resource Development:
A KBE is one where "human resource development is pervasive: education and training are of a high standard, widespread and continue throughout a person's working life (and even beyond)". (APEC 2000)

The four indicators of the degree of human resource development are secondary and tertiary education, knowledge workers in the labor force, and the Human Development Index, a composite index developed by the United Nations Human Development Report Office.

- The indicator for secondary enrolment has changed this year from a gross estimate to the net enrolment estimates published by the UNESCO and defined as the enrolment of the school-age group for the secondary education level, expressed as a percentage of the total population in that age-group. As shown in Table A-2, with the exception of Korea, all of the APEC economies for which data are available are making gains in this area.

- The percent of persons aged between 25 and 34 with at least a tertiary education increased in all APEC economies for which data are available between 1998 and 2002, with the exception of Mexico and the Philippines where declines occurred.

Table A-2: Secondary Net Enrolment Ratio, Both Sexes

Year	1998/1999	1999/2000	2000/2001	2001/2002	2002/2003
Australia	.		89.6	88.5	88.0
Canada	94.0		97.6		
Chile	70.3	71.8	74.5		78.6
Hong Kong, China			74.0	74.9	75.6
Indonesia		48.3			54.0
Japan		99.5	99.6	99.7	99.8
Republic of Korea	96.5	94.4	90.9	88.6	87.1
Malaysia	68.9	68.9	69.1	69.4	70.0
Mexico	54.9	56.1	58.2	60.2	62.6
New Zealand	92.1		91.6		92.7
Papua New Guinea	20.4	21.5	22.7	23.8	
Peru	62.2		65.8	68.9	69.2
Philippines	50.8		52.5	56.5	59.3
Chinese Taipei	92.6	92.2	92.9	93.7	93.8
Thailand					
United States	88.3	86.6	87.1	85.3	88.4
Viet Nam	59.5	61.4	62.5	65.3	

Sources: UNESCO Institute for Statistics, Online Database Access and Chinese Taipei

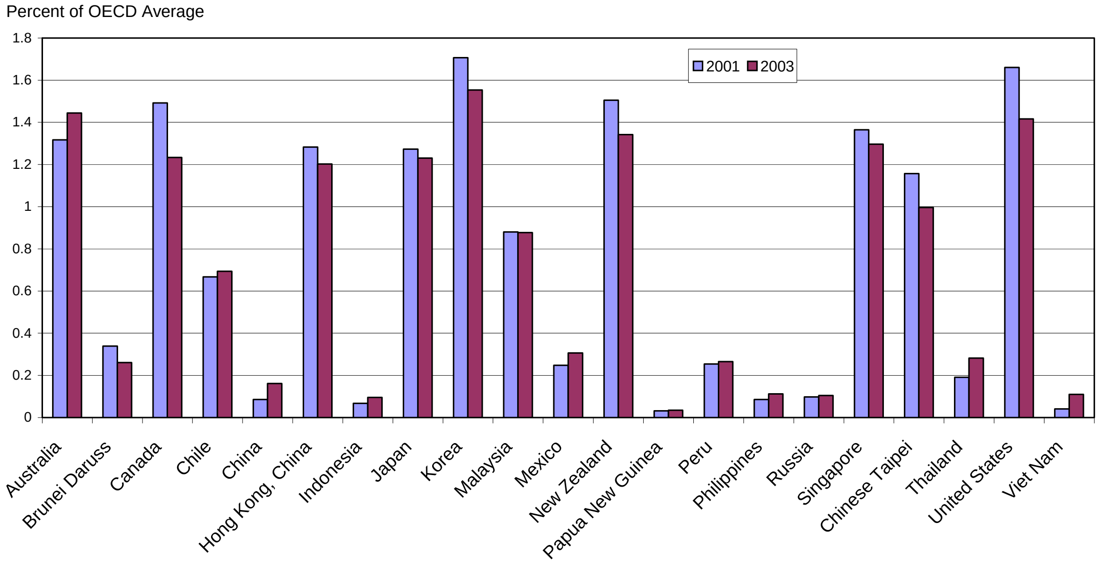
Information and Communication Technology:
A KBE is one where "an efficient infrastructure operates, particularly in information and communications technology (ICT), which allows citizens and businesses to readily and affordably access pertinent information from around the world". (APEC 2000)

The number of broadband users has been added to the ICT indicators of main telephone lines, cellular subscribers, and computers and Internet users per capita. Together these indicators describe economies moving toward becoming KBEs.

- Growth in telephony continues to be dominated by increases in cellular services rather than landlines.

- The increase in Internet users between 2001 and 2003 was substantial in all APEC economies. In particular, most of the economies with relatively low proportions of Internet users had gains greater than the 30 percent increase in the OECD average. This is shown in Figure A-2 by the gains on the OECD average made by Chile, China, Indonesia, Mexico, Peru, the Philippines, Thailand, and Viet Nam.

Figure A-2: Per Capita Internet User as a Percentage of the OECD Average



Source: International Telecommunications Union, ICT Statistics, 15 March 2005.

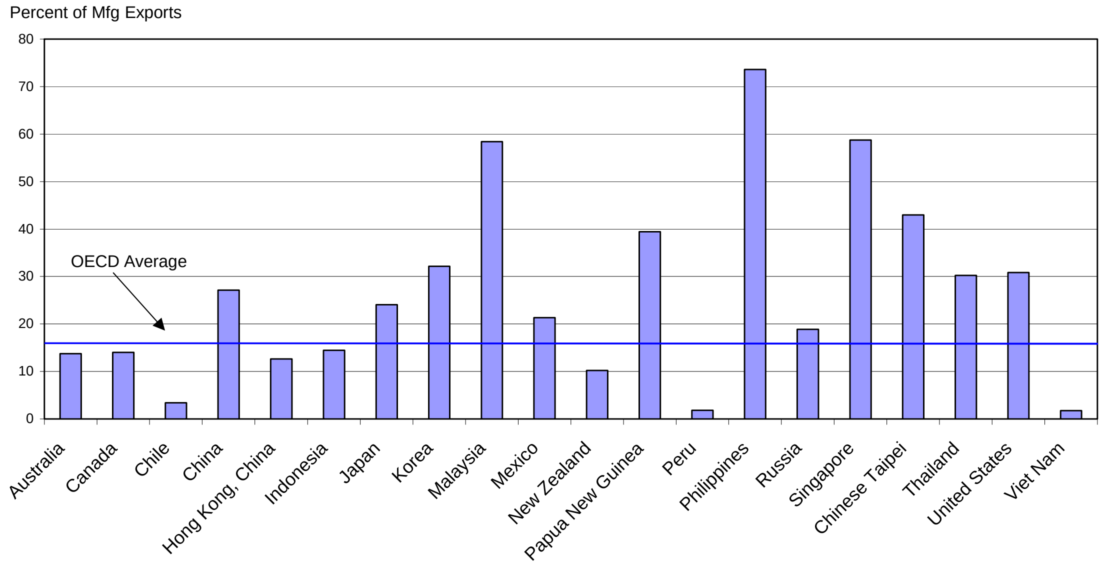
Business Environment:

A KBE is one where "the business environment is supportive of enterprise and innovation. (The term "business environment" includes the economic and legal policies of government, and also the mix of enterprises operating in the economy.)" (APEC 2000)

The indicators used for tracking changes in the business environment are data on service and high-technology exports and opinion survey results on government and financial institutional transparency, competition policy, and the impact of protectionism. Foreign direct investment (FDI) as a percentage of GDP was dropped as an indicator this year because it is subject to very wide year-to-year swings that do not appear to correlate to any real, meaningful change in the business environment.

- High-technology exports comprise a major proportion of total manufacturing exports in most APEC economies. As shown in Figure A-3, the proportion of high-tech exports is higher than the OECD average for 12 of the 20 APEC economies (with some being significantly higher). However, a more informative comparison would be a presentation of the value-added by high-technology exports. If a source for these data can be found, this change in indicator will be incorporated into next year's Annex.

Figure A-3: High-Technology Exports as a Percentage of Manufacturing Exports, 2003*



**Chinese Taipei and Viet Nam are 2002*
Source: World Bank, World Development Indicators,

- Although not absolute, there continues to be a strong relationship among the opinion survey results dealing with business perception of government and financial institutions' transparency, competition policy, and the impact of protectionism: economies tend to receive similar ratings across all four indicators. Some exceptions include Hong Kong, China (higher in financial institution transparency and lack of protectionism and lower in government transparency and effective competition policy); Malaysia, Mexico, New Zealand, and Singapore (higher in government transparency than other indicators); and China (lower rating for financial institutions' transparency).

Table A-3: Indicators, Explanations, and Sources

Indicator	Significance for KBE	Details	Source	Data Year	OECD Reference Value
Innovation System					
Researchers per 1,000 Population	Indicates potential to create new (technical) knowledge	Researchers (full-time work equivalent) per 1,000 population	OECD, Main Science and Technology Indicators, 2005 Tables 9 and E and World Competition Yearbook (WCY) 2005 Table 4.3.07	2002 except Chile which is 2000 and Mexico, New Zealand, Thailand which are 2001	4.75
Total Expenditure on R&D as a percentage of GDP	Indicates current effort to create new (technical) knowledge.	Gross annual expenditure on R&D (GERD= Business Exp + Public Exp) as a percentage of GDP	OECD, Main Science and Technology Indicators, 2005 Table 2 and WCY 2005 Table 4.3.03	2003, except for Australia; Hong Kong, China; Malaysia; the Philippines which are 2002, and Indonesia and New Zealand which are 2001	2.24
Business Expenditure on R&D as a percent age of GDP	Commitment by enterprises to knowledge creation		OECD, Main Science and Technology Indicators, May 2004, Table 24and WCY 2004, Table 4.3.04. OECD, Main Science and Technology Indicators, 2005 Table 24 and WCY 2005 Table 4.3.03 and Table 1.1.01	2003	1.51
US Patents per million population	Industries which patent extensively mostly do so in the USA (a major technology market) as well as at “home.”	Number of US Patents awarded in specific year to residents of specified economy per million in population.	Patent Counts by Country/State and Year, All Patents, All Types: 1 January 1977–31 December 2004, April 2005, US Patent and Trademark Office, Office of Electronic Information Products, April 2005.and Population WCY 2005, Table 4.1.4	2004	79.87

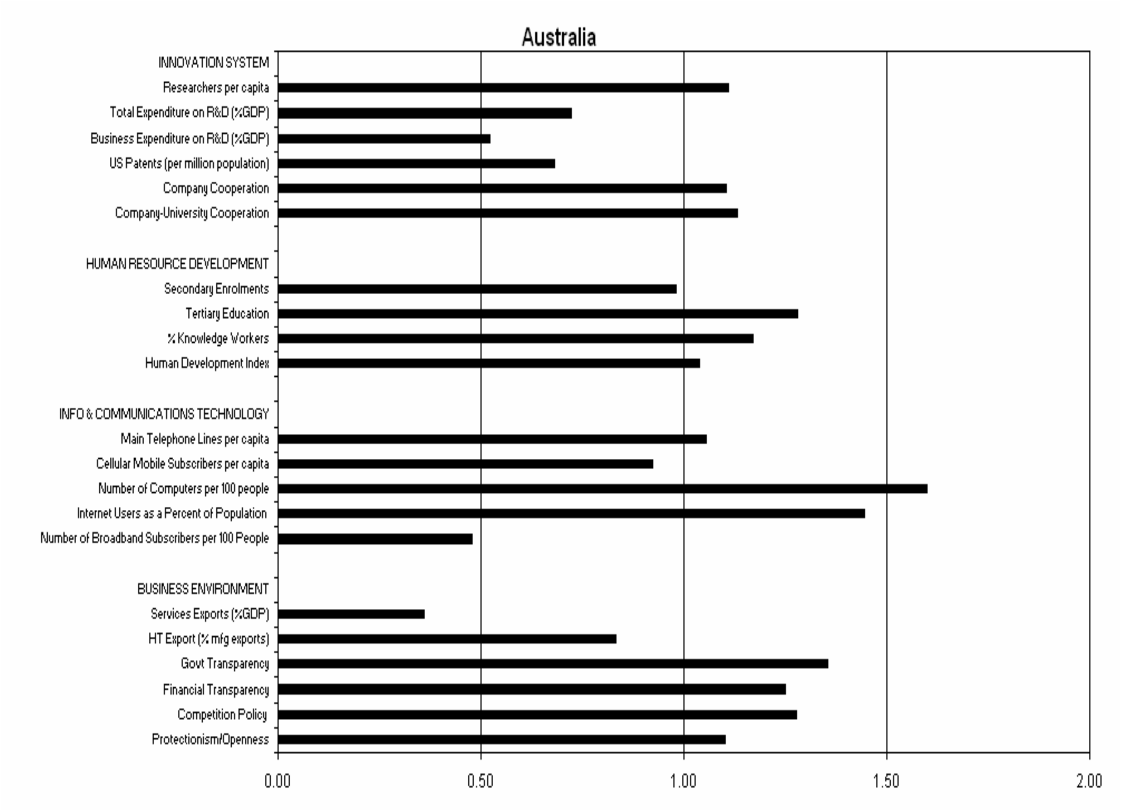
Indicator	Significance for KBE	Details	Source	Data Year	OECD Reference Value
Company Cooperation (survey rating)	Partial indicator for the extent of knowledge networks	WCY survey (scale 0-10): “Technological cooperation is developed between companies.”	WCY 2005, Table 4.2.14	2005	6.14
Company-University Cooperation (survey rating)	Partial indicator for extent of knowledge networks	WCY survey (scale 0-10): “Knowledge transfer is highly developed between companies and universities.”	WCY 2005, Table 4.5.15	2005	4.98
Human Resource Development					
Secondary Enrolments as a Percentage of Relevant Age Group	Potential for skilled workforce in the future	Enrolment of the theoretical school-age group for the secondary education level, expressed as a percentage of the total population in that age group.	*http://stats.uis.unesco.org/* and Chinese Taipei and Hong Kong, China governments	2002/2003 school year, except for Canada which is 2000/01, Papua New Guinea and Viet Nam which are 2001/2002, and Chinese Taipei which is 2004	89.84
Percentage of Population between 25 and 34 that have attained at least a Tertiary Education	Potential availability of workers that either have needed skills or can be trained for technology jobs		WCY 2005,Table 4.5.05	2002, except for China which is 1998	28.09

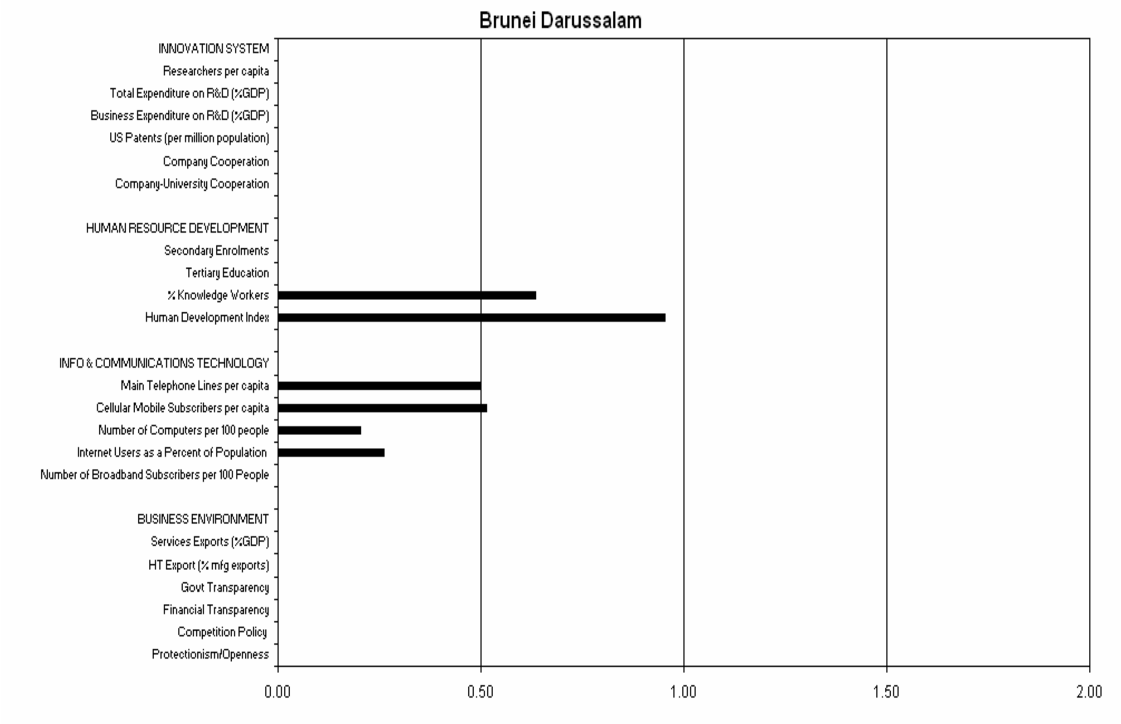
Indicator	Significance for KBE	Details	Source	Data Year	OECD Reference Value
"Knowledge Workers" as a Percentage of the Labor Force	Indicates current status as a KBE	Knowledge workers are all those whose occupation is reported to the ILO as Group 1 (legislators, senior officials and managers), Group 2 (professionals) and Group 3 (technicians and associate professionals) for ISCO-88 and as Group 0/1 (professional, technical and related workers) and Group 2 (administrative and managerial workers) for ISCO-68	ILO, Laborstat;*http://laborsta.ilo.org/cgi-bin/brokerv8.exe* and Chinese Taipei government	2003, except for Malaysia, Papua New Guinea, the Philippines, Thailand which are 2000; Brunei and Mexico which are 2001, the US which is 2002, and Chinese Taipei which is 2004	37.03
Human Development Index (HDI, rating)	Broad indicator of social development: KBE cannot develop unless all components of HDI as reasonably high	UNDP index based on three indicators of human development: life expectancy at birth, educational attainment (measured by a combination of adult literacy and school enrollments) and GDP per capita at purchasing power parity (maximum value=1.0000)	*http://hdr.undp.org/reports/* global/2004/pdf/hdr04_HDI.pdf and Chinese Taipei government	2002, except for Chinese Taipei which is 2003	0.91
Information and Communication Technology (ICT) Infrastructure					
Main Telephone Lines per 100 Inhabitants	Primary indicator of domestic telecommunications capacity		International Telecommunication Union *www.itu.int/ITU-D/ict/statistics,* 15 March 2005	2003	51.45
Cellular Mobile Subscribers per 100 Inhabitants	Indicator of newer communications technology—may substitute for telephone lines		International Telecommunication Union *www.itu.int/ITU-D/ict/statistics*, 15 March 2005	2003	78.00

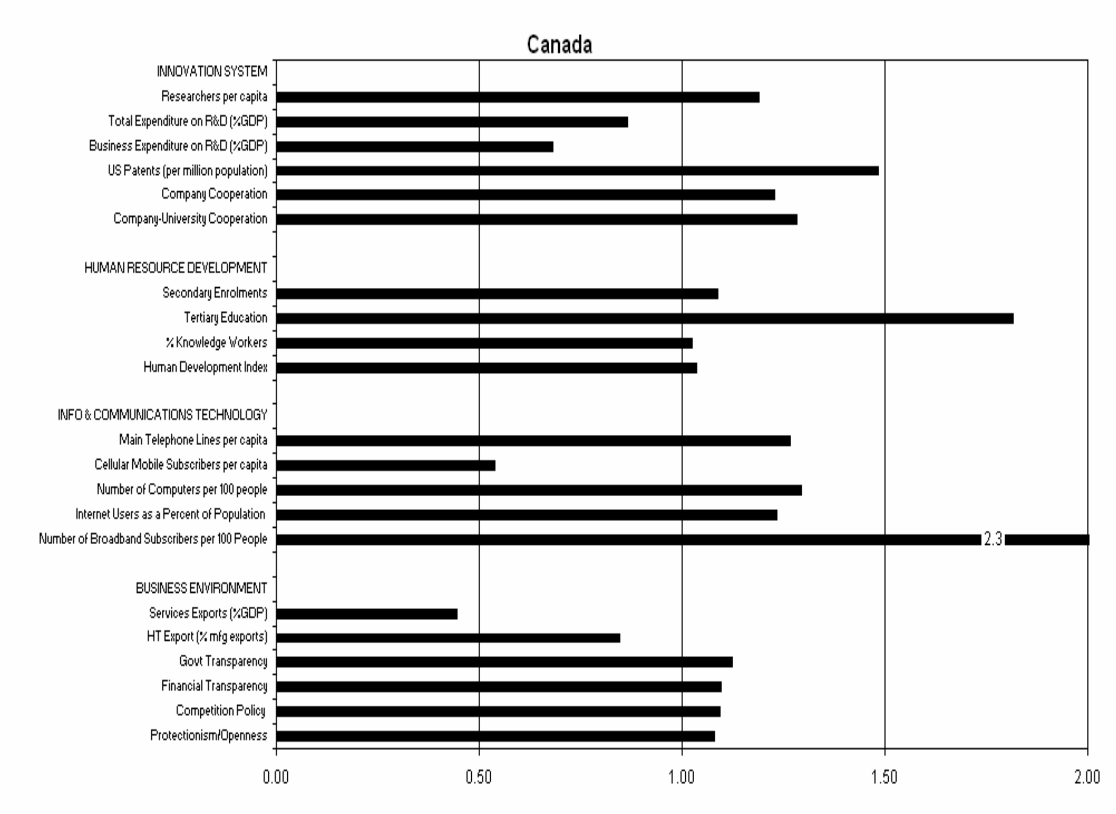
Indicator	Significance for KBE	Details	Source	Data Year	OECD Reference Value
Number of Computers as a Percentage of Population	Spread of technology infrastructure		International Telecommunication Union *www.itu.int/ITU-D/ict/statistics*, 15 March 2005	2003	37.67
Internet Users as a Percent of Population	Indicates ability to engage in a variety of electronic activities, including commerce, information dissemination and retrieval,		International Telecommunication Union *www.itu.int/ITU-D/ict/statistics*, 15 March 2005	2003	39.23
Number of Broadband Subscribers per 100 Inhabitants	Adoption of the latest ICT technology		WCY 2005, Table 4.2.9; Source: International Telecommunications Union	2003, except for Chile, Indonesia, Mexico and Russia which are 2002; OECD average is for 2002/2003 depending on most recent data	6.31
Business Environment					
Service Exports as a percentage of GDP	Indicator of knowledge-intensity and size of service sector. Exportable services tend to be knowledge-intensive; Most developed economies tend to have higher proportion of service exports.	Exports of commercial services as percent of GDP (includes transportation, travel, communication, construction, insurance, financial, computer, information, other business, and cultural and recreational services, and royalties and license fees; excludes government)	World Trade Organization, International Trade Statistics, *http://www.wto.org/english/res_e/statis_e/statis_e.htm*, Chinese Taipei government, and World Bank GDP (www.worldbank.org)	2003, except Viet Nam is 2002 and Chinese Taipei is 2004	10.97

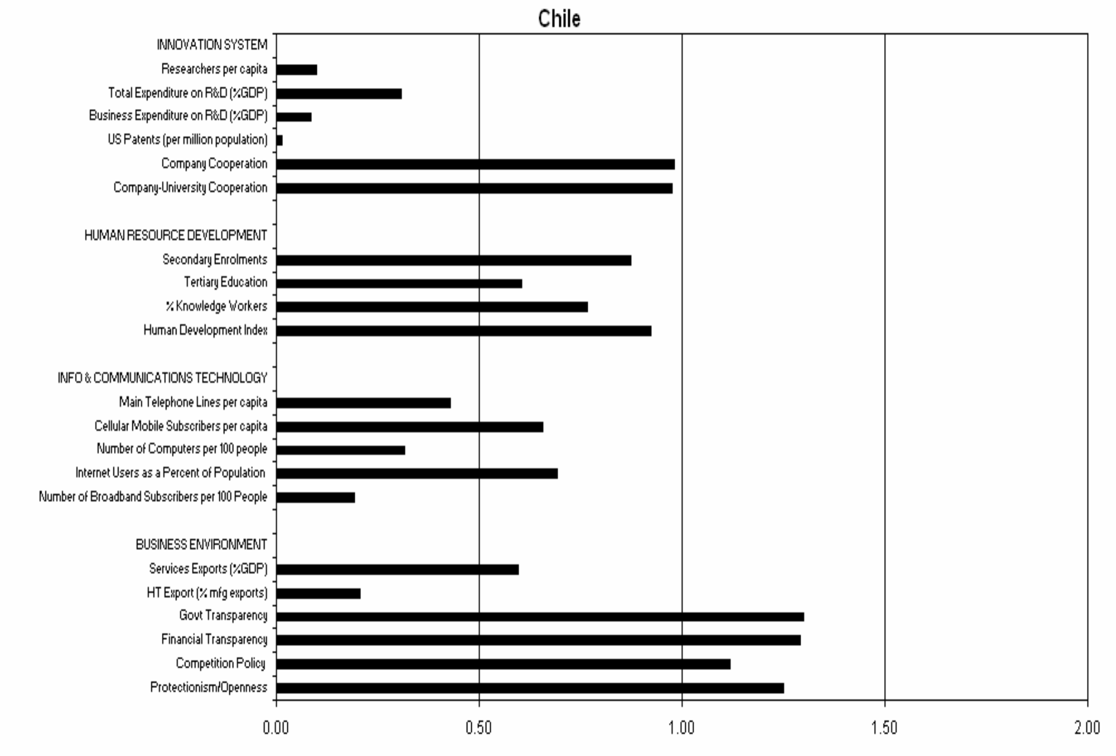
Indicator	Significance for KBE	Details	Source	Data Year	OECD Reference Value
High-Tech Exports as a percentage of Manufactured Exports	Indicator of knowledge intensity of manufacturing	High-technology exports are products with high R&D intensity, such as in aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery.	World Development Indicators 2005, World Bank *http://www.worldbank.org/data/wdi 2005/index.html*	2003, except ChineseTaipei and Viet Nam are2002	16.55
Government Transparency (survey rating)	Indicates clarity of policy and (to lesser extent) absence of cronyism—both elements of a KBE	WCY survey (scale 0-10): "Transparency of government policy is satisfactory."	WCY 2005, Table 2.3.14	2005	5.07
Financial Institutions' Transparency (survey rating)	Without reasonably high rating of financial institution transparency outside investment is deterred.	WCY survey (scale 0-10): "Financial institutions' transparency is widely developed in your economy."	WCY 2005, Table 3.3.18	2005	6.39
Competition Policy (survey rating)	Competition encourages innovation.	WCY survey (scale 0-10): "Competition legislation in your economy is efficient in preventing unfair competition."	WCY 2005, Table 2.4.10	2005	5.95
Protectionism/ Openness (survey rating)	Openness and access to outside goods and services is an indicator of openness to outside ideas.	WCY survey (scale 0-10): "Protectionism in your economy does not affect the conduct of your business."	WCY 2004, Table 2.4.02	2005	6.61

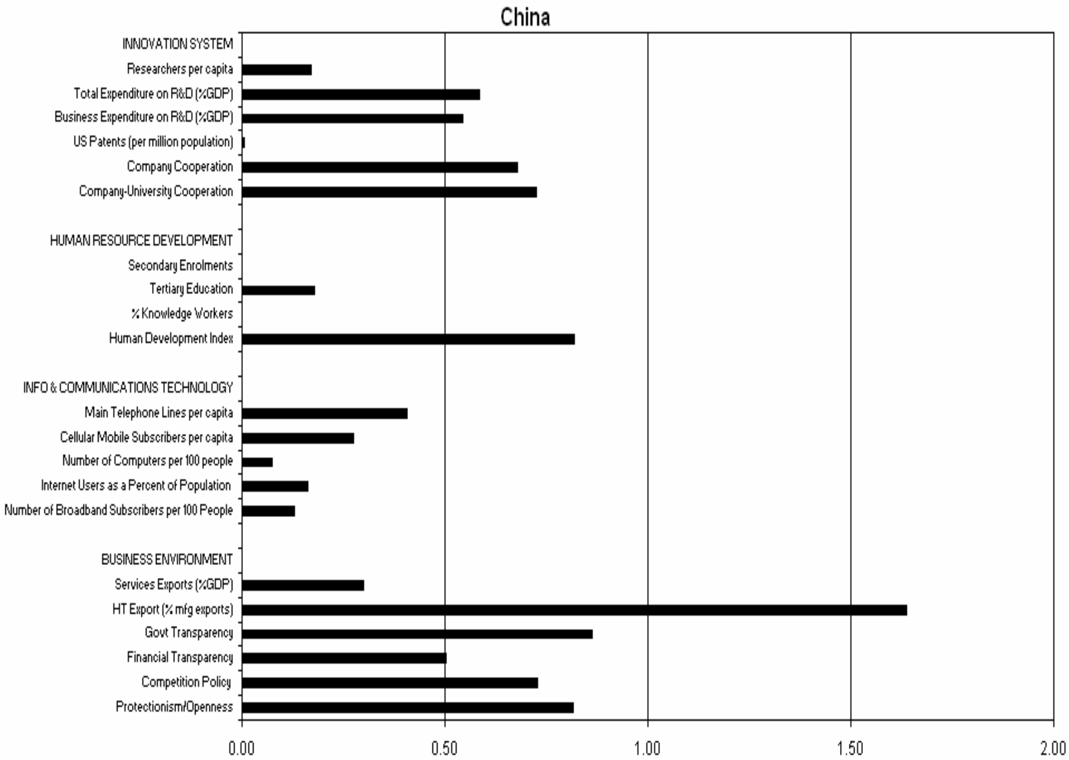
Figure A-4: KBE Indicators for the APEC Economies

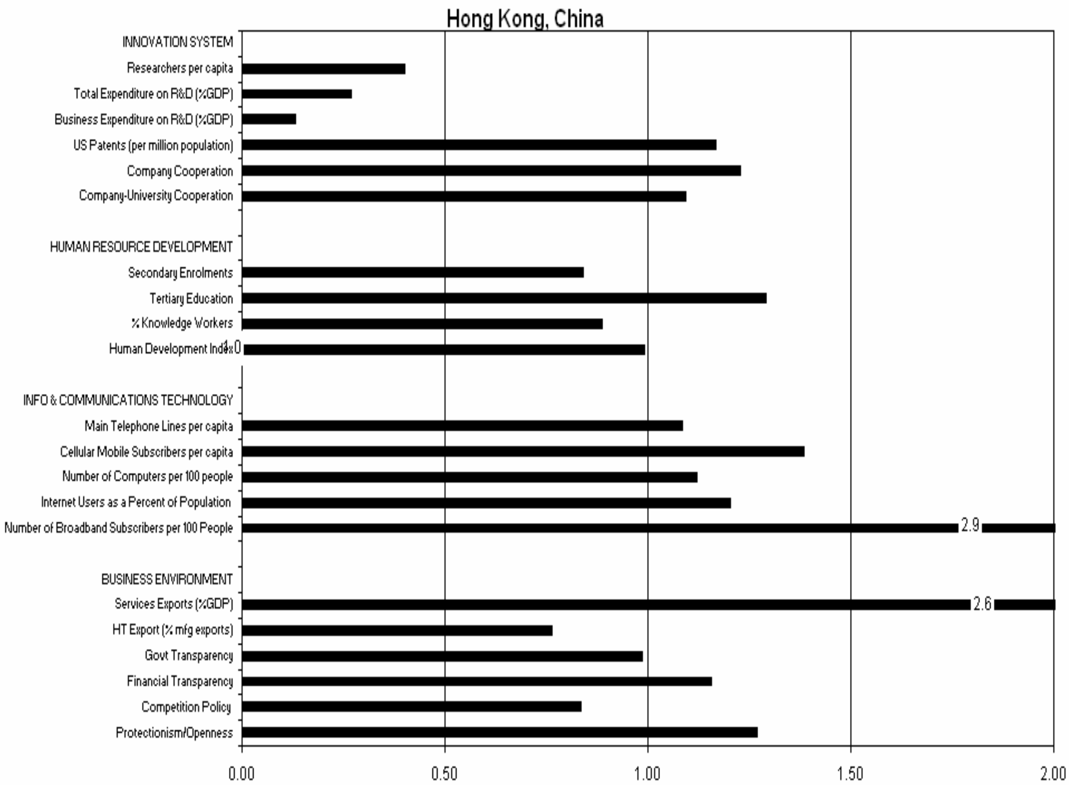


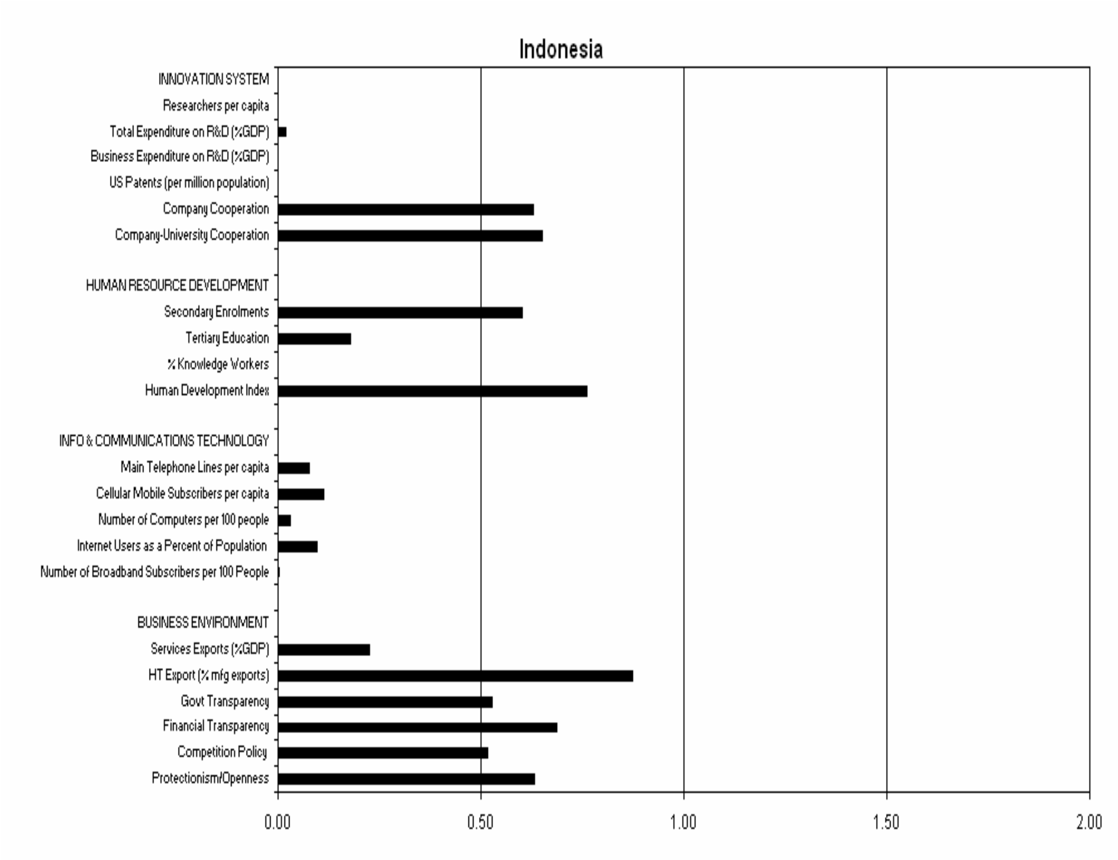


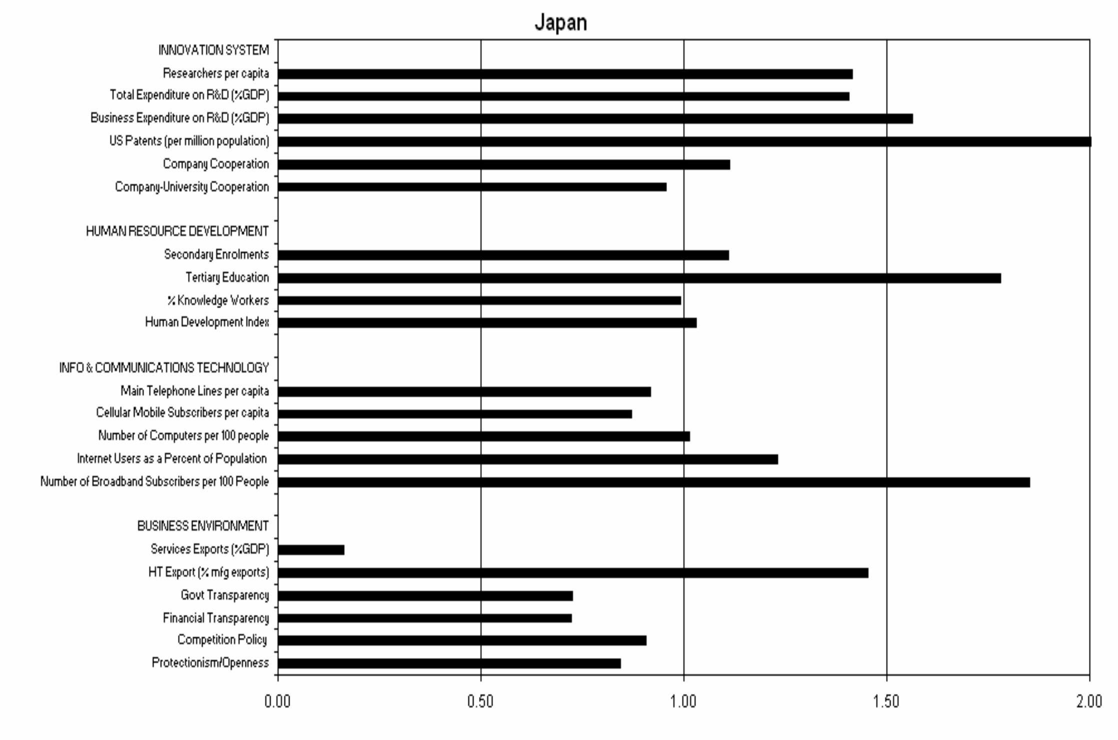

Canada
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
2.3
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

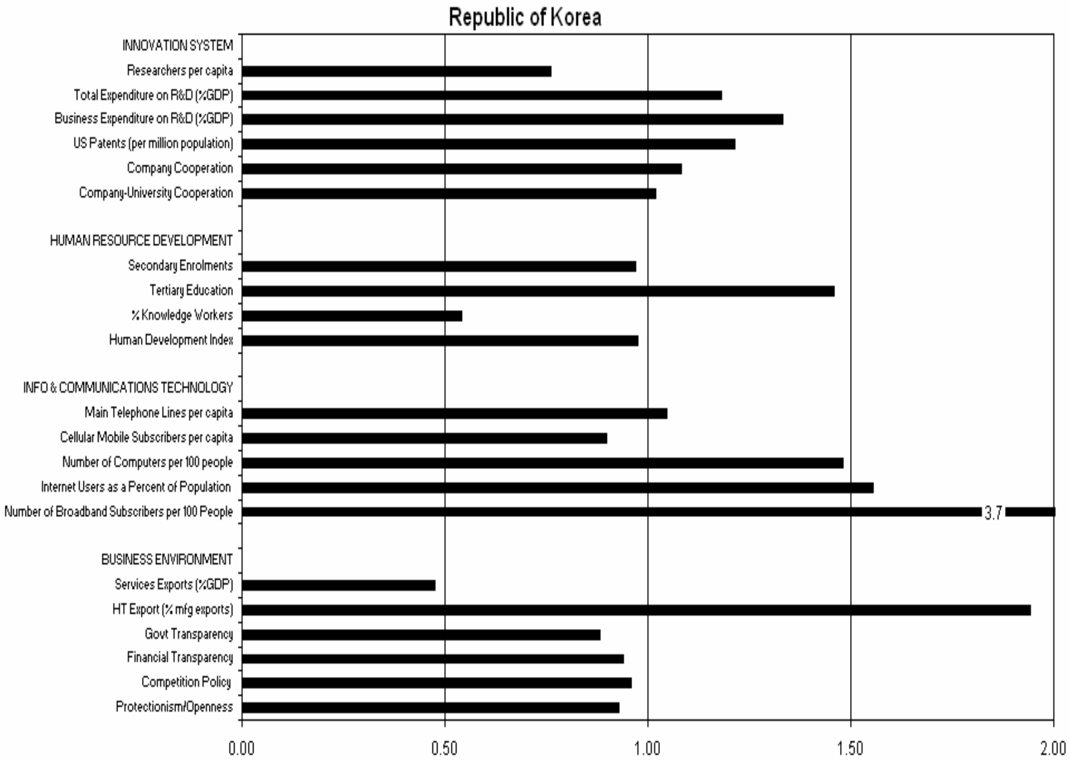

Chile
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

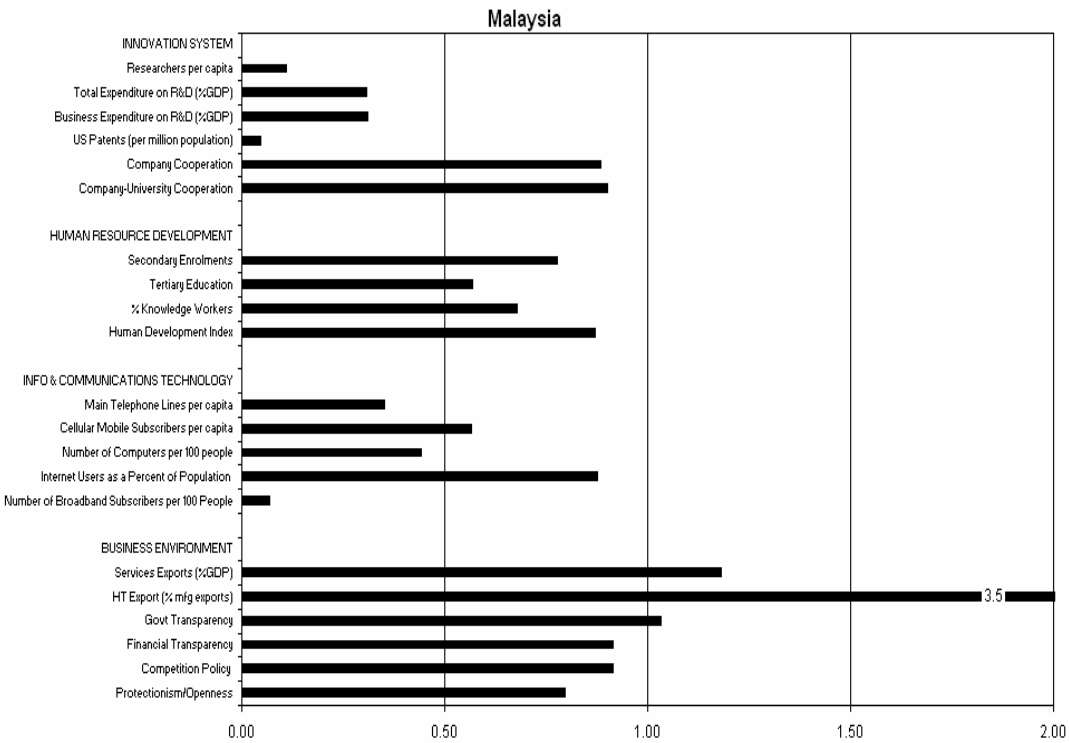

China
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

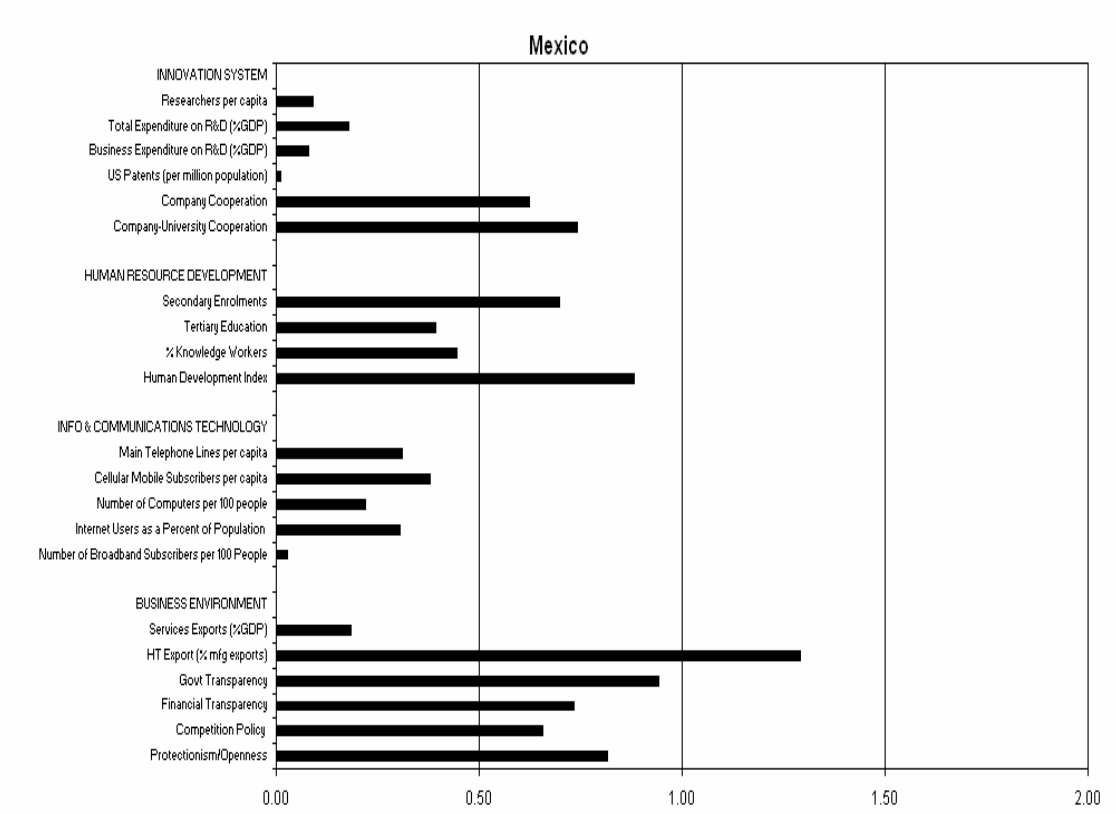

Hong Kong, China
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
1.0
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
2.9
BUSINESS ENVIRONMENT
Services Exports (%GDP)
2.6
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

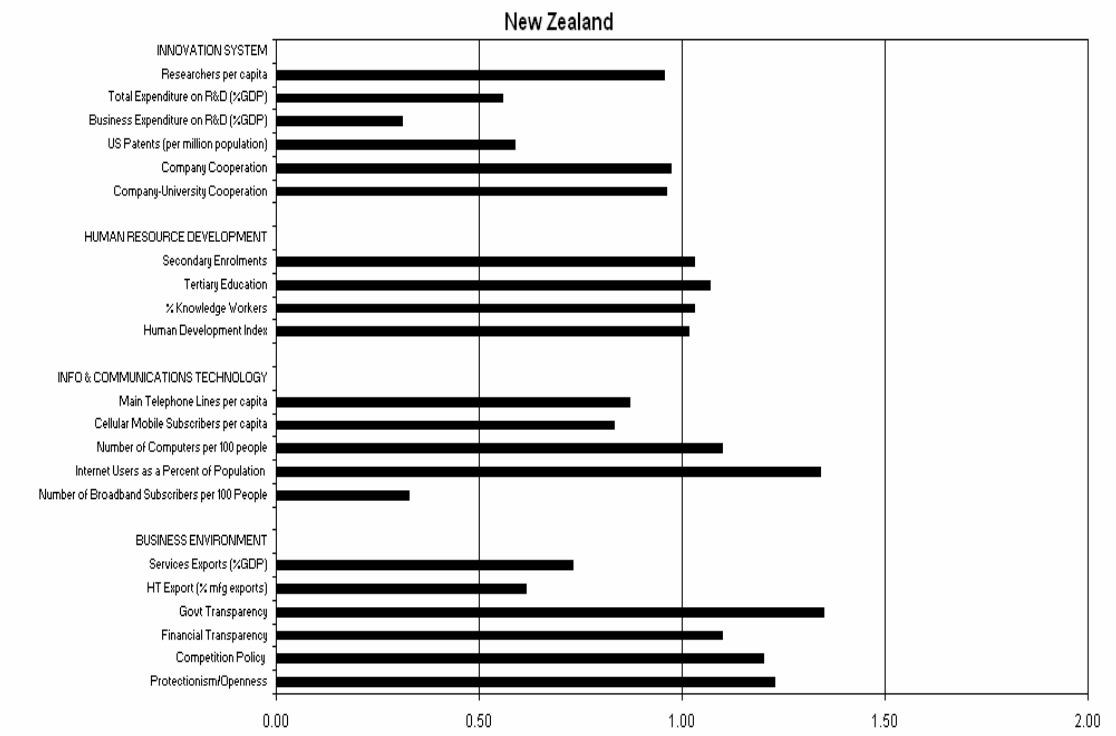

Indonesia
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

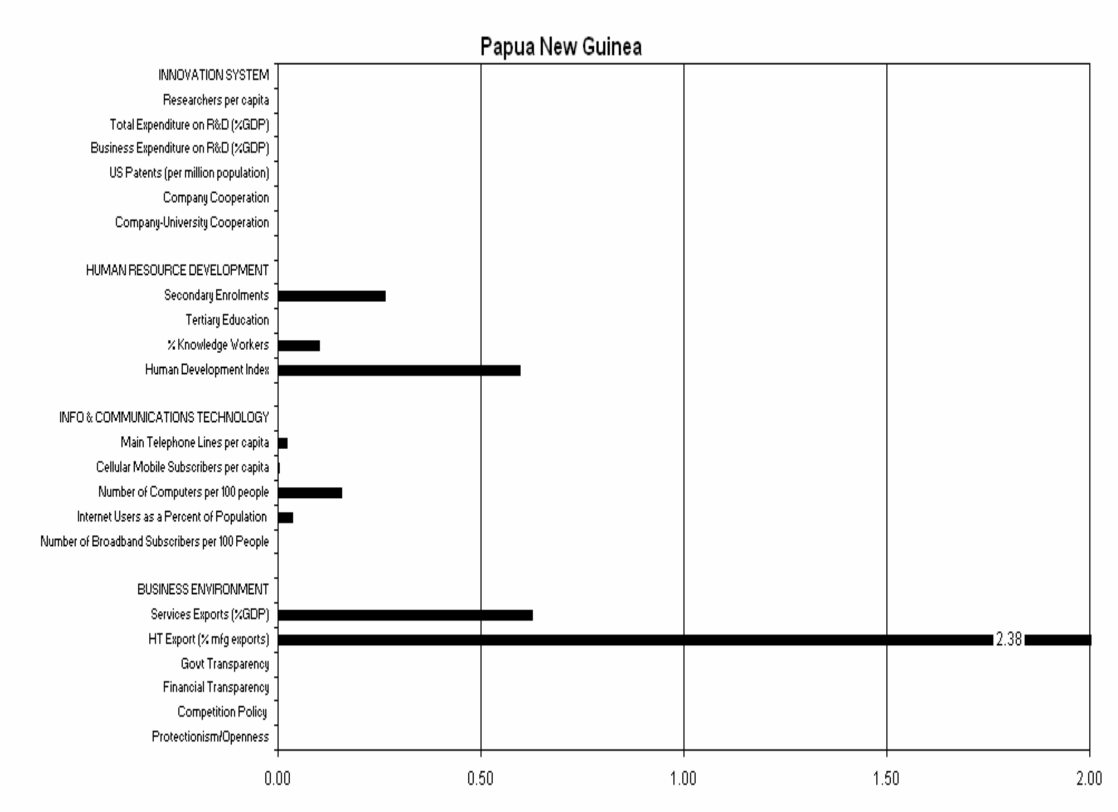

Japan
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

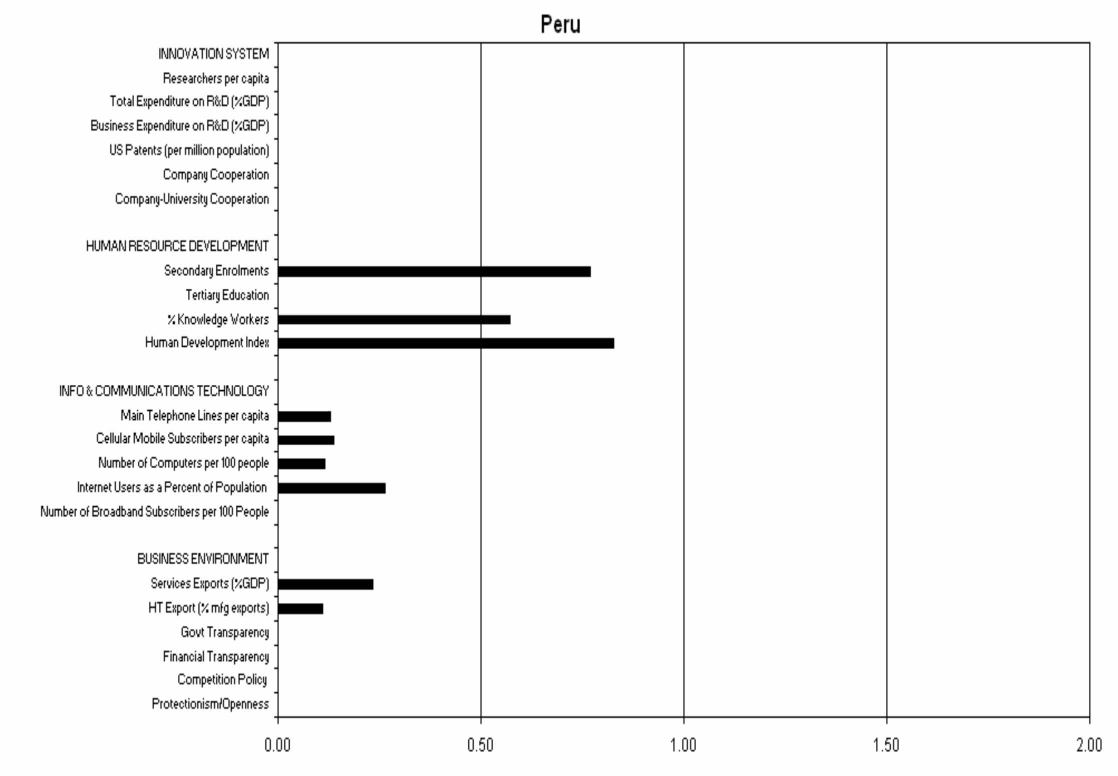

Republic of Korea
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
3.7
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

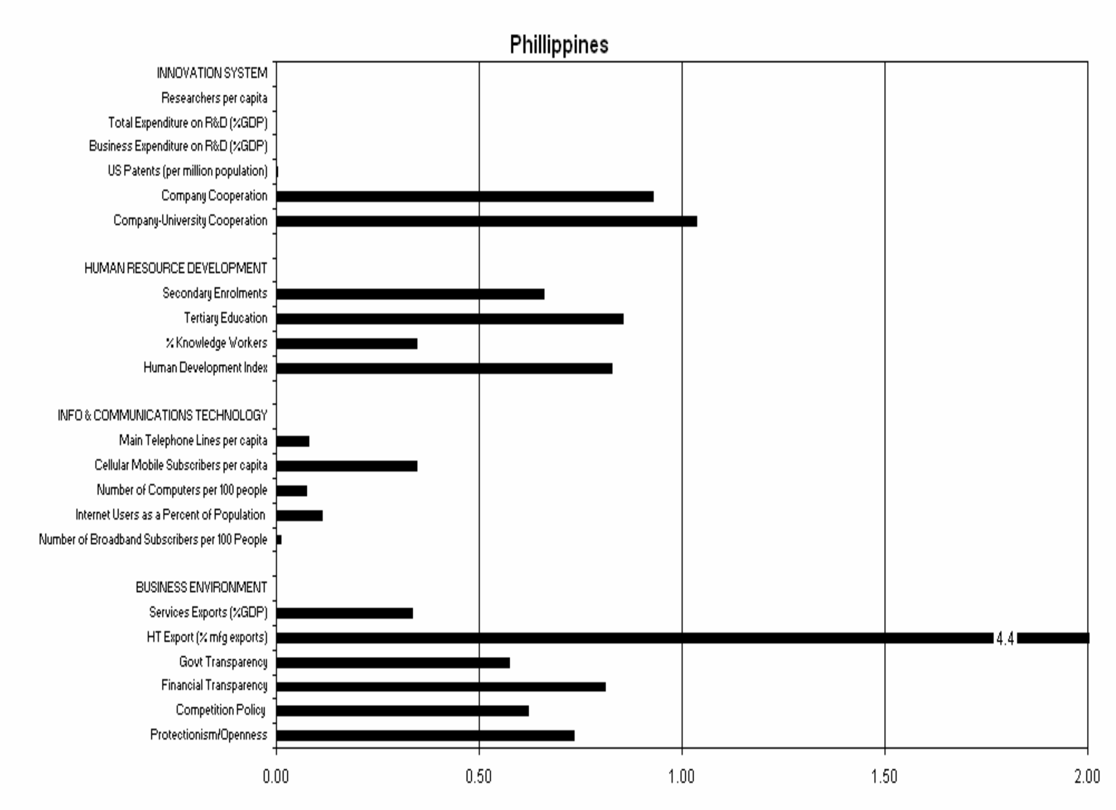

Malaysia
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
3.5
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

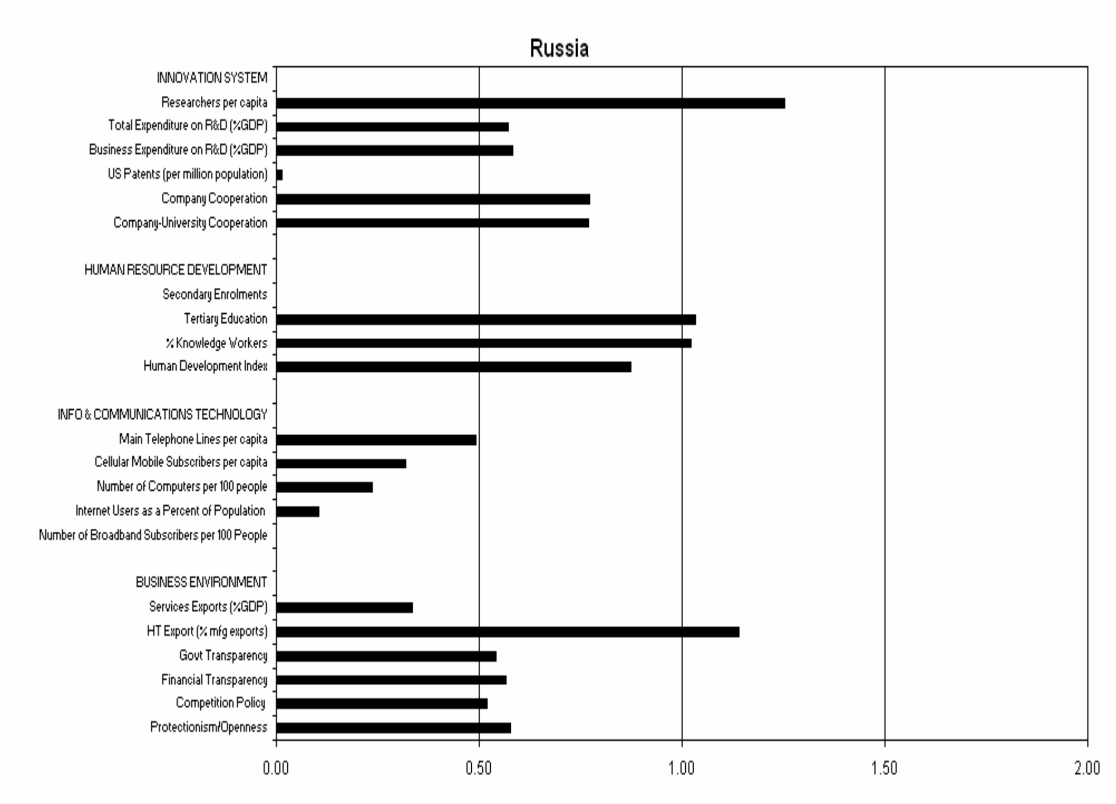

Mexico
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

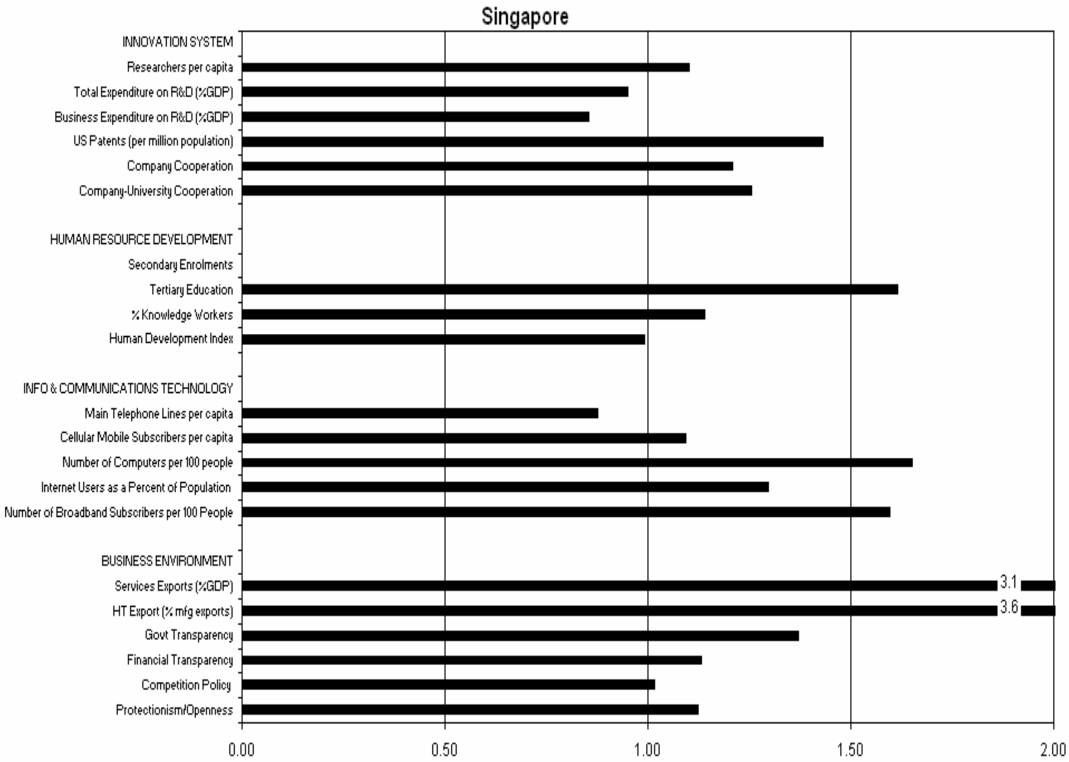

New Zealand
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

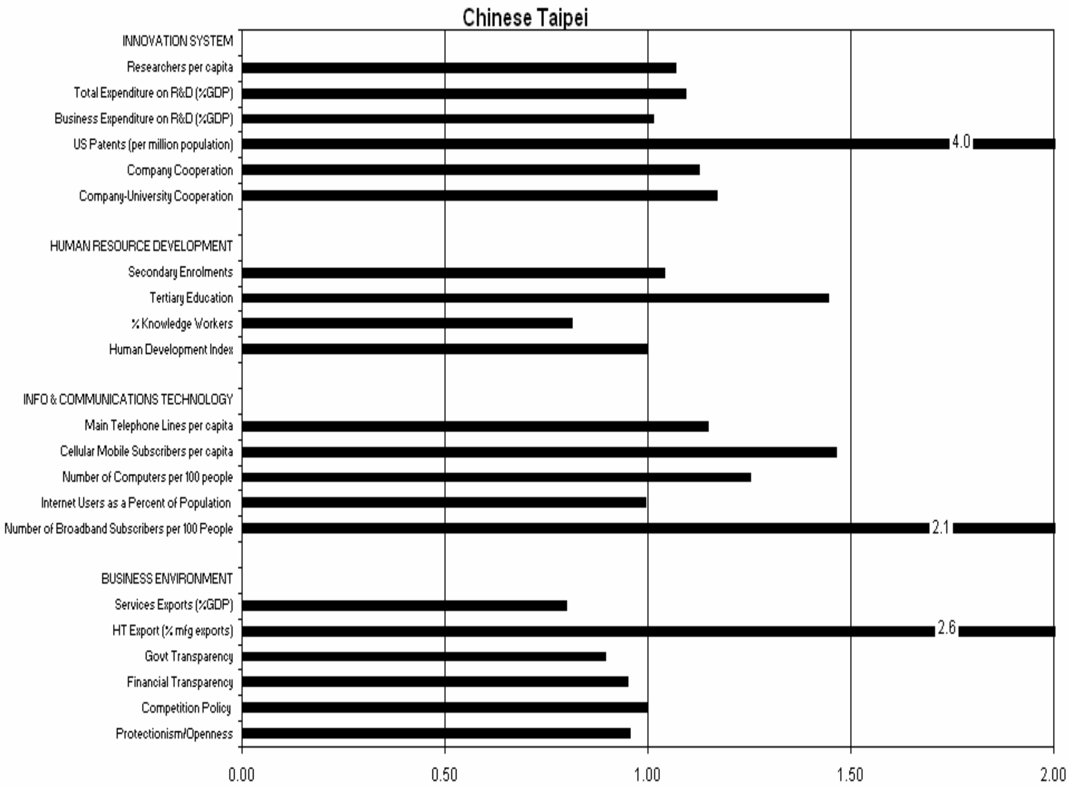

Papua New Guinea
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
2.38
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

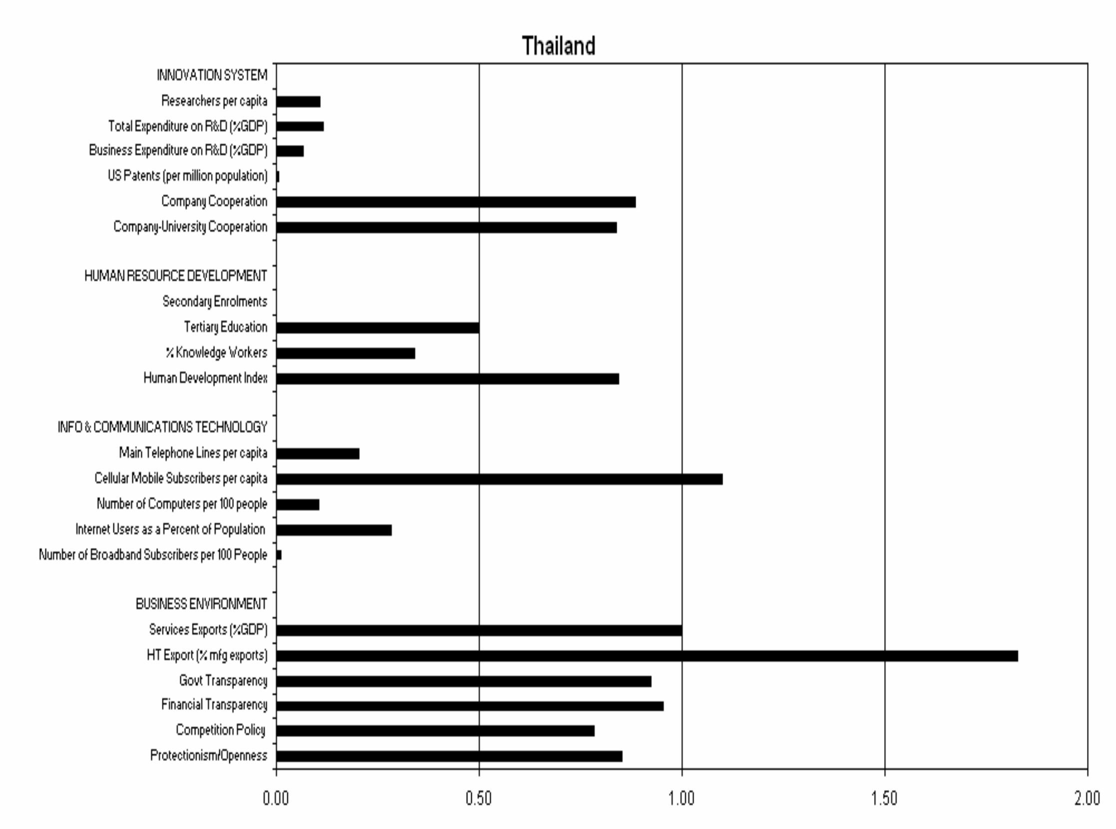

Peru
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

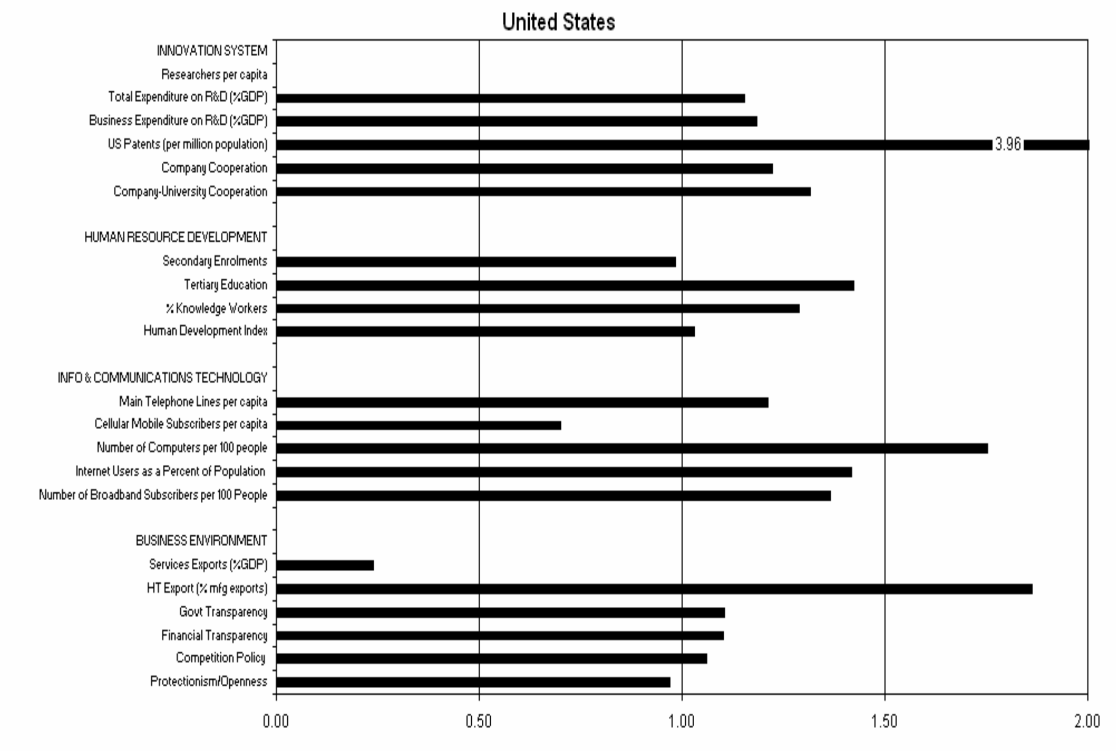

Phillippines
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
4.4
0.00
0.50
1.00
1.50
2.00

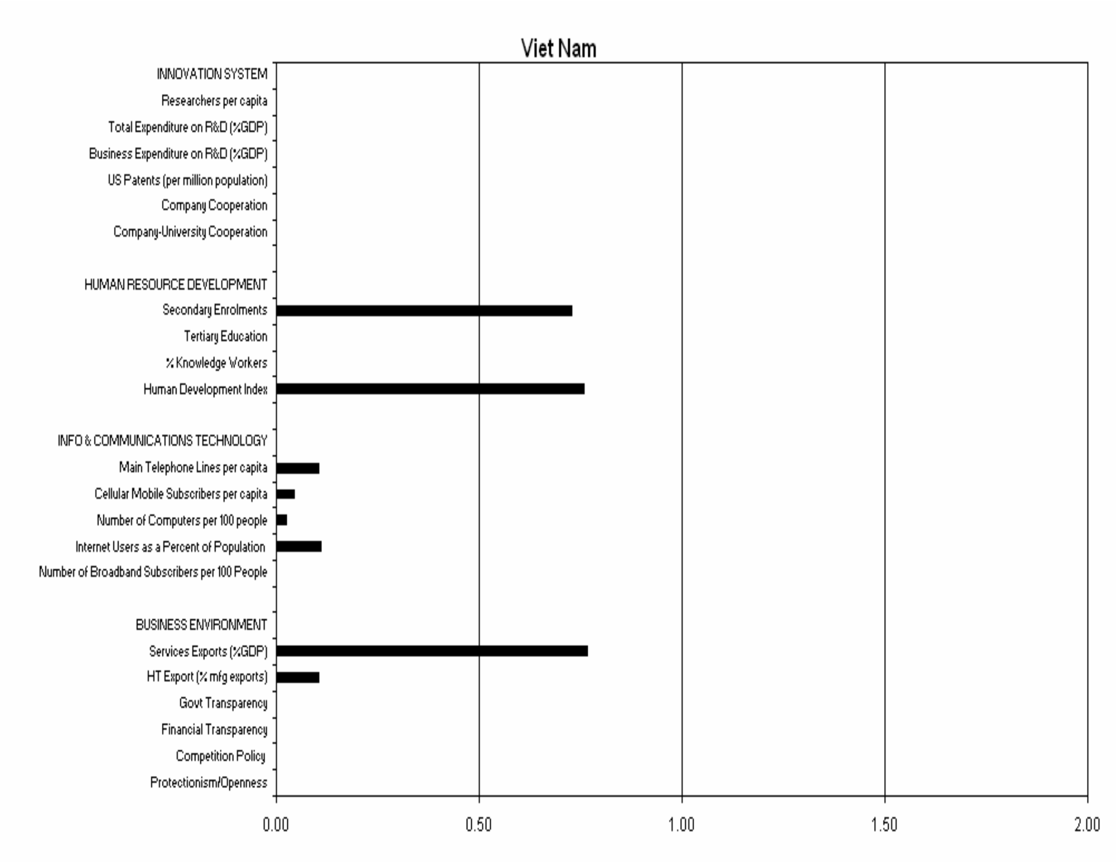

Russia
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00


Singapore
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
3.1
3.6
0.00
0.50
1.00
1.50
2.00


Chinese Taipei
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
4.0
2.1
2.6
0.00
0.50
1.00
1.50
2.00


Thailand
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00


United States
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
3.96
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00


Viet Nam
INNOVATION SYSTEM
Researchers per capita
Total Expenditure on R&D (%GDP)
Business Expenditure on R&D (%GDP)
US Patents (per million population)
Company Cooperation
Company-University Cooperation
HUMAN RESOURCE DEVELOPMENT
Secondary Enrolments
Tertiary Education
% Knowledge Workers
Human Development Index
INFO & COMMUNICATIONS TECHNOLOGY
Main Telephone Lines per capita
Cellular Mobile Subscribers per capita
Number of Computers per 100 people
Internet Users as a Percent of Population
Number of Broadband Subscribers per 100 People
BUSINESS ENVIRONMENT
Services Exports (%GDP)
HT Export (% mfg exports)
Govt Transparency
Financial Transparency
Competition Policy
Protectionism/Openness
0.00
0.50
1.00
1.50
2.00

ANNEX II

Individual Economy Reports

AUSTRALIA

The Australian economy grew solidly in 2004, reflecting strong consumption, dwelling investment and business investment. Net exports continued to detract from economic growth but by less than in the previous year. The unemployment rate fell to its lowest rate in 28 years by the end of 2004, while inflation remained contained.

REAL GROSS DOMESTIC PRODUCT GROWTH

Real gross domestic product (GDP) increased by 3.0 percent in 2004 (year-average terms), slightly below the growth rate recorded in 2003.

- Household consumption grew by a very strong 5.5 percent in 2004 reflecting low unemployment, solid wages growth and high household wealth as a result of past rises in house prices.
- Strong growth in house prices also supported high levels of dwelling investment over most of 2004. However, house price growth and dwelling investment both moderated towards the end of the year.
- Business investment increased by 10.2 percent in 2004, building on the very strong growth experienced in each of the two previous years.
- Public final demand grew by 4.2 percent in 2004 following growth of 3.8 percent in 2003.
- Net exports subtracted 2.1 percent from growth in 2004. This reflected sustained strong growth in imports and only modest growth in exports, partly due to the effects of the exchange rate appreciation and a lagged supply response to increased demand for non-rural commodities.

INFLATION

The consumer price index (CPI) increased by 2.6 percent through 2004. This outcome was in the middle of the medium-term inflation target band. The major contributors to inflation during the year were housing, transport and food prices while clothing and footwear prices fell. Excluding the impact of automotive fuel prices, the CPI increased by 2.0 percent through the year.

EMPLOYMENT

Employment grew by 2.6 percent through 2004. The unemployment rate fell steadily over the year to reach 5.1 percent in December.

Wages, as measured by the wage price index (WPI), rose 3.5 percent through the year to December. Public sector wages increased by 4.1 percent through the year to December while private sector wages increased by 3.4 percent.

BALANCE OF PAYMENTS

The current account deficit increased to $53.9 billion or 6.4 percent of GDP in 2004, up from $46.9 billion or 6.0 percent of GDP in 2003.

In 2004, export volumes increased by 4.2 percent while import volumes rose by 14.3 percent. The terms of trade increased by 9.8 percent in 2004, largely reflecting strong increases in non-rural commodity prices. The trade deficit widened slightly to $25.7 billion in 2004.

GROSS EXTERNAL DEBT

Australia's gross external debt was $699.2 billion in December 2004, an increase from $611.4 billion in 2003.

EXCHANGE RATE

Australia has had a floating exchange rate since 1983. The Reserve Bank of Australia (RBA) undertakes foreign exchange market operations for its clients (mainly the Australian Government) and on its own account. During 2004, the RBA did not intervene to influence the exchange rate of the Australian dollar. However, the RBA continued to add to its holding of foreign reserves, doing so during periods of strength in the exchange rate. The Australian dollar was relatively stable in 2004, appreciating (in nominal terms) by around 4.0 percent against the US dollar and depreciating by 3.5 percent against the euro and by around 0.7 percent against the Japanese yen. The movements of the Australian dollar against those currencies contributed to a 0.5 percent decrease in the trade-weighted index.

FISCAL POLICY

The government's medium-term fiscal strategy has the primary objective of maintaining budget balance, on average, over the course of the economic cycle. The 2004–05 underlying cash balance (data are not available on a calendar year basis) is expected to be in surplus of 1.1 percent of GDP (or 0.8 percent on an accruals basis). Further, over the eight years to 2004–05, the government has achieved cumulative underlying cash surpluses estimated at around $48 billion. These surpluses, combined with the proceeds from the sale of financial assets, have enabled the government to reduce the Australian Government's general government sector net debt from 19.1 percent of GDP in 1995–96 to an estimated 1.9 percent of GDP at the end of 2004–05. Consistent with the fiscal strategy, the government introduced its eighth budget surplus in the 2005–06 budget. In the 2005–06 financial year, the Australian Government is expected to be in an underlying cash surplus of 1.0 percent of GDP (or 0.8 percent measured on an accruals basis).

MONETARY POLICY

The Board of the Reserve Bank of Australia has the primary responsibility for the conduct of monetary policy. The independence of the Reserve Bank Board in conducting monetary policy was formalised in the Statement on the Conduct of Monetary Policy agreed between the Treasurer and the Reserve Bank Governor in August 1996 and reaffirmed and updated for current practice in July 2003. This statement includes a commitment by the Reserve Bank Board to hold consumer price inflation to between 2.0 and 3.0 percent, on average, over the course of the economic cycle. The medium-term focus of the inflation target allows for the natural short-run variation in inflation over the cycle. The instrument of monetary policy is the 'cash rate', which is the market interest rate on overnight funds. The target cash rate remained unchanged at 5.25 percent throughout 2004.

MEDIUM-TERM OUTLOOK

Australian economic forecasts are prepared on a financial year basis.

The Australian economy is expected to record solid growth in 2005–06, after a period of modest growth in 2004–05. The rebalancing of growth towards the external sector is expected to continue, reflecting strong world demand for Australian exports and an easing of consumption and dwelling investment to more moderate rates of growth.

- **Real GDP** grew by 2.3 percent in 2004–05 and is expected to grow by 3.0 percent in 2005–06.

Following several years of strong growth, **household consumption** is forecast to ease over 2005–06. This expected slowdown reflects households consolidating their balance sheets in response to the recent slowdown in housing wealth and higher oil prices.

Dwelling investment is expected to decline modestly in 2005–06. A period of slower growth is expected given that in the three years to 2003–04, dwelling investment grew by almost 50 percent. However, the current housing downturn is expected to be muted compared with past cycles, with dwelling investment supported by a strong labour market and solid underlying demand for new dwellings.

Business investment is expected to grow solidly in 2005–06, building on several years of strong growth. The investment environment remains favourable, with high capacity utilisation, a relatively low cost of capital and strong corporate balance sheets.

Australia's **net export** position is expected to strengthen in 2005–06. **Exports** volumes are expected to grow solidly, underpinned by increased capacity in the mining sector. **Imports** growth is expected to moderate in line with easing gross national expenditure growth.

The **current account deficit** is expected to narrow to 5.25 percent of GDP in 2005–06 reflecting increased exports volumes and prices. The narrowing in the trade balance will be partially offset by a higher net income deficit, as some portion of higher company profits are paid to overseas investors.

- Australia's terms of trade are forecast to increase in 2005–06, reflecting markedly higher commodity prices. The boost to commodity prices reflects the increase in world demand for raw materials, and the limited world supply response.

Employment growth is expected to moderate in 2005–06, consistent with output growth. The unemployment rate remained at 5.0 percent in August 2005, the lowest rate in 28 years, and is expected to remain around this level over 2005–06.

Inflation is expected to remain within the target band of 2.0 to –3.0 percent. However, in the near term, the pass-through of higher oil prices to consumer prices remains an upside risk.

Wages are expected to increase modestly in 2005–06. Reflecting the low unemployment rate, some localised wage pressures have appeared in particular regions and occupations; however, there is little evidence of generalised wage pressures or skill shortages.

STRUCTURAL REFORM

Australia has undergone major macroeconomic and microeconomic reform over the course of the last two decades, which has contributed significantly to strong and sustained economic performance since the early 1990s. Significant areas of reform have included the introduction of a medium-term fiscal framework and monetary policy framework, competition reform in many product markets, labour market reform, significant changes to taxation arrangements, financial sector reform, welfare reform, opening Australia to international trade and reform in communications and transport. Nevertheless, there are still significant areas where further reform could enhance Australia's long-term growth prospects.

The Australian Government has identified priories for future reform, including:

- Improving participation in the workforce, by strengthening the capacity of individuals to work through better health and education, by improving incentives and removing barriers to undertaking work through welfare reform, and by creating more flexible and adaptable retirement income arrangements;

- Following-on from the above point, expanding available employment options through greater flexibility in workplace relations—in particular, reducing the degree of regulation around the termination of employment, transforming the determination of minimum wages, unifying the Federal and State industrial relations systems, streamlining agreement-making processes and simplifying awards (minimum working conditions);

- Improving productivity by enhancing Australia's international integration and engagement. This is being pursued in a number of ways including the freeing up of trade and support for the development of rules-based multilateral systems governing such areas as trade, investment, taxation, financial regulation, terrorist financing and money laundering. An open trade policy will encourage businesses to make the best use of improvements in technology, including information and communications technologies. Productivity can be supported through appropriate infrastructure provision, sound governance arrangements in both the private and public sectors, efficient management of our natural resources and by specialising in the industries to which Australia is best suited including by achieving economies of scale and scope; and

- Continuing certainty and credibility of Australia's economic management through the ongoing operation of a medium-term fiscal framework and monetary policy framework.

In 2005, the Australian Government published a Statement on 'Prosperity and Sustainability'.[1] This statement outlines reasons for the rise in Australia's prosperity since the early 1990s, both by historic standards and compared with other OECD economies, and also outlines policies and institutions most likely to lead to further increases in Australia's prosperity and well-being over the medium to long term.

---

1 Australian Government Treasury (2005). Budget Paper No. 1, Budget Strategy and Outlook 2005-06, Statement 4: 'Prosperity and Sustainability'.

ANNEX I

AUSTRALIA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	388.2	373.7	353.8	402.4	515.4	616.4
Real GDP	4.2	3.3	2.7	3.8	3.5	3.0
Consumption	4.3	3.5	2.3	3.8	4.2	5.0
Private Consumption	4.9	3.1	2.9	3.9	4.3	5.5
Government Consumption	2.3	4.6	0.5	3.5	4.0	3.3
Investment	7.1	1.1	-0.3	16.0	7.7	6.6
Private Investment	5.4	0.9	-3.4	18.9	9.2	8.5
Government Investment	14.2	1.3	2.3	7.7	2.6	8.3
Exports of Goods and Services	4.7	10.9	1.8	0.1	-2.3	4.2
Imports of Goods and Services	9.3	7.6	-4.1	11.3	10.5	14.3
Fiscal and External Balance (percent of GDP)						
Budget Balance **	0.7	2.1	0.9	-0.1	1.0	1.0
Merchandise Trade Balance	-2.5	-1.2	0.5	-1.4	-3.0	-2.9
Current Account Balance	-5.7	-4.1	-2.4	-4.3	-6.0	-6.4
Capital And Financial Account Balance	5.6	3.9	2.2	4.2	5.9	6.5
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	0.7	4.1	3.6	2.9	2.8	3.6
CPI	1.5	4.5	4.4	3.0	2.8	2.3
M3	9.4	7.6	8.8	9.5	10.6	10.3
Short-term Interest Rate (percent)^	5.0	6.2	4.9	4.8	4.9	5.5
Real Effective Exchange Rate (level, 2000=100)*	104.9	100.0	96.1	101.5	114.7	124.0
Unemployment Rate (percent)	6.9	6.3	6.8	6.4	6.0	5.5
Population (millions)	19.0	19.2	19.4	19.7	19.9	20.1

Notes:
* OECD Main Economic Indicators.
** Figures refer to financial year e.g. 2004 is the financial year 2003–04. Source: *Budget Strategy and Outlook 2005-06*, Budget Paper No. 1.
^ 90 Day Bank Accepted Bills, annual average, RBA Bulletin.

ANNEX II

AUSTRALIA: FORECAST SUMMARY (percent change from previous year)

	2004–2005						2005–2006					
	Official	IMF	ADB	OECD	PECC	Link	Official	IMF	ADB	OECD	PECC	Link
Real GDP	2	N.A.	N.A.	N.A.	N.A.	N.A.	3	N.A.	N.A.	N.A.	N.A.	N.A.
Exports	2	N.A.	N.A.	N.A.	N.A.	N.A.	7	N.A.	N.A.	N.A.	N.A.	N.A.
Imports	10	N.A.	N.A.	N.A.	N.A.	N.A.	8	N.A.	N.A.	N.A.	N.A.	N.A.
CPI	2.5	N.A.	N.A.	N.A.	N.A.	N.A.	2.75	N.A.	N.A.	N.A.	N.A.	N.A.

*Official forecasts are based on financial years.

ANNEX III

AUSTRALIA: MEDIUM-TERM TREND PROJECTIONS (percent)*

	2006–07 to 2007–08	2008–09
Real GDP	3.5	3.25
CPI	2.5	2.5

*Official projections are based on financial years.

BRUNEI DARUSSALAM

REAL GROSS DOMESTIC PRODUCT

The economic activity for 2004 remained subdued with GDP growing by only 1.7 percent. The subtle growth, however, was supported by improved performances seen in agriculture; forestry; fishery; mining, quarrying and manufacturing; construction; retail; and transport and communication sectors.

The **oil and gas sector** registered a contraction of **1.5** percent in 2004 compared to 3.6 percent growth in 2003. The average weighted oil production decreased by 0.7 percent from 207,240 barrels per day in 2003 to 205,750 barrels per day in 2004. Meanwhile, the average weighted liquid natural gas (LNG) production dropped by 3.2 percent, from 1,049,143.0 million Btu per day in 2003 to 1,016,001.86 million Btu per day in 2004.

The price of crude oil averaged out at **US$34.00** per barrel in 2004 compared to US$30.17 per barrel in 2003. Meanwhile, the price of LNG averaged out at **US$4.88** per million Btu in 2004 compared to US$4.54 per million Btu in 2003.

The **non-oil and gas sector** grew by an estimated **5.1** percent in 2004 (compared to 3.6 percent growth in 2003) in which the government sector grew at an estimated **4.8** percent in 2004 (compared to 0.4 percent growth in 2003). Meanwhile, the private sector grew at an estimated **5.4** percent compared to 8.0 percent growth in 2003.

The performance of the individual sub-sectors under the non-oil and gas sector have been positive with the exception of four sectors i.e., restaurants and hotels; banking and finance; real estate/business services; and ownership of dwellings which have shown some contractions.

Activities in the primary sector showed significant growth rates. Activities in the **agricultural sector** are estimated to register a 10.8 percent growth in 2004 compared to the same period a year ago. The **forestry sector** registered an estimated **29.1** percent growth in 2004 compared to 0.3 percent growth in 2003. **The fishery sector** registered an estimated **29.2** percent growth in 2004 compared to 9.3 percent growth in 2003.

The **non-oil mining, quarrying and manufacturing sector** is estimated to have expanded by 5.9 percent in 2004 compared to 2.6 percent growth in 2003. The improved growth was mainly attributed to better performances in garments; cement; sawn timber; roofing; switchboards and bricks productions. The **construction sector** registered an estimated 3.8 percent growth in 2004. The value of construction cost of work done increased by 3.8 percent from B$231.6 million Brunei dollars (B$) in 2003 to B$ 240.4 million in 2004.

In the services sector, the **wholesale sector** registered an estimated **9.0** percent growth in 2004 compared to 1.9 percent growth in 2003 while the **restaurant and hotel sector** is estimated to contract by 0.2 percent in 2004 compared to a year ago. The overall performance of the **transport and communications sector** grew at an estimated **14.1** percent in 2004 compared to 12.5 percent growth in 2003. The **banking & finance sector** registered a contraction of 6.2 percent in 2004 compared to 4.5 percent growth in 2003. However, the **insurance sector** registered an estimated **4.9** percent growth in 2004 compared to 17.9 percent growth in 2003.

INFLATION

The average consumer price index (CPI) for 2004 was 101.2, an increase of 0.9 percent from the previous year. Upward pressure was exerted primarily by rises in the major group indices: food and non-alcoholic beverages by 1.6 percent; transport, 2.3 percent; medical and health, 0.3 percent; recreation and entertainment, 6.5 percent; and miscellaneous goods and services, 0.6 percent.

Consumers paid 10.7 percent more for meat and meat products in 2004 compared to in 2003. This is because of the increases in prices of: beef (cattle), fresh and frozen by 20.4 percent; buffalo, fresh and frozen by 4.2 percent; mutton/lamb, fresh and frozen by 3.6 percent; fresh chicken by 12.1 percent; frozen chicken by 5.8 percent; processed meat products and meat products by 4.8 percent; and canned meat and meat preparation by 3.8 percent. The increase in the price of chicken feed was one of the main costs in the rise in fresh and frozen chicken prices. The feed, which is comprised of soya bean and maize, is now $30 per bag, up from $25. Meanwhile the rise in the cost of beef, cattle and mutton was mainly attributed to the higher cost of imported beef from Australia due to higher exchange rates, and transportation costs.

The increase in the recreation and entertainment major group index was the largest contributor to the 12 month increase in the CPI for the year 2004 and it rose by 6.5 percent when compared to 2003. This was primarily caused by the increases in holiday package prices due to the rise in air fuel costs.

The following decreases in the indices were noted: clothing and footwear 2.0 percent; housing, water, electricity and maintenance, 0.7 percent; household goods, services and operation, 4.2 percent; communication, 2.7 percent; and education, 0.3 percent.

EMPLOYMENT

The total labour force in Brunei Darussalam in 2004 was estimated to be around 160,500 persons; and of this figure 95.2 percent were employed (4.8 percent unemployed). The government absorbed a large percentage of the total employment. Employment in the private sector is still dominated by foreign workers (70 percent of the total); most of whom are in semi- and un-skilled occupations.

BALANCE OF PAYMENTS

Brunei Darussalam recorded a surplus in the current account balance in 2004. This was contributed by the increase in total exports due to higher oil prices. The current account balance increased by 6.57 percent from B$4,328 million in 2003 to B$4,612.8 million in 2004. There was a significant increase in services payments for transportation and travel in Q4 2004.

In 2004, the total trade was B$10,975.1 million, an increase of 9.6 percent from B$10,016.2 million in 2003. The trade surplus in 2004 increased by 14.1 percent, from B$5,392.4 million in 2003 to B$6,150.2 million, contributed mainly by higher exports.

Exports

Total exports in 2004 increased by 11.1 percent from B$7704.3 million in 2003 to B$8,562.7 million. Exports for both oil and gas, and non-oil and gas sectors in 2004 were B$7,827 million and B$735.9 million respectively. The value of non-oil and gas exports decreased by 22.7 percent, from B$951.4 million in 2003 to B$735.9 million in 2004 due to a reduction in garments exports.

Total value of petroleum exports increased by 29.7 percent, from B$3,788 million in 2003 to B$4,912.5 million in 2004 due to higher oil prices. The average oil price increased by 38.6 percent, from US$30.2 per barrel in 2003 to US$41.8 per barrel in 2004.

The total export value for LNG decreased by 1.7 percent from B$2,964.5 million in 2003 to B$2,914.2 million in 2004. This was due to reduction in export volume by 1.6 percent from 1,014,203.48 MMBtu per day in 2003 to 998,051.34 MMBtu per day in 2004. MMBtu = million Btu.

The value for non-oil and gas exports decreased by 22.7 percent from B$951.4 million to B$735.9 million in 2004. The value of garment exports decreased by 22.5 percent from B$398.4 million in 2003 to B$308.8 million in 2004.

In 2004, Japan remained the dominant export market, accounting for 37.7 percent of total exports followed by ASEAN (17.2 percent), Korea (12.9 percent), Australia (11.7 percent), USA (6.8 percent), India (6.9 percent) and China (4.1 percent).

India's share of the export market increased from 2.0 percent in 2003 to 6.8 percent in 2004 due to its increasing demand for energy. In 2004, exports to India increased significantly (by 212.7 percent), followed by Australia (55.9 percent), Korea (27.6 percent) and Japan (2.3 percent).

However exports to China decreased by 32.5 percent as did those to ASEAN (5.4 percent) and the USA (1.0 percent).

Imports

In 2004, total imports increased by 4.4 percent to B$2,412.5 million from B$2,311.8 million in 2003. The increase was due to the increase in the imports of beverages and tobacco (by 41.5 percent) followed by machinery and transport equipment (3.3 percent), miscellaneous manufactured articles (11.6 percent), miscellaneous transactions (9.7 percent), chemicals (9.1 percent), food and live animals (1.9 percent) and manufactured goods (0.4 percent).

With respect to the origin of imports in 2004, 42.0 percent of total imports were from ASEAN economies. This was followed by imports from the European Union (18.0 percent), the USA (11.0 percent), Japan (9.0 percent), China (6.0 percent), Hong Kong, China (5.0 percent) and Australia (3.0 percent).

Imports from the European Union (mainly from Germany and the United Kingdom), the USA and China increased in 2004 compared to 2003 and consisted mainly of manufactured goods, and machinery and transport equipment.

EXCHANGE RATE

The value of the Brunei dollar has been stable during the past years and reflects the value of the Singapore dollar as the Brunei currency is pegged to the Singapore dollar. The exchange rate on average has fallen from B$1.7 in 2003 to B$1.6927 in 2004, reflecting deterioration in the value of the corresponding US dollar.

FISCAL POSITION

In 2004, Brunei Darussalam had a budget surplus of B$1,217.6 million. This budget surplus is tied tightly to increases in the price of oil, which is the mainstay of Brunei Darussalam's economy and government income. The actual revenue collected in 2004 was B$6,126.3 million, which was 30.1 percent higher than the estimated revenue of B$4,708.4 million at the beginning of the year. On the other hand, the actual expenditure was B$4,908.7 million, which was 46.0 percent higher than the budgeted expenditure of B$3,362.4 million.

MONETARY DEVELOPMENT

The broader measure of money supply M2, on average increased by 13.4 percent, from B$9,894 million in 2003 to B$11,221 million in 2004. This increase has been contributed by increases in both M1 and quasi money, by 8.7 percent and 14.9 percent, respectively. For M1, demand deposits increased at a faster rate of approximately 11.0 percent during the period compared to 2.4 percent for currency in circulation. The increase in fixed deposits (by 13.0 percent) and savings (by 10.4 percent) contributed to the increase in quasi money aggregates during the same period.

Bank lending to various economic activities increased significantly from B$5,386 million in 2003 to B$5,576 million in 2004. In total, bank loans increased by 3.5 percent during the period and this growth was mainly contributed by lending to manufacturing activities although the percentage of total loans was relatively small. Loans for personal purposes still form the largest proportion of total loans (66.7 percent in 2004 compared to 65.3 percent in 2003) and grew by about 5.7 percent during the period. The proportions of loans to construction and general commerce increased minimally from 8.5 percent to 8.9 percent for the former and 8.9 percent to 9.0 percent for the latter.

Regarding non-performing loans (NPL), the financial sector showed continued improvement. The NPLs decreased from B$672 million in December 2003 to B$656 million during the same period in 2004 and registered -2.5 percent rate of growth.

MEDIUM-TERM OUTLOOK

The Brunei Darussalam economy is projected to grow by about 3.6 percent in 2005 and this growth in GDP, to a large extent, will be contributed by activities in the non-oil private sector. The oil and gas sector as well as the government sector will grow at a relatively lower rate.

The expected growth in the economy is seen amidst a downward adjustment of the world's output growth from 5.0 percent to 4.3 percent and developing Asian economies' growth from 7.6 percent to 6.9 percent.[2] The increasing trend in the price of oil has curbed earlier forecasts.

The oil sector will grow at a modest pace. Any alteration in oil production in the short-term will depend on whether Brunei oil companies take advantage of the expected upward trend in the world's oil price. By December 2004, the world oil price lingered around the US$40 mark which was higher than OPEC's benchmark price. But unprecedented oil demand from advanced economies (and China) and uncertainties in the environment for oil market, such as tight supply, make it vulnerable to price fluctuations.

In 2004, the non-oil private sector was propelled by activities in transport and communications, retail trade, manufacturing, construction, insurance and primary industries. The same activities are projected to contribute to the growth in the non-oil private sector in 2005. In particular, commendable growths are expected from activities in wholesale and retail trades, real estates and business services, banking and insurance and primary industries activities in agriculture and fishery.

The government sector has been a significant contributor to the economy, especially in its distributive role in terms of development expenditure. Government finance in 2004 experienced a budget surplus, as expected, mainly due to the increase in revenue. This, together with the concerted effort to speed-up implementation of the 8th National Development Plan projects, will help the overall growth of the economy in 2005, as the 5th and final year of the plan period. The government sector is expected to grow by 2.8 percent in 2005.

The monetary sector's growth has been optimistic over the twelve month of 2004, with money supply and near money growing by nearly 20.0 percent between January and December. This commendable growth has been brought about by a large expansion in demand deposits (by 59.0 percent) during the same period although albeit there was a small reduction in currency in circulation. A good sign of the growing economy in 2005 is a reduction in aggregates of non-performing loans, especially in Q4 2004. The growth in loans aggregates in 2004 is also an important development that could positively contribute to greater economic activities in 2005.

Brunei Darussalam recorded a positive trade balance in 2004 brought about by an increase in the value of exports. Based on the previous trend in the average annual growth rate of exports, it is

[2] International Monetary Fund forecasts in its September issue of World Economic Outlook. GDP growth forecasts for some ASEAN economies have also been adjusted downwards. The OECD also presents similar (downward adjustment) outlook for the world economy for 2005.

forecast to increase by 7.0 percent in 2005 compared to 11.0 percent in 2004. At the same time, the economy also witnessed a considerable increase in the value of imports during the same period. Almost all import items showed increases compared to the previous year. This increase was most significant in machinery and transport equipment items which, among others, consist of passenger cars. The increased imports of both consumer and non-consumer goods shows some degree of confidence in the economy and in 2005 imports are forecast to grow by 4.0 percent.

As estimated earlier, the consumer price index grew at a modest rate of 0.9 percent in 2004. The non-oil private sector is partly consumer-driven in nature and the expected increase in activities in retail trade and other consumer-related economic sectors will help push the inflation rate in 2005.

Employment opportunity in the private sector is one of the indicators of businesses' confidence in the economy. In 2004, there was a large increase of approximately 69.0 percent in advertised job vacancies, from 293 job advertisements in Q1 2004 to 495 job advertisements in Q4 2004 and those not advertised. This trend is expected to be repeated in 2005.

Annex I

BRUNEI DARUSSALAM: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in million B$)	7,144.7	7,441.1	7,481.9	7,651.7	8,254.9	9,270.4
Real GDP	4,031.4	4,145.3	4,271.6	4,392.3	4,559.7	4,638.6
Consumption						
Private Consumption	N.A	N.A	N.A	N.A	N.A	N.A
Government Consumption	3,126.08	3,043.36	2,745.21	3,776.65	3,291.51	4,065.03
Investment (B$ million)						
Private Investment (Foreign + Local)	1,520.6	1,235.2	1,232.9	3,098.9	5,343.3	368.76
Government Investment (Investment in public ent.)	N.A.	91.4	57.5	57.8	23.3	N.A.
Exports of Goods and Services (only f.o.b, total goods + services not available)						
Exports of goods f.o.b. (million B$)	4,325.14	6,733.52	6,521.76	6,628.7	7,704.33	8,562.65
Imports of goods c.i.f (million B$)	2,250.65	1,907.8	2,045.76	2,786.56	2,311.82	2,412.49
Fiscal and External Balance (percent of GDP)						
Budget Balance						
Merchandise Trade Balance (million B$)	2,191.8	4,925.2	4,582.7	3,987.4	5,513.0	6,302.0
Current Account Balance (million B$)	4,474.5	6,906.7	3,490.4	3,140.1	4,328.5	4,820.4
Capital and Financial Non-reserve Assets Balance (million B$) excluding the figure from Brunei Investment Agency (BIA)	N.A	-1,608.1	169.6	0.7	-809.3	-2,146.9
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	1.8	1.8	1.8	1.7	1.8	2.0
CPI	-0.1	1.2	0.6	-2.3	0.3	0.9
M2	7,691.4	9,686.5	8,998.2	8874.3	10,856.3	12,725.4
Short-term Interest Rate (percent) #	1.25	1.25	0.5	0.4	0.225	0.225
Real Effective Exchange Rate (level, 1995=100)						
Unemployment Rate (percent)	4.5	4.7	5.6	3.5	4.5	4.8
Population (millions)	0.317	0.325	0.333	0.344	0.350	0.358

Note:
Short-term Fixed Deposit Rates
Except for 2001, rates are based on job seekers numbers

ANNEX II

BRUNEI DARUSSALAM: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**Link**
Real GDP	1.7	N.A.	N.A.	N.A.	N.A.	N.A.	3.6	N.A.	N.A.	N.A.	N.A.	N.A.
Exports (US$ Mln)	11.1	N.A.	N.A.	N.A.	N.A.	N.A.	7.0	N.A.	N.A.	N.A.	N.A.	N.A.
Exports of Goods (US$ Mln)	5,058.6	N.A.	N.A.	N.A.	N.A.	N.A.		N.A.	N.A.	N.A.	N.A.	N.A.
Imports (US$ Mln)	4.4	N.A.	N.A.	N.A.	N.A.	N.A.	4.0	N.A.	N.A.	N.A.	N.A.	N.A.
Imports (US$ Mln)	1,425.2	N.A.	N.A.	N.A.	N.A.	N.A.		N.A.	N.A.	N.A.	N.A.	N.A.
CPI	0.9	N.A.	N.A.	N.A.	N.A.	N.A.	1.1	N.A.	N.A.	N.A.	N.A.	N.A.

ANNEX III

BRUNEI DARUSSALAM: MEDIUM-TERM TREND FORECAST (percent)

	Period*
Real GDP	3.6 (2005)
GDP Deflator	2.3

Note: (*) Please specify the forecasting period.

CANADA

REAL GROSS DOMESTIC PRODUCT GROWTH

- In 2004, the Canadian economy grew by a solid 2.9 percent following growth of 2.0 percent in 2003. Strong growth in final domestic demand offset weakness in export growth, particularly in the second and third quarters of 2004, as a result of the significant appreciation of the Canadian dollar against the US dollar.

- Strong final domestic demand growth reflects healthy job creation, high levels of income and consumer and business confidence and record levels of corporate profits. However, much of this demand continues to be channelled into imports, reflecting past appreciations of the Canadian dollar.

- Thanks to appropriate macroeconomic policies, final domestic demand growth has been robust—particularly consumer spending, residential investment and business investment. The recent strength of investment in machinery and equipment is a good indication that Canadian businesses are responding well to the challenge of the higher dollar. The stronger dollar also makes it easier for firms to invest in equipment that is priced in US dollars.

- Looking ahead, solid domestic fundamentals, low interest rates and high levels of consumer and business confidence are expected to support healthy Canadian economic growth.

INFLATION

- The 12-month rate of increase in the consumer price index has continued to exhibit volatility, rising to 2.4 percent in April and falling to 1.6 percent in May. This is largely due to fluctuations in gasoline prices.

- In contrast, the core rate of inflation has remained relatively stable, fluctuating in a range between 1.6 and 1.9 percent since the beginning of the year.

- According to the July 2005 Monetary Policy Report Update, with economic growth projected to continue to operate near its production capacity, some reduction of monetary stimulus will be required in the near term.

EMPLOYMENT

- The labour market has remained remarkably healthy, despite the shock to the economy from the appreciation of the Canadian dollar.

- In 2004, the economy created 230,000 new jobs, all of which were full-time positions. The employment rate reached a record high of 62.8 percent in May 2004 and remained close to that level for the rest of the year and into 2005.

- With strong job creation in Canada, the unemployment rate fell from 7.3 percent in December 2003 to a thirty-year low of 6.7 percent in June 2005, despite near record rates of participation in the labour market.

BALANCE OF PAYMENTS

- Canada's current account has improved dramatically from the deficits recorded in the 1990s. The current account moved into surplus late in 1999 and the surplus has remained healthy, despite the appreciation of the Canadian dollar against the US dollar.

- In 2004, the current account balance as a share of GDP stood at 1.6 percent, down somewhat from 1.9 percent in 2003.

GROSS EXTERNAL DEBT

- With sustained current account and fiscal surpluses over recent years, Canada's net foreign debt as a share of GDP has fallen from 43.8 percent of GDP in 1993 to less than 14.0 percent in 2004.

EXCHANGE RATE

- The Canadian dollar has appreciated about 30 percent against the US dollar since 31 December 2002.

- Stronger global growth and increased demand for commodities has driven part of the rise in the value of the Canadian dollar over the past two years. Since Canada is a net exporter of commodities, the Canadian dollar often rises against the US dollar when global commodity prices increase.

- However, the appreciation of the Canadian dollar also reflects global portfolio adjustments in response to persistent US current account imbalances. All major floating currencies have climbed sharply against the US dollar over the past two years.

FISCAL POLICY

- Thanks to sound fiscal management, the federal government has now recorded seven consecutive budgetary surpluses—and is expected to record its eighth in fiscal year 2004–05.

- Canada's fiscal performance over the past 10 years is unmatched among G-7 economies. In 1995 Canada's total government deficit was well above the G-7 average. However, significant fiscal improvements at all levels of government enabled Canada's total government to post a surplus in 1997. Since then Canada has recorded a total government surplus every year, while the average deficit among G-7 economies has deteriorated rapidly since 2000. Indeed, Canada has been the only G-7 economy to record a total government budget surplus in each of the past three years.

- This strong overall fiscal performance, together with sustained economic growth, has given Canada a net debt-to-GDP ratio of under 39.0 percent in 2004, the lowest in the G-7.

MONETARY POLICY

- Since 1991, the Federal Government and Bank of Canada have maintained an official target range for the inflation rate, which was gradually lowered to between 1.0 and 3.0 percent by 1993. The commitment to keep inflation within that target range was renewed in February 1998 and again in May 2001, with the latter in effect until the end of 2006. The commitment to a low and stable inflation environment enables policy to best contribute to a sustained economic expansion in Canada, thereby leading to the likelihood of lower unemployment and improved productivity.

- Since 1993, inflation in Canada has averaged 1.9 percent, which is very close to the mid-point of the current inflation targeting range.

- Low and stable inflation, together with a strong fiscal position, has given the Bank of Canada the flexibility to respond quickly and decisively to domestic or external shocks.

MEDIUM-TERM OUTLOOK

- Canada's latest survey of private sector forecasters, conducted in June, projected economic growth of 2.7 percent in 2005 and 2.9 percent in 2006.

- Forecasters expected growth to average about 3.0 percent per year over 2007–2009.

STRUCTURAL REFORM

- The macroeconomic reforms taken over the last decade have enabled the Canadian economy to weather economic shocks better than in the past. The OECD recently acknowledged this benefit, stating: "the Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well designed macroeconomic framework and the pay-off from a range of structural reforms implemented since the late 1980s."[3] (See attached background document, attachment 1, for further detail.)

[3] OECD, Economic and Development Review Committee, Economic Survey of Canada (October 2004).

ATTACHMENT 1

STRUCTURAL REFORMS IN CANADA, 1989–2003

The need for structural reform in the Canadian economy was clear by the early 1990s. As in various other industrialized economies, GDP growth had slowed considerably, reflecting a downturn in productivity growth that began in the 1970s and persisted until the mid-1990s. As a result, growth in real household income stagnated. Unemployment increased from an average of 4.9 percent during the 1960s to 9.4 percent during the 1980s and over 10.0 percent by the early 1990s. Inflation exploded following the oil shocks of the 1970s and years of chronic deficits, used to finance current spending, had pushed Canada's debt-to-GDP ratio to levels above the G7 average. By 1992, net lending in Canada had reached over 9.0 percent of GDP and net financial liabilities[4] had reached 68.0 percent of GDP (compared to the OECD average of 49.0 percent). The impending retirement of the baby-boom generation gave added impetus to fiscal reforms lest both current debt and unfunded liabilities be passed on to future generations.

In the early 1990s, decisive action was taken to stop the vicious cycle of deficit and debt accumulation and to improve economic fundamentals. Trade liberalization, tax reform and inflation targeting were supplemented by pension reform spending reallocation and labour market policies designed to foster income growth and job creation. The following provides a chronological account of the structural reforms over the past 15 years which contributed to the improved economic environment Canada has today.

1989 CANADA-US AGREEMENT ON FREE TRADE

In 1989, Canada signed the free trade agreement with the United States to promote productivity improvements, full employment and encourage foreign direct investment. The agreement would also promote competitiveness and ultimately boost living standards in Canada.

Although there were some inevitable job losses during the transition period, trade with the United States has increased substantially, as has productivity, direct foreign investment and growth in Canadian living standards. Exports to the United States, as a share of total exports, increased from 73 percent in 1988 to 84 percent in 2002.

1991 Sales Tax Reform

In January 1991, the Goods and Services Tax (GST) replaced the out-dated Manufacturers' Sales Tax (MST), which had been in effect since 1924. The MST was highly complex in that it was subject to no fewer than 22,000 special provisions and administrative arrangements. The GST, a multi-stage, value-added tax, is simpler, fairer and more visible than its predecessor.

Businesses are entitled to receive a fully refundable credit (i.e., an input tax credit) for the GST they pay on the goods and services they purchase as inputs into their production and distribution processes. To offset the regressive impact of a broader taxation base on low-income Canadians, the GST credit, a refundable income tax credit, was introduced along with the tax.

The replacement of the MST by the GST has helped to make Canadian manufacturers more competitive. The GST applies to all imported goods and services, but does not apply to Canadian manufactured goods and services that are exported to other international markets. The GST has also made consumption tax rates more equal across commodities, thereby reducing relative price distortions in the economy.

---

[4] Net lending and net financial liabilities are the measures of the deficit and debt commonly used by the OECD.

On 1 April 1997, three of the Atlantic provinces—New Brunswick, Nova Scotia, and Newfoundland and Labrador—combined their provincial sales taxes with the GST to create a single harmonized value-added tax structure. In partnership with the Government of Canada, these three provinces introduced a new 15 percent joint federal–provincial Harmonized Sales Tax (HST).

1991 Inflation targeting

Low inflation facilitates long-term planning and encourages business investment that ultimately boosts productivity. In 1991, the Bank of Canada and the Government of Canada agreed to a targeting framework in order to bring inflation down to low and stable levels. In 1991, inflation stood at 5.9 percent. The targets sought to bring inflation first to 3.0 percent, then to 2.5 percent and ultimately to the mid-point of the Bank's 1.0 to –3.0 percent target range. Despite a spike in year-over-year inflation recently due to special factors such as energy and tobacco price increases, and insurance rate hikes, inflation expectations remain firmly anchored at 2.0 percent.

1994 North American Free Trade Agreement (NAFTA)

In 1994, the Canada-US Free Trade Agreement was expanded to include the phased elimination of tariffs between Canada, the United States and Mexico. The agreement created, at the time, the largest free trade area in the world. As a result, Canadian exports to Mexico doubled between 1994 and 2000.

1995 Fiscal consolidation

During the mid-1990s, the Finance Committee of the House of Commons held hearings across Canada and subsequently recommended to Parliament that immediate and decisive action be taken to halt the government's fiscal deterioration. Canadians accepted that the process of fiscal consolidation would involve difficult decisions but felt that the continued accumulation of debt to fund current programs was unacceptable.

In 1995, the government implemented the Program Review, a year-long, top-to-bottom review of all departmental programs, covering about $52 billion in spending. The main objective of the program was to review all categories of federal government spending—except certain statutory programs—in order to bring about the most effective and cost-efficient way of delivering programs and services to Canadians. In 1994, current expenditures of the Federal government stood at 16 percent of GDP. By 2002, after several major reinvestments, current expenditures stood at 12.7 percent. Programs that were deemed inefficient or no longer relevant to current conditions were eliminated or drastically cut, and funds were reallocated towards those programs that worked well and would foster economic growth and job creation.

As part of the Program Review, subsidies were reduced to limit distorting effects on economic activity. Furthermore, the government's interests in Cameco, Canadian National Railways, Petro-Canada, the Air-Navigation System and Canada Communication Group were privatized or commercialized.

Together with spending reductions, deficit targets were established, and a prudent approach to budget planning was implemented to ensure that targets would be met. In the space of four years, the federal government eliminated a deficit of $42 billion and placed the federal debt on a permanent downward track. To ensure continued balanced budgets, the government uses prudent economic assumptions to develop fiscal projections for budget-planning purposes. Economic prudence, which rises over time, is built in to the five-year fiscal projections to provide further assurance against falling back into deficit. Finally, the annual Contingency Reserve is set aside to guard against unforeseen circumstances. If it is not needed, the Contingency Reserve is applied against the federal debt.

In 1990, debt charges absorbed 35.0 percent of federal revenues. By 2002, interest payments on the federal debt took less than 20.0 percent of federal revenues, freeing revenues for other priorities of Canadians.

Sustained budgetary surpluses finally put the debt burden on a downward track. In 1997, the federal net public debt-to-GDP ratio recorded its first significant decline in 25 years, falling to 64.7 percent from 68.3 percent in 1996 (National Accounts Basis). Currently, federal net public debt stands at 43.8 percent.

1996 Labour Market Reform

In the early 1990s, labour market policies contributed to a high level of structural unemployment and a pattern of repeat use, particularly among seasonal workers. The Unemployment Insurance Program underwent a series of major reforms during the 1990s, which made the program less generous. The 1990s reforms increased the number of weeks required to qualify for benefits and reduced weeks of benefit entitlement. The replacement rate was reduced from 60 percent to 57 percent and those who left their jobs voluntarily were disentitled to benefits. The 1994 reforms increase qualifying weeks, reduced benefit durations and further adjusted replacement rates.

With the 1996 Employment Insurance Act, income benefits were redesigned to promote greater labour force attachment and to introduce stronger insurance principles into the system. Eligibility was changed to hours of work rather than weeks worked, a new benefit structure was introduced and eligibility requirements were tightened.

The switch to the new hours-based system introduced a disincentive for some workers to accept part-time and temporary employment with lower than average earnings because inclusion of earnings from these ‘small weeks’ in the calculation of average earnings lowered benefit entitlement. To address this issue, the Small Weeks Project was introduced which allowed claimants to exclude (or equivalently ‘bundle’) any weeks of work with earnings under a certain threshold in the calculation of weekly benefits while still counting the hours in determining benefit duration. The increase in labour force attachment associated with the Small Weeks initiative indicates that it has achieved its primary goal of encouraging workers to accept small weeks of work.

Social Assistance Reform

During the 1980s reforms to provincial social assistance programs generally made the system more generous and tended to encourage repeated and long-term use. Major and far reaching changes were subsequently implemented motivated by a desire to counteract the dramatic increase in program expenditures that occurred during the early 1990s (between 1989 and 1994 real social assistance expenditures in Canada doubled). These reforms represented a systematic change from those in the 1980s, involving not only changes in program parameters such as benefit levels, but also measures aimed at restricting eligibility through tightened administrative procedures.

1995 Domestic Trade Liberalization

The Agreement on Internal Trade continued progress toward eliminating barriers to trade within Canada. Efforts are underway to extend the AIT to public entities that were not covered by the original agreement.

1997 Pension Reform

Inaugurated in 1966, the Canada Pension Plan (CPP) underwent a major set of reforms in the mid-1990s to place the plan on a long-term sustainable path. Contribution rates—shared equally between employer and employee—were increased over six years from the 1998 rate of 5.85 percent of contributory earnings to 9.9 percent in 2003.

The year's basic exemption—the first $3,500 of earnings in any year on which no contributions are paid—was maintained and frozen. Effective April 1998, an arm’s-length investment board was created to increase plan returns, tighten the provision of benefits and keep contribution rates down. The reserve fund is invested prudently in a diversified portfolio of securities and managed by a new Canada Pension Plan Investment Board, acting at arm's length from government.

2000 Tax Reduction Plan
As federal finances were placed on a healthy and sustainable track, the government began to reduce taxes on individuals and businesses, to reduce distortions in the economy and to foster job creation and economic growth.

The 2000 Budget announced a $100-billion tax reduction package, the largest tax cut in Canadian history. Full-indexation of Canada's personal income tax system was restored to eliminate automatic tax increases from inflation. All personal income tax rates were lowered and bracket thresholds were increased. The 5.0 percent deficit-reduction surtax on middle-income earners (up to $85,000) was eliminated and the surtax will be completely eliminated by 2004. The National Child Benefit (NCB) and the Canada Child Tax Benefit were enriched to provide further assistance to low income families with children. Tax measures were announced to support those seeking education and retraining. Tax measures were implemented to assist those saving for retirement. The RRSP contribution limit was raised and the allowable foreign content of RRSPs and RPPs was increased.

To encourage innovation and growth the tax package also included measures to reduce taxes in the business sector. Corporate tax rates were reduced from 28.0 percent to 21.0 percent over five years for the highest taxed business sectors. Effective January 2001, the tax rate on small businesses with income between $200,000 and $300,000 was lowered to 21.0 percent from 28.0 percent. The amount of capital gains included in income for taxation purposes was cut from 75.0 percent to 66.0 percent.

To foster job creation by firms, Employment Insurance rates paid by workers were lowered from $3.07 per $100 of insurable earnings in 1994 to $2.10 in 2003, a 32.0 percent reduction. To encourage capital formation, capital taxes are scheduled to be eliminated over five years. Finally, taxation differentials across sectors were reduced.

1999–2002 Regulatory Reform
A strong regulatory environment plays a key role in attracting investment and promoting innovation. In 1999, the government put in place a new regulatory policy, (Regulatory Impact Assessment), to ensure that government regulation generated the greatest net benefit to Canadians. In the 2002 Speech from the Throne, the Government of Canada announced a smart regulation strategy that would contribute to innovation and economic growth and reduce the administrative burden on business. The 2003 Budget provided $4 million over two years to fund an External Advisory Committee to recommend areas where the government needs to redesign its regulatory approach to create and maintain a Canadian advantage.

2001 Financial Sector Reforms (2001)
Between 1992 and 1998, the government established a demutualization regime for insurance companies to facilitate technological change and restructuring within the industry.

To encourage competition, Canada took measures to facilitate entry into the payments and banking systems, including entry by foreign banks. A consumer protection agency for federal financial institutions was established in 2001. Currently, efforts are underway to simplify securities regulation in Canada.

Canada has taken steps to ensure confidence in Canadian markets in the wake of the Enron affair and subsequent corporate scandals. The Canadian Public Accounting Board (created July 2002) will administer and enforce a new system of auditor oversight. New draft guidelines by the Accounting Standards Board (AcSB) and securities regulators aim at improving the transparency of financial statements.

2003 Continued Trade Liberalization
As of January, all products from the least developed economies became eligible for duty and quota-free entry, with the exception of certain dairy, poultry and egg products. Progress is being made on eliminating duties on textiles and clothing in accordance with the 2005 deadline under the Agreement on Textiles and Clothing.

2003 Expenditure Review
Following the success of the 1995 Program Review, the government launched announced an ongoing review of all non-statutory programs in 2003 to ensure they continue to be relevant, effective and affordable. Over a five-year cycle the Treasury Board will examine the programs of federal departments and agencies, to determine systematically whether the program is still relevant to the needs of Canadians and whether the program's resources are being used in the most efficient and effective way to deliver appropriate results.

Results

Canada has made a number of structural reforms over the past 15 years with an eye to improving the efficiency of the economy, and ultimately, long-term growth. Government spending was reduced and deficit targets were established to halt the vicious cycle of deficit and debt. The resulting surpluses were used to reduce taxes on individuals and businesses. The Bank of Canada established the credibility of its inflation targets that facilitated the conduct of monetary policy and allowed the bank to respond quickly and effectively to changing economic conditions. Economic and social policies were structured to help Canadians acquire skills, adapt to change and participate in the labour market with confidence. Trade agreements allowed Canadian businesses to make the most of opportunities in foreign markets. Employment insurance reform reduced and restructured benefits with a view to strengthening incentives to work. Fiscal discipline and a stronger economy allowed the government to make strategic investments in research and innovation. Increased funding was provided to support the development of new ideas and to help businesses bring new concepts to market.

The structural reforms implemented in Canada together with a favourable international climate have led to renewed income and productivity growth. Today, the Canadian economy is much better placed to weather an economic downturn than it was in the early 1990s, as evidenced by the recent global slowdown in which Canada avoided recession. Economic imbalances have given way to solid fundamentals which will help support the economy through any future slowdown.

CHILE

REAL GROSS DOMESTIC PRODUCT GROWTH

The Chilean economy had a recovery in 2004, with a GDP rate of growth of 6.1 percent in a favorable international environment. Domestic demand experienced a greater expansion of private consumption and investment, in a context of improving labor conditions.

Exports of goods and services expanded by 12.8 percent this year, due to the rise of 14.1 percent in the exports of goods and 8.0 percent in the export of services, which added 3.7 percent and 0.6 percent, respectively, to the growth rate of GDP. Exports from the mining sector displayed a noticeable growth due the favorable performance of copper exports. Exports of industrial goods also displayed a sharp increase, highlighted by the export of a wide array of products, specially from the following sectors: foodstuffs; wood and furniture; paper and printed products; and metallic goods, machinery and equipment.

INFLATION

Price increases in 2003 were lower than expected, due to the impact of supply factors, such as the peso appreciation and less compressed margins in specific sectors, reflecting greater competition and/or efficiency gains in the production and distribution chains of non-perishable goods and fuels. In December 2004, the annual consumer price inflation (CPI) was 2.4 percent.

EMPLOYMENT

Chile’s unemployment rate was 8.8 percent up to November 2004, and 7.8 percent in the last three months of 2003. Up to November 2004, employment increased by 153,000 jobs, in comparison to the same period of the previous year (a 2.7 percent annual increase). Discounting seasonality, there were 120,000 jobs created between the moving quarters ending in July and November (equivalent to a 2.1 percent increase).

BALANCE OF PAYMENTS

In the external sector, the volume of export goods rose by close to 50 percent. This increase was mainly due to the growth observed in the volumes and prices of shipments of mining and industrial goods, which showed an increase in value in terms of US dollars of 94.4 percent and 25.5 percent, respectively. The accumulated value of exports was close to 32 billion US$, which constitutes an historic record.

In 2004, the balance of payments posted a current account surplus close to US$1.9 billion, which represents close to 2.0 percent of GDP. This result is explained by a surplus in the goods and transfers accounts, which reached US$9 billion and US$0.9 billion, respectively. These figures were partially counter-balanced due to deficits in the rents and services accounts that registered net outflows of US$7.5 billion and US$0.5 billion, respectively.

EXCHANGE RATE

The floating exchange rate system has continued to ensure that the exchange rate is the main variable when correcting for domestic and external changes affecting Chile’s economy. Thus, the US dollar’s weakness in the main financial markets, better financial conditions, and the improved terms of trade associated with trends in the copper price, explain most of the real appreciation.

This loss of value of the US dollar against most currencies in the world is believed to be the main element behind the exchange rate swings of recent months. In this context, since the last *Report* the Chilean peso has appreciated by 8.7 percent, 4.0 percent and 1.5 percent with respect to the dollar, the yen and the euro, respectively. In summary, the peso has experienced a smaller multilateral appreciation, in both real and nominal terms. Once the effects of the depreciation of the dollar in the prices of commodities and in global activity, there should not be any additional effect on the real value of the peso, especially considering the meagre net capital flows into emerging economies.

FISCAL POLICY

The short-term fiscal outlook has remained stable. The central government's 12-month accumulated budgetary surplus reached 2.9 percent of GDP with important annual growth in revenues (23.3 percent), combined with a rise in budgetary spending in line with previous months (5.1 percent).

The substantial improvement in external and domestic conditions has been behind a significant rise in national income, particularly in the case of the public sector. The central government boosted savings significantly, given the temporary nature of most of these revenues and its own fiscal policy, and saving is estimated to have reached more than 2.0 percent of GDP—as of October, the government's projection was 1.9 percent—which was substantially higher than budgeted for in the 2004 annual budget (-0.1 percent of GDP).

As of the third quarter of 2004, the total accumulated balance, as per the central government's definition, had reached 1.8 percent of GDP, while the structural surplus accumulated during the first nine months stood at 0.7 percent of GDP, both in line with the general surplus expected for 2004.

In June 2004, net central government debt reached 5.9 percent of GDP, one percentage point lower than in December 2003 because of the actual surplus and GDP growth. Gross debt, meanwhile, went from 13.3 percent to 12.8 percent of GDP between late 2003 and June 2004. Given the large surplus in fiscal spending to date, the government made prepayments and deposits to the copper compensation fund (*Fondo de Compensación del Cobre*). The Central Bank's net debt, meanwhile, went from 0.5 percent to –0.2 percent of GDP in the same period. The consolidated net debt of central government and the Central Bank fell from 7.4 percent to 5.7 percent of GDP in the same period, and by late 2004 it had reached about 5.0 percent of GDP. The consolidated gross debt fell from 34.3 percent of GDP in December 2003 to 32.3 percent in June 2004.

MONETARY POLICY

Monetary policy remains expansionary, although it has not become more so since mid-2004, when the process of reducing the strong monetary stimulus began. Loans continue to perform well, companies continue to use financing sources other than bank credit, bank interest rates have increased (although they are still low), and monetary aggregates have risen at significant rates.

Since September 2004, the Central Bank's Board has applied a steady reduction to the strong monetary stimulus, consistent with keeping inflation at about 3.0 percent annually over the usual policy horizon. Since then, the monetary policy rate (MPR) has been increased by 75 basis points to 2.5 percent.

After a strong rise in September, interest rates on Central Bank instruments fell and in general they now stand at moderately higher levels than those prevailing 2003, especially for nominal short-term and indexed instruments.

Since 2003, interest rates on indexed instruments (BCU) have risen by about 20 to 60 basis points, reaching from 2.6 percent to 3.2 percent for five and ten-year maturities. Interest rates on two- and five-year nominal bonds (BCP) have risen by 40 and 90 basis points to reach 3.9

percent and 5.0 percent, respectively. Only interest rates on ten-year peso bonds have not changed, remaining at 5.9 percent, while interest rates on PDBC-90s remain at around the MPR.

The slope of the forward curve derived from the structure of short-term interest rates reveals that agents expect monetary impulse to decline gradually. The market anticipates a 70 basis point rise in the MPR during the first half and a further 75 basis point rise in the second. Compared to September 2003, these expectations have risen, which indicates the market expects the MPR to rise another 20 basis points by September 2006.

Despite recent increases in the MPR, according to different measures of the neutral real interest rate, in the third and fourth quarters of 2004 monetary policy reached its most expansionary point since the early 1990s. Compared to the previous six months, this increase reflected expectations of rising inflation (the Central Bank's survey of expectations for one year hence reveals an average of 2.3 percent for the first half year, and 2.8 percent for the second.)

MEDIUM-TERM OUTLOOK

Toward the medium term, however, faster than expected closing of gaps will counterbalance reduced price pressures, so the inflation forecast for the end of the projection horizon is not materially different from was expected from mid-2004. As a result of the gradual normalization of the monetary impulse, among other factors, CPI inflation is expected to reach an average of 2.9 percent per annum during 2006, and 3.2 percent at the end of the projection horizon, due to the fact that core inflation will continue on a similar upward trend as it showed in 2004, after the deceleration of late 2003, and be barely above 3.0 percent toward 2006. In this context, it believed that the Central Bank will be able to continue with the gradual normalization of monetary policy, whose precise pace will depend on how the relevant indicators unfold over time. As a working assumption, projections have been based on the monetary policy interest rate increasing at a barely higher pace than the one implicit in asset prices in the last two weeks, and consistent with CPI inflation's gradual convergence to 3.0 percent.

The main risk scenarios are associated with how the world economy will perform in the coming years. The gradual slowdown of world activity could be sharper than forecast, especially in the context of a strong and disorderly adjustment of current accounts, interest rates and currencies in the main economic areas. The international oil market continues to be tight, and the risk of geopolitical problems persists, so the oil price may deviate from the path considered in the projected baseline scenario, or its contractionary effects on the world economy may exceed present estimates. In any case, as opposed to recent years, the increased financial strength shown by emerging economies—Chile included—makes them less vulnerable to these developments.

Locally, the greater uncertainties are believed to come from the possibility that domestic output and expenditure could react more intensely than foreseen to the current favourable macroeconomic conditions. The baseline scenario considers that output surprises of the past few months will not be repeated. However, the large increases that the various monetary aggregates continue to show may be an indication that this dynamism will persist. Also, it cannot be ruled out that the improved outlook of the labour market, the better growth prospects or more optimistic expectations will originate an increase in consumption and investment that will exceed those considered in the baseline. On the price and cost side, alternative scenarios can be outlined where margin pressures result in a faster acceleration of underlying prices than that considered in the baseline scenario. The effects of the legal reduction in the working day over the economy at large are yet to be seen. It is also important to consider scenarios where the exchange rate experiences a new appreciation over and above the one observed so far, for example, because of an additional depreciation of the US dollar in international markets. Finally, estimations consider that problems in the provision of natural gas from Argentina, if similar in magnitude to the shortages of last year, will have no major macroeconomic implications, aside from their effects on specific sectors.

The implications of alternative scenarios over monetary policy in Chile depend critically on how they show up in medium-term inflationary pressures. Overall, it is estimated that these scenarios configure a balance of risks that is in equilibrium for growth and upward biased, in the medium term, for inflation.

ANNEX I

CHILE: OVERALL ECONOMIC PERFORMANCE

	1999	**2000**	**2001**	**2002**	**2003**	**2004** [I]
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	72,995	75,210	68,568	67,266	73,374	94,100
Real GDP	-0.8	4.5	3.4	2.2	3.7	6.1
Consumption	-0.4	3.6	2.9	2.5	3.9	5.2
Private Consumption	-1.0	3.7	2.9	2.4	4.1	5.6
Government Consumption	2.7	3.0	2.9	3.1	2.4	3.0
Investment	-18.2	8.9	4.3	1.5	5.7	12.7
Private Investment	-20,9	12.0	13.0	4.4	10.3	10.4
Government Investment	-3.4	-12.7	8.1	5.5	-1.9	3.8
Exports of Goods and Services	7.3	5.1	7.2	1.6	5.9	12.8
Imports of Goods and Services	-9.5	10.1	4.1	2.3	9.5	18.6
Fiscal and External Balance (percent of GDP)						
Budget Balance	-2.1	-0.6	-0.5	-1.2	-0.4	2.2
Merchandise Trade Balance	3.3	2.8	2.7	3.5	4.8	9.6
Current Account Balance	0.1	-1.2	-1.6	-0.9	-1.5	1.5
Capital and Financial Non-reserve Assets Balance	0.3	1.0	2.0	2.6	2.3	-0.6
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	2.4	4.6	3.8	4.2	5.5	6.6
CPI	3.3	3.8	3.6	2.5	2.8	1.1
M2 [II]	10.6	8.4	7.0	9.2	-1.6	21.8
Short-term Interest Rate (percent) [III]	10.6	10.76	6.96	3.81	2.77	1,81
Real Effective Exchange Rate (level, 1995=100)	5.5	4.5	11.3	1.2	7.7	-4.9
Unemployment Rate (percent)	9.8	9.2	9.0	9.0	8.5	8.8
Population (millions)	15.0	15.2	15.4	15.6	15.8	16.0

ANNEX II

CHILE: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	IMF	ADB	OECD	PECC	Link	Official	IMF	ADB	OECD	PECC	Link [iv]
Real GDP	4.5-5.5	4.5	N.A.	N.A.	4.5	N.A.	5.25-6.25	5.8	N.A.	N.A.	5.5	5.0
Exports	4.8	N.A.	N.A.	N.A.	6.0	N.A.	5.6	N.A.	N.A.	N.A.	6.7	5.5
Imports	7.5	N.A.	N.A.	N.A.	6.0	N.A.	6.9	N.A.	N.A.	N.A.	9.5	9.5
CPI	3.0	3.0	N.A.	N.A.	2.5	N.A.	3.2	3.3	N.A.	N.A.	3.0	3.5

ANNEX III

CHILE: MEDIUM-TERM TREND FORECAST (percent)

	Period
Real GDP [v]	4.2
CPI [vi]	2.9

Notes:

[1] Preliminary figures.

[ii] M2=M2A Currency +demand deposits in checking accounts of the non financial private sector net of float + demand deposits not included in checking accounts +demand saving deposits+ time deposits of the private sector

[iii] Short interest rate is 90 days “Pagaré descontable Banco Central de Chile” (PDBC)

[iv] IIF

[v] FMI

[vi] Banco Central de Chile

CHINA

In 2004, China’s economy maintained steady and rapid development, overall economic strength increased, significant progress was made in reform, breakthroughs were achieved in ‘opening up’, social development was accelerated, and people's lives improved.

REAL GROSS DOMESTIC PRODUCT GROWTH

China's GDP in 2004 reached US$1,649.2 billion, an increase of 9.5 percent over the previous year. The completed investment in fixed assets of the economy in 2004 was US$846.7 billion, up by 25.8 percent over the previous year, or 1.9 percentage points lower as compared with the growth in 2003. Retail sales of consumer goods totaled US$652.4 billion, up 13.3 percent. The volume of imports and exports totaled US$1.15 trillion, an increase of 35.7 percent, moving China up to third place in the world from fourth in the previous year. Urban per capita disposable income was US$1138.4, an increase of 7.7 percent in real terms after allowing for price factors, and rural per capita net income was US$354.7, up 6.8 percent in real terms after allowing for price factors.

In the first quarter of 2005, China’s GDP grew by 9.4 percent. As the result of macro-economic adjustment, total fixed assets investment increased by 25.3 percent, 22.7 percentage points lower than the same period of 2004.

INFLATION

The general level of consumer prices in China for the year was up by 3.9 percent over the previous year. Of this total, the prices for service items were up 2.3 percent. The retail prices of commodities were up by 2.8 percent, while the producers’ prices for manufactured goods increased by 6.1 percent, and the purchasing prices for raw materials, fuels and power went up by 11.4 percent. The prices for investment in fixed assets were up 5.6 percent. Producers’ prices of farm products were up by 13.1 percent. In the first quarter of 2005, CPI was up by 2.8 percent, mainly driven by food prices, which were up by 6.1 percent year-on-year (y-o-y).

EMPLOYMENT

Work related to employment, reemployment and social security to promote harmonious social development is being energetically supported and funding for reemployment subsidies has been increased by US$268.8 million, up 54.6 percent year-on-year. Local authorities also made corresponding allocations for employment subsidies, effectively contributing to employment and reemployment efforts. The "two guarantees" [a guarantee of a basic living allowance for workers laid off from state-owned enterprises and a guarantee that the pensions of retirees are paid on time and in full, tr.] have been successfully maintained and work continued to ensure that the urban poor receive subsistence allowances. The central government spent US$1.7 billion on basic living allowances for laid-off workers to ensure they were paid on time and in full and took concrete measures to incorporate the allowances into the unemployment insurance system. US$6.3 billion in transfer payments for old-age insurance were paid, guaranteeing that basic pensions for workers retiring from state-owned enterprises were paid on time and in full. In addition, allocations from the central budget were used to support pilot programs to improve urban social security systems in Jilin and Heilongjiang provinces.

In 2004, about 9.8 million new jobs were provided to urban residents, 800,000 more than the expected target, and 5.1 million laid-off workers were re-employed. The urban registered unemployment rate was 4.2 percent at the end of 2004, or 0.1 percentage point lower than that in 2003.

BALANCE OF PAYMENTS

Total value of imports and exports in 2004 reached US$1,154.8 billion, up 35.7 percent over the previous year. Of this total, the value of exports was US$593.4 billion, up 35.4 percent, and the value of imports was US$561.4 billion, up 36.0 percent. China had a trade surplus of US$32.0 billion, an increase of US$6.5 billion as compared with that in the previous year.

The year 2004 witnessed the approval of establishment of 43,664 foreign direct invested enterprises in China, up by 6.3 percent over the previous year; the contracted foreign capital through foreign direct investment stood at US$153.5 billion, up 33.4 percent; and the foreign capital actually utilized was US$60.6 billion, up 13.3 percent.

In 2004, the accomplished business revenue through contracted overseas engineering projects was US$17.5 billion, up by 26.0 percent, and the business revenue through overseas labor contracts was US$3.8 billion, up by 13.4 percent.

In 2004, a total of 109.04 million international visitors came to China for tourist, business or family reunion purposes, an increase of 19.0 percent year-on-year. Of all the international tourists, overnight visitors accounted for 41.76 million, up 26.7 percent. Foreign exchange earnings from international tourism topped US$25.7 billion, up 47.9 percent. A total of 28.85 million Chinese visitors went abroad, up 42.7 percent. Of this total, 22.98 million were on private visits, a year-on-year rise of 55.2 percent, and 79.7 percent of all outgoing visitors.

In the first quarter of 2005, total exports and imports reached US$295.2 billion, up 23.1 percent, of which imports were US$139.3 billion (up 12.2 percent), exports, were US$155.9 billion (up 34.9 percent), and recorded a surplus of US$5.73 billion.

GROSS EXTERNAL DEBT

By the end of 2004, except for Hong Kong, China; Macao SAR and Chinese Taipei, the recorded balance of the foreign debts amounted to US$228.6 billion, US$34.97 billion more than the previous year (up by 18 percent). The long-term and mid-term debts were US$124.29 billion, which accounted for 54.37 percent, up by 6.6 percent; while short-term debts reached US$104.31 billion, US$27.27 billion more than the previous year.

EXCHANGE RATE

The renmimbi (RMB) exchange rate remained stable; the year-end exchange rate was 8.2765 RMB to 1 USD, which was 2 basis points higher than that at the end of the previous year. By the end of 2004, China's foreign exchange reserves reached US$609.9 billion, an increase of US$206.7 billion as compared with that at the end of the previous year. By the end of June 2005, China's foreign exchange reserves reached US$711.0 billion, an increase of US$101.0 billion, and US$33.7 billion more, compared with the increased amount of the same period of 2004. The foreign exchange reserves were from foreign direct investment (FDI) and trade surplus.

FISCAL POLICY

From a base of just over US$241.6 billion for 2003, China's revenue rose to US$318.4 billion (excluding revenue from generation of debt, both here and below), US$56.1 billion or 21.4 percent more than the previous year and representing 111.8 percent of the budgeted figure. Expenditures totaled US$342.7 billion, an increase of US$44.8 billion or 15.1 percent year-on-year and representing 105.9 percent of the budgeted figure. Expenditures exceeded revenue by US$24.2 billion.

Total revenue in the central budget amounted to US$182.2 billion, up US$26.0 billion (after deducting the additional US$15.4 billion used for export tax rebates), or 16.6 percent over the previous year and representing 109.1 percent of the budgeted figure. Total expenditures in the central budget came to US$220.8 billion (including US$125.4 billion in tax rebates and subsidies for local authorities), US$25.9 billion or 13.3 percent more than the previous year and representing 107.4 percent of the budgeted figure. The deficit in the central budget was US$38.6 billion, less than that approved at the Second Session of the Tenth NPC.

MONETARY POLICY

By the end of 2004, the broad money supply (M2) was US$3.05 trillion, reflecting a year-on-year increase of 14.6 percent. Narrow money supply (M1) was US$1.16 trillion, up 13.6 percent. Cash in circulation (M0) was US$253.7 billion, up 8.7 percent. Savings deposits in renminbi and foreign currencies in all financial institutions totaled US$3.06 trillion at the end of 2004, up 15.3 percent. Loans in renminbi and foreign currencies by all financial institutions reached US$2.28 trillion, up 14.4 percent.

MEDIUM-TERM OUTLOOK

The year 2005 is crucial for accomplishing all the tasks of the Tenth Five-Year Plan (2001–2005) and for laying a solid foundation for development during the Eleventh Five-Year Plan (2006–2010). The main targets for this year's economic and social development are as follows: GDP growth around 8.0 percent, 9 million new jobs for urban residents, registered urban unemployment rate within 4.6 percent, a rise in the consumer price index of no more than 4.0 percent, and a basic balance in international payments.

STRUCTURAL REFORM

1. *Continuing rural reforms*. The reform of rural taxes and administrative charges constitutes a profound transformation of the rural economic and social framework. The government will exempt farmers from the agricultural tax and eliminate all unreasonable financial burdens on them, a complete reversal of the practice that has lasted more than two millennia: farmers paying grain tax to the government for working the land. Attaining this goal is only the first step in our reform of rural taxes and administrative charges. The government will work harder, as it has a long way to go to solidify what it has achieved in this reform. New conflicts and problems in the reform will be resolved as soon as they arise, concentrating on the underlying reforms of government institutions at the town and township level, the rural compulsory education system, and the financial management system for counties and townships. This will be a more important, complicated and arduous task. In addition, the government will deepen the reform of the grain distribution system, rural financial reforms, and the reform of the rural land management system.

2. *Deepening the reform of state-owned enterprises*. This reform continues to be the central link in economic restructuring, and it must proceed unwaveringly in accordance with the principles and policies set by the Central Committee and the State Council.

First, the government will continue to strategically readjust the distribution and structure of the state-owned sector of the economy and improve the mechanism for ensuring rational distribution of state funds by increasing investment in some areas and pulling it out of others. It will energetically develop large companies and large enterprise groups that own intellectual property rights, have ‘name brand’ products and are internationally competitive.

Second, the government will speed up the transformation of large state-owned enterprises into stock companies. It will improve corporate governance and change the operational mechanisms of enterprises to meet the requirements for a modern enterprise system. A system for annually assigning responsibility for an enterprise’s performance and a system for holding enterprise executives responsible for their work during their terms of service will be instituted. The government will standardize the system of benefit packages for these executives.

Third, the process of relieving state-owned enterprises of the obligation to operate social programs will be accelerated. The government will continue to carry out policy-based closures and bankruptcy proceedings for enterprises, and a legal mechanism will be established for declaring them bankrupt.

Fourth, reform of the of the government, telecommunications and civil aviation industries will be deepened and reform of the postal and railway systems and urban public utilities continued by liberalizing market access and instituting competitive mechanisms. The government will improve the management system and the methods of oversight for state assets and institute a budget system for the use of state capital. It will standardize the procedures for transforming state-owned enterprises and for transferring state equity, to prevent erosion of state assets and protect the legitimate rights and interests of employees. The reform of collectively owned enterprises and promote the development of a diversified collective sector of the economy will be deepened.

3. *Encouraging, supporting and guiding the development of the non-public sector of the economy*. The government will conscientiously implement the State Council's Guidelines for Encouraging, Supporting and Guiding the Development of the Non-Public Sector of the Economy, Including Self-Employed Workers and Private Companies, so as to create a legal, policy and market environment that ensures fair competition for all non-public enterprises. More industries and fields will be opened to non-public capital, and financing channels for non-public enterprises will be widened. Private property and the rights and interests of these enterprises will be protected in accordance with the law. These enterprises will be better served and supervised. They need to improve their quality, and they must abide by the laws, regulations and policies of the state, conform to regulations for industrial safety and environmental protection, and guarantee the legitimate rights and interests of their employees.

4*. Accelerating the reform of the financial system*. This is an important task affecting the overall interests of reform and development. The government will accelerate the reform of state-owned commercial banks by carrying forward the successful pilot program turning them into stock companies. The reform of policy banks and other commercial banks will be carried forward. The government will vigorously yet steadily develop financial institutions with different forms of ownership. It will continue working hard to implement the State Council's Guidelines for Promoting the Reform, Opening Up and Steady Growth of the Capital Market. It will strengthen the infrastructure of the capital market and formulate sound regulations for it so as to protect the legitimate rights and interests of investors, particularly non-government investors, thereby creating a favorable environment for its steady and sound development. The reform of the insurance industry and standardize order in the insurance market will be deepened. The government will steadily deregulate interest rates to leave them to market forces, and reform the mechanism for setting the exchange rate for the renminbi and keep it basically stable at a proper and balanced level. The system of financial oversight and management will be improved and our financial oversight and management work will be strengthened and improved.

5*. Promoting reform of fiscal and tax systems and the investment system*. The government will strengthen the public finance system and improve and standardize the system of transfer payments from the central government. Fiscal systems at and below the provincial level will be improved. The VAT reform will be carefully carried out on a trial basis in selected areas, and a plan will be formulated for implementing the reform in all other areas. The mechanism for granting export tax rebates will be improved. Reform of the budget management system will be deepened. The government's decision on reforming the investment system will be fully carried out, and methods for implementing it will be formulated. The systems for examining and approving projects and keeping records will be improved. A system for regulating investment from all sectors of society and that meets the needs of the new situation will be established. The government will standardize the scope and procedures for government investment, improve the monitoring system, and formulate a responsibility system for investments made by government bodies and state-owned enterprises and a system for assigning responsibility for bad investment decisions in order to eradicate the problem of no one being held accountable for them.

6. *Strengthening the market system*. The government will energetically develop the market for factors of production. It will standardize and develop the equity exchange market. The reform of the distribution system will be continued, and modern distribution methods will be vigorously developed. Price reforms will be deepened to better balance price relationships. The government will thoroughly rectify and standardize order in the market, focusing on continuing the work of cleaning up the markets for food and medicine, which have a direct bearing on people's health and safety. It will continue to rectify and standardize the agricultural equipment and supplies, construction and real estate markets. A campaign to protect intellectual property rights will be launched. The government will crack down severely on pyramid schemes and all other types of fraudulent commercial activities, as well as economic crimes such as smuggling, tax evasion and fraud, and money laundering. The establishment of a credit system for the general public will be accelerated.

This year the government is faced with many new situations as the economy opens up to the outside world. Tariffs need to be reduced to the level promised when China joined the WTO, most non-tariff measures need to be eliminated, and the services sector needs to be opened wider to foreign competition. The government will respond to these new situations to ensure success in opening up.

First, improvement in the growth pattern of foreign trade will be speeded up. The export mix will be improved, upgrading of the processing trade promoted and continued growth of exports ensured. The government will continue to effectually import energy, important raw materials, key technologies and major equipment. It will reform the system of port management, simplify customs clearance procedures and handle international trade frictions and disputes properly.

Second, the government will continue to utilize foreign capital energetically and rationally. It will improve the performance of foreign capital and better integrate efforts to attract foreign investment with efforts to improve the economy's industrial structure and technological level. Foreign investors will be encouraged to invest in new and high technology industries, modern services, modern agriculture and the central and the government stern regions. It will keep the number of projects that consume excess quantities of resources and that are highly polluting to a minimum.

Third, the government will further implement the “go global” strategy. It will encourage qualified enterprises to invest and do business in other economies, give them more credit, insurance and foreign exchange support, and strengthen guidance and coordination for enterprises operating abroad. A sound system for managing and supervising state assets abroad will be developed.

Fourth, the government will do all work for the transition period of our entry into the WTO promptly and will continue to develop multilateral and bilateral economic relations and actively participate in regional economic cooperation.

ANNEX I

CHINA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	991.1	1080	1159	1237.1	1409.9	1649.2
Real GDP	7.1	8.0	7.3	8.0	9.1	9.5
Consumption	7.9	10.4	8.1	10.2	9.2	10.2
Private Consumption	6.8	9.5	6.9	13.6	7.7	10.6
Government Consumption	12.0	13.8	12.2	18.2	6.8	8.8
Investment	5.2	9.3	12.1[1]	16.1	26.7	25.8
Private Investment	-	-	-	-	-	-
Government Investment	-	-	-	-	-	-
Exports of Goods and Services	6.1	27.8	6.4	22.3	34.6	35.4
Imports of Goods and Services	18.2	35.8	8.2	21.2	39.9	36.0
Fiscal and External Balance (percent of GDP)						
Budget Balance	-2.1	-2.8	-2.6	-3.0	-2.7	2.3
Merchandise Trade Balance	2.9	2.23	1.6	2.5	1.8	1.9
Current Account Balance	1.07	1.90	1.5	2.86	3.26	4.16
Capital and Financial Non-reserve Assets Balance	0.01	0.18	3	2.61	3.7	6.67
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	-3.0	0.9	0.0	-1.3	3.9	6.9
CPI	-1.4	0.4	0.7	-0.8	1.2	3.9
M2	14.7	12.3	14.4	16.8	19.6	14.6
Short-term Interest Rate (3 months) (percent)	1.98	1.71	1.71	1.71	1.71	1.71
Real Effective Exchange Rate (level, 1995=100)	8.28	8.28	8.2766	8.2773	8.2767	8.2765
Unemployment Rate (percent)	3.1	3.1	3.6	4.0	4.3	4.2
Population (millions)	1259.1	1265.8	1276.3	1284.5	1292.3	1,299.88

ANNEX II

CHINA: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	IMF	ADB	OECD	PECC	Link	Official	IMF	ADB	OECD	PECC	Link
Real GDP	9.5	9.5					8	8.5				
Exports	35.4											
Imports	36.0											
CPI	3.9	3.9					4	3.0				

ANNEX III

CHINA: MEDIUM-TERM TREND FORECAST (percent)

	2006–2010
Real GDP	7.0
GDP Deflator	3.0

HONG KONG, CHINA

REAL GROSS DOMESTIC PRODUCT

The economy of Hong Kong, China entered into a full-fledged upturn in 2004, following the swift rebound in the second half of 2003 after the waning of the negative impacts due to the severe acute respiratory syndrome (SARS). This once again demonstrated the resilience and strength of the economy of Hong Kong, China. For 2004 as a whole, the gross domestic product (GDP) grew by a remarkable 8.2 percent in real terms, distinctly faster than the 3.1 percent growth in 2003. The economy continued to expand at a brisk pace in the first half of 2005, with GDP growing by 6.2 percent in the first quarter and 6.8 percent in the second quarter. On a seasonally adjusted quarter-to-quarter comparison, GDP expanded for the eighth straight quarter, by 3.0 percent in real terms in the second quarter of 2005. The growth continued to be broad-based, underpinned by strong growth in merchandise exports and exports of services, pick-up in investment demand as well as steady growth in consumer demand.

Externally, merchandise exports sustained remarkable growth throughout 2004, boosted by sturdy demand in all the major markets. Merchandise exports held up strongly in the first half of 2005, thanks to the sustained expansion of the global economy as well as the China's strong trade flows. Exports to nearly all major markets maintained strong growth momentum. In particular, the growth in exports to both the US and the EU picked up further. Exports to China also accelerated, amidst its vibrant industrial activity. Apart from this, the increasing competitiveness of China's products in the world market, coupled with the weakness of the US dollar in the past year, also rendered a further boost to Hong Kong's exports. Total exports of goods grew further by 10.5 percent in real terms in the first half of 2005, following a strong growth of 15.3 percent for 2004 as a whole.

On invisible trade, exports of services grew noticeably further, by 8.3 percent in real terms in the first half of 2005, following a remarkable 15.3 percent growth for 2004 as a whole. Of particular note was the continued surge in exports of trade-related services, supported by the strong trade flows, and the further increase in exports of travel-related services, underpinned by vibrant inbound tourism. Visitors arrivals from the long-haul destinations such as the US and Europe, as well as from Japan and Southeast Asia, all recorded strong double-digit growth in the first seven months of 2005. The growth in the number of visitors from China slowed somewhat in the first seven months of 2005, following a high growth in 2004 reflecting the implementation of the Individual Visitor Scheme. Conceivably some residents of China might have postponed their leisure trips to Hong Kong, China, ahead of the opening of the Hong Kong Disneyland in September 2005.

The domestic sector has also picked up further. Private consumption expenditure grew by 6.8 percent in real terms in 2004, and further by 3.5 percent in the first half of 2005 over a year earlier, as consumer sentiment remained upbeat on the back of the improving job opportunities and the resurgence of labour income. The positive wealth effect from the cumulative surge in property prices was also contributory. Overall investment spending picked up further, rising by 2.0 percent in real terms in the first half of 2005 over a year earlier, following a 4.1 percent increase for 2004 as a whole. The better economic prospects, grounded on the increasingly entrenched economic recovery, gave a significant boost to overall business confidence. Investment in machinery and equipment picked up strongly as the continued expansion of commercial activity at a relatively robust pace gave rise to a genuine need to accelerate the investment plans. As to expenditure on building and construction, the fall in private sector activity continued into the first half of 2005, as not many large-scale building projects were launched in the past several quarters. Public sector building and construction activity was also subdued, reflecting the scale-back of the Public Housing Programme and the completion of the two key railway projects last year.

The economy of Hong Kong, China, continued to cruise well in July 2005. So far, the dampening impacts of interest rate increases and higher oil prices on overall consumer spending have been rather moderate. In July, retail sales continued to grow solidly, by 5.6 percent in real terms over a year earlier, while merchandise exports grew by 8.1 percent in value terms over a year earlier, supported by continued steady to strong growth in the China, the US and the EU markets.

The short-term outlook for the economy of Hong Kong, China remains favourable. The local interest rate rises, which have been taking place at a gradual and rather predictable pace, have so far had only a slight dampening effect on overall economic growth, apart from leading to some recent cooling-off in property market activity. According to the latest forecast released by the government in August, the forecast real GDP growth for 2005 as a whole is maintained at 4.5 to 5.5 percent. But given the favourable outturn in the first half of 2005, GDP growth for 2005 is likely to be closer to the upper end of the range forecast. The scope for any further upside, however, is limited by various uncertainties including those stemming from soaring oil prices and lately also by the dampening caused by Hurricane Katrina on US economic growth.

INFLATION

The economy of Hong Kong, China, came out of the 68-month long deflation in mid-2004. For 2004 as a whole, the decline in overall consumer prices, as measured by the composite consumer price index (CPI), narrowed to 0.4 percent in 2004 from 2.6 percent in 2003. Consumer price inflation in 2005 has been gradually edging up, along with the increasingly entrenched economic recovery, and as the dragging effect of the earlier fall-offs in private housing rentals gradually waned. For the first seven months of 2005 as a whole, consumer price inflation was still very moderate, averaging at only 0.7 percent. The near-term inflation outlook is for a further rise in the coming months, as local business costs are expected to rise in the course of an increasingly entrenched recovery, and high oil prices and the recent 2.0 percent renminbi revaluation will feed through to lift import prices. Still, on the whole, local price pressures are expected to be well contained through the end of 2005. For 2005 as a whole, the forecast rate of change in the composite CPI is at 1.5 percent.

EMPLOYMENT

Labour market conditions improved visibly further in 2004, in tandem with the strong revival in overall economic activity. At 6.8 percent, the unemployment rate in 2004 was distinctly below that in 2003, at 7.9 percent. Moreover, the unemployment rate fell almost continuously over the course of the year, from 7.3 percent on a seasonally adjusted basis in the first quarter to 6.6 percent in the fourth quarter, as well as extensively across many different economic sectors, occupation categories and education attainment levels.

This improved unemployment situation was mainly attributable to a strong expansion of 2.8 percent in total employment, which more than offset the 1.6 percent growth in the labour supply. Meanwhile, there was a shift in the employment composition from part-time and temporary workers to full-time workers alongside the upturn in business activity.

In the first eight months of 2005, labour demand remained strong, underpinned by the sustained pick-up in the economy. Total employment went up by 2.2 percent in June – August 2005 over a year earlier, outpacing the 1.1 percent growth in the labour force. As a result, the seasonally adjusted unemployment rate came down further to 5.7 percent, the lowest level recorded since August – October 2001. Also, there was a noticeable reduction in long-term unemployment, both in absolute and proportionate terms.

EXTERNAL TRADE ACCOUNTS

According to the merchandise trade statistics, Hong Kong, China's total exports of goods picked up distinctly further to a 15.9 percent growth in value terms to HK$2,019.1 billion

(US$259.3 billion) in 2004. Imports of goods were likewise robust, leaping by 16.9 percent in value terms to HK$2,111.1 billion (US$271.1 billion) in 2004. On balance, the visible trade deficit reckoned on a GDP basis widened to HK$72.5 billion (US$9.3 billion) in absolute terms. The corresponding ratio to the value of imports of goods was 3.5 percent in 2004. However, benefiting from an enlarged invisible trade surplus of HK$188.1 billion (US$24.2 billion), there was a combined surplus of HK$115.6 billion (US$14.8 billion), equivalent to 5.0 percent of the total value of imports of goods and services, in 2004.

In the first half of 2005, Hong Kong, China's total exports of goods surged further, by 11.6 percent over a year earlier to HK$1,034.1 billion (US$132.7 billion). Imports of goods increased by 9.1 percent to HK$1,085.4 billion (US$139.3 billion) over the same period. On balance, the visible trade deficit reckoned on a GDP basis narrowed, in absolute terms, to HK$39.3 billion (US$5.0 billion). The corresponding ratio to the value of imports of goods was 3.7 percent in the first half of 2005. Together with an enlarged invisible trade surplus of HK$99.0 billion (US$12.7 billion), a combined surplus of HK$59.7 billion (US$7.7 billion), equivalent to 5.0 percent of the total value of imports of goods and services, was recorded in the first half of 2005.

BALANCE OF PAYMENTS

Hong Kong, China's overall balance of payments recorded an enlarged surplus of HK$25.5 billion (US$3.3 billion), equivalent to 2.0 percent of GDP in 2004, compared with a surplus of HK$7.6 billion (US$1.0 billion), equivalent to 0.6 percent of GDP in 2003. The increase was attributable mainly to the marked reduction in net outflow of financial non-reserve assets brought about by the increase in resident banks' external liabilities, comprising mainly loans and deposits from overseas economies. In the first quarter of 2005, a surplus of HK$2.6 billion (US$0.3 billion), equivalent to 0.8 percent of GDP in that period, was recorded. Analysed by major components, the current account surplus narrowed to HK$127.4 billion (US$16.4 billion), equivalent to 9.9 percent of GDP in 2004, while net outflow of financial non-reserve assets in the capital and financial account fell to HK$108.7 billion (US$14.0 billion), 8.4 percent of GDP in the same year. The current account surplus and net outflow of financial non-reserve assets in the capital and financial account were equivalent to 10.4 percent and 15.3 percent of GDP, respectively, in the first quarter of 2005.

GROSS EXTERNAL DEBT

Hong Kong, China's gross external debt amounted to HK$3,366.1 billion (US$433.0 billion) at the end of 2004, equivalent to 260.8 percent of GDP in that year. Reflecting the status of Hong Kong, China, as a regional financial and business hub, more than 90.0 percent of this debt was associated with the normal operations of banks and with inward direct investment. Within the total gross external debt at end-2004, 69.0 percent came from transactions of the banking sector, and 23.6 percent were debt liabilities to affiliated enterprises and foreign direct investors. In the first quarter of 2005, the gross external debt amounted to HK$3,192.7 billion (US$409.3 billion), equivalent to 244.7 percent of GDP in that quarter.

EXCHANGE RATE

As appreciation pressures in late 2003 abated, the Hong Kong dollar exchange rate progressively depreciated towards the convertibility rate of HK$7.8/US$1 during the first four months of 2004. The movement was facilitated by strong-side- operations of the Hong Kong Monetary Authority (HKMA). Thereafter, the Hong Kong dollar exchange rate stayed close to the convertibility rate between April and September 2004, with the Convertibility Undertaking being triggered frequently. The Hong Kong dollar exchange rate started to strengthen again in October 2004, reaching a level of 7.7703 on 8 December 2004. In response, the HKMA conducted numerous strong-side operations. The market exchange rate gradually returned to close to the convertibility rate towards the end of 2004. For 2004 as a whole, the HKMA purchased HK$ 16.63 billion of Hong Kong dollars on a net basis.

The Hong Kong dollar exchange rate stayed close to the weak-side convertibility rate of 7.8 in the first four months of 2005, with the weak-side Convertibility Undertaking being triggered occasionally. In order to make interest rate and exchange rate adjustments more effective, the HKMA introduced three refinements to the Linked Exchange Rate System on 18 May. First, a strong-side Convertibility Undertaking was established at 7.75 to anchor exchange rate expectations on the strong side. Secondly, the weak-side Convertibility Undertaking was gradually shifted from 7.80 to 7.85 to create a symmetric Convertibility Zone around 7.8. Thirdly, the possibility of carrying out market operations consistent with Currency Board principles within the Convertibility Zone was introduced. Financial markets reacted favourably to these measures, with Hong Kong dollar Interbank interest rates rising to track US dollar interest rates more closely, and discounts in the Hong Kong dollar forward market narrowing. Thereafter, the Hong Kong dollar exchange rate strengthened slightly, reportedly attributable to an increased demand for Hong Kong dollars associated with equity initial public offerings in June and expectations of a further renminbi appreciation after a change in the renminbi exchange rate regime in late July. The overall exchange value of the Hong Kong dollar, as measured by the trade-weighted Nominal Effective Exchange Rate Index, rose from 96.0 at end-2004 to 97.4 at end-August 2005.

FISCAL POLICY

The unaudited financial results for 2004–05 (ending on March 31) showed a surplus of HK$21.4 billion or 1.7 percent of GDP in 2004 as compared with the original budget deficit of HK$42.6 billion. As at end-March 2005, fiscal reserves stood at HK$296 billion, HK$20.7 billion more than the balance of HK$275.3 billion at end-March 2004. The increase is due to the surplus of HK$21.4 billion for the year ended 31 March 2005, offset partly by a provision of HK$0.7 billion for the diminution in market value of investments with the Exchange Fund during January to March 2005. The fiscal reserves at end-March 2005 represented 15 months of government expenditure in 2004–05.

The 2005–06 budget forecasts a deficit of HK$10.5 billion, equivalent to 0.8 percent of the forecast GDP for 2005. The budgeted government expenditure represents a growth of some 4.9 percent in money terms over 2004–05.

In the remaining years of the Medium-Range Forecast from 2006–07 to 2009–10, government expenditure is planned to fall at an average annual rate of 0.2 percent in money terms.

MONETARY POLICY

Hong Kong dollar Interbank interest rates increased during the first nine months of 2004, upon continued increases in the US Federal funds target rate. Interest rates then started to ease, attributable to increased liquidity inflows. For 2004 as a whole, the three-month Interbank interest rate rose by only 22 basis points, significantly less than the 125 basis points increase in the US Federal Funds rates. Meanwhile, the best lending rate of banks in Hong Kong, China, was unchanged at 5.0 percent at the end of 2004.

Reflecting a cumulative hike of 125 basis points in the US Federal Funds target rate as well as an outflow of funds after the introduction of the three refinements to the Linked Exchange Rate System, Hong Kong dollar Interbank interest rates increased notably during the first eight months of 2005. Specifically, the three-month Interbank interest rate rose by 347 basis points to 3.75 percent at end-August 2005. Meanwhile, the best lending rate of banks in Hong Kong, China, rose by 175 basis points to 6.75 percent.

The growth rates of Hong Kong dollar narrow money and broad money diverged in 2005. Hong Kong dollar narrow money (HK$M1) declined by 4.0 percent in July 2005 compared with a year earlier, reflecting mainly a fall in demand deposits. The latter was mainly attributable to an increase in deposit rates. Hong Kong dollar broad money (HK$M3) grew strongly, by 9.3 percent in July 2005 from a year ago. The expansion in HK$M3 was generally in line with the pace of economic growth.

Domestic credit increased further upon buoyant economic activity, with loans for use in Hong Kong, China, rising by 9.8 percent in July 2005 from a year ago. The overall quality of the loan portfolio of banks continued to improve. Specifically, the ratio of overdue and rescheduled loans to total loans for retail banks declined from 1.48 percent at end-2004 to 1.13 percent at end-June 2005. Banks remained well capitalised, with a 15.3 percent consolidated capital adequacy ratio for all locally incorporated Authorised Institutions at end-June 2005, well above the standard set by the Bank for International Settlements.

MEDIUM-TERM OUTLOOK

The medium-term prospect for the economy is bright, as Hong Kong, China, will continue to reinforce its existing strengths and identify new areas for development. Hong Kong, China, will continue to serve as an eminent foothold and conduit for business between China and the rest of the world. Also, the closer business links between Hong Kong, China, and other economies in East Asia render added scope. This, coupled with the envisaged benefits derived from further integration and co-ordination with China's economy, will help Hong Kong, China, speed up the process of economic restructuring towards higher value-added services and a knowledge-based economy in the coming years. The productivity growth achieved in the process will help the economy of Hong Kong, China, attain a 4.0 percent trend in GDP growth over the next four years 2006–2009.

STRUCTURAL REFORM

Being a free market economy, the private sector is the prime driver of economic growth in Hong Kong, China, on the back of a very favourable business environment underpinned by a sound legal system, an independent judiciary, a low and simple tax regime, free flows of capital and information, and a clean and efficient government.

As an on-going effort, the government is striving to make the business environment more user-friendly by: conducting a regulatory review to break down barriers and streamline licensing procedures in certain businesses; promoting an e-government programme and e-business in the private sector; and increasing the transparency of the existing regulatory regime to promote fair competition. To meet the needs of Hong Kong, China, in its structural transition to a knowledge-based economy, the government is investing heavily in education and attracting more talented people and professionals from overseas.

To entrench Hong Kong, China's position as an international financial centre, the government continues to enhance corporate governance, and improve the transparency and independence of the regulatory framework for the accounting profession. Also, the new capital adequacy standards for banks under the Basel II framework will be implemented to strengthen risk management capability and stability of the banking system.

The government has worked strenuously in recent years to address the fiscal deficits problem. Operating expenditure has been trimmed considerably, through a reduction in the civil service establishment, adjustment to civil service pay, reprioritisation of service provision, structural reorganisation and streamlining. Coupled with a significant increase in tax revenue amidst a strong economic upturn since mid–2003, additional receipts from land premium and the issue of HK$26 billion government bonds, the consolidated government account reverted to a surplus in 2004–05, the first time since 1999–2000. Discounting proceeds from bond issuances, the consolidated account remained in deficit of HK$4 billion in 2004–05. The Government will continue to maintain fiscal discipline.

ANNEX I

HONG KONG, CHINA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	163.3	168.8	166.5	163.7	158.4	165.7
Real GDP	4.0	10.0	0.6	1.8	3.1	8.2
Consumption	1.4	5.5	2.6	-0.5	-0.6	5.9
Private Consumption	1.4	6.0	2.1	-1.0	-1.0	6.8
Government Consumption	3.1	2.1	6.0	2.5	1.9	0.7
Investment	16.6	11.0	2.6	-4.5	0.9	4.1
Private Investment	-19.8	15.5	3.7	-5.2	0.8	6.2
Government Investment	0.6	-10.3	-2.3	-1.4	1.4	-6.0
Exports of Goods and Services	4.4	16.4	-1.7	9.1	13.1	15.3
Imports of Goods and Services	-0.2	16.8	-1.5	7.5	11.5	13.8
Fiscal and External Balance (percent of GDP)						
Budget Balance	0.8	-0.6	-4.9	-4.8	-3.3	1.7
Merchandise Trade Balance	-3.5	-6.5	-6.7	-4.6	-5.1	-7.1
Current Account Balance	6.3	4.1	5.9	7.6	10.4	9.9
Capital and Financial Non-reserve Assets Balance	-0.4	1.6	-4.7	-13.3	-13.9	-8.6
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	-5.8	-5.6	-1.8	-3.5	-6.4	-3.3
CPI (Composite CPI)	-4.0	-3.8	-1.6	-3.0	-2.6	-0.4
M2 (as at end of year)	8.8	7.8	-2.7	-0.9	8.4	9.3
Short-term Interest Rate (percent, average for the year) [1]	5.84	6.11	3.56	1.79	0.96	0.39
Real Effective Exchange Rate (level, 1995=100)	113.7	108.2	108.2	103.9	96.6	91.4
Unemployment Rate (percent)	6.2	4.9	5.1	7.3	7.9	6.8
Population (millions) (mid- year)	6.6	6.7	6.7	6.8	6.8	6.9

Note:
[1] Three-month HIBOR.

ANNEX II

HONG KONG, CHINA: FORECAST SUMMARY (percent change from previous year)

	2005						2006					
	Official	IMF	ADB	OECD	PECC	Link	Official	IMF	ADB	OECD	PECC	Link
Real GDP	4.5-5.5	4.0	5.4	N.A.	4.7	N.A.	N.A.	4.0	4.3	N.A.	4.1	N.A.
Exports	N.A.	N.A.	12.2[1]	N.A.	10.0[2]	N.A.	N.A.	N.A.	12.3[1]	N.A.	9.1[2]	N.A.
Imports	N.A.	N.A.	12.6[1]	N.A.	9.8[2]	N.A.	N.A.	N.A.	12.1[1]	N.A.	8.9[2]	N.A.
CPI	1.5	1.0	1.2	N.A.	1.5	N.A.	N.A.	1.1	2.2	N.A.	2.0	N.A.

Notes: [1] Of merchandise goods only, in value terms.
[2] Of goods and services, in real terms.

ANNEX III

HONG KONG, CHINA: MEDIUM-TERM TREND FORECAST (percent)

	2006–09
Real GDP	4
GDP Deflator	1.5

INDONESIA

Overall Indonesia's economic performance in 2004 showed a continued momentum of solid expansion, even surpassing the forecast at the beginning of year. Throughout the year, the economy grew rapidly, reaching a post-crisis high of 5.13 percent. The growth was accompanied by a more balanced pattern of expansion, from a prolonged consumption driven economy to a more balanced one with investments and exports playing a bigger role. The high growth resulted from the consistent implementation of policies in achieving macroeconomic stability. In addition, economic agents' optimism—bolstered by a democratic, safe, and orderly Indonesian election—lent further support.

These positive macro-economic developments in 2004, which continued to the first quarter 2005, have provided hope for further improvement of the Indonesian economy in the year ahead. Economic growth is forecast to reach 5.5 percent to 6 percent in 2005, despite the calamity of the tsunami in Aceh and North Sumatra, and is expected to reach 5.5–6.5 percent in 2006. This positive outlook is driven by buoyant investment, despite the slower growth of global economy compared to the previous year. Investment and exports in 2005 are expected to grow by 14.5–16.4 percent year-on-year (y.o.y) and 7–8 percent (y.o.y), respectively. The inflation pressure IN 2005 is foreseen to continue and the headline inflation rate is expected to be above the target of 6.0 ± 1.0 percent due to the increase in domestic fuel price. The inflation rate is expected to be lower in the next 2006. The pressure on the rupiah is also expected to remain and the average rupiah exchange rate is expected to depreciate at Rp. 9,800 per US dollar.

Despite these positive developments, there are still many challenges that need to be addressed. Domestically, macro-economic conditions still face problems, notably those related to inflationary pressures and pressure on the rupiah. The government's policy decision to cut the fuel subsidy in March 2005 has led to increase in inflationary pressures. In addition, the government is confronted with challenges to overcome the unemployment problem and to improve the investment climate. On the external side, the increase in the global interest rate will lead to a downturn in global demand and this could have an unfavourable impact on export performance.

REAL GROSS DOMESTIC PRODUCT GROWTH

Continued sound macroeconomic policies pursued by the authorities have lent support to the Indonesian economy's continued favourable performance during 2004. Real GDP grew by 5.13 percent, with low inflation and relatively stable rupiah exchange rates. It is gratifying to note that the growth has taken place across a wider spectrum of economic sectors, as the contribution of investment and exports in 2004 began to pick up. In 2004, real investment increased by 15.7 percent, supported by surges in import of raw materials and capital goods. Export also showed a healthy growth of 8.47 percent in the same year.

There was continued expansion in 2005 as indicated **in the first quarter** when real GDP recorded to grow by 6.35 percent (y.o.y), mainly driven by significant growth in investment and exports. Consumption also showed growth although it is tending to slow down. From the supply side, this growth was mainly driven by the manufacturing, transportation, and communication sectors.

These positive developments are expected to further the upturn of Indonesian economy **for the whole year of 2005**. The economic growth is forecast to reach 5.5 to 6.0 percent during the year, underpinned by improved monetary indicators and macroeconomic stability. The growth projection is also supported by the commitment made by the government to establish a conducive environment for investment and to maintain fiscal sustainability through a budget deficit reduction, to below 1.0 percent of GDP.

On the demand side, the underlying structure of growth in 2005 is anticipated to continue following a healthier pattern. While economic growth remains consumption driven, the role of investment to support economic growth is projected to improve further as public and private investment activity increases. This upturn is mainly due to improving optimism among business agents about the economic outlook and is supported by the consistent government and Bank Indonesia policy of maintaining a stable macro-economy. Nevertheless, exports are forecast to experience a rather slower growth due to the expected deceleration in the global economic growth and declines in the volume of international trade.

On the supply side, economic growth in 2005 will be driven by increases in all economic sectors, with the manufacturing industry; transportation and communications; trade, hotel and restaurant; as well as financial sectors the main contributors. The growth of these sectors is mainly led by increase in demand for goods and services as well as enhanced capacity utilization of these sectors.

INFLATION

During 2004, well-controlled base money and the stable exchange rate of the rupiah have helped the Central Bank keep consumer price inflation (CPI) subdued. In 2004, yearly inflation was recorded at 6.4 percent, slightly higher than in 2003 (5.1 percent), but still within the target range of 5.5 ± 1.0 percent. The main contributors to inflation in 2004 were prices for housing, followed by food, transportation and communication.

In the first quarter of 2005, inflation rose to 8.81 percent (y-o-y), slightly higher than that in the previous quarter of 2004 (6.4 percent). Upward pressure on inflation was attributable to the increase in the fuel price, and higher inflation expectations earlier stemming from the government's plan to increase the fuel price. Additionally, inflationary pressure also resulted from the depreciating trend in the rupiah exchange rate.

Looking forward, inflationary pressure is expected to continue. Pressure on the rupiah exchange rate, as well as expectation of inflation, is expected to remain high. The high expectation of inflation is mainly because of increases of energy prices. Accordingly, core inflation is forecast to grow at 7.3 percent **in 2005**.

EMPLOYMENT

In line with the continuing economic recovery in 2004, the number of jobs created during the year increased. Nevertheless, the labour market has not demonstrated adequate improvement. During 2004, Indonesia's open unemployment rate rose to 9.9 percent (10.3 million people) from 9.5 percent in 2003. This was due to the relatively low a number of jobs created (2.3 million) compared with the introduction of new workers into the labour market (3.7 million). In addition, development of the labour market was also burdened by layoffs in several manufacturing industries, including textiles and footwear, and at SOEs involved in the aerospace industry.

Looking forward, unemployment is expected to remain a serious challenge in **2005** as the economy is expected to grow at only slightly higher than in 2004. A considerably higher economic growth is required to provide more job creation to absorb the additional new labour entering the work force. In this regard, the unemployment rate in 2005 is forecast to reach the same level as that in 2004.

BALANCE OF PAYMENTS

Indonesia's balance of payments (BOP) performance in 2004 continued to improve. The current account recorded a surplus along with the improvement of export performance. As well, the capital account rebounded from a deficit in 2003 to record a surplus **in 2004** due to the increase in private capital inflow. With these developments, overall balance of payments in 2004 was in surplus and foreign exchange reserves by the end of the year rose to $36.3 billion or equivalent to 5.6 months of imports plus official foreign debt repayments.

In the first quarter of 2005, Indonesia's balance of payments continued to improve. The current account experienced a surplus and amounted to $1.4 billion even though imports increased. Meanwhile, the capital account, which recorded a surplus in 2004, experienced a deficit of $0.1 billion as a result of a deficit in the public capital account. Against these developments, official reserves became $36.03 billion, or the equivalent to 4.5 months of imports and official debt repayments. **For the whole 2005**, however, Indonesia's balance of payments is forecasted to get worse as compared to the previous year. The current account surplus is forecasted to decline faster than expected amid the projected high increase of imports and the moderate growth of exports. Meanwhile capital account surplus is projected to decline and expected to record an insignificant surplus. Against these developments, official foreign exchange reserves are forecast to decrease to $30.6 billion or the equivalent of 4.0 months of imports and official foreign debt repayments.

GROSS EXTERNAL DEBT

Public external debt is defined as central government and central bank debt to foreign creditors. In 2004, 85.5 percent of Indonesia's public external debt was owned by central government. Although there was substantial progress in some indicators, the level of the debt and the resulting burden still pose challenges for the future.

Comparing the levels in US dollar terms, over recent years public external debt has tended to increase. From US$69.4 billion in 2001, the debt rose to US$74.5 billion in 2002, then to US$80.9 billion in 2003. In 2004, it was slightly decreased to US$80.7 billion, due to debt repayment, some of which was partially offset by the strengthening of the Japanese yen, primarily, and other currencies, to a lesser extent, against the US dollar. Japanese yen-denominated debt accounted for 38.8 percent of Indonesia's total outstanding public external debt as of 31 December 2004.

Although the level of public external debt is relatively high, other indicators show an improvement. The external public debt to GDP ratio in 2002 was 36.8 percent and the ratio continuously declined to 33.5 percent and 31.3 percent in 2003 and 2004, respectively. The debt to export ratio also shows a better condition in 2004. The ratio, which was 110 percent and 114 percent in 2002 and 2003, declined to 100.2 percent in 2004. The decrease of this ratio was not only attributed to repayment of loans but also to a significant increase in exports and GDP.

The external public debt mainly came from multilateral and bilateral creditors. By 31 December 2004, the composition of government external borrowings sources was: US$28.9 billion (or 35.8 percent) by multilateral creditors; US$30.3 billion (or 37.5 percent) by bilateral creditors; US$18.0 billion (or 22.3 percent) by export agency creditors; US$3.2 billion (or 4.0 percent) by commercial creditors; and US$0.2 billion (or 0.2 percent) by leasing creditors. Of the US$28.9 billion of multilateral debt outstanding, debt to the IMF accounted for US$9.6 billion. Since all of the IMF loans committed under the IMF program have been disbursed and the government has decided to formally end the program, currently Indonesia is only servicing its outstanding debt to the IMF. During 2004, Indonesia received US$250 million of loans disbursements from the Asian Development Bank (ADB) and US$300 million from the World Bank. By the end of 2004, the total World Bank and ADB debt outstanding was US$17.8 billion, which was used to fund development programs in nearly all sectors of the Indonesian economy, particularly to enhance corporate governance.

Indonesia's debt to the Consultative Group for Indonesia (CGI) was approximately US$49.1 billion. In January 2005, the CGI held a meeting at which it pledged to provide Indonesia with loans and grants through budget and other channels in an amount of up to US$5.1 billion in 2005, including US$1.7 billion earmarked to support reconstruction efforts in the provinces of Aceh and North Sumatra which were devastated by the tsunami in December 2004.

The Paris Club, an informal voluntary group of 17 creditor economies that seeks to coordinate solutions for payment difficulties experienced by debtor nations through extending or guaranteeing bilateral credits, played an important role in easing the Indonesia foreign exchange burden in the wake of the Asian financial crisis. During 1998 and 2002, several agreements on debt rescheduling have been achieved. Yet, as a result of the government's decision to exit the IMF program in 2003, Indonesia is no longer eligible for debt re-scheduling through the Paris Club and is required to repay its outstanding loans according to their repayment schedules.

On 10 March 2005, the Paris Club creditors offered to allow Indonesia, as well as other economies affected by the tsunami, to defer debt payments to the end of 2005 (debt moratorium) in order to allow Indonesia to commit additional government resources to tsunami-related humanitarian and relief efforts. The debt moratorium is targeted at the principal and interest maturities falling due in 2005 on eligible sovereign claims defined as the ODA debt and the restructured non-ODA debt. Through this scheme, the creditors offered that the deferred amounts be repaid over 5 years during which there will be one year of grace.

The government has also recently expanded its sources of external financing by accessing the international capital markets. In March 2004, Indonesia issued $1.0 billion in 6.75 percent bonds due in 2014 in the international capital markets. These bonds will be mature on 10 March 2014. The offering was the first time Indonesia has accessed the international capital markets for financing since the onset of the Asian financial crisis.

EXCHANGE RATE

The rupiah exchange rate was largely stable in 2004, especially in the second half of the year. The rupiah exchange rate closed at Rp. 9,283 per US dollar at end-December 2004. **During 2004**, the exchange rate averaged at Rp. 8,940/USD, representing a 3.9 percent depreciation from the previous year. The rupiah exchange rate's stability benefited from measures pursued by the government and the monetary authority to improve macroeconomic stability; strengthen coordination and consistency in policy measures; build a more resilient banking system and foster positive expectations.

During the first quarter of 2005, the rupiah exchange rate experienced gradual depreciation with a relatively low volatility. During the quarter, the rupiah/ US dollar rate averaged Rp. 9,279 and closed at Rp. 9,465 by end-March 2005. This depreciation trend was attributable to the increase of domestic foreign exchange demand that was not supported by a sufficient foreign exchange supply.

Later in 2005, the rupiah exchange rate is predicted to depreciate further, in line with the unfavourable balance of payments performance. Rupiah exchange rate pressure is also expected to increase, resulting from deteriorating risks factors, a rise in international oil prices, high inflationary pressure, and excess foreign exchange demand in the domestic foreign exchange market. Taking into account these developments, the average rupiah exchange rate in 2005 is forecast at Rp. 9,800 per US dollar or within the range Rp.9,700–Rp.10,100 per US dollar.

FISCAL POLICY

In 2004 fiscal policy was set to comply with the medium-term's development plan framework for 1999–2004. In general, the fiscal policy was aimed to improve the fiscal sustainability through the reduction of fiscal deficit and to achieve a balanced budget in 2008. In order to reduce the fiscal deficit, the government has put in place several policies, such as: improvement of fiscal discipline; gradual reduction of subsidy and foreign debt; improvement of progressive tax revenue; and reforms in government expenditure. In general, these efforts were taken through a fiscal consolidation. Despite facing some challenges in 2004, such as increased oil prices and the natural disaster in December 2004, the government continued its commitment to reduce the budget deficit and maintained a fiscal sustainability.

The government expected to reach the budget deficit in 2004 at Rp. 26.3 trillion (1.3 percent of GDP). However, the oil price rise and the disaster, among other things, has caused the deficit to increase by Rp. 2.3 trillion, to Rp 28.6 trillion (1.4 percent of GDP). This level was lower than that of 2002 and 2003, which reached 1.5 percent and 1.9 percent, respectively. The strong government commitment and fiscal consolidation, which have been the main directors of fiscal policy in 2004, contributed greatly to the decline of fiscal deficit.

In the government revenue side, the realization of total revenue in 2004 was roughly the same as in the revised budget, at around 20.0 percent of GDP. The government's total tax revenue in 2004 was 14.1 percent of GDP. The revenues from several land and building taxes, and customs duties, were higher than those in the budget. The increase in tax revenues was due to the reforms taken by the government in tax collection and administration. Although the world oil price increased in 2004, government revenue from oil resources did not exceed the budget level. The decline of oil production has limited the "windfall profit" resulting from the high oil price.

On the government expenditure side, the realization of total expenditure was 1.5 percent higher than in the revised budget. The high oil price increased the oil price subsidy to 16.6 percent of the allocated revised budget. This situation also appeared on the specific allocated fund to local governments account, where the spending increased by about 12.0 percent of the budget level. In order to meet the objective of a low budget deficit, government had to adjust the spending on other accounts to lower than their budget levels.

The fiscal policy 2005 is set in accordance with several directives. It should be able to maintain macro-economic stability, give limited stimulus to accelerate the economic growth, and reduce poverty and the unemployment rate. At the same time, the fiscal policy should continue the fiscal consolidation in order to maintain fiscal sustainability, including debt sustainability. In this regard, government has set the fiscal deficit ratio for 2005 to below 1.0 percent. The government also set several measures to improve fiscal condition, such as: tax and non-tax reforms; government expenditure budgeting reforms; debt management and source of financing reforms; and state's financial institution reforms.

On the revenue side, the government is introducing deregulation on: tax income law, VAT and general tax regulation, and this policy is expected to bring results in 2006. The government will also continue to intensify the modernization and reform of its tax and non-tax administration, tax collection and the tax service. On the expenditure side, policy direction in 2005 is aimed at improving the effectiveness and efficiency of government expenditure management through the implementation and introduction of: a unified budget, a performance based-budget, a mid-term expenditure framework and a state accounting standard.

The total requirement for budget financing in 2005 is Rp. 86.1 trillion or 3.3 percent of GDP, comprised of: 0.7 percent state budget deficit, 2.6 percent debt principal payment and 0.04 percent secondary mortgage facilities. In nominal terms, the total budget financing requirement in 2005 fell 10.2 percent from the level of Rp. 95 trillion in 2004. In terms of its ratio to GDP, total financing decreases to 3.3 percent in 2005 from the ratio of 4.2 percent in 2004. The 2005budget financing requirement will be financed by domestic sources, such as government saving, IBRA asset sales, privatization and government bonds (69.1 percent) and through foreign loans (30.9 percent).

Up to the first quarter of 2005, the realization of revenue and grants was 31.4 percent of the revised budget, comprised of Rp. 119.5 trillion and Rp. 4.6 billion, government revenue and grants, respectively. The actual revenue is sourced from tax revenues (up to Rp. 96.1 trillion or

32.3 percent of the 2005 budget), and non-tax revenue (up to Rp. 23.5 trillion or 28.7 percent of the budget). The government expenditure to 30 April 2005 was 24.9 percent of the budget, comprises central government expenditure and local spending as amount of Rp. 60.2 trillion and Rp. 38.8 trillion respectively. For this moment, the government enjoyed a surplus budget as much as Rp. 20.6 trillion or 18.6 percent higher than the revised budget.

MONETARY POLICY

Monetary policies adopted by Bank Indonesia in 2004 continued to be geared toward achieving the medium-term inflation target set by the government while maintaining support to economic growth. Rates on monetary instruments had trended downward for the whole year, yet at a much slower pace than they did in 2003, partly because of the shift in policy stance near mid-year from the cautious easing (accommodative) policy to the tight bias policy.

During the first five months of 2004, well-contained inflationary pressure allowed the monetary policy stance to be relatively accommodative through edging-down the interest rate on monetary instruments. Toward the second half of 2004, inflationary pressures started to emerge, owing to rapid expansion in domestic demand and depreciation of the rupiah. Therefore, since June 2004 Bank Indonesia has raised the interest rate on Sertifikat Bank Indonesia (SBI) gradually to keep inflation under control. By the end of 2004, the rate on 1-month SBIs stood at 7.43 percent, down 88 basis points (bps) from the rate in 2003, compared with a drop of 462 bps during 2003. Similarly, other longer- and shorter-term monetary instruments also experienced a fall in rates for the whole year. These declines were followed by even larger drops in the Interbank money market rates, bank deposit rates and bank credit rates.

Meanwhile, Bank Indonesia also sought to absorb excess liquidity from the banking sector through open market operations (OMOs) and sterilization. These policies have contributed to a sustained base money growth, although growth has slightly exceeded its indicative target as it responded to higher currency demand and banks' excess reserves.

On maintaining exchange rate stability, in June 2004 Bank Indonesia issued the Rupiah Stabilization Policy Package aimed at mopping up excess liquidity and arresting further weakening of the rupiah. In addition, Bank Indonesia attempted to improve the effectiveness of the implementation of monetary policy by realigning the interest rate structure; reducing the frequency of SBI auctions; and easing SBI repurchase agreement (repo) regulation. The realignment of interest rate structure was intended to improve monetary policy transmission. The reduction of the frequency of one-month SBI auctions was directed at maintaining the stability of the SBI interest rate and promoting money market developments. Meanwhile, the easing of SBI repo requirements was intended to help banks in managing their liquidity.

In the first quarter of 2005, the tight bias policy continued as inflationary pressure saw a moderate increase. In April 2005, in the effort to curb further rupiah deprecation, Bank Indonesia issued a few short-term regulations, ie, lowering the net open position limit for banks and activating the Fine-Tune Operation (FTO) instrument for the first time. This regulation was intended to absorb domestic excess liquidity so as to restrain speculative activities that have brought the rupiah exchange rate down recently.

Taking into account factors that are likely to affect inflation in the period ahead, Bank Indonesia will **continue implementing a tight-biased monetary policy in 2005**. Operationally, this would be achieved through optimal liquidity absorption in order to balance between liquidity and economic needs. This is done by directing base money toward its targeted average growth of 11.5 percent–12.5 percent. However, the changing inflation expectations in Indonesia lessen the effectiveness of monetary policy. Considering the importance of expectations as one of the determinants of inflation, Bank Indonesia will seek to manage inflation expectations by building a track record that enhances credibility.

In order to increase effectiveness and send a clearer signal of the monetary policy stance, starting in July 2005, Bank Indonesia implemented new and enhanced monetary policy measures within its Inflation Targeting Framework (ITF). The ITF encompasses four main areas: the uses of an interest rate called the BI rate as its operational target; a forward-looking decision making process; a more transparent communication strategy; and strengthened policy coordination with the government. The move is intended to strengthen the effectiveness and good governance of its monetary policy-making to achieve the prices stability needed to support sustainable economic growth and social welfare. In this regard, monetary policy will continuously pursue the balance between medium inflation targets and maintaining growth momentum.

In operational implementation of monetary policy, open market operations (OMOs) would still be the main instrument. Open market operations are comprised of regular OMOs (conducted through auctions of SBI and provision of Bank Indonesia Deposit Facility (FASBI)), and non-regular OMOs (conducted through fine-tuning operations). Fine-tuning operations would be used whenever necessary to increase Bank Indonesia's flexibility in controlling money market liquidity. In addition to using SBI repos, Bank Indonesia will also utilize Government Bonds (SUNs) in FTO in accordance with the State Treasury Law. Other instruments used in conducting monetary policy include the discount rate, minimum reserve requirements and regulations on credits or financing.

To support exchange rate stability, Bank Indonesia will continue to minimize the potential risks to rupiah volatility. The bank's policy involves improvement of regulation on foreign currency transaction; management of foreign currency supply and demand; the structure of capital inflows; and improvement of rupiah exchange rate expectations. Additionally, Bank Indonesia also seeks to enhance the effectiveness of the foreign exchange transaction monitoring system, which will in turn support to the effectiveness of exchange rate policies and also functions as a reference for future policy decision-making processes.

Further in the medium term, the monetary policy will continue to focus on the achievement of a gradual downward trend in the medium-term inflation target while sustaining the momentum for growth. To achieve the inflation target, the focus would be on controlling factors that influence inflation, notably the output gap, the exchange rate, and the inflation expectations. Following the coordination between the Ministry of Finance and Bank Indonesia, the Ministry of Finance issued the Decree No.339/KMK.011/2004 setting out inflation targets as follows: for 2005, 2006, and 2007, respectively, 6.0 percent, 5.5 percent, and 5.0 percent, each with a deviation of $\pm$ 1.0 percent. The coordination is further stepped up by establishing the Inflation Control Team, whose members represent several related agencies. In order to promote monetary policy, effectiveness Bank Indonesia will continue to carry out policy coordination and the strategic partnership with the government and other economic agents in order to synchronize the specific steps and the general directions of monetary, fiscal and real sector policies.

MEDIUM-TERM OUTLOOK

Indonesia's macro-economic conditions during 2004-2009 are expected to be favourable as a response to the development strategy and policies, as well as reforms, in the domestic market. Considering the global and domestic economic outlook, Indonesia's economic growth is expected to grow faster. The growth rate is forecast to increase from 5.5 percent in 2005 to 7.6 percent in 2009, or on average by 6.6 percent per year. During this period, the manufacturing sector is expected to grow at 8.6 percent per year, mainly driven by the growth of the food, beverages and tobacco; paper and printed products; and fertilizer industries. The agriculture sector is expected to grow at 3.5 percent per year.

Higher economic growth would bring wider job opportunities for the labour force. The unemployment rate is expected to decline from 9.7 percent in 2005 to 5.1 percent in 2009. In this regard, the manufacturing industry, and building, trade, hotel, restaurant services would be the leading sectors in providing jobs. With the improvement of employment conditions, social welfare will also be improved. The poverty rate is expected to decline to 8.2 percent of total population in 2009.

One of the main prerequisites to achieve these targets is the maintenance of macro-economic stability. The maintenance of macro-economic stability in 2004 provides a solid foundation for the further acceleration of economic activity. Entering 2005, continuing efforts to maintain macro-economic stability include the government's determination to maintain fiscal sustainability through the projection of a small deficit in the 2005 state budget and Bank Indonesia's commitment to a stable value of the rupiah and a stronger banking system. Meanwhile, to achieve the economic growth target, the government emphasizes structural reforms, which lay the foundations for medium-term development. In this regard, one of the government's important steps is to boost investment through the creation of a conducive business climate, which includes the acceleration of infrastructure development. These various aspects of economic policy have fostered optimism in the Indonesian economy, which is projected to grow in the range of 5.5 percent to 6.0 percent in 2005.

STRUCTURAL REFORMS

a. Fiscal Sector

The government's fiscal policy in 2004 was set to comply with the medium-term development plan framework for 1999–2004. In general, the fiscal policy was aimed to improve fiscal sustainability through the reduction of the fiscal deficit and to achieve a balanced budget in 2006. In order to reduce the fiscal deficit, government has instigated several policies such as: improvement of fiscal discipline; gradual reduction of subsidy and foreign debt; improvement of progressive tax revenue; and reforms in the government expenditure. In general, these efforts were taken through a fiscal consolidation. Despite some challenges faced in 2004, such as the increase in oil prices and the natural disaster in December, the government continued its commitment to reduce the budget deficit and maintained fiscal sustainability.

Recognizing the need to improve its budget management and processes, the Ministry of Finance in 2004 established a single treasury unit responsible for both foreign and domestic debt financing, and introduced an improved computer support system to promote better transparency and accountability in financial management. In 2005, the government plans to launch an integrated budgetary system to clarify and focus government spending decisions and improve efficiency.

The 2005 fiscal policy is set in accordance with several directions. It should be able to maintain macro economic stability, give limited stimulus to accelerate the economic growth, and reduce the poverty and unemployment rate. At the same time, it would continue the fiscal consolidation in order to maintain fiscal sustainability, including debt sustainability. In this regard, government has set the fiscal deficit ratio for 2005 at below 1.0 percent.

The government also set several measures to improve the fiscal condition, such as tax reforms and reforms of the state's financial institutions. The government also attempted the improvement of the administration of customs and the implementation of related fiscal decentralization measures under the revised Central and Local Fiscal Balance For the latter, attention was focused on improving the on-lending mechanism and on-grant facility to relatively poorer local governments as well as rationalization and redirection of the budget to priority areas, including targeted compensation measures for fuel subsidy reduction and Aceh reconstruction and recovery. In line with the fiscal consolidation, the government also takes the Public Financial Management reforms in several key areas, i.e., public expenditure management; debt management; procurement; and accounting, auditing and control for all levels of government.
On the revenue side, the government deregulation of tax income law, VAT, and general tax regulation and this policy is expected to bring results in 2006. The government will also continue to intensify the modernization and reform of tax and non-tax administration, as well as tax collection and the tax service. On the expenditure side, policy direction in 2005 is aimed to

improve the effectiveness and efficiency of government expenditure management. This direction is taken through the implementation and introduction of a unified budget, a performance based-budget, mid-term expenditure framework and state accounting standard.

b. Financial Sector

Progress has been made in the key areas of structural reform. In order to build a foundation for optimal banking intermediation, banking policy will be directed towards a sound, strong and efficient banking system that will provide a stable financial system capable of supporting and boosting the Indonesian economy. This vision is translated into the Indonesian Banking Architecture (API) program, which was released in the beginning of 2004 by Bank Indonesia.

As part of the API implementation, in January 2005, Bank Indonesia issued a new banking regulation package. This package is expected to facilitate the consolidation process in the banking industry and support investment in infrastructure as well as economic activities, including infrastructure investment in Aceh. At the same time, the regulations tightened the provisions regarding overall asset quality, consolidated banking supervision, and transparency. In particular, the policy package covers eight regulations to effect: (i) changes in the legal lending limits, (ii) the policies of commercial banks regarding assets quality, (iii) information transparency of banks' products and use of bank personal data, (iv) prudential principles for asset backed securitizations, (v) special treatment of bank's foreign debts, (vii) resolution of customers' complains and (viii) creation of a debtor information system.

With regard to the financial safety net, the authorities have continued to make progress. On 22 September 2004 a new law establishing a deposit insurance agency, the Indonesia Deposit Insurance Corporation was adopted. The new law becomes effective, and the Indonesian Deposit Insurance Agency will become fully operational, on 22 September 2004. When it becomes operational, the Indonesia Deposit Insurance Agency will assume responsibility for protecting bank depositors. As an interim measure from the date of the enactment of this new law and its effective date, the president issued a decree on 18 October 2004 which provides that the government will continue to guarantee all commercial bank payment liabilities (which consist of all third party deposits, including demand deposits, time deposits, deposit certificates, savings and other liabilities treated as deposits, and Interbank claims, including liabilities in the form of interbank money market transactions) only during the five month period from 19 April 2005 to 22 September 2005.

After the new law becomes effective on 22 September 2005, the government will guarantee:

- all third party deposits, except Interbank claims, during the first six months after the law is effective (from 22 September 2005 until the date falling six months after that date);
- third party deposits up to Rp. 5 billion only, during the next six month period;
- third party deposits up to Rp. 1 billion only, during the next six month period; and
- third party deposits up to Rp. 100 million only, thereafter.

As a result of its continuing efforts to eradicate money laundering, on 11 February 2005 Indonesia was removed from the NCCT list. As an effort to combat money laundering activities, the authorities have taken some policy measures namely: 'Know Your Customer' regulations and an anti-money laundering law which was amended in 2003. It has also established a financial intelligence unit, the Centre for Financial Transaction Analysis and Reporting (PPATK) that has made arrangements to cooperate on investigations into suspect financial transactions with Bapepam, Bank Indonesia, and the Ministry of Finance. PPATK plans to make similar arrangements with the Indonesian Police and the Attorney General's Office. PPATK has also launched a nationwide program to educate relevant audiences on potential money laundering activities.

c. Improvement in Investment Climate

The government has indicated its strong commitment to continue the reform program aimed at improving the investment climate and encouraging private sector growth. Efforts in this area were focused on the improvement of legal and judicial system, revising the tax and customs regulations, and enhancement of good governance. In this regard, in October 2004 the parliament approved the amendment of laws on decentralization and bankruptcy. The amendment to the decentralization law mainly clarifies the decentralization of responsibilities across different levels of the government. This is aimed at reducing potential harmful economic effects of taxes and penalties imposed by the local government.

With regard to external trade policies, ensuring consistency in regulations and taxes introduced at different levels of government is a high priority for improving the investment environment. In this respect, the government took some measures to improve competitiveness and reduce trade distortions. The overall program design and schedule, including exceptions, and implementation of the harmonized tariff system with a flat tariff of 5.0 percent, are being developed, with initial implementation scheduled for 2005. The government has also strengthened its efforts in reducing export and import impediments, as well as enhancing bilateral and regional cooperation. In addition, 21 regulations related to labour rigidity issued by local governments have been revoked.

The recently-elected government has put anti-corruption efforts as another top priority. The Anti-Corruption Commission is fully operational, with the installation of judges for the Anti-Corruption Court, and a number of cases are currently being processed. In this connection, a presidential decree was issued in 2004 to enhance the transparency, efficiency, and accountability of public management. All government officials are required to report their wealth to the Anti-Corruption Commission annually. The reform program for the commercial court will be continued, and a training program to improve the capacity of judges and law enforcement agencies is underway.

d. Developing Infrastructure

Infrastructure is one of the main factors supporting economic growth and the distribution of development in Indonesia. Recognizing that capability of the government in the provision of infrastructures had been receding after the crisis in 1997, the government held an Infrastructure Summit in mid-January 2005. The government estimated about US$145 billion was needed to build infrastructure projects for the next five years. The government is looking for investors (both domestic and international) willing to invest US$80 billion in infrastructure projects and has offered a rate of return in the range 15.0 percent to 23.0 percent.

In this Summit the government has presented its Declaration on Developing Infrastructure, which lays out the broad framework for private sector participation. The new government is determined to increase public infrastructure investment through Public-Private Partnerships (PPPs). The government concurred that it will be important to establish an institutional framework for PPP projects that ensures that projects with the highest social rate of return are chosen, and one that prevents the creation of un-funded liabilities for the budget. It will also be important that the fiscal implications of possible PPPs be transparently accounted for and reported.

ANNEX I

INDONESIA: OVERALL ECONOMIC PERFORMANCE

	1998	1999	2000	2001	2002	2003	2004	2005
GDP and Major Components (percent change, year over year, except as noted)								
Nominal GDP (level in billion US$)	97.50	139.50	150.70	140.95	161.48	184.23	185.76	-
Real GDP	-13.3	0.8	4.9	3.83	4.38	4.88	5.13	5.5-6.0
Consumption	-	-	2	3.9	4.74	4.55	4.6	3.8-4.8
Private Consumption	-	-	1.6	3.9	3.84	3.89	4.94	4.0-5.0
Government Consumption	-	-	6.5	7.56	12.99	10.03	1.95	1.7-2.7
Investment	-33.01	.18.2	16.74	6.49	4.69	1.04	15.71	15.4-16.4
Private Investment	-	-	-	-	-	-	-	-
Government Investment	-	-	-	-	-	-	-	-
Exports of Goods and Services	11.18	(31.8)	26.48	0.64	(1.22)	8.19	8.47	8.5-9.5
Imports of Goods and Services	(5.29)	(40.68)	25.93	4.18	(4.25)	2.73	24.95	16.0-17.0
Fiscal and External Balance (percent of GDP)								
Budget Balance	97.50	139.50	150.70	140.95	161.48	184.23	185.76	-
Merchandise Trade Balance	-13.3	0.8	4.9	3.83	4.38	4.88	5.13	5.5-6.0
Current Account Balance			2	3.9	4.74	4.55	4.6	3.8-4.8
Capital and Financial Non-reserve Assets Balance			1.6	3.9	3.84	3.89	4.94	4.0-5.0
Economic Indicators (percent change, year over year, except as noted)								
GDP Deflator (percent change, y-o-o)	-	-	-	16.89	11.40	4.69	7.08	-
CPI	77.63	2	9.4	12.6	10.03	5.1	6.4	6 +/- 1
M2	62.14	11.9	15.6	12.99	4.72	8.42	8.14	-
Short-term Interest Rate (percent) #	64.1	26	12.53	17.62	12.99	8.31	7.43	-
Real Effective Exchange Rate (monthly REER, December)	76.8	85.71	72.53	80.08	95.28	100.39	91.39	-
Unemployment Rate (percent)	5.5	6.4	6.1	8.1	9.1	9.5	9.9	-
Population (millions)	204.031	202.9	205.843	208.901	212.003	215.152	216	-

ANNEX II

INDONESIA: FORECAST SUMMARY (percent change from previous year)

		2004					2005					2006				
	2003	Official	IMF	ADB	OECD	PECC	Official	IMF	ADB	OECD	PECC	Official	IMF	ADB	OECD	PECC
Real GDP	4.88	5.13	4.8	4.5			5.5-6.0	5	4.5							
Exports	8.19	8.47					8.5-9.5									
Imports	2.73	24.95					16.0-17.0									
CPI	5.1	6.4	5	6.5			6+/- 1	7	6.5							
Budget Balance	-2.1	-1.4			-1.3		-0.7		-0.8							

ANNEX III

INDONESIA: MEDIUM-TERM TREND FORECAST (PERCENT)

	2005
Real GDP	5.5-6.0
GDP Deflator	

JAPAN

REAL GROSS DOMESTIC PRODUCT

The Japanese economy is emerging from prolonged stagnation after the burst of the bubble economy and realizing private demand-led economic growth. Japan was in an economic environment of negative growth with large amounts of non-performing loans (NPLs) when the "Intensive Adjustment Period" (FY2002–FY2004) began.

However, during the structural reform, the target of halving major banks' NPL ratio has been achieved. In the corporate sector, there has been progress in overcoming the problem of excess-employment, excess-capital stock and excess-liabilities. As a result, the corporate structure has been strengthened and corporate profits have been improving. The recovery of the corporate sector is gradually spreading over to household sectors through the improvement in employment and income situations.

The Japanese economic recovery has been led by private demand without fiscal supports. The real GDP growth rate in FY2004 is 1.9 percent, of which private demand accounts for 1.8 percent. The government projected the real GDP growth rate for FY2005 to be about 1.6 percent (with the nominal GDP growth rate about 1.3 percent) in the Economic Outlook for FY2005 and Basic Economic and Fiscal Management Measures (hereinafter referred to as the Outlook) decided by the Cabinet in January 2005.

In August, the Cabinet Office made an economic forecast based on the recent developments, "A Forecast of Economic Situation for FY2005 (estimated by Cabinet Office)" (hereinafter referred to as "Forecast"). In the Forecast, the Cabinet Office forecast the real GDP growth rate to be about 1.6 percent (with the nominal GDP growth rate about 1.0 percent).

According to the Forecast, by virtue of the spill-over of good corporate sector performances to the household sector, the Japanese economy will continue to follow a growth path of recovery mainly led by private demand. On the other hand, the possible ramifications of oil price fluctuations on the domestic and overseas economy require attention.

INFLATION

The Japanese economy is in a mild deflationary phase. The domestic corporate goods prices index (CGPI) has been rising due to increased material prices. The consumer prices index (CPI) has been on a slight declining trend year-on-year.

In the Outlook the percentage changes for FY2005 over the previous fiscal year of CGPI and CPI were projected to be about 0.4 percent and 0.1 percent, respectively.

According to the Forecast, they are estimated to be about 1.3 percent and 0.1 percent, respectively.

EMPLOYMENT

The employment situation was severe as the unemployment rate remained within the 5.3 percent to 5.5 percent range from late 2001 to the middle of 2003. However, it has decreased gradually to around 4.5 percent level reflecting the increase in the employees and the decline in unemployed persons, and has been on the downward trend. Wages have been increasing moderately after a long decline as the rising trend of part-time workers, which had been a major contributor to lowering wages, has almost stopped.

In the Outlook the unemployment rate for FY2005 was projected to be about 4.6 percent. According to the Forecast, it is estimated to be about 4.3 percent.

BALANCE OF PAYMENTS

Export volumes started to increase in the second half of 2003 after the soft patch between the end of 2002 and mid-2003 with weakening global economic resilience as the main cause.

Although the exports volume decreased in the middle of 2004, it is picking up. Import volumes has been on an increasing trend since the beginning of 2002 with a recovery of domestic demand.

As for the balance of payments for 2004, the current account surplus registered 18.6 trillion yen, an increase compared with the surplus of 15.8 trillion yen in 2003. The capital and financial account recorded a net inflow of 1.7 trillion yen, changing from the net inflow of 7.7 trillion yen in 2003. The year-on-year growth in reserve assets was 17.3 trillion yen, down from 21.5 trillion yen in 2003.

Looking forward, the real contribution of net exports to GDP growth was projected to be about 0.4 percent in the Outlook. According to the Forecast, it is estimated to be about 0.2 percent.

EXTERNAL DEBT

At the end of 2004, net external assets were 185.8 trillion yen, up from 172.8 trillion yen of 2003. The external assets increased to 433.9 trillion yen. The external liabilities increased to 248.1 trillion yen.

EXCHANGE RATE

In the first half of 2005, the yen against the US dollar moved in the direction of depreciation, from the 103-yen level in January to the 112-yen level in July. Since August, it has been see-sawing around 110 yen.

FISCAL POLICY

Japanese public finance is confronted with a considerably severe situation with the national and regional long-term debts amounting to approximately 750 trillion yen at the end of 2004, which is about 150 percent of the nominal GDP.

The government, in view of promoting the public expenditure reform, has maintained stable fiscal management since the FY2002 budget by holding general account expenditures and general expenditures at levels lower than those of the previous fiscal year in substance. Local government expenditures have also been under intensive review in accordance with the national policy. Meanwhile, tax revenues have been on the increase against a background of rising corporate profits.

As for the FY2006 budget, based on the Basic Policies for Economic and Fiscal Management and Structural Reform 2005, central and local government will keep in line with each other to maintain and strengthen the expenditure reform. Government bond issuance will be restrained as much as possible. However, fiscal soundness should be pursued in balance with economic vitality.

As for the medium-term fiscal management, based on the view that fiscal soundness cannot be achieved without steady economic growth and appropriate fiscal structural reform, the government aims to ensure the size of government (ratio of general government expenditure to GDP) does not exceed the FY2002 level until FY2006, and stays firmly on the path of public expenditure reform in accordance with local governments.

Additionally, by FY2006, with the continuing efforts of both central and local governments to reduce expenditure, based on assessment of necessary public services and expenditure levels, as well as on the progress of economic revitalization and fiscal conditions, the government will judge the required measures for taxation.

Beyond FY2007, Japan aims to achieve a surplus in the primary balance in the early 2010s through continuing the same level of effort as before to improve the fiscal balance and realization of sustainable economic growth led by private demand. The central and local governments will take concerted action to promote the reform of both expenditure and revenue in an integrated manner and reach a conclusion concerning the above efforts within the concentrated consolidation period (FY2005-FY2006).

MONETARY POLICY

In March 2001, the Bank of Japan (BOJ) adopted the quantitative easing policy. Since January 2004, the target balance of current accounts held at the Bank remains "around 30 to 35 trillion yen". With the target amount of the banks' current accounts at the BOJ left unchanged, the growth of the monetary base has decelerated, from 4.0 percent at the beginning of 2005 to 1.0 or 2.0 percent in the middle of 2005. The growth of M2+CD has remained at around the 2.0 percent level.

Should there be a risk of financial market instability, such as a surge in liquidity demand, the BOJ will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

The government expects that, considering market trends and expectations, the BOJ will exercise effective monetary policy management, which will be consistent with the government's efforts for emergence from deflation.

MEDIUM-TERM OUTLOOK

According to the "Structural Reform and Medium-Term Economic and Fiscal Perspectives — FY2004 Revision" decided by the Cabinet in January 2005, a steady progress toward overcoming deflation can be expected through the combined efforts of the government and the BOJ. In addition, with the recovering productivity of the corporate sector on the one hand and the decreasing working population on the other, promoting structural reforms for maintaining and improving Japanese economic vitality will enhance the potential for medium-term growth. In view of these factors, in FY2006 and thereafter, the economy will go on a growth path of around 1.5 percent or higher in real terms and around 2.0 percent or higher in nominal terms.

STRUCTURAL REFORM

For the revitalization and development of the Japanese economy, it is necessary to establish a system suitable in the 21st century, and to ensure an emergence from deflation. While the reforms have yet to be accomplished, sprouts of the achievement of the reforms have thrived, and it is necessary to grow these sprouts into a big tree. Under the principles of "No Growth without Reform", "Leave to the private sector what can be done by the private sector", and "Leave to local governments what can be done by local governments", the government will continue to carry out structural reforms, aiming to bring out an eagerness for challenge in individuals and corporations and the initiative of local governments, and will achieve the sustainable economic growth driven by private demand.

During the two crucial years of the Concentrated Consolidation Period (FY2005–FY2006), the following three issues require particular emphasis.

The first task is to establish a "small and efficient government."

The second task is to establish a foundation that will allow Japan to overcome the two most important environmental changes for the Japanese economy in the 21st century, that is, the trend of a declining birth rate and an aging society, and the trend of globalization, with an eye to the new dynamic era.

The third task is to overcome deflation and revitalize our economy to secure private demand-led economic growth.

Main issues of the structural reform are as follows:

1. Privatization of Japan Post
   To realize the privatization of Japan Post from FY2007, the government will make efforts towards enactment of related bills.

2. Reform of Policy-based Finance
   Following the Council on Economic and Fiscal Policy (CEFP)'s "On the Reform of Policy-based Finance" (December 2002), CEFP will deliberate through September and October of this year, and formulate a basic policy direction to achieve ideal government financial services.

3. Strengthening Management of Government Assets and Debts
   The government will aim to effectively utilize central government assets, including its properties, to their fullest potential, and reinforce management of debts such as government bonds. For this purpose, it will strengthen management of government assets and debts and carry out a "comprehensive review of the balance sheet". As the first step, under the coordination of the related ministries and agencies, CEFP will deliberate concerning the management of assets and debts, aiming to publish a basic policy direction around September/October this year.

4. Shift from Central to Local Government
   The government will steadily realize the reforms based on: the "Agreement between the Government and the Ruling Parties", the overall picture of the reform package of three issues up to FY2006; and the four "Basic Policies" formulated since FY2001. In order to do so, the government will follow up on its progress within the CEFP.

   The Government will aim for a transfer of tax revenue resources of approximately 3 trillion yen.

   With regard to the reform of subsidies, the government will carry out reforms linked to the transfer of tax revenue resources and reforms to increase the discretionary level and largely expand the independence of local governments. To this end, the decision on the remaining issues will be made by autumn 2005. In conjunction, the government will promote the administration of central and local governments.

   Furthermore, measures will be undertaken to increase the transparency and predictability of local financial plans. For instance, efforts will be made to correct the disjunction between the local financial plans and the final accounts, for the purpose of moving toward a solution within the concentrated consolidation period (FY2005–FY2006).

5. The thorough opening up of public services to the private sector, through such means as the full-scale introduction of "market testing"
   To improve the efficiency of public services, the government will develop a system aiming towards the full-scale introduction of "market testing".

For this, based on the “Three year Program for Promoting Regulatory Reform (revision)”[5] , the government will swiftly prepare a draft proposal of the “Improvement of Public Services Efficiency Bill (or Market Testing Bill) (provisional title)” to submit it to the Diet within FY2005.

6. Reform of Budget System
The reform of the budget system will be settled so as to realize its outcome through: goals (Plan), efficient execution of budget (Do), thorough evaluation (Check), reflection of goals in the budget (Action).

In order to do so, the government will shift the “Model Projects” from a trial to a general framework. As the first step, while maintaining the basic outline of the “Model Projects”, the government will establish from the FY2006 budget “Performance-based Projects” whose association with policy evaluation will be strengthened. Also, the government will review the budget documents and closing statements so that the budgets and accomplishments can be assessed in conjunction with the budget and final account for each policy.

For sustaining and strengthening the special accounts reform, relevant ministries will steadily implement the reform policies formulated on the basis of the “Basic Policies 2004.” Comprehensive deliberation will be continued concerning the role of designated revenue sources, including the nature of each revenue source and the appropriate allocation of resources. Basic policy direction will be clarified within the concentrated consolidation period, FY2005-FY2006.

7. Thorough Administrative Reform of Central and Local Government
Concerning the central government, the following points will be pursued with vigor, among other efforts.

- Concerning local branch offices, there will be a fundamental review of the necessity of operations. A drastic review will be carried out including commissioning to the private sector, opening up to the private sector by means of market tests, transferring tasks to local governments, conversion to incorporated administrative agencies and some possible abolition and integration. The Ministry of Internal Affairs and Communications will clearly indicate the strategies for FY2006, including the measures to be taken by each ministry.

- Concerning the local governments, the following points will be pursued with vigor, among other efforts.

- Concerning the “Intensive Reform Plans”, to be publicized to the people by local governments based on the “New Local Administrative Reform Guide,” the Ministry of Internal Affairs and Communications will provide information with appropriate indices in a way that allows for comparison of the progress of the reform among different local governments at glance. Furthermore, with the cooperation of local governments, a public announcement system will be established within FY2005 which will allow comparative analysis of payroll information (such as salary, various bonuses, number of employees for each rank) and financial status.

8. Reforming Total Personnel Expenses for Public Employees
Paying attention to the relevant points, including those below, the government will establish a basic policy direction for total personnel costs reform by September/October of FY2005, and will reflect it in the budget and local financial plans of FY2006 and thereafter. In so doing, the government will work to reduce total personnel costs in the public sector as a whole.

[5] “Three year Program for Promoting Regulatory Reform (revision)”(Cabinet Decision: 25 March 2005)

- Concerning the central government, a personnel reduction plan will be established to promote a drastic relocation of personnel. Meanwhile, a greater net reduction throughout the whole sector must be attained, by measures such as a thorough review of administrative works and projects. Building on the previous achievement of net reduction, the government will decide on the net reduction target for the next personnel reduction plan period, while also taking into account the administrative demands.

- Concerning the local governments, the task is to make a clear quantitative target for the personnel quota to achieve the net reduction target in the "New Local Administrative Reform Guide."

Also, to ensure the effectiveness of the reform of public employees, the government will work continually on public-private interactions, among others.

9. Ensuring Safety and Reassurance of Citizens
The government will promote disaster prevention investments including measures against large-scale earthquakes such as earthquake-proofing of public facilities and housing, as well as soil conservation and flood control measures. Meanwhile, safety measures for public transportation on land, sea and air will be promoted comprehensively. Furthermore, as the increasing diversification and incidence of crimes is causing significant anxiety among the people, the government will promote measures to improve public law and order, and revive "Japan as the safest economy in the world."

10. Social Security System Reform
Concerning the increase of social security benefits, taking note especially of the rapidly increasing medical services, the government will set a policy objective aiming for a substantive achievement in rationalizing medical expenses. Necessary measures will be taken to achieve this objective after reviewing the achievements periodically from all perspectives. A conclusion will be reached by the end of 2005, along with concrete measures to achieve the objective by considering issues such as the burden level that the economy can tolerate, the aging population, local efforts and the characteristics of medical services. On that basis, the government will boldly implement the FY2006 medical system reform.

In order to achieve the above-mentioned objective, comprehensive and immediate efforts will be made while assessing the effects of the measures taken so far.

11. Measures to Reverse the Declining Birth Rate
The government will promote as a basic policy measure the reversal of the trend of a declining birth rate in order to build a society in which people will feel comfortable giving birth to children and bringing them up. Specifically, it wants to ensure that individuals can maintain a balance between work and personal life (including childcare) and select various ways of working depending on each individual's incentives and abilities. The government will engage in measures such as the promotion of environmental improvements as a national campaign, with public and private participation, while taking into account the needs of small-to-medium-sized enterprises.

Furthermore, to deliberate on comprehensive support measures for women on issues including their reemployment and business promotion, the government will establish a "Conference on support measures for women's renewed challenges" (provisional title) by related ministers, and within 2005 will formulate the "Support plan for women's renewed challenges" (provisional title). In addition, to expand the options of various ways of working such as shorter time shifts, the government will promptly deliberate on the implementation of a shorter-time working system for its employees so that it can serve as a model.

12. Educational Reform

Concerning compulsory education, a guideline for the implementation of an external assessment and publication of the results will be made within FY2005. With regard to the freedom of choosing schools, the government will foster appropriate implementation depending on the local circumstances and facilitate nationwide adoption.

By September/October of FY2005, basic policies for revising the curriculum guidelines will be compiled. Furthermore, to assess and analyze the academic abilities of students and to strive for the improvement and upgrading of teaching methods based on these assessments, appropriate measures will be deliberated, including nationwide academic ability surveys. Along with their implementation, the government will strive to improve "solid academic prowess" by a variety of education and teaching methods such as small-group guidance differentiated by the level of proficiency.

The government will emphasize education aimed at improving human capability from an early age, and promote sound fostering of juveniles and their vocational training.

Furthermore, concerning higher education, the government will promote improvement in the quality of education and research in graduate schools.

13. Strengthening Human Capability

Especially concerning the younger generation, where there is a high incidence of unemployment due to employment mismatches, the government will take the following policies.

(1) In promoting effective and efficient capacity building, it is important to further utilize the occupational training facilities of the private sector and take other measures to facilitate competition among training facilities. Therefore, from the standpoint of maximizing the individual's freedom of selection, the government will deliberate on matters such as the effectiveness and problems of the voucher systems for occupational training for youth and will aim to come to a conclusion within a year, while examining the efforts made overseas and by local governments.

(2) While inspiring an incentive to work in young workers, the government will promote their vocational independence. To reverse the trend of an increasing number of the NEET[6] and the "freeters," the government will strengthen and promote the "Independence and Challenge Plan for Young Workers."[7] For example, the government will enhance and strengthen the plan to convert 200,000 'freeters' to full-time employees and take measures concerning the NEET such as improving the local consulting systems. The government also will further promote measures such as career education to cultivate views toward work, etc., among children and students and promote business-university networks in the regions.

In addition, in order to utilize foreign human resources, the government will facilitate the acceptance of skilled foreign labourers.

14. Strengthening Global Strategy

The CEFP will draft "The Global Strategy of Japan" (provisional title) by April/May 2006, in order to tackle globalization in a comprehensive and strategic manner through measures including economic diplomacy, domestic structural reform, regional management and an international division of labour.

---

[6] NEET stands for Not in Education, Employment or Training, referring to young people who are not students, employed, or in vocational training.

[7] "Independence and Challenge Plan for Young Workers" (24 December, 2004)

In addition, the Government will actively pursue measures including the following: The government will continue to make utmost efforts aiming at the successful conclusion of DDA (Doha Development Agenda). Japan will strengthen economic relations with other economies by promoting Economic Partnership Agreements (EPAs) and by strengthening and accelerating the Program for the Promotion of Foreign Direct Investment into Japan.

EPAs, against the background of growing economic globalization, contribute to the development of Japan's foreign economic relations as well as the attainment of its economic interests as a mechanism to complement the multilateral trading system centering on the WTO. Simultaneously, EPAs facilitate promotion of structural reforms of Japan and its partners.

While EPAs with Singapore and Mexico were entered into force in 2002 and 2005, respectively, Japan's economy has reached agreements in principle on the major elements of the EPA with the Philippines, Malaysia and Thailand. Negotiations with Indonesia, the Republic of Korea and ASEAN as a whole are currently in progress. These efforts are designed to realize our policy to promote economic partnerships with East Asia as its focus, and the government shall do its utmost to conclude these EPAs as soon as possible.

In addition to the above-mentioned negotiations, the possibility of EPA negotiations with other economies/regions will be studied, taking into account the progress of on-going negotiations as well as the importance of EPAs to Japan's economy and society. In identifying economies or regions to negotiate with, overall factors including the economic and diplomatic perspectives and the situation of these economies and regions shall be considered.

The government shall endeavour to ensure that the promotion of EPA negotiations will facilitate Japan's negotiations at the WTO.

To stimulate inward foreign direct investment (FDI), there has been a steady implementation of the "Program for the promotion of Foreign Direct Investment into Japan", for the purpose of creating new markets and job opportunities through the introduction of new management know-how and technology.

With these reforms implemented, the dynamism of the Japanese economy is now being regenerated.

15. Financial System Reform

The government has aggressively carried out the measures included in the "Financial Revival Program" formulated in 2002, such as tightening banks' assessment of assets, improving banks' capital, strengthening banks' governance, and promoting the simultaneous revival of industrial and financial sectors. As a result, major banks' non-performing loans ratio has dropped from 8.4 percent in March 2002 to 2.9 percent in March 2005.

In order to create a "financial services nation" in which the level of users' satisfaction is high, which is evaluated well internationally, and which contributes to regional economies, the financial administration will enact measures in accordance with the work schedule of the "Program for Further Financial Reform" formulated in 2004 as a guideline of the financial administration during the "Concentrated Consolidation Period".

16. Revitalization of Regional Economies

The Headquarters for the Regional Revitalization decided the "Program for the Promotion of Regional Revitalization" in February 2004.

Along with the program, the government has provided various assistance measures based on Regional Revitalization Plans submitted by local governments and certified by the prime minister.

The Regional Revitalization Law was enacted in April 2005, and incorporates assistance measures such as subsidies and tax incentives.

The government will continue to promote regional revitalization effectively in supporting local governments' efforts aiming at revitalizing local economies and job creation in local area.

A VISION OF JAPAN IN THE 21st CENTURY

"Japan's 21st Century Vision" was compiled by the special board of inquiry established under the CEFP to further clarify the shape of the 21st century Japan that is supposed to be realized by structural reform. It is hoped that this report will provide valuable food for thought at all levels and in all sectors of Japanese society.

This report examines the coming quarter century (up to 2030), and covers a wide range of possibilities depending upon the issue at hand. It first points out scenarios to avoid: 1) the economy stagnates and contracts; 2) government becomes a weight and a burden on private-sector economic activity; 3) Japan is left behind in globalization; and 4) an increasing number of people lose hope and society becomes unstable. It then sounds the alarm on scenarios that are likely to emerge if measures are not taken to deal with change, given the major trends we face today.

It further presents a vision of how things should be in 2030: 1) an open, culturally creative nation; 2) healthy life expectancy of 80 years enjoyed by "people who are rich in free time"; and 3) contented public, small government. The strategy and concrete actions it recommends for achieving that future vision are: 1) create a virtuous cycle of rising productivity and growing income; 2) take maximum advantage of globalization; and 3) create systems to provide public values as selected by the citizenry. At the same time, it describes the economy that would underpin that envisioned era, one in which rising labour productivity will sustain growth, and the real GDP growth rate will be somewhere in the order of 1.5 percent.

ANNEX I

JAPAN: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year - earlier period, except as noted)						
Nominal GDP (level in billion US$)	4,476	4,747	4,165	3,984	4,305	4,673
Real GDP	-0.1	2.4	0.2	-0.3	1.4	2.7
Consumption						
Private Consumption	-0.0	0.5	1.1	0.5	0.2	1.5
Government Consumption	4.7	4.9	3.0	2.6	1.2	2.7
Investment						
Private Residential Investment	0.1	0.6	-5.4	-4.2	-1.1	2.2
Private Non-Resi. Investment	-4.5	8.7	0.8	-6.7	6.3	6.0
Government Investment	5.3	-10.3	-4.1	-4.3	-10.6	-10.5
Exports of Goods and Services	1.5	12.1	-6.0	7.3	9.1	14.4
Imports of Goods and Services	3.7	8.5	-0.7	1.3	3.8	8.9
Fiscal and External Balances (percent of GDP)						
Budget Balance*	-8.6	-7.0	-6.6	-7.9	-7.7	N.A.
Merchandise Trade Balance	2.7	2.4	1.7	2.3	2.4	2.8
Current Account Balance	2.6	2.5	2.1	2.8	3.2	3.7
Capital and Financial Non reserve Assets Balance	-1.2	-1.8	-1.2	-1.7	1.6	0.3
Economic Indicator (percent change, year over year - earlier period, except as noted)						
GDP Deflator	-1.3	-1.5	-1.3	-1.3	-1.4	-1.2
CPI	-0.3	-0.7	-0.7	-0.9	-0.3	0.0
M2+CD	3.6	2.1	2.8	3.3	1.7	1.9
Short-term Interest Rate (CD New Rate, percent)	0.12	0.17	0.07	0.02	0.01	0.01
Real Effective Exchange Rate (level, 2000=100)**	96.4	100.0	88.9	84.0	84.3	85.0
Unemployment Rate (percent)	4.7	4.7	5.0	5.4	5.3	4.7
Population (millions)	126.7	126.9	127.3	127.4	127.6	127.7

Notes:

* Refers to fiscal year (April to March)
** The calculation method of the real effective exchange rate was changed in February 2002, and the figures are retroactively revised accordingly.

ANNEX II

JAPAN: FORCAST SUMMARY (percent change from previous year)

	2005						2006					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**CAO**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**CAO**
Real GDP	1.6	0.8	1.6	1.5	1.3	1.6	N.A.	1.9	1.5	1.7	1.6	N.A.
Exports	7.1	5.6	N.A.	4.6	4.7	N.A.	N.A.	5.6	N.A.	7.8	5.1	N.A.
Imports	5.6	6.9	N.A.	6.4	5.1	N.A.	N.A.	4.1	N.A.	5.9	4.3	N.A.
CPI	0.1	-0.2	N.A.	-0.2	0.0	0.1	N.A.	0.0	N.A.	0.1	0.2	N.A.

-as of September 2005

Notes:

The Official figure and the CAO figure for 2005 refer to FY 2005 (from April 2005 to March 2006).
IMF: *World Economic Outlook* (April 2005)
ADB:*Asian Development Outlook 2005 update* (August 2005)
OECD: *Economic Outlook 77* (May 2005)
PECC: *Pacific Economic Outlook 2005-2006* (June 2005)
CAO: *A Forecast of Economic Situation for FY 2005 (Calculated by Cabinet Office)* (August 2005)

ANNEX III

JAPAN: MEDIUM-TERM TREND FORECAST (percent)

	Average for 2006–2012
Real GDP	1.5
CPI	2.1
CGPI	1.6
GDP deflator	1.8

KOREA

REAL GROSS DOMESTIC PRODUCT GROWTH

Last year, Korea's real gross domestic product (GDP) grew 4.6 percent year-on-year. Accelerated by the growth rates of 30 percent or more in exports and a transition to an increase in facility investments, the GDP growth rates estimated 5.3 percent in the first quarter (Q1), 5.5 percent in Q2, and 4.7 percent in Q3 in 2004. However, the pace of growth slowed in exports, and construction investments decreased, despite the pick up in private consumption. As a result, Q4 recorded 3.3 percent.

Seasonally adjusted change from the previous quarter, one of the major criteria which describes current economic flow, has increased on a moderate pace since Q2, recording 0.7 percent in Q1, 0.6 percent in Q2, 0.8 percent in Q3 and 0.9 percent in Q4, quarter-on-quarter (q-o-q). By expenditure item: Due to sluggish domestic demand for durable goods and overall services, private consumption recorded a negative growth of 0.5 percent. However, the economic conditions picked up in Q4 with an increase of 0.6 percent. Capital investment posted a 3.8 percent growth with a notable increase in machinery investments, whereas construction investments remained at a 1.1 percent growth due to stagnant demand for residential building construction and the slow down was exacerbated by a negative 3.4 percent in Q4. Exports growth in 2004 plummeted to 21.0 percent from the high growth of 18.5 percent in 2003 while imports growth increased to 13.8 percent from the 10.1 percent recorded in 2003.

In 2005, real GDP expanded to 2.7 percent in Q1 and 3.3 percent in Q2, estimating an average of 3.0 percent during the first half of this year. Changes from the previous quarter's (seasonally adjusted) growth rate was low at 0.4 percent in Q1 but recorded 1.2 percent during Q2, the annual rate is estimated as 4.9 percent, which is close to the potential growth rate of Korea. By sector: Private consumption continued its expansion starting from Q1 with 1.4 percent and Q2 with 2.7 percent. Construction investments recorded a negative 2.9 percent in Q1 then a transition to a favourable state with an increase of 1.8 percent was made in Q2. The recovery of facility investments is still insufficient as growth remains at 3.0 percent (3.1 percent in Q1 and 2.8 percent in Q2) during the first half of this year. Exports growth is losing its steam steadily after increasing growth rates for two consecutive years—from 2003 to 2004—with a result of 7.1 percent growth. Imports recorded a 3.4 percent growth.

For the second half of 2005, given favourable domestic economic conditions with an impressive increase in private consumption stemming from the progress made in household debt adjustment, the Korean economy shows signs of gradual recovery at a mere 5.0 percent potential growth rate pace.

INFLATION

In 2004, the consumer price index (CPI) rose by an annual average of 3.6 percent, proving it is being stabilized close to the government's estimated rate of mid-3.0 percent, and recorded a 3.0 percent increase compared to the end of 2003. In addition, core inflation, the barometer of long-term price movements, increased by an annual average of 2.9 percent, hovering around the Bank of Korea target rate[1] of 3.0 percent.

[1] BOK mid-term inflation target (2004-2006): 2.5-3.5 percent.

Table 1: Price Movement (Growth rate compared to the preceding quarter (month)

(Unit: percent)

	2004					2005		
	Yearly	Q1	Q2	Q3	Q4	First Half	Q1	Q2
Consumer price	3.6	3.3	3.3	4.3	3.4	3.1	3.2	3.0
Core Inflation	2.9	2.8	2.7	3.2	3.2	2.8	3.0	2.5

With regard to macro-economic developments: due to the rise in international oil prices and raw materials, and plummeting costs of agricultural, livestock and fishery products as a result of intense heat and mad-cow disease, there was much room for a price hike in light of costs. However, from a demand-side perspective, due to the torpid domestic demand the room for a price increase is limited. In addition, the revaluation of the foreign exchange rate and stable public rate management by the government has helped stabilize the prices.

The CPI growth rate increased 3.1 percent, stabilizing a little above the 3.0 percent forecast by the government. During the first half of 2005, core inflation rose to 2.8 percent. Even though there were difficulties in controlling prices due to the mounting pressure for cost increases derived from soaring oil prices, the revaluation of the foreign exchange rate and the stable price of agricultural products (helped by the mild weather since February) have helped the CPI maintain its stable trend.

In the second half of 2005, stability of consumer prices is expected to persist and maintain a low – 3.0 percent average rate. Factors of uncertainty for inflation, namely skyrocketing international oil prices and a temporary disturbance in agricultural products’ supply are anticipated. However, the economy is projected to maintain stable movement during the first half of this year with the help of the rebound effect from the second half of 2004, sound movement of housing costs and private services.

UNEMPLOYMENT RATE

Poor performance of the overall job trends in 2003 (a decrease of 30,000 employed) was turned around in 2004 with a 420,000 increase in the number employed. As the positive trend in labour market made the expectation for employment rise, the economically active population made a significant increase (450,000 persons) along with an increase of 0.6 percent in the labour force participation rate, year-on-year, to reach a record of 62.1 percent.

In spite of the increase in the number of employed persons, the unemployment rate was set 0.1 percent higher posting 3.7 percent due to the increase in the economically active population.

The number of the employed rose at a slow pace in the beginning of this year. However, as numbers started boosting from March the employment condition is gradually improving. The number of the employed increased 260,000 compared to the previous year, and the unemployment rate recorded 3.6 percent during the first half of this year.

The employment conditions have been visibly on the path to recovery this year. As the real economy is expected to recover through the improvement of domestic demand, employment indicators are projected to gain positive results throughout the second half of 2005. During the second half of 2005, the government forecasts that the number of the employed will increase by 350,000 compared to last year and there will be a fall in unemployment rate.

Table 2: Trends in Employment

(Growth rate (%) compared to the same period of the previous year)

	2003	2004	2005						
			First Half	Jan	Feb	Mar	Apr	May	Jun
Economically active population	36.0	461.0	308.0	214.0	116.0	229.0	304.0	480.0	502.0
Labour force Participation rate (%)	61.5	62.1	61.9	60.8	60.7	61.8	62.4	62.8	62.9
The increase of payroll employment	-30.0	418.0	262.0	142.0	80.0	205.0	262.0	460.0	424.0
Unemployment rate (%)	3.6	3.7	3.9	4.2	4.3	4.1	3.8	3.5	3.6

* The number of the unemployed was previously based on a one-week job seeking period. But as of June 2005, the calculation was changed to be based on a four-week job seeking period, which results in an increase of approximately 0.2 percent each, compared to the previous data.

BALANCE OF INTERNATIONAL PAYMENT

As the merchandise trade surplus rose significantly with the help of favorable conditions for exports, Korea's current account surplus, estimated at US$27.61 billion in 2004 was 2.3 times bigger than last year (US$11.95 billion) and has recorded a surplus for seven consecutive years. Thanks to the capital inflow for securities investment and direct investment, the capital account balance recorded an inflow surplus of US$8.32 billion.

Table 3: Trends in Balance of International Payment

(Unit: $ hundred million)

	1999	2000	2001	2002	2003	2004	05 Q1
Current account balance	245.2	122.5	80.3	53.9	119.5	276.1	60.6
- Merchandise trade balance	284.6	169.5	134.9	147.8	219.5	381.6	94.1
- Service balance	∆6.5	∆28.5	∆38.7	∆82.0	∆74.2	∆87.7	∆30.5
- Income account balance	∆51.6	∆24.2	∆12.0	4.3	3.3	7.2	2.4
- CTAB	18.7	5.7	∆3.9	∆16.2	∆29.0	∆25.0	∆5.3
Capital account balance	20.4	121.1	∆33.9	62.5	139.1	83.2	32.1

Although merchandise trade surplus rose (US$8.64 billion → US$9.41 billion), the current account balance in Q1 was US$6.06 billion which was a decrease of US$70 million compared to 2004 Q1 from US$6.13 billion due to the deficit of trade in services (∆ US$1.92 billion → ∆ US$3.05 billion) including the travel balance.

The capital account balance recorded an inflow surplus of US$3.21 billion. While the securities investment account and direct investment account recorded an outflow, other investment accounts posted an inflow surplus owing to the payback of foreign loans by the deposit banks.

The current account balance in 2005 is expected to reach US$14 billion, a lower estimate than that of the previous outlook (December 2004), which stated US$20 billion. As growth in exports declines due to the unfavourable foreign exchange rate and high oil prices, the surplus in the merchandise trade balance is expected to decrease. With an increase in overseas travelling, studying abroad and external dividend payments of the settling corporation, negative forecasts have been made for the services balance and income account balance that will affect the growth of the current account balance and cause it to lose its steam in 2005.

FOREIGN DEBTS

As of the end of Q1 of 2005, Korea's total foreign debts were US$186.6 billion, an increase of US$8.6 billion from the end of 2004, while foreign assets amounted to US$295.5 billion, up by US$6.7 billion.

Long-term debts grew to US$118.2 billion, which was a similar level to that at the end of 2004. Short-term debts recorded a quarterly growth of US$8.4 billion reaching $68.4 billion due to the rise in bank borrowings in foreign currency (of US$6.1 billion[2]) and unsettled spot exchange (of US$1.4 billion).

Net assets were US$108.9 billion, a decrease of US$1.9 billion from the end of last year, and are still maintained in the high US$100 billion range.

Korea's foreign debt to GDP ratio was estimated at about 26.6 percent during Q1 2005, which categorizes Korea as one of the economies with no foreign debt issues (within 30 percent) according to World Bank standards. Korea also maintains its ratio of liquid foreign debts to foreign reserves, a barometer of the capability for short-term external payment, at a steady 43.0 percent. Throughout this year, Korea is expected to maintain its stable status.

Table 4: State of Total Foreign Debts and Foreign Assets

(Unit: $ Hundred million)

	End 2002	End 2003	End 2004	End March 2005	Growth Rate	
					05 Q1	2004
Foreign Debts (A)	1,430	1,616	1,780	1,866	86	164
Long-terms Debts	933	1,068	1,180	1,182	2	112
Short-term Debts	497	548	600	684	84	52
Foreign Assets (B)	1,851	2,334	2,888	2,955	67	554
Foreign Reserves	1,214	1,554	1,991	2,055	64	437
Net Assets (B-A)	421	718	1,108	1,089	∆19	390
Foreign Debts/GDP (%)	26.1	26.6	26.2	26.6	0.4p	0.4p
Liquidity Foreign Debts/Foreign Reserves (%)	56.7	48.5	40.7	43.0	2.3p	7.8p

FOREIGN EXCHANGE RATE

At the end of 2004, the dollar-won exchange rate stood at 1,035.1 won (a 15.2 percent appreciation), which was a drop of 157.5 won, compared to the end of the previous year (1,192.6 won). The annual average of the dollar-won exchange rate was 1,144.7 won, a 4.1 percent appreciation in the value of the won compared to 1191.9 won on average in 2003. With expectations of broad-based dollar weakness and appreciation of the Korean won, domestic exporters had sold a significant amount of dollars which resulted in a drop of 100 won in Q4.

---

[2] In general, borrowings in foreign currency are temporary loans from banks, loans that are settled upon liquidation, to cover forward bid excess positions created when export companies conduct forward exchange sales.

During Q1 of 2005, the won-dollar exchange rate was back on a moderate pace. However, factors such as continued selling of the US dollars by exporters and revaluation of the Chinese renmimbi have weakened the dollar to a 1000 won range. On the contrary, the dollar is on the back of a rising trend due to interest rate hike by US Federal Reserve Bank, and recorded 1025.4 won as of June 2005, down by 0.9 percent from the same quarter of 2004.

Table 5: Trends of the Won-Dollar Exchange Rate

(As of the end of the quarter)

	2004				**2005**					
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June
won/dollar	1151.8	1119.6	1048.2	1035.1	1025.6	1006.0	1015.5	1002.8	1007.7	1025.4
yen/dollar	111.1	105.7	102.9	130.1	103.7	105.3	107.5	105.4	108.2	110.2
won/100yen	1033.5	1061.8	1018.3	1012.1	990.1	957.6	952.5	946.4	931.2	930.8

FISCAL POLICIES

In terms of scale, the government adopted austere budget policies in 2004 compared to the previous year. To facilitate economic recovery, the government sped up budgetary expenditures (55.0 percent of the total) for pertinent projects (including national funds and state-owned companies) during the first half of 2004. During the second half of 2004, fiscal spending had expanded to support low-income families and SMEs that were struggling as a result of the attenuated domestic demand (supplementary budget bill 1.8 trillion won, additional spending 2.7 trillion won).

In this process, it is evident that fiscal spending was expanded in 2004 compared to 2003. Considering the integrated fiscal balance, however, national debts were recorded at a mere 203.1 trillion won (26.1 percent of GDP) while the proportion of debts in deficit was quite low, indicating the soundness of Korea’s fiscal status.

With expectations of gradual recovery, fiscal policies were settled close to neutral with minimum expansion. However, recovery was expected to proceed at a moderate pace during the first half of this year. Early execution of the budget was planned with a focus on the improvement of the perception of the economy, which includes projects relevant to new job creation, low-income families support and small and medium size business (SME) promotion. (Such spending to be 59.3 percent of the annual plan, a 4.3 percent increase compared to the previous year.) The government has reinforced fiscal countermeasures while making a significant contribution supporting the insufficient demand. Furthermore, it has selected entities that will implement the Comprehensive Investment Plan for the second half of this year on the earliest possible date.

During the first half of 2005, the economy has shown visible signs of recovery through the early expenditure of fiscal resources, namely the expansion in public construction investments. On the other hand, there are concerns about austere management of budgetary expenditures in the second half. To prevent such problems, the government seeks to expand public spending of 3.1 trillion won in national funds and state-owned companies and will review the feasibility of additional spending plans including the supplementary budget bill according to the economic conditions and financial situations. In addition, the government aims to implement the Comprehensive Investment Plan and the Private Capital Project without fiasco during the second half of this year to manage economic conditions and to set an efficient example for the new investment method by funneling additional financial resources from the private sector into public investments.

MONETARY POLICY

Monetary policies have been adopted that are conducive to recovery in domestic demand while stabilizing domestic prices in 2004. Although domestic demand in private consumption, facility investments and so forth show a downward curve, as industrial production makes headway due to a hike in exports along with the volatile status of inflation due to high prices of raw materials, the government was urged to maintain target call rates at 3.75 percent until July. However, as unfavourable economic conditions were expected with the oil price unexpectedly maintaining its upward trend and a stagnant information and communications industry, the government has lowered by 0.25 percent its target call rates for July and November.

The overall prices in 2005 are expected to remain stable. As for the forecast in demand: Domestic demand is gradually recovering with minimal pressure for inflation. As for the forecast in costs: Risks for high costs are relatively low compared to the previous year due to the revaluation of the Korean won and continuing low growth in incomes. However, factors of unrest are expected to persist due to the prolonged high OR increase in international oil prices. Furthermore, ample market liquidity is projected to increase demand pressure in the next phase of economic recovery and there is the potential to stimulate the growth of asset prices.

In consultation with the government, the Bank of Korea will manage these risks. The government will make attempts to stabilize core inflation within the range of price stability targets in 2005 and 2006. In spite of this, the Korean government intends to focus its efforts on domestic recovery together with maintaining the stability of price movements.

STRUCTURAL REFORM

1. Financial Sector

Since the financial crisis, the government has vigorously carried out financial restructuring to restore the financial market function. In this process, 809 financial institutions were either merged or liquidated while public funds worth 1661.1 trillion won were injected to enhance the soundness of financial institutions. Consequently, the soundness of financial institutions recovered, as evidenced by the amount of non-performing loans in financial institutions, which decreased to 40.2 trillion won (4.2 percent of the total loans) as of the end of September 2003 from 88 trillion won (14.9 percent of the total loans) in 1999. Profitability of financial institutions such as banks has significantly improved.

The government plans to steadily implement financial restructuring based on market principles to prevent a delay in restructuring from turning into a destabilizing factor in the financial market. The privatization of the remaining banks that received public funds will be carried out without delay and restructuring of the non-banking sector including investment trust companies on will be implemented on a continual basis.

2. Corporate Sector

The corporate restructuring implemented in the aftermath of the financial crisis has remarkably enhanced corporate financial status. The debt-to-equity ratio in the manufacturing sector dropped to 123 percent as of 2003 from the pre-crisis level of about 400 percent. This ratio is lower than that of developed economies such as the United States and Japan.

Concerning restructuring of non-viable companies, a total of 83 firms have undergone restructuring through the workout program since the financial crisis. In accordance with the workout procedure, 57 companies took the path to management normalization, 19 firms completed an early liquidation process and 7 firms are currently in the workout program.

Along with such efforts, a basis for constant corporate restructuring based on market principles has been laid. The constant assessment system of the credit risk of companies was introduced (in February 2003) with creditor banks taking on a leading role. The Corporate Restructuring Promotion Act (enacted in September 2002) established the laws and institutions under which companies that prove problematic according to evaluation results will go swiftly through a restructuring based on market principles. In accordance with the pre-prepared guidelines of corporate restructuring, further restructuring will be implemented in a drastic and swift manner. In addition, to ensure a level playing field, the government aims to establish a fair and transparent economic system based on the "Three-year Market Reform Action Plan" announced in October 2003.

ANNEX I

KOREA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	445.2	511.8	462.0	545.9	608.0	680.1[p]
Real GDP[1]	9.4	5.5	2.8	7.0	1.9	3.8[p]
Consumption	9.7	7.1	4.9	7.6	Δ0.3	0.2[p]
Private Consumption	11.5	8.4	4.9	7.9	Δ1.2	Δ0.5[p]
Government Consumption	2.9	1.6	4.9	6.0	3.8	3.0[p]
Investment	8.3	12.2	Δ0.2	6.6	4.0	1.9[p]
Private Investment	N/A	N/A	N/A	N/A	N/A	N/A
Government Investment	N/A	N/A	N/A	N/A	N/A	N/A
Exports of Goods and Services	8.6	19.9	Δ12.7	8.0	19.3	31.0
Imports of Goods and Services	28.4	34.0	Δ12.1	7.8	17.6	25.5
Fiscal and External Balance (percent of GDP)						
Budget Balance	Δ3.0	1.1	0.6	2.3	2.8	2.0
Merchandise Trade Balance	6.4	3.3	2.8	2.7	3.6	5.6
Current Account Balance	5.5	2.4	1.7	1.0	2.0	3.9
Capital and Financial Non-reserve Assets Balance	0.5	2.4	Δ0.7	1.1	2.3	1.2
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	Δ0.1	0.7	3.5	2.8	2.7	2.7
CPI	0.8	2.3	4.1	2.7	3.6	3.6
M2	5.1	5.2	8.1	14.0	3.0	5.2
Short-term Interest Rate (percent)[2]	4.92	5.05	4.63	4.16	3.95	3.61
Real Effective Exchange Rate (level, 1995=100)	N/A	N/A	N/A	N/A	N/A	N/A
Unemployment Rate (percent)	6.3	4.1	3.8	3.1	3.4	3.5
Population (millions)	46.6	47.0	47.4	47.6	47.8	48.1

Note:
[1] 2000 Constant Price
[2] Call rate

ANNEX II

KOREA: FORECAST SUMMARY (percent change from previous year)

	2004					2005				
	Official	IMF	ADB	OECD	PECC	Official	IMF	ADB	OECD	PECC
Real GDP	3.8 [p]	4.6	4.6	4.6	4.6	N/A	4.0	4.1	4.3	4.0
Exports	31.0	N/A	30.6	19.7	20.2	N/A	N/A	11.8	9.8	9.0
Imports	25.5	N/A	25.2	13.8	12.4	N/A	N/A	13.5	8.7	10.8
CPI	3.6	3.6	3.6	3.6	3.6	N/A	2.9	3.0	3.2	2.9

ANNEX III

KOREA: MEDIUM-TERM TREND FORECAST (percent)

	2006
Real GDP	5.2
GDP Deflator	3.0

Reference: World Economic Outlook, IMF

MALAYSIA

REAL GROSS DOMESTIC PRODUCT GROWTH

The Malaysian economy expanded by 7.1 percent in 2004, the fastest rate of expansion since 2000 and on the back of stronger external and domestic demand. Notwithstanding some moderation in global growth in the second half of the year, the Malaysian economy remained resilient with the private sector continuing to be the principal driving force of domestic economic expansion amidst an environment of low and stable inflation as well as improved labour market conditions.

The overall federal government deficit declined to 4.3 percent of GDP in 2004 (2003: -5.3 percent), below the estimated 4.5 percent announced last September. The government, while consolidating, continues to remain supportive of growth with policies targeted at enhancing the business environment for the economy.

DEMAND SIDE

Since the Asian financial crisis, domestic demand has played an increasingly important role in economic growth—the result of a deliberate policy to reduce over dependence on the external sector. Aggregate **domestic demand,** which grew at 7.3 percent (2003: 5.9 percent), thus continued to contribute significantly to the economic expansion in 2004 with the private sector leading growth and contributing 6.2 percent to the economic growth.

Both **private consumption and investment** expanded strongly, by 10.1 percent (2003: 6.6 percent) and 15.8 percent (2003: 0.4 percent), respectively, due to a sustained increase in disposable incomes, stable labour market conditions, a low inflation and interest rate environment as well as improved consumer sentiment. In line with the on-going fiscal consolidation of the federal government, public consumption experienced a slower growth of 6.6 percent (2003: 10.0 percent). Likewise, total investment expenditure increased moderately by 3.1 percent (2003: 2.7 percent) due to the softening in infrastructure projects. This was, however, offset by a strong recovery in private investment activities, supported by higher inflows of foreign direct investment (FDI), favourable exports, strong internally generated funds and improved business confidence.

SUPPLY SIDE

All economic sectors, except construction, experienced positive growth, with manufacturing providing the strongest stimulus to overall GDP growth in 2004.

The **manufacturing sector** strengthened to 9.8 percent in 2004 (2003: 8.3 percent), led mainly by; the strong demand for global semiconductors in the first half of the year, sustained external demand for resource-based products (including rubber, wood and chemicals),and higher production in domestic-oriented industries (including fabricated metal and transport equipment industries). The electronics industry posted weaker growth in the fourth quarter (Q4) of 2004 as manufacturers rationalised their inventories in line with the down-cycle in global demand

The **services sector** registered an impressive 6.7 percent growth in 2004 (2003: 4.4 percent), contributed mainly by a strong expansion in consumption, tourism, communications, trade, finance and business related activities.

The **agriculture sector** expanded by 5 percent (2003: 5.7 percent) supported by higher production in crude palm oil and rubber amidst favourable commodity prices, while growth in the **mining sector** of 4.1 percent (2003: 5.9 percent) was on account of increased output in crude oil and natural gas, benefiting from higher domestic and external demand.

The **construction sector** contracted by 1.9 percent (2003: 1.9 percent) since the sustained growth in the property sub-sector was weighed down by lower civil engineering activity following the completion in recent years of most large infrastructure projects as well as the consequent reduction in public spending on infrastructure projects in 2004.

INFLATION

Inflation continued to remain low despite the consumer price index (CPI) edging up slightly to **1.4 percent in 2004** from 1.2 percent in 2003 due to increases in prices of food, beverages and tobacco as well as an upward adjustment in retail prices of petroleum products. Nevertheless, the level remained manageable as labour market conditions remained stable supported by productivity growth and an expansion in capacity.

EMPLOYMENT

Labour market conditions in 2004 remained favourable with the unemployment rate marginally lower at **3.5 percent** (2003: 3.6 percent). Robust domestic economic activities continued to generate more job opportunities while growth in labour productivity (as measured by real sales value of product per employee) in the manufacturing sector rose by 15.6 percent, exceeding the 1.8 percent growth in real wages.

BALANCE OF PAYMENTS

The external sector continued to strengthen considerably, as reflected in the significant increase of internal reserves while the external debt position remained manageable.

The **current account** recorded a larger surplus of 56.6 billion ringgit or 13.4 percent of GNP in 2004 (2003: 50.8 billion ringgit; 13.7 percent). Trade surplus continued to remain large at 81.1 billion ringgit (2003: 81.3 billion ringgit) as a result of stronger growth in exports of manufactured goods and higher earnings from commodity exports. Malaysia has enjoyed a surplus in the current account since November 1997. Reflecting strong domestic activities, imports grew by 26.3 percent (2003: 4.4 percent). There was a significant improvement in the services account deficit, due mainly to higher tourism receipts.

The **financial account** turned around to record a net inflow of 15.4 billion ringgit in 2004 (2003: -12.1 billion ringgit) on account of mainly higher inflows of FDI and portfolio funds following stronger economic growth and improved corporate earnings. FDI was mainly channeled into the services, manufacturing and oil and gas sectors.

Net international reserves stood at a record high of 253.5 billion ringgit or US$66.7 billion as at end-2004. The reserves increased further to 280.2 billion ringgit or US$73.7 billion by 30 April 2005, sufficient to finance 8.7 months of retained imports and are 6.8 times the short-term external debt.

GROSS EXTERNAL DEBT

As at end-2004, total external debt increased moderately to 197.3 billion ringgit or US$51.9 billion (2003: US$49.1 billion), attributable to higher short-term borrowings by the banking sector, which was largely due to hedging activities for trade-related transactions and treasury activities. The share of short-term debt to total debt remained low at 21.8 percent. Given the prudent debt management policy, Malaysia's share of external debt to GNP improved to 46.6 percent (2003: 50.2 percent), while the debt service ratio improved to 4.3 percent (2003: 6.2 percent).

EXCHANGE RATE[1]

The pegged exchange rate arrangement continues to accord benefits to the Malaysian economy by providing predictability and stability for international trade and investment. The exchange rate regime would only be reviewed in the event the ringgit is headed for sustained misalignment arising from major structural changes within the international and regional financial systems, or if fundamentals warranted a change in the system.

The stock market performed well in 2004, supported by strong economic growth, higher corporate earnings and renewed foreign interest. The Kuala Lumpur Composite Index (KLCI) rose 14.3 percent to 907.43 points at end-2004 (end-2003: 793.94 points), while market capitalisation increased by 12.8 percent to 722 billion ringgit (end-2003: 640.5 billion ringgit).

The stock market, however, consolidated during the first quarter of 2005, with the KLCI closing lower at 871.35 points at end-March 2005. The somewhat lacklustre performance of the market was attributed to concerns that resurging oil prices and further interest rate hikes would affect growth.

FISCAL POLICY

Federal government recorded a smaller fiscal deficit of 4.3 percent of GDP in 2004 (2003: -5.3 percent). The improvement in the fiscal position was due to better revenue collection and lower disbursements of development expenditure. The fiscal deficit was financed mainly from domestic sources.

MONETARY POLICY

Macroeconomic policy in 2004 was focused on maintaining stability and improving the risk-bearing capacity of the economy. While the government continued to pursue gradual fiscal consolidation to strengthen its fiscal position, the monetary policy stance remained accommodative to support domestic economic activities. Interest rates remained consistent with domestic economic activity and were supportive of growth. The financially sound positions of the corporate, household and banking sectors were instrumental in ensuring the effectiveness of the accommodative monetary policy.

The effectiveness and efficiency of the conduct of monetary policy was further improved when the Central Bank introduced **a new interest rate framework** in April 2004 whereby the overnight policy rate (OPR) replaced the 3-month intervention rate as the indicator of the monetary policy stance. The OPR was set at the prevailing interbank overnight rate of 2.70 percent and allowed to fluctuate within a margin of ±25 basis points (bps) so as to minimise excessive volatility in the corresponding market rate. The new interest rate framework also allowed for greater efficiency in the operation of the banking system, thereby facilitating an effective and efficient pricing of financial products. For example, banking institutions were allowed to set their own base lending rate (BLR) taking into account their institutional cost structure and strategies.

The banking sector continued to remain robust with a high level of capitalisation, and marked improvement in profitability. Loans growth expanded at 8.5 percent, while net non-performing loans (NPLs) fell to 7.6 percent (based on 3-month classification), the lowest since the Asian financial crisis. The risk-weighted capital ratio (RWSR) of the banking system stood at 13.8 percent while the core capital ratio (CCR) was at 10.8 percent as at end-December 2004.

---

[1] The seven-year exchange rate regime was replaced by a managed float of the ringgit against a basket of the trade-weighted currencies of Malaysia's major partners on 21 July 2005. The primary objective of the exchange rate policy is to promote stability—an essential element for a highly open and trade reliant economy. However, to prevent speculative activity, the ringgit remains non-internationalised.

MEDIUM-TERM OUTLOOK

Prospects for the Malaysian economy in 2005 remain sound, driven largely by strong private sector demand, despite moderating world economic and trade activities.

The Malaysian economy enters the year 2005 from a position of strength amidst downside external risks, including high oil prices, inflationary pressures and rising interest rates. Growth prospects will continue to be favourable with strong underlying domestic economic conditions stimulated to a large extent by robust private consumption and investment expenditure.

A major challenge for 2005, aside from high oil prices and interest rate hikes, will be volatility in the currency market. However, **Real GDP in 2005** is expected to continue to register strong albeit lower growth of between **5.0 percent and 6.0 percent.** This projection takes into account the uncertainties related to international developments, such as moderating world economic growth and trade, a downturn in the global semiconductor industry as well as the impact of high oil prices and interest rate hikes.

Economic growth will continue to be supported by all sectors, except construction. The services sector is expected to lead the expansion, growing by 5.7 percent, followed by mining (5.0 percent), manufacturing (4.5 percent) and agriculture (3.3 percent). The **construction sector** is projected to recover with a smaller decline of 1.0 percent from the –1.9 percent in 2004, its continued performance being affected by excess capacity and slower activity in the civil engineering segment. The performance of the **services sector** will be driven largely by consumption and tourism-related activities as well as expansion in the telecommunication, finance and business services related industries. **Manufacturing activity** will continue to be influenced by international developments, particularly the global semiconductor industry, while the **agriculture sector** will continue to benefit from high production of crude palm oil, and rubber, as well as rising contributions from other food crop-related activities. The **mining sector** is expected to remain strong with high oil prices and continued external and domestic demand.

All **demand** components, except public investment, are expected to register positive growth in 2005. **Private investment** spending will increase strongly, by 9.6 percent, mainly on account of higher capital outlays in the manufacturing, services, oil and gas as well as agriculture sectors. **Private consumption** is envisaged to expand by 8.5 percent, underpinned by stable labour market conditions, a supportive credit environment and high commodity prices.

Public expenditure is expected to further decline in line with the fiscal consolidation efforts of the government. This is reflected in a contraction of 11.6 percent in the growth of **public investment**. Nevertheless, **public consumption** is estimated to increase moderately by 4.5 percent, on account of higher spending on supplies and services. On the federal government account, the overall deficit as a percentage of GDP is expected to fall to 3.8 percent in 2005, reflecting continued fiscal prudence and consolidation efforts.

The **current account** surplus of the balance of payments is likely to remain large at 14.9 percent of GNP, following the continued build-up in the trade account surplus as the moderation in export growth (7.0 percent) is expected to be offset by slower growth in imports (6.3 percent). In addition, the **services account** is expected to register a smaller deficit with continuing growth in tourist arrivals.

The on-going improvements in productivity and the capacity expansion that have been taking place over the years are likely to mitigate any build-up of inflationary pressures in 2005. The **inflation rate** is expected to register an increase of 2.5 percent, taking into account the edging up of the CPI in the first half of this year due to the one-off impact of price adjustments to retail prices of petroleum products as well as higher taxes on cigarettes and tobacco. The favourable economic growth environment will provide greater job opportunities across major sectors of the economy, with the **unemployment rate** projected to remain low at 3.5 percent in 2005.

STRUCTURAL REFORM

Malaysia achieved significant progress in further strengthening the financial system[2]. The national asset management company, **Danaharta,** the remaining agency of the three institutions[3] established to address financial sector restructuring during the Asian financial crisis, had successfully redeemed all 15 tranches of its bonds worth 11.1 billion ringgit by March 2005. The bonds had been issued to finance **Danaharta's** acquisition of non-performing loans. With this progress, **Danaharta** is on track to wind up its operations in 2005, signifying the conclusion of the financial sector restructuring exercise. In addition, the ongoing mergers between finance companies and commercial banks have also helped strengthen the capacity and capability of domestic banking institutions.

The **Financial Sector Master Plan (FSMP),** a blueprint for the financial sector launched in 2001, is on track.[4] The **FSMP** is currently into its second phase of implementation, whereby progressive liberalisation will take place to level the playing field between the domestic and incumbent foreign banking institutions. The key liberalisation measures initiated include:

- the approval to three foreign financial institutions to operate Islamic banking in Malaysia;
- allowing foreign equity of up to 49 percent in the Islamic subsidiary of commercial banks;
- allowing up to 49 percent foreign ownership of investment banks; and
- according greater operational flexibility to incumbent foreign banks.

The capital market also witnessed the implementation of several initiatives under the **Capital Market Masterplan (CMP)[5]** during 2004, aimed at further enhancing market liquidity and efficiency as well as investor protection and corporate governance. Among others, the key initiatives include:

- demutualising the Kuala Lumpur Stock Exchange by converting it into a public company limited by shares from a company limited by guarantee;
- liberalising the foreign exchange administration rules to allow the multilateral development banks (MDBs), multilateral financial institutions (MFIs) and multinational corporations (MNCs) to issue ringgit-denominated bonds in Malaysia;
- allowing five foreign stockbrokers and five global fund managers to establish fully-owned operations in Malaysia; and
- allowing 100 percent foreign ownership in futures broking companies and venture capital companies.

---

[2] The deposit insurance system was introduced in September 2005. The system is expected to further strengthen consumer protection infrastructure as well as strengthen incentives for financial institutions to adopt sound financial and business practices and enhance public confidence in the financial system by providing explicit protection of deposits.

[3] The other two being Danamodal and Corporate Debt Restructuring Committee (CDRC). The CDRC ceased operations in August 2002, while Danamodal, which was setup to recapitalise the banking sector, wound up its operations in February 2004.

[4] It comprises 119 recommendations to be implemented in 3 phases over a 10-year period. The FSMP outlines the medium- and long-term strategies for the development of the financial sector. To date, 43 recommendations have been fully implemented while another 26 recommendations are being implemented on a continuous basis. The completed recommendations essentially focus on building the capacity and capability of domestic financial institutions to improve their level of effectiveness and competitiveness.

[5] Launched in March 2001, the 10-year masterplan is now in its 2nd phase. A total of 94 out of 152 (62 percent) recommendations have been completed.

ANNEX I

MALAYSIA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	50.7	55.1	55.4	57.9	61.0	65.3
Real GDP	6.1	8.3	0.4	4.1	5.3	7.1
Consumption	5.7	10.5	5.8	6.4	8.5	10.6
Private Consumption	2.9	12.5	2.5	4.4	8.1	11.4
Government Consumption	17.1	3.0	17.0	11.9	9.8	8.2
Investment	-6.5	25.7	-2.8	0.2	4.0	5.4
Private Investment	-23.1	32.6	-19.9	-15.1	1.6	18.4
Government Investment	16.3	19.4	14.5	11.2	5.2	-1.3
Exports of Goods and Services	13.2	16.1	-7.5	3.6	11.3	20.8
Imports of Goods and Services	10.6	24.4	-8.6	6.1	5.2	26.3
Fiscal and External Balance (percent of GDP)						
Budget Balance (percent of GDP)	-3.2	-5.8	-5.5	-5.6	-5.3	-4.3
Merchandise Trade Balance (percentage change)	28.6	23.1	20.9	19.1	35.5	7.0
Current Account Balance (percent of GNP)	15.9	9.4	8.3	9.1	13.7	13.4
Capital and Financial Non-reserve Assets Balance						
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	0.0	4.9	-2.9	3.8	3.5	6.0
CPI	2.8	1.6	1.4	1.8	1.2	1.4
M2	13.7	5.2	2.2	5.8	11.1	25.4
Short-term Interest Rate (percent) (S3 month weighted average Interbank)	4.08	3.19	3.13	3.13	2.87	2.80
Real Effective Exchange Rate (level, 1995=100)						
Unemployment Rate (percent)	3.4	3.1	3.6	3.5	3.6	3.5
Population (millions)	22.7	23.5	24.0	24.5	25.0	25.6

ANNEX II

MALAYSIA: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**Link**
Real GDP	7.1	7.1	7.1	N.A.	N.A.	N.A.	5.0-6.0	6.0	5.7	N.A.	N.A.	N.A.
Exports	20.6	N.A.	20.5	N.A.	N.A.	N.A.	7.0	N.A.	12.0	N.A.	N.A.	N.A.
Imports	25.1	N.A.	25.8	N.A.	N.A.	N.A.	6.2	N.A.	15.8	N.A.	N.A.	N.A.
CPI	1.4	1.4	1.4	N.A.	N.A.	N.A.	2.5	2.5	2.4	N.A.	N.A.	N.A.

ANNEX III

MALAYSIA: MEDIUM-TERM TREND FORECAST (percent)

	2001–2005
Real GDP	4.2
GDP Deflator	N.A.

MEXICO

REAL GROSS DOMESTIC PRODUCT GROWTH

Mexico's economic activity, as measured by gross domestic product (GDP), grew at a real annual rate of 4.4 percent during 2004. The economic expansion continued through the first quarter (Q1) of 2005; the GDP grew at a real annual rate of 3.0 percent during this period. It should be mentioned that these figures do not fully reflect the economy's vigor since Q1 2004 had a total of five work days less than Q1 2003. The tertiary sector grew at an annual rate of 4.8 percent during the first two months of 2005. Industrial production grew 2.4 percent in the same period. Agricultural activity grew at a relatively moderate pace of 0.4 percent when compared to the first two months of 2004.

INFLATION

The annual inflation rate, measured by the variation of the consumer price index (CPI), stood at 5.19 percent at the end of 2004. During the first quarter of 2005, the registered annual inflation was 4.39 percent. The main reasons behind the declining inflation in this period are the dissipation of the disturbances in the supply that affected the prices of the agricultural goods in 2004 and the decline in the annual inflation of the administered and concerted goods, during the first quarter of the year.

EMPLOYMENT

The productive dynamism registered in the first quarter of 2005 encouraged the creation of formal jobs. During the first quarter of 2005, the number of formal employees registered in the Mexican Social Security Institute (Instituto Mexicano del Seguro Social, or "IMSS") grew by 103,399 people. By 31 March, the total number of registered employees was 12,612, 825 workers; in annual terms this represented a 2.4 percent increase.

BALANCE OF PAYMENTS

During 2004 the fast growth in the aggregated demand supply led to a significant increase in annual terms in the imports of services and goods. This situation was compensated mainly by the increase in oil and manufacturing exports, and in the transfers incomes, therefore the deficit in the current account of the balance of payments experienced only a slight increase compared to that observed in 2003. As a result, the deficit stood at US$8,712 million, US$125.6 million higher than 2003. As a percentage of GDP, this deficit stood at 1.3 percent in 2004, the same percentage as in 2003.

- The trade balance registered a deficit of US$8,530 million. This deficit resulted from the expansion by 15.6 and 14.5 percent of imports and exports of goods, respectively.
- The non-factoring services balance registered a deficit of US$4,563 million. In this category, the tourist balance registered an annual increase of 21.1 percent, which represented a record surplus of US$3,879 million.
- The factorial services balance registered a deficit of US$12,662 million. This increase in the deficit was motivated mainly by a substantial reinvestment of profits that equaled US$533.3 million.
- The net foreign transfers reached a historically high level of US$17,043 million, which implies an annual expansion of 23.0 percent.

During 2004 the economy's dynamism and the better outlook for 2005 encouraged capital flows to Mexico. The capital account of the balance of payments registered a surplus of US$13,691 million, US$4,352 million lower than in 2003.

A net foreign indebtedness of US$993.8 million was registered, reflecting that the net amortizations of the public sector, which stood at US$4,439.5 million, were partially offset by the private sector's net disbursements of US$3,445.7 million.

Foreign investment totaled US$19,273 million. This flow was composed of US$16,601.9 million of foreign direct investment (FDI) and US$2,671.2 million of foreign portfolio investment, with an annual increase of 46.0 and 243 percent, respectively.

Errors and omissions in 2004 registered a negative flow of US$921.2 million, which when added to the results in the current and capital accounts, produced an accumulation of net international reserves of US$4,061.4 million.

GROSS EXTERNAL DEBT

On 6 January, Moody's upgraded the ratings of the Mexican external debt from Baa2 to Baa1. This equaled the ratings between the local and foreign currency Mexican sovereign liabilities, reflecting the diminishing relative importance of external debt in total debt and a solid international liquidity position, factors that have allowed a continuous reduction of the indicators of foreign vulnerability and, with them, a lessened sensitivity of public finances to adverse situations.

Similarly, Standard and Poor's upgraded the long term debt denominated in foreign currency from BBB- to BBB, and the short- and long-term debt denominated in local currency from "A-" to "A" and from "A-2" to "A-", respectively. This upgrade was the result of gradually increasing macro-economic stability due to the responsible handing of public debt, a steady improvement in external liquidity and deepening domestic financial markets.

At the end of the first quarter of 2005, net public debt represented 24.2 percent of GDP, 1.0 percentage point above its level at the end of 2004. This can be explained by increases in both domestic and external debt as percentages of GDP.

By the end of the first quarter, the net external public debt balance was US$78.6 billion, US$601.3 million more than the US$78 billion balance at the end of 2004. This was due to a net external debt acquisition of US$1.37 billion, a reduction of US$559.2 million in federal government foreign financial assets and downward accounting adjustments of US$995.1 million. It should be pointed out that the foreign indebtedness is transitory and that it will diminish gradually as the debt matures during the following months and is repaid according to this year's financing program and the debt reduction ceiling of US$500 million approved by Congress.

EXCHANGE RATE

The peso-US dollar exchange rate continued its appreciating trend during most of the first quarter of 2005. Nevertheless, the international markets aversion to risk observed from the first two weeks of March had a negative impact on the peso. In this context, on 31 March 2005, the spot exchange rate was 11.17 pesos per US dollar, showing a depreciation of 0.14 percent with respect to the fourth quarter of 2004.

FISCAL POLICY

During the first quarter, the fiscal balance accumulated a surplus of 26.4 billion pesos, 46.4 percent less, in real terms, than the fiscal surplus in the same period of 2004. The primary balance reached a surplus of 81.4 billion pesos, equivalent in real terms to 20.8 percent less than a year ago.

Budgetary revenues reached 471.9 billion pesos, 1.9 percent higher in real terms than those obtained in the same quarter of 2004. These revenues exceeded by 4.39 billion pesos the amount published in the Official Gazette (*Diario Oficial de la Federación*) for 2005. Of these revenues, 10.2 billion pesos came from public entities under direct budgetary control other than PEMEX and 831 million pesos came from oil. On the other hand, non-oil tax revenues and non-tax revenues of the federal government were below target by 2.56 billion pesos and 4.12 billion pesos, respectively.

Oil income grew 4.2 percent in real terms, mainly because of the increase in international oil prices. Of the non-oil tax revenues, which, in general grew 1.1 percent in real terms, value added tax revenue stands out with a 7.5 percent increase.

MONETARY POLICY

The monetary base, which consists of currency in circulation and financial institutions deposits with the Central Bank, stood at 311.9 billion pesos at the end of March 2005. This balance represents an increase of 11.7 percent in real terms with respect to the same period of 2004. Net domestic credit of the Central Bank (defined as the difference between the monetary base and net international assets) presented a negative balance of 405.2 billion pesos, which is comparable with the negative balance of 422.1 billion pesos observed at the end of March 2004.

Net international assets of the Central Bank were 717 billion pesos at the end of March, 27.5 million pesos higher than for the same period of 2004. The balance of net international assets in US dollars was 64.1 billion, US$2.4 billion higher than for the same period of 2004.

ANNEX I

MEXICO: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	480.6	580.8	621.9	648.6	638.7	676.5
Real GDP	3.8	6.6	0.0	0.8	1.4	4.4
Consumption	4.4	7.4	1.9	1.4	2.1	4.7
Private Consumption	4.3	8.2	2.5	1.6	2.3	5.5
Government Consumption	4.7	2.4	-2.0	-0.3	0.8	-1.2
Investment	7.7	11.4	-5.6	-0.6	0.4	7.5
Private Investment	7.2	9.0	-5.9	-4.1	-1.5	8.5
Government Investment	10.7	25.2	-4.2	17.0	8.5	3.6
Exports of Goods and Services	12.4	16.4	-3.8	1.6	2.7	11.5
Imports of Goods and Services	14.1	21.5	-1.6	1.5	0.7	10.2
Fiscal and External Balance (percent of GDP)						
Budget Balance [1]	1.2	1.1	0.7	1.2	0.7	0.3
Merchandise Trade Balance	-1.2	-1.4	-1.5	-1.2	-0.9	-1.3
Current Account Balance	-2.9	-3.2	-2.9	-2.1	-1.3	-1.3
Capital and Financial Non-reserve Assets Balance	2.9	3.2	4.3	3.5	2.8	2.0
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	15.1	12.1	5.8	7.0	8.5	6.1
CPI	12.3	9.0	4.4	5.7	4.0	5.2
M2	8.7	7.1	11.9	5.0	8.6	6.8
Short-term Interest Rate (percent) [2]	21.4	15.2	11.3	7.1	6.2	6.8
Real Effective Exchange Rate (level, 1995=100)	66.4	58.8	53.6	52.2	61.3	66.0
Unemployment Rate (percent)	2.5	2.2	2.5	2.7	3.3	3.8
Population (millions)	98.1	98.7	100.1	101.4	102.7	104.0

Notes

[1] 2002 includes the liquidation of the National Bank of Rural Credit (Banrural); 2003 and 2004 include the cost of the Voluntary Retirement Program (PSV).

[2] Annual average 28th CETES interest rate.

ANNEX II

MEXICO: FORECAST SUMMARY (percent change from previous year)

	2005					
	Official	IMF	ADB	OECD	PECC	Link
Real GDP	3.8	N.A.	N.A.	N.A.	N.A.	N.A.
Exports	6.8	N.A.	N.A.	N.A.	N.A.	N.A.
Imports	6.2	N.A.	N.A.	N.A.	N.A.	N.A.
CPI	3.0	N.A.	N.A.	N.A.	N.A.	N.A.

ANNEX III

MEXICO: MEDIUM-TERM TREND FORECAST (percent)

	2006–2008
Real GDP	4.1
GDP Deflator	3.4

NEW ZEALAND

SUMMARY

- The New Zealand economy has averaged 4.0 percent annual growth in the past six years, well above the OECD average of 2.6 percent. The drivers of this growth have included both cyclical and structural factors.
- Growth in 2004 was sustained by continuing income growth and rising household wealth stemming from the strong labour and housing markets and high international commodity prices. Consumption expenditure remained strong but residential investment fell in the second half of 2004.

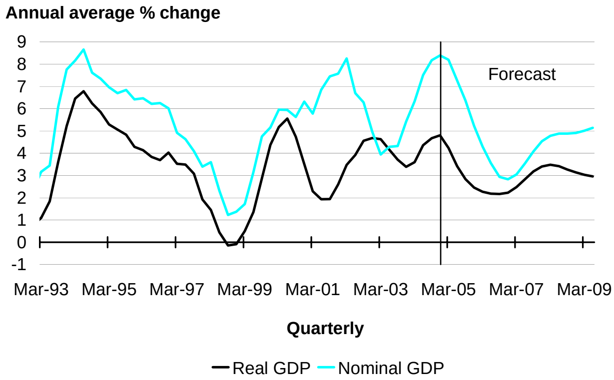
Growth slowed in the second half of 2004. The 2005 Budget Economic and Fiscal Update forecasts growth of 2.3 percent in the March 2006 year and 2.5 percent in the March 2007 year, compared with 4.2 percent in the March 2005 year. Growth is forecast to rebound to 3.5 percent in March 2008, before declining to 3.0 percent in the year ended March 2009.

- High exchange and interest rates, declining net migration inflows, slower trading partner growth and a forecast decline in the terms of trade are the main drivers of slower growth. Further out, a projected fall in exchange and interest rates and a return to trend growth in the global economy are expected to lead to stronger growth.
- CPI inflation is expected to remain near the top of the Reserve Bank's target for the next 2 to 3 years.
- Short-term interest rates are forecast to remain at current levels until the end of 2005 and then to revert to their assumed neutral level of 5.8 percent by March 2009 in line with forecast inflation.
- Growth in nominal GDP is forecast to decline from 8.4 percent in calendar year 2004 to 4.3 percent in the year to March 2006. In the near term, the higher growth in nominal GDP is expected to be reflected in higher corporate profits, but this component is likely to decline as the economy slows.
- The deficit on the current account is expected to increase further, peaking at around 7.0 percent of GDP in late 2006-early 2007.

INTRODUCTION

The New Zealand economy has grown strongly in the past six years after emerging from the 1997/98 recession. Annual GDP growth averaged 4.0 percent in the period from 1999 to 2004, well above the average for OECD member economies of 2.6 percent.

Figure 1 – Growth in real and nominal GDP



Sources: Statistics New Zealand, The Treasury

The rate of growth in the economy slowed in the second half of 2004, after fast growth in the first half of the year, with domestic activity slowing, particularly residential investment. The strong growth performance over 2004 has been driven by a number of factors, including a sharp lift in New Zealand's terms of trade, a period of high net migration, house price appreciation and a strong labour market, with the unemployment rate reaching 3.6 percent in December 2004.

With the domestic economy exhibiting healthy growth, the volume of imports has lifted sharply. Together with a rise in profits of foreign-owned firms, and therefore an increase in the investment income deficit in the current account, the lift in import volumes has seen the current account deficit expand to 6.4 percent of GDP.

Strong growth has contributed to increased pressure on resources and a lift in the rate of inflation. Capacity utilisation in the manufacturing and construction industries reached a 43-year high of 92.6 percent in the quarter beginning December 2004 according to the QSBO. High capacity utilisation, strong employment growth and low unemployment have led to increased inflation pressures.

GROSS DOMESTIC PRODUCT GROWTH

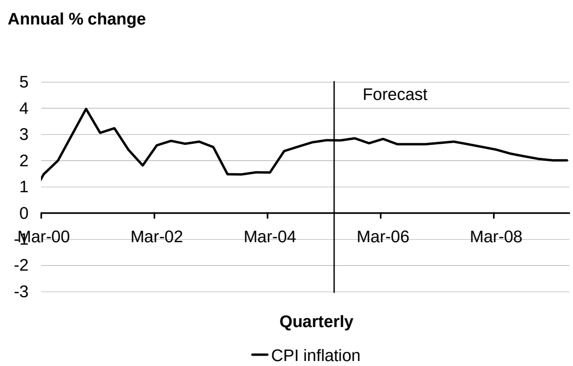
The 2005 Budget Economic Update forecasts the rate of growth in the New Zealand economy to slow in the next two years as a number of influences begin to weigh against growth. Amongst them are higher exchange and interest rates, the continuing slowdown in net migration inflows, slower trading partner growth in 2005 and a forecast decline in the terms of trade. We estimate that growth in real GDP peaked at 4.8 percent in calendar year 2004 and will slow to 2.3 percent in the March 2006 year and 2.5 percent in the March 2007 year, but will then pick up to 3.5 percent in the following year and 3.0 percent in the fiscal year ending March 2009.

Nominal GDP growth is forecast to decline from an estimated 8.2 percent in the March 2005 year to 4.3 percent in the March 2006 year and 3.0 percent in the March 2007 year, but then to recover to 5.0 percent growth in the March 2009 year. We expect nominal GDP to increase by more than forecast in the December Update in the year to March 2006, because of the high terms of trade in the current period and slightly higher inflation, reflecting the strength of the economy. In income terms, much of the additional nominal GDP appears as operating surplus, or profits. Corporates are currently performing well and profit growth has been strong, boosting corporate tax revenue. However, as the economy slows we expect profit growth to slow markedly as cost pressures remain (particularly in the labour market) and competition limits price increases.

INFLATION

High capacity utilisation, strong employment growth and low unemployment have led to increased inflation pressures. In the March 2005 QSBO, a net 40 percent of firms reported facing higher costs in the quarter, up from a net 35 percent in the previous quarter. A net 23 percent of firms raised their prices in the March quarter and 31 percent intended to do so in the following quarter. These figures point to increasing inflation pressure and declining profit margins as firms are squeezed by increased input costs, and competitive markets, the strong exchange rate and lower manufacturing costs in Asia restrict their ability to raise prices to final consumers.

Figure 2 – Consumer price inflation



Sources: Statistics New Zealand, The Treasury

We expect annual CPI inflation to remain within the Reserve Bank's target zone of 1.0 percent to 3.0 percent "on average over the medium term" in the next year despite the current high capacity utilisation and economic activity only just coming back to its potential level. Aggregate inflation has been suppressed by low tradables inflation (as a result of the appreciation of the exchange rate) and contributions from temporary factors such as declines in international airfares. Non-tradables inflation has been boosted by high rates of growth in construction costs, price increases in transportation (largely as a result of oil price increases) and rising costs of household operations (chiefly energy costs). We expect the first two of these to ease over the forecast period, but there will be a degree of persistence as the economy slows only gradually. Tradables inflation will increase as the fall in the exchange rate translates into increasing import prices.

EMPLOYMENT

With economic growth expected to slow over the next two years, employment growth is also forecast to slow, however there will be some offset to total labour income from increased wage growth. Growth in full-time equivalent employment is forecast to fall to a low of 0.5 percent in the year to June 2006, but to recover to 1.2 percent by the end of 2007. This slowing in employment growth is forecast to contribute to a lift in the unemployment rate, which increases to 4.5 percent in June 2009.

IMPORTS

Strong consumption and investment growth led to an acceleration in import volume growth from 8.1 percent in calendar year 2003 to 15.7 percent in 2004. Forecast falls in these major components of domestic demand will lead to a decline in import growth from an estimated 12.8 percent in the year to March 2005, to 4.1 percent in the year to March 2006, and then to average 2.5 percent growth in the following three years.

EXPORTS

In the export sector, the recent appreciation of the exchange rate is expected to suppress export receipts and put some export volumes, namely manufactured and services exports, under pressure, leading to a period of weak growth. There is uncertainty about how the high exchange rate will impact on export receipts in the near term. For some commodity exports, notably dairy, beef and lamb, the exchange rate has been offset by historically high international prices, leaving prices above their decade average in New Zealand dollar terms. Forestry products are a notable exception to this commodity picture. For manufactured product exporters, the effect of the exchange rate depends on the markets they export to; while the New Zealand dollar has appreciated strongly against the United States dollar, it has not posted such large gains against other currencies. Some manufacturing exporters have a natural hedge in imported raw materials and some took out long-term forward contracts to protect their returns. However, many of these forward contracts are about to expire, leaving firms to face a potentially abrupt transition to current exchange rates.

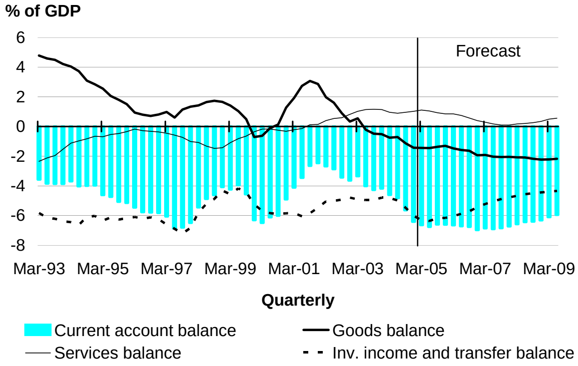
In the services sector, especially inbound tourism, the appreciation of the New Zealand dollar has only limited impact on the number of visitors in the short term, but it does reduce the amount travellers are prepared to spend once they arrive in New Zealand. In the longer term the high exchange rate begins to affect the number of visitor arrivals as New Zealand loses competitiveness as a holiday destination. The strong exchange rate also encourages more New Zealanders to travel overseas for holidays, detracting from services export receipts.

CURRENT ACCOUNT

We expect the current account deficit to continue to increase, peaking at 7.0 percent of nominal GDP in late 2006– early 2007. After that, it will decline gradually to around 6.0 percent of GDP in June 2009. The increase in the deficit is expected to initially be driven by an increase in the deficit on goods as a result of the continuing momentum in the domestic economy maintaining import growth, while export growth slows as a result of the high exchange rate and slower trading partner growth.

Subsequently, import prices are expected to increase more than export prices as the terms of trade deteriorate, further contributing to the deficit on goods. The balance on investment income remains negative throughout the forecast period, as the profits that accrue to foreign investors in New Zealand continue to exceed returns from New Zealand's overseas investments, but this component of the current account deficit decreases in the forecast period as business profitability declines.

Figure 3 – Current account deficit



Sources: Statistics New Zealand, The Treasury

GROSS EXTERNAL DEBT

New Zealand's total external debt for the year to December 2004 was $152 billion, up from $137 billion in December 2003. The net international asset position saw liabilities exceed assets by $124 billion in December 2004, compared with $106 billion in December 2003.

FISCAL POLICY

The operating balance before revaluations and accounting changes (OBERAC) is estimated to be 4.9 percent of GDP in June 2005, before declining to 4.3 percent of GDP in 2006 and 3.0 percent of GDP in 2009. Core Crown net debt is estimated to be 7.7 percent of GDP in 2006, compared with 15.4 percent in 2002, and is forecast to be 7.5 percent of GDP in 2009. Gross debt is forecast to fall from 22.6 percent in 2005 to 20.2 percent in 2009. Throughout the forecast period the accumulated assets of the New Zealand Superannuation Fund will grow from an estimated 4.3 percent of GDP in 2005 to 10.9 percent of GDP in 2009.

Current fiscal policy in New Zealand is geared towards running operating surpluses sufficient to meet the contributions to the New Zealand Superannuation Fund and to slowly reduce gross debt as a percentage of GDP over the longer term and passing through 20 percent of GDP before 2015.

MONETARY POLICY

The Reserve Bank of New Zealand is an independent central bank and through the Reserve Bank Act (1989) it is charged with maintaining price stability in New Zealand. The Act requires that there be a Policy Targets Agreement between the Minister of Finance and the Governor of the Reserve Bank. The most recent Policy Targets Agreement was signed in September 2002, and requires the Bank to maintain inflation in the range of 1.0 percent to 3.0 percent on average over the medium term. The agreement also states that in pursing its primary objective of price stability, the Bank shall seek to avoid "unnecessary instability in output, interest rates, and the exchange rate".

Short-term interest rates are expected to remain around current levels of 7.0 percent until the first quarter of 2006 in order to lean against current inflation pressures. Interest rates are then forecast to decline towards their assumed neutral level of around 5.8 percent by June 2009.

MEDIUM-TERM OUTLOOK

GDP growth is forecast to pick up to 3.5 percent in the year to March 2008 as the lagged impact of an expected depreciation of the exchange rate boosts exports. By the end of the forecast period in March 2009 growth of 3.0 percent is forecast. Nominal GDP will be rising at a rate of approximately 5.0 percent per annum.

ANNEX I

NEW ZEALAND: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion NZ$)	106.641	113.375	121.954	128.010	134.953	146.274
Real GDP	4.4	3.5	2.6	4.7	3.4	4.8
Consumption	4.3	0.9	2.9	3.9	4.5	6.1
Private Consumption	3.7	2.1	2.4	4.2	5.1	6.1
Government Consumption	6.5	-3	4.5	2.8	2.3	6.3
Investment	7.3	8.3	0.9	10.7	10.7	12.7
Private Investment	8.4	13.2	-3.6	8.5	15.6	12.1
Government Investment	2.3	-14.4	28.4	20.9	-9	16.1
Exports of Goods and Services	8.1	6.1	2.6	6.1	1.9	5.2
Imports of Goods and Services	11.9	0.2	2	9.4	8.1	15.7
Fiscal and External Balance (percent of GDP)						
Budget Balance (June yr)	0.2	0.8	1.8	2.2	4.3	4.7
Merchandise Trade Balance	-0.7	1.3	2.9	0.3	-0.5	-1.4
Current Account Balance	-6.3	-4.9	-2.5	-3.6	-4.2	-6.4
Capital and Financial Non-reserve Assets Balance	n/a	n/a	n/a	n/a	n/a	n/a
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	0.3	2.6	4.5	0.4	2	3.9
CPI	-0.1	2.6	2.6	2.7	1.8	2.3
M2	8.2	0.9	14.7	8.0	4.1	2.7
Short-term Interest Rate (percent)	5.4	6.7	5	5.9	5.3	6.7
Real Effective Exchange Rate (level, 1995=100)	105.9	104.5	97.3	98.7	113.1	126.5
Unemployment Rate (percent)	6.2	5.6	5.4	4.9	4.6	3.6
Population (millions)	3.851	3.873	3.912	3.976	4.039	4.084

ANNEX II

NEW ZEALAND: FORECAST SUMMARY (percent change from previous year)

	2005						2006					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**Link**
Real GDP	2.5	2.8		2.9			2.2	2.6		2.4		
Exports	2.7			5.4			4.1			8.3		
Imports	4.8			5.2			6.7			6.3		
CPI	2.7	3.0		3.2			2.6	2.7		2.8		

ANNEX III

NEW ZEALAND: MEDIUM-TERM TREND FORECAST (percent)

	Period (at forecast end-point)
Real GDP	3.0
GDP Deflator	2.0

Note: (*) Please specify the forecasting period.

PAPUA NEW GUINEA

DEVELOPMENTS IN THE ECONOMY OF PAPUA NEW GUINEA: 2004 AND THE FIRST QUARTER OF 2005

1. ECONOMIC INDICATORS

Economic Growth

In Papua New Guinea, there has been an improvement in economic activity which continued in 2004, with the economy growing by 2.7 percent in real terms. The non-mining economy grew by 3.2 percent in real terms, reflecting continued solid growth in the agriculture sector, with increased exports of cocoa, copra, palm oil and tea partly offset by lower coffee exports.

The mining and quarrying sector grew by 2.3 percent in 2004, with higher production in major gold mines offsetting lower copper production. The petroleum sector declined by 8.5 percent in 2004, with the natural decline in oil production from the Gobe and Kutubu oilfields more than offsetting increased value added from improved productivity.

Economic growth is expected to reach 3.0 percent in 2005, with non-mining GDP expected to grow by 3.2 percent in the year. The improvement in the economic outlook for 2005 reflects increased investor and consumer confidence following a period of macroeconomic stability – reflecting the Papua New Guinea government's prudent management of fiscal and monetary policy – and high commodity prices.

The construction sector is expected to drive growth, as several new projects are in the construction phase and the combination of low interest rates and strong domestic demand is translated into several new residential and commercial building projects.

The outlook for 2006 is for continued solid economic conditions, with economic growth increasing to 3.4 percent. This will be the fourth successive year of economic growth equal to or above population growth of 2.7 percent, a significant improvement from the first part of the decade and an indication that GDP per capita is slowly improving.

This forecast for economic growth in 2006 is a realistic assessment of what is likely to be achieved not what is desired. The government of Papua New Guinea is currently undertaking economic and structural reform programs thereby implementing policies to create an environment conducive for investment as well as to create a stable investment climate. It is also working towards providing an efficient, effective and affordable public sector as well as creating a competitive and dynamic private sector.

Macroeconomic stability has enabled economic growth to reach solid levels in Papua New Guinea's (PNG's) economy and growth higher still is expected in 2006. However, it is still well below the level needed to see sustained improvements in living standards.

The PNG Government has recognised the fact that the engine for economic growth is the private sector.

There are a number of critical cross-cutting structural issues that are consistently raised by the private sector as impeding business: poor road maintenance, inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs, and a range of issues around land tenure, access and utilisation and the aspects of the taxation system which are internationally uncompetitive.

To increase economic growth, the government intends to introduce a number of measures to address the ongoing problems of inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs, a range of issues around land and poor service delivery by the public sector

To address these challenges the government is reviewing the functions of government departments and working on the economic and structural issues that are impeding business in PNG. Below is a list of activities that the PNG Government is currently undertaking:

- The Rightsizing initiative;
- Continuing to implement the recommendations of the Foreign Investment Advisory Service (FIAS) review of PNG's investment regime, with a view to streamlining investment regulations and processes to remove unnecessary impediments to investment. Note that substantial progress has already been made in removing red tape through the National Working Group on Business Impediments;
- Looking at options to improve the service provided to consumers by utility providers, including through increased competition (e.g., open access in mobile telephone market);
- Examining opportunities to transfer non-core public sector functions to the private sector, through contracting out services and by otherwise reducing public expenditures and increasing private sector opportunities;
- Reviewing government asset holdings with a view to selling off non-core, un-utilised, or unproductive assets, to provide increased funding for core priorities;
- Examining competition within coastal shipping to assess the merits of strengthening competition and regulatory control in this area;
- Reviewing the regulatory impediments around air transport with a view to increasing competition and reducing air transport costs;
- Reviewing the Department of Lands and Physical Planning procedures to increase efficiency and reduce the time taken to process land-related transfers. Processes can be made more transparent and timely by the removal of unnecessary discretion;
- Continuing the rehabilitation and maintenance program on major roads, ports and airstrips under its Medium-Term Development Strategy (MTDS);
- Continuing Green Revolution incentives and assess other incentives within the recently approved Investment Incentive Guidelines;
- Increasing the proportion of the Budget allocated to MTDS priority areas to 50 percent of the Budget in 2006; and
- Examining the scope to address aspects of PNG’s taxation system that are eroding international competitiveness—for instance, the high marginal tax rate in PNG’s personal income tax system, and the double taxation of company dividends—taking into account the impact on sustainability of revenue flows and the continued ability of the government to fund Medium-Term Development Strategy priorities that are necessary to support and facilitate economic growth.

The Papua New Guinea Government has already identified the structural factors impeding private sector economic activity and is implementing measures to address them.

Employment

Employment in the total private non-mining formal sector increased marginally by 0.3 percent in the year ending 2004 compared to 6.4 percent for the year ending 2003. The highest employment growth of 4.4 percent was recorded in the manufacturing sector, followed by wholesale, financial/business and other, retail and transportation.

Inflation

The annual inflation outcome for 2004 was 2.1 percent in year-average terms, the lowest annual outcome since 1989 and the second lowest annual outcome since Independence. This is a significant improvement on the very high rates of previous years, and is clearly attributable to prudent fiscal and monetary management and a stable exchange rate.

Inflation has continued to decline in 2005, with the annual inflation rate in the March quarter (in through-the-year terms) of 0.1 percent, the lowest annual inflation rate since Independence.

Interest Rates

With inflation remaining low, interest rates have remained around historically low levels. The weighted average yield on Treasury Bills was 4.4 percent at the most recent auction, well below the official Kina Facility Rate of 7.0 percent.

Balance Of Payments

The current account recorded a surplus of K237 million or 1.7 percent of GDP in 2004. This reflects a trade surplus of K1,058 million, a transfers surplus of K585 million largely offset by an income deficit of K1,406 million.

The trade surplus in 2004 reflected exports of goods and services of K8,889 million offsetting imports of goods and services of K7,831 million.

The current account balance for March quarter 2005 recorded a deficit of K211 million. This is attributed to the deficit in the balance of income more than offsetting the surplus in the balance of trade and the balance of transfers.

Financial Account

The financial account recorded a net outflow of K79 million in the March quarter of 2005, compared to a net outflow of K125 million in the corresponding quarter of 2004. This is due to the net outflows of portfolio investment totaling K145 million, reflecting investments in short-term money market instruments by mineral companies. This, combined with the purchase of financial derivative instruments of K3 million, more than offset a net inflow of other investments totalling K56 million, mainly reflecting payments of trade credits by non-residents, drawdown in foreign currency account balances of mineral companies and lower loan repayment by the government

Exchange Rate and Foreign Reserves

The Kina has remained stable against the US dollar and Australian dollar in 2005. Over the course of 2005, the Kina has appreciated from 32 US cents to 32.1 US cents, an increase of 0.3 percent and from 41.06 cents to 42.03 cents against the Australian dollar, an increase of 2.4 percent.

The stability of the currency reflects the government's sound economic management and continued high international prices of major commodity exports. Foreign exchange reserves have also remained high and at near record levels.

Public Debt

As at the end of 2004, public debt was K7.5 billion or 54.3 percent of GDP, with K4.3 billion (or 57 percent) external debt and K3.2 billion (or 43 percent) domestic debt).

Risks

The IMF expects that prices of two of PNG's key mineral commodity exports, copper and oil, will moderate somewhat in 2006, reflecting slower growth in demand and increased supply.

It is notoriously difficult to pick the turning point of commodity price movements. It is possible that commodity prices will remain higher than expected for longer than expected. On the other hand, it is possible that the sustained high level of commodity prices (particularly oil) will result in more subdued global demand for all commodities, seeing prices fall further and more quickly than expected.

The economic outlook for 2006 assumes no significant disruptions to major mining and petroleum projects – existing and prospective. Nevertheless, there will always be some risk of such disruptions. There would be significant fiscal implications if there were any sustained disruption to resource flows from these projects.

In particular, the Ok Tedi mine is dependent on the continuing flow of water through the Fly River. An *El Nino* event would result in supply being disrupted for a protracted period, with very significant economic implications. An *El Nino* event would also have significant adverse consequences for the agricultural sector, including subsistence farming, with consequent social and economic implications.

More generally, the economic outlook assumes that the MTFS targets are adhered to. Loss of control of aggregate expenditure, or lack of progress on key public expenditure reform programs, would place at risk the macroeconomic stability on which the improved economic outlook has been built.

Table 1: Economic Indicators

	2002	2003	2004	2005
Economic Growth (real GDP)				
Real GDP growth	-1.0	2.8	2.7	3.0
Employment Growth				
Non-Mining sector	2.9%	6.4%	0.3%	n/a
Inflation				
CPI change (year average)	11.8	14.7	2.1	1.5*
CPI change (through-the-year year-on-year?)	14.8	8.5	2.4	0.1*
Interest rate				
Treasury Bill yield (Weighted ave)	13.3	18.3	9.0	4.4**
Exchange rate				
Kina/USD (year-end)	.2488	.3000	.3200	.3210**
Kina/AUD (year-end)	.4396	.4001	.4106	.4203**
International Reserves				
Kina	1,378.1	1,731.3	2,060.8	1,805.8*
US dollars	342.9	519.4	659.5	579.7*
Trade Balance	180	1,348	1,058	134*
Exports of Goods and Services	7,017	8.671	8,889	2,219*
Imports of Goods and Services	6,837	7,323	7,831	2,085*
Current Account Balance	-502	496	237	-211*
Trade Balance	180	1,348	1,058	
Income Balance	-787	-1,699	-1,408	
Transfers Balance	106	847	585	
Public Debt (percent GDP)	75.3%	60.0%	54.3%	54.1%*
Domestic (K m)	2,588.1	3,022.9	3,181.4	3,366.8*
External (K m)	5,594.6	4,709.1	4,314.4	4,089.3*
Total (K m)	8,812.9	7,732.0	7,495.8	7,456.1*

Sources: BPNG, NSO, Treasury.
* March quarter 2005.
** As at 30 June 2005.

2. SOCIAL INDICATORS

The most recently available social indicators for Papua New Guinea are set out in the Medium-Term Development Strategy 2005–2010. The MTDS noted that our social indicators were among the lowest in the region.

The challenge for the government is how to translate the turnaround in the economy into improved social well-being, as measured by key social indicators, without compromising the macroeconomic stability on which it is built.

Table 2: Social Indicators

	PNG	Fiji	Vanuatu	Samoa
Infant Mortality (per 1000 live births)	64	18	34	20
Under Five Mortality (per 1000 live births)	89	21	42	25
Maternal Mortality (per 100,000 live births)	300	75	130	130
Life Expectancy (years, at birth)	54	70	69	70

Source: Medium Term Development Strategy

PERU

REAL GROSS DOMESTIC PRODUCT

Over the year 2004 the Peruvian economy grew by 4.8 percent achieving 42 months of consecutive growth. This performance was mainly associated with sound macroeconomic and growth-promoting policies as well as to a positive international environment.

Domestic demand grew by 3.9 percent this year, explained mainly by the expansion of private investment (9.0 percent). This was associated with mining and gas projects as well as the increase in the construction sector. Private consumption expanded 3.4 percent in a context of a greater increase in family incomes (5.5 percent) and a larger amount of consumer credits granted by financial institutions. On the other hand, exports of goods and services recorded a 14.7 percent growth, reflecting the important expansion of mining, agricultural, fishing and textile exports.

GDP growth was driven by the expansion of non-primary activities such as non-primary manufacturing (6.9 percent), construction (4.7 percent) and other services (4.7 percent). Primary activities grew by 3.1 percent led by the dynamism of metallic mining (5.3 percent) and fishing (30.5 percent).

INFLATION

By December 2004, annual inflation, measured by the consumer price index (CPI) was 3.5 percent, meeting the target set by the Central Bank (2.5 percent +/- 1 percentage point) for a third consecutive year.

Core inflation, an indicator of the actual trend of prices in the economy by excluding high items which have a high price volatility was 2.63 percent in 2004. Non-core inflation (5.2 percent) was affected for temporary supply shocks that affected by goods like fuel, public utilities and transport.

EMPLOYMENT

Urban employment estimated by the Ministry of Labor through the National Survey on Monthly Variation of Employment in firms with 10 employees or more increased by 3.6 percent in 2004, mainly associated with the evolution of economic activity.

BALANCE OF PAYMENTS

In 2004, the current account deficit of the Balance of Payments dropped from 1.5 percent to 0.0 percent of GDP. The smaller deficit was attributable to the higher surplus in trade balance, helped by a 31 percent increase in remittances from Peruvians living abroad and partially compensated by the larger deficit in investment income.

The trade balance registered a surplus of US$2.8 billion for the third consecutive year and a historic record. This reflected the growth of exports by 39 percent mainly associated with the better terms of trade of mining exports. Traditional exports were led by copper, because of higher prices and volumes as well as higher prices of gold in the international market. Non-traditional exports, particularly textiles, increased as a consequence of the Andean Trade Promotion and Drug Eradication Act (ATPDEA).

Imports grew by 19 percent, mainly due to higher oil prices as well as larger imports of intermediate and capital goods for the industry and durable consumer goods.

The financial account of the balance of payments recorded a positive flow of US$2.2 billion, up US$1.6 billion from 2003. This was due to higher direct investment associated with profits generated and retained by foreign companies to finance new projects such as Alto Chicama, and a lower outflow of investment portfolio resources of pension funds in assets abroad. During 2004, Eurobond placements valued at US$0.8 billion took place in October, at a dollar rate of 8.54 percent, as part of the strategy of public pre-financing debt for 2005.

Foreign direct investment amounted US$1.8 billion in 2004, mainly explained by projects like Camisea, Alto Chicama and Yanacocha. Net international reserves increased by US$2.4 billion reaching a balance of US$12.6 billion. This level is equivalent to 2.6 times external debt due in one year, 15 months of imports and 4.4 times the monetary base balance. These indicators reflect the economy's strong position to face restrictive conditions in the international capital markets or an unexpected demand for foreign exchange.

EXTERNAL DEBT

Medium and long-term external debt, including bonds, totalled US$ 28.3 billion or 41.3 percent of GDP, an increase of US$ 1.3 billion over 2003. Public sector medium and long-term debt went up by US$ 1.7 billion compared to 2003, of which US$1.1 billion was due to a net increase of indebtedness and US$ 0.5 billion to the depreciation of the dollar, mainly against the yen and the euro.

EXCHANGE RATE

In 2004, the free-floating exchange rate regime was maintained. As of December 2004, the exchange rate was S/. 3.282, down 5.5 percent from a year ago, in a context where most of Peru's main trade partners have consistently appreciated their currencies against the US dollar.

In real terms, the nuevo sol appreciated by 1.5 percent as nominal exchange rate went down by 5.5 percent and domestic inflation and external price index increased 3.5 and 7.8 percent, respectively.

FISCAL POLICY

The overall public sector deficit fell to 1.1 percent of GDP in 2004 from 1.7 percent in 2003. This reduction was mainly due to a decrease in non-financial expenditure of the central government from 14.9 to 14.6 percent of GDP and an increase in central government current revenue, from 14.9 to 15.1 percent of GDP.

The surplus in the primary balance, which excludes interest payments from the overall balance, improved from 0.4 percent of GDP in 2003 to a 1.0 percent in 2004.

The improvement of current revenues reflected the effect of a higher rate of economic activity, the extension of administrative measures designed to enhance tax collection, the creation of the financial transaction tax established in March 2004, and the effect of the 1.0 percent increase in the rate of the IGV (value added tax) since August 2003. Specifically, the IGV collection increased from 6.7 percent of GDP in 2003 to 6.9 percent of GDP in 2004.

MONETARY POLICY

Since 2002, the Central Bank monetary policy has been conducted under an inflation targeting regime. The target is set at an annual rate of inflation of 2.5 percent, with a margin of 1.0 percent point up or down.

During 2004, the economy was affected by successive inflationary supply shocks. Given the temporary nature of these shocks, the Central Bank decided to maintain its monetary stance. However, by mid-year and due to the persistence of the inflation rate's deviation from the target, the Central Bank increased its reference interest rate twice (August and October 2004) to prevent the inflation rate increases from affecting the other components of the retail prices index. This decision was consistent with the need to gradually reduce the monetary stimulus. As a result, the interbank interest rate came up from 2.5 percent in December 2003 to 3.0 percent in December 2004.

During 2004, an upward trend was observed in the annual rates of growth of the monetary aggregates, particularly in domestic currency. These increases were associated with the greater public demand for domestic currency as well as growth in economic activity. Credit of the financial system to the private sector in nuevo sols expanded 11 percent in 2004, especially in the small business segment (15.2 percent). The credit dollarization coefficient decreased from 73 to 71 percent. In terms of broad money of the financial system, the dollarization coefficient fell from 47 to 42 percent, due to the 23.6 percent increase for sol-denominated broad money.

2005 AND MEDIUM-TERM OUTLOOK

During 2005, real GDP and the domestic demand are both expected to grow 5.5 and 5,4 percent, respectively.

The balance of payment current account is expected to become a surplus of 0.2 percent of GDP, due to a trade surplus for a fourth consecutive year mainly associated to the expansion of exports (27.6 percent). Central Bank international reserves should remain closer to US$14 billion during 2005.

The fiscal deficit should continue decreasing to 1.0 percent of GDP in 2005, as stated in the Fiscal Responsibility and Transparency Law.

Monetary policy will continue to be conducted under the inflation targeting regime with a target of 2.5 percent and a 1.0 percent margin up or down.

ANNEX I

PERU: OVERALL ECONOMIC PERFORMANCE

	1998	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)							
Nominal GDP (level in billion US$)	56.7	51.4	53.1	53.6	56.5	60.6	68.4
Real GDP	-0.6	0.9	2.8	0.3	4.9	3.8	5.1
Consumption	-0.6	0	3.5	1.3	3.9	3.0	3.3
Private Consumption	-0.9	-0.4	3.5	1.4	4.4	3.1	3.3
Government Consumption	2.5	3.5	3.1	0.1	0.2	2.9	3.9
Investment	-2.1	-13.5	-2.9	-7.6	4.5	4.5	6.5
Private Investment	-2.4	-15.2	-2.0	-4.5	0.1	5.4	9.4
Government Investment	2.9	6.2	-14.9	-22.9	-4.8	5.0	2.8
Exports of Goods and Services	5.6	7.6	7.9	7.1	6.8	5.9	15.2
Imports of Goods and Services	2.3	-15.2	3.7	2.6	2.1	3.3	9.5
Fiscal and External Balance (percent of GDP)							
Budget Balance	-0.9	-3.2	-3.3	-2.6	-2.3	-1.8	-1.1
Merchandise Trade Balance	-4.4	-1.4	-0.9	-0.5	0.5	1.2	4.0
Current Account Balance	-6.0	-3.0	-2.9	-2.2	-2.0	-1.8	-0.1
Capital Account Balance	3.3	1.1	1.9	2.9	3.3	1.5	3.4
Economic Indicators (percent change, year over year, except as noted)							
GDP Deflator	6.2	3.9	3.6	1.3	0.6	2.2	5.4
CPI (end of period)	6.0	3.7	3.7	-0.1	1.5	2.5	3.5
M2 [1]	15.4	1.7	6.0	6.9	17.0	10.7	16.2
Short-term Interest Rate (percent) [2]	19.0	14.9	12.7	8.6	3.2	3.4	2.7
Real Effective Exchange Rate (level, 1994=100)	12.6	4.5	-5.2	-4.3	-0.6	7.5	-1.5
Unemployment Rate (percent) [3]	N.A	N.A.	N.A.	N.A	9.4	9.4	9.4
Population (millions)	25.1	25.5	25.9	26.3	26.7	27.1	27.5

Notes:

[1] Average percentage change of banking sector’s broad money in domestic currency
[2] Average interbank interest rate in domestic currency
[3] Data from Employment Permanent Survey, National Institute of Statistics INEI

ANNEX II

PERU: FORECAST SUMMARY (percent change from previous year)

	2004					2005				
	Official	**IMF**	**ADB**	**OECD**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**Link**
Real GDP	5.1					4.5				
Exports [1]	39.6					8.8				
Imports [1]	18.9					8.4				
CPI	3.5					2.3				

[1] Exports and imports of goods in US dollars

ANNEX III

PERU: MEDIUM-TERM TREND FORECAST (percent)

	2005
Real GDP	4.5
GDP Deflator	2.5

THE PHILIPPINES

REAL GROSS DOMESTIC PRODUCT GROWTH

The Philippines posted overall growth that was better than expected given the concerns of the business sector and unexpected shocks to the economy. Real GDP grew by 6.0 percent in 2004, surpassing both the 4.5 percent growth realized in 2003 and the 4.9–5.8 percent official target for the year. Meanwhile, gross national product (GNP) grew by 6.2 percent during the year, also exceeding both its 5.1 percent growth in 2003 and the 5.2–6.0 percent official target, due mainly to net factor income from abroad (NFIA). The steady increase in remittances from overseas Filipino workers (OFWs), from 2.6 percent of GDP in 1990 (US$1.2 billion) to 9.9 percent of GDP in 2004 (US$8.5 billion), bolstered NFIA levels.

Production in agriculture, industry and services all contributed to this growth, with the services sector continuing to be the main factor behind the growth of the economy. Services grew by 7.1 percent in 2004, faster than its 5.8 percent growth in 2003 and the 5.7–6.6 percent official target for the year. This was due mainly to growth in transport, communications and storage (11.2 percent) arising from continued strong demand for mobile communications services, as well as in trade (6.8 percent). The expansion of major players in the telecommunications market and investments in call centers and business process outsourcing (BPO) establishments also contributed to growth in private services and ownership of dwellings and real estate.

The agriculture, fishery, and forestry sector grew by 4.9 percent in 2004, faster than the 3.2 percent growth in 2003. The official target for the sector in 2004 was 4.0–5.0 percent. The gains were due largely from growth in the rice, corn and fishery sectors, which offset the poor performance of the livestock and poultry sectors. The agriculture, fishery and forestry sector also benefited from favorable weather conditions, higher demand and government support in the form of distribution of quality seeds and fertilizers, credit support and effective pest and disease control, among others.

The industrial sector grew by 5.2 percent in 2004, faster than the 3.6 percent growth in 2003. This performance hit the high end of the official 4.4–5.2 percent target range. Manufacturing continued to expand, growing by 5.1 percent in 2004 compared to the 4.2 percent growth in 2003, due to strong consumer and export demand. Both domestic- and export-oriented industries enjoyed positive growth, led by furniture and fixtures, publishing and printing, and electronic products. Another factor behind industrial growth was the recovery of the construction sector, which benefited from increased demand for housing and commercial spaces, expansion of retailers into the rural areas and completion of certain infrastructure projects. This led the construction sector to rebound from a 4.0 percent contraction in 2003 to 7.4 percent growth in 2004, far outstripping the 2.4–2.9 percent official target.

On the demand side, consumer spending and exports contributed the most to economic growth. Personal consumption expenditure (PCE) grew by 5.8 percent in 2004, a slight increase from 5.3 percent the year before, due to increased rural incomes, election-related spending and remittances from OFWs. On the other hand, government consumption expenditure (GCE) experienced no change compared to the 2.6 percent growth during the previous year, due to the continued implementation of austerity measures to control the budget deficit.

Total real exports grew by 14.1 percent, much faster than the 3.7 percent growth in 2003 and the 3.4–4.4 percent target for the year, due to the increase in merchandise exports. The growth in merchandise real exports could be attributed to favorable conditions in the global electronics market, recovery/expansion in the Philippines' main export destinations, and a depreciation of both the real and effective exchange rates that made the prices of Philippine products more attractive. Exports of semiconductors recovered from its poor performance in 2003 to help fuel the growth of merchandise exports, along with exports of transmission apparatus, which benefited from the burgeoning transport industry in Asia. In the realm of services, exports of non-factor services expanded by 23.1 percent as tourism activity recovered from its 2003 slump, and call center and BPO activities drove the growth in the miscellaneous services sector. On the other hand, imports of merchandise goods and non-factor services slowed down from 8.9 percent in 2003 to 5.9 percent in 2004 because of increased international commodity prices and depreciation of the peso.

Gross domestic investments continued to recover, accelerating growth from 1.5 percent in 2003 to 9.6 percent in 2004. While real investments in durable equipment decelerated from 8.5 percent growth in 2003 to 5.8 percent in 2004, investments in construction recovered from a 2.9 percent decline in 2003 to a 3.0 percent hike in 2004. Breeding stocks and orchard development, meanwhile, grew by only 0.8 percent. Investments were mainly in telecommunications, tractors and road vehicles, reflecting the expansion of telecommunication companies, strong agriculture production and recovery in the construction sector.

In the first quarter of 2005, real GDP posted a growth of 4.6 percent, lower than the 6.3 percent growth realized during the same quarter in 2004 due mainly to the contraction in agricultural production.

Growth in the services sector accelerated to 7.1 percent during the first quarter of 2005 from 6.6 percent during the same period a year ago. This performance was due mainly to growth in trade, transportation, communication and storage, ownership of dwellings and financial services. Growth in the industrial sector during this quarter decelerated slightly to 4.2 percent from the 4.7 percent growth realized during the same period in 2004. A decline in the performance of mining and quarrying caused this deceleration, despite the accelerated growth experienced by all other industrial sub-sectors. The agriculture, fishery and forestry sector experienced the greatest decline during the period, slowing down from 8.0 percent growth in the first quarter of 2004 to a 0.1 percent contraction during the same period in 2005. The positive performances of fishery and poultry were unable to mitigate the negative impact of the decline in the performance of almost all major crops, especially rice and corn.

On the demand side, PCE growth decelerated from 5.7 percent in the first quarter of 2004 to 5.0 percent one year later, as higher prices of goods and services dampened consumer spending. With the ongoing implementation of austerity measures, GCE contracted by 0.6 percent in the first quarter of 2005 compared to a 4.1 percent increase recorded in the first quarter of 2004.

Total real exports grew by only 3.4 percent during the first quarter of 2005, a modest performance compared to the 11.6 percent growth realized during the same period a year before, due to decelerated growth in exports of goods and non-factor services. Lower exports of crude coconut oil, centrifugal sugar and iron ore agglomerates, among others, pulled down total real merchandise export growth to 3.1 percent during the first quarter of 2005 from a 9.2 percent increase in the first quarter of 2004. The recovery of exports of semiconductors, finished electrical machinery, and desiccated coconut, among others, was not able to offset the decline. However, exports of non-factor services grew by 5.2 percent during the first quarter of 2005, a significant improvement compared to the 0.01 percent growth realized a year ago.

Total imports contracted by 3.5 percent during the first quarter of 2005, a turnaround from the 4.5 percent growth realized a year ago, due mainly to the 4.0 percent contraction in merchandise imports experienced during the period. Only imports of dairy products posted an increase during the first quarter of 2005, growing by 9.2 percent. Meanwhile, imports of non-factor services grew by 6.0 percent, up from the 2.0 percent growth in the first quarter of 2004. Travel services grew by 41.0 percent, up from a 16.2 percent contraction a year ago, as expenditures of resident travelers abroad increased during the first quarter.

Gross domestic investments contracted by 7.4 percent during the first quarter of 2005. This was due mainly to the decrease in investments in durable equipment, particularly in office machinery, industrial machinery and electrical machinery and apparatus, among others.

Despite a higher NFIA, the real GNP growth in the first quarter of 2005 decelerated to 4.8 percent compared to 6.3 percent growth posted during the first quarter of 2004. In the first three months of 2005, the NFIA grew by 7.6 percent resulting from increased earnings and deployment of OFWs.

INFLATION

The annual inflation rate reached 6.0 percent in 2004, beyond the 4.5-5.0 percent target set for 2004, due mainly to supply-side shocks experienced during the year.

The inflation rate for food, beverage and tobacco increased from 2.2 percent in 2003 to 6.2 percent in 2004. Higher prices for food items like fish and corn resulted from supply constraints, brought about in part by the typhoons that occurred in the latter part of the year. Higher meat prices resulted from consumers buying less poultry due to the avian flu scare. Meanwhile, the inflation rate for services and fuel, light and water increased from 5.6 percent and 6.3 percent, respectively, in 2003, to 7.4 percent and 9.2 percent in 2004. The increase in international petroleum prices to unanticipated levels led to increases in domestic pump prices, which in turn raised transport fares and power rates.

Inflation continued to rise during the first quarter of 2005, again due to supply-side factors. Average inflation during this period was at 8.5 percent, up from 8.1 percent in the previous quarter and 4.1 percent a year ago. Food inflation decelerated relative to the previous quarter as supplies recovered from the impact of the typhoons, but this remained higher than the level recorded during the first quarter of 2004. Meanwhile, non-food inflation increased compared to both the previous quarter and the first quarter of 2004, driven primarily by the renewed surge in global petroleum prices that led to successive local fuel price hikes. This pushed up inflation particularly in water, electricity and most services.

EMPLOYMENT

Total employment grew by 3.2 percent from 30.6 million in 2003 to 31.6 million in 2004. An additional 977,000 workers were employed in 2004 compared to 574,000 during the previous year. The services sector was the leading employer for the year and generated the most new jobs (658,000). Most of the jobs in this sector were in trade, public administration and defense, financial intermediation, and education. Meanwhile, agriculture, manufacturing and mining were among the main employers in the other sectors of the economy. In 2004, the agriculture, fishery and forestry sector was able to generate 161,000 new jobs, while industry generated 158,000.

However, these gains were not enough to accommodate the 1.3 million new entrants into the labor force in 2004, and resulted in an increase in the average unemployment rate from 11.4 percent in 2003 to 11.8 percent in 2004. The average underemployment rate also increased, from 17.0 percent in 2003 to 17.6 percent in 2004.

As of April 2005, total employment stood at 32.2 million, a 2.2 percent increase from the 31.5 million realized a year ago. The national employment rate increased from 86.3 percent in April 2004 to 91.7 percent, and the unemployment rate similarly improved from 13.7 percent to 8.3 percent. However, the underemployment rate increased from 18.5 percent in April 2004 to 26.1 percent a year later.

The number of employed persons in the agricultural sector decreased by 1.1 percent from 11.1 million as of April 2004 to about 11.0 million a year later. Meanwhile, employment in the industrial and services sectors increased by 2.0 percent and 4.8 percent, respectively, to 5.2 million and 16.0 million.

BALANCE OF PAYMENTS (BOP)

The overall BOP position for 2004 registered a deficit of US$280 million, a dramatic change compared to the surplus of US$115 million realized during the previous year. However, this deficit was lower than the expected deficit of US$516 million for the year.

The current account registered a surplus of US$2.1 billion. Contributing to this surplus was the continued rise in OFW remittances due to the growing demand for Filipino workers abroad, particularly for highly skilled, educated labor and professionals. The services account registered a net deficit of US$1.3 billion in 2004, but this was an improvement compared to the US$1.7 billion deficit in 2003. The improvement in the services account was due mainly to the increase in tourism receipts.

Merchandise export earnings grew by 9.6 percent to US$38.7 billion, driven mainly by exports of electronics and machinery and transport equipment. On the other hand, merchandise import payments rose by 10.6 percent to reach US$45.1 billion as imports of all major commodity groups except capital goods increased. Coupled with the continuing deficit in services, the greater expansion in imports led the overall trade balance deficit to worsen from US$7.2 billion in 2003 to US$8.2 billion in 2004.

The capital account balance likewise worsened, from US$1.5 billion in 2003 to US$1.7 billion in 2004. This was due partly to the lower net inflow of direct investments as residents increased their equity capital placements abroad. Non-residents' net investments in equity capital more than doubled to US$745 million, reflecting improved global economic conditions and the conclusion of the May congressional elections, but the net repayments of maturing loans negated this. The bulk of equity capital investments were channeled to the manufacturing, trading and services sectors. Portfolio investments remained in deficit as residents' investments in foreign debt securities increased compared to last year. Tempering this net outflow was the increased subscription by non-residents to bonds issued by the public sector and commercial banks. The net outflow in the other investments account decreased from US$305 million in 2003 to US$265 million in 2004 due to non-residents' shift from withdrawal to placement of deposits in local banks, and domestic banks' shift from net repayment to net profit of short-term loans.

Gross international reserves (GIR) reached a level of US$16.2 billion at the end of 2004. This is 5.0 percent lower than the level in 2003, but exceeded the US$14-$15 billion target for the year. The level of US dollar reserves is adequate to cover about 3.7 months' worth of imports of goods and payment of services and income, or 3.2 times the amount of the economy's short-term foreign liabilities based on original maturity (1.6 times based on residual maturity). Foreign investments comprised about 78 percent of reserves. By currency composition of reserves (excluding gold), 82.8 percent were in US dollars.

At the end of the first quarter of 2005, the Philippines' overall BOP position stood at a US$783 million surplus, a reversal from the US$378 million deficit recorded during the same quarter in 2004, due to improvements in the current account and net inflows in the capital and financial accounts during the period.

The current account balance improved from US$109 million in the first quarter of 2004 to US$546 million in 2005 due to reduced deficits in the trade-in-goods, services and income accounts. The trade-in-goods deficit narrowed from US$1.8 billion in the first quarter of 2004 to US$1.7 billion a year later as the growth of merchandise exports (4.3 percent) outstripped that of imports (3.5 percent). The bulk of export revenues came from shipments of electronics, garments and machinery and transport equipment. The trade-in-services deficit likewise decreased to US$161 million in the first quarter of 2005 as inflows of passenger transport, finance, and construction services, among others, increased. Other services, e.g., travel and communication services, remained in surplus but at lower levels compared to last year.

The capital and financial account improved from a US$518 million deficit in the first quarter of 2004 to a US$636 million surplus a year later. Positive changes in business and investment sentiments led to higher net inflows of direct and portfolio investments, and lower net outflows in other investments.

Meanwhile, as of end-April 2005, GIR stood at US$16.7 billion. This is adequate to cover about 3.8 months' worth of imports of goods and payments of services and income, or 3.5 times the economy's short-term debt based on original maturity (1.7 times based on residual maturity).

GROSS EXTERNAL DEBT

Total external liabilities dropped by 4.4 percent from US$57.4 billion in 2003 to US$54.8 billion in 2004, due largely to the net transfer of credit exposures from non-residents to residents.

Medium- and long-term loans amounting to US$49.8 billion represented about 90.8 percent of total debt stock. Total public sector borrowings decreased by 4.1 percent from US$39.5 billion in 2003 to US$37.9 billion in 2004. Private sector borrowings likewise decreased by 5.3 percent from US$17.9 billion to US$16.9 billion during the same period. These loans were used mainly to provide budgetary support, refinance maturing obligations, and fund projects in communication, transportation and other infrastructure; sewerage and sanitation' and power and energy. All medium- and long-term loans have a weighted average based on original maturity of 17.4 years, with public sector debt averaging at 19.6 years and private sector debt at 10.9 years.

By creditor, official loans comprised 46 percent, foreign holders of bonds and notes, 28.9 percent, and banks and other financial institutions, 20.4 percent. Of all external loans, 51.2 percent were denominated in US dollars and 30.0 percent in Japanese yen.

As of March 2005, total external liabilities stood at US$55.3 billion, 0.9 percent lower than the level realized a year ago. Medium- and long-term loans accounted for 90.0 percent (US$49.8 billion) of this total, with a weighted average maturity of 17.7 years. The average maturity of public sector debt (20.0 years) is practically double that of private sector debt (10.9 years).

EXCHANGE RATE

The peso-dollar exchange rate averaged P56.04/US$ in 2004, a 3.4 percent depreciation from the average exchange of P52.20/US$ in 2003. Corporate demand for dollars rose due to higher import requirements brought about mainly by the hike in world oil prices and hedging against future dollar requirements in light of volatile energy prices. Concerns over the economy's fiscal situation, the surge in world oil prices, and credit rating downgrades by international agencies also exerted downward pressure on the peso.

Higher OFW remittances tempered the depreciation, as did positive market sentiments following the decision of the California Public Employees' Retirement System, a large US pension fund, to continue investing in the Philippines; the conclusion of the May elections; and the announcement of the Arroyo Administration's 10-point agenda, which would implement structural reforms to achieve fiscal balance by 2010, combat corruption and reduce poverty.

The peso rebounded in first quarter of 2005 to register an average exchange rate of P55.01/US$ for the period, a marginal appreciation from the P55.97/US$ rate realized a year ago. This was due to sustained dollar inflows from OFW remittances and portfolio investments owing to a positive outlook on the economy. The peso also benefited from the continued weakness of the US dollar and the trend toward appreciation among regional currencies.

FISCAL POLICY

The Philippine Government recorded a deficit of P187.1 billion for 2004, P 10.7 billion lower than the full year target of P197.8 billion. Revenue collections increased by 11.7 percent to P699.8 billion as the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) strengthened implementation of administrative reforms begun in 2002. The BIR fully harnessed its IT capabilities in detecting patterns of tax evasion and continued its Tax Compliance Verification Drive and other programs that enhance tax compliance. The BOC, on the other hand, improved its human resource management and overhauled customs processing system and warehousing procedures.

Total disbursements reached P886.8 billion, a 7.3 percent increase from the previous year's level and 1.44 percent higher than the full year program. Highest increase in spending went to government infrastructures and capital outlays, which went up by 17.7 percent. This improved the share of government investment to 14.7 percent from last year's 13.5 percent.

For the first four months of 2005, the Philippine Government posted a deficit of P60.1 billion with the total revenue collections reaching P255.4 billion, an 11.8 percent increase from the first four-month level in 2004. The April 2005 collection was by far the highest recorded in the bureau's history. Likewise, customs collections increased by 9.6 percent and BTr's income grew by 22.4 percent for the period, reflecting continuing efforts to implement administrative reforms, enforce tax laws, and generate revenues from privatization of government assets.

Total disbursements grew by 7.7 percent to P315.55 billion for the first four months of 2005. The increase was mainly due to interest payments, personal services and the local governments' internal revenue allotment.

MONETARY POLICY

The Bangko Sentral ng Pilipinas (BSP) maintained policy rates in 2004 reflecting their consideration that the rise in inflation was supply-side-driven and could be addressed only by non-monetary measures. The overnight borrowing or reverse repurchase rate (RRP) remained at 6.75 percent and the overnight lending or repurchase rate (RP) at 9.0 percent. However, in order to pre-empt inflation-caused volatility in the foreign exchange market, the BSP raised the liquidity reserve requirement from 8.0 percent to 10.0 percent in February 2004 while maintaining the regular reserve requirement at 9.0 percent.

Domestic interest rates rose during the year, reflecting concerns over rising inflation, fiscal sustainability and the status of the economy's credit ratings. The average bank lending rate increased from 9.5 percent in 2003 to almost 10.0 percent in 2004. The average 91-day T-bill rate likewise increased from 6.0 percent to 7.3 percent during the period. The average savings deposit rate remained unchanged at 4.2 percent.

In April 2005, the BSP raised key policy rates for the first time since October 2000, increasing the RRP and RP rates by 0.25 percent to 7.0 percent and 9.25 percent, respectively. Demand-driven inflationary pressures remain limited, but increasing oil prices, both local and international, and other potential supply-side factors are affecting public expectations of future inflation. The rate increases aim to keep these expectations from spreading and prevent supply shocks from generating second-round effects.

MEDIUM-TERM OUTLOOK

Both real GDP and GNP are projected to grow by 5.3 percent in 2005. The agriculture, fishery and forestry sector is expected to grow by only 3.0 percent in 2005 due to the worse than expected effect of the El Niño phenomenon on the agriculture sector. On the other hand, efforts to promote investments and exports are expected to lead the industrial sector, particularly mining and quarrying, to grow by 4.7 percent. The services sector will continue to drive growth, expanding by

6.6 percent, due to the continuing growth of information and communications technology-related businesses and tourism, which is expected to prop up other services like real estate and private services. In 2006-2007, the GDP growth is projected to be between 5.7 percent and 6.5 percent.

Merchandise exports in dollar terms are expected to grow by 6.0 percent in 2005 due to the projected modest growth in world trade. Export promotion efforts will concentrate on goods and services in those sectors where the Philippines enjoys comparative advantage, and focus on sustaining trade with Japan and the Association of South East Asian Nations (ASEAN) as well as tapping the opportunities presented by the growth of China. Meanwhile, merchandise imports in dollar terms are expected to grow by 2.6 percent.

The inflation rate is expected to reach the 7.6-8.0 percent range in 2005 due to expectations that world oil prices will remain high given the continuing tight supply situation. Exerting additional upward pressure are possible increases in transport fares, and adjustments in power rates.

The government will continue to be guided by the strategies laid out in the Medium-Term Philippine Development Plan for 2004-2010. More efficient revenue collection and prudent spending will be undertaken to ease business concerns regarding the fiscal situation and raise resources for much-needed infrastructure. The government will also seek to address the factors affecting wages, knowledge and the costs of power, transport and doing business in order to enhance the competitiveness of Philippine goods and services. Micro, small and medium enterprises and agribusiness will also be assisted to generate employment, income and development in rural areas.

STRUCTURAL REFORM

The government recognizes that fiscal and structural reforms are fundamental elements in achieving growth and prosperity. A number of economic reform bills and new policies were implemented in 2004 and 2005.

On 20 December 2004, the president signed into law Republic Act (RA) 9334 on the indexation of excise taxes on alcohol and cigarettes, one of the measures aimed at addressing the weakness of the current excise tax system. The law took effect on 1 January 2005. Meanwhile, the president signed into law on 24 May 2005, RA 9337, which further expands the value added tax (VAT) base as well as providing for rate adjustment in 2006 towards a more efficient and productive VAT system. The higher incremental revenues from the implementation of the new law would not only reduce the risk of a higher deficit but will increase the likelihood of fiscal flexibility and macro-stability in 2006 and beyond. While the law was to have taken effect on 1 July 2005, the Supreme Court ordered its temporary suspension in response to a petition against its implementation. The High Court later ruled that the law is constitutional.

To improve efficiency in collecting revenues, the BOC and BIR continued their automation drive and simplified their procedures, which allowed them to better detect leakages and recover revenue losses. In addition to improving efficiency, these initiatives also increased transparency and accountability and reduced opportunities for corruption. The government also enacted RA 9335, or the Attrition Act of 2005, which sets a reward and penalty system to spur government revenue collection efforts. In managing its expenditures, the government is guided by the 2004-2010 Medium-Term Public Investment Program in order to ensure that the programs and projects to be implemented will address key developmental concerns.

With regard to the banking sector, the BSP issued guidelines in June 2004 governing the development and implementation of banks' internal credit risk rating systems to ensure that banks' credit management processes are sound and effective. The BSP is also pushing for the formation of a central credit bureau, which would maintain a central data bank holding records of borrowers' transactions that would support banks' access to credit information.

On the non-bank financing sector, the Securities and Exchange Commission laid out the guidelines for the eventual shift to a risk based capital adequacy framework among its regulated and monitored entities. A Fixed Income Exchange was created in 2004 to serve as a secondary market for government securities and alternative funds from the traditional banking system. It is expected to be fully operational in 2005.

With regard to foreign investments liberalization, the Sixth Regular Foreign Investment Negative List was issued in 2004. The list specifies the few areas in which investment is limited to Filipinos as provided for in the Philippine Constitution and other laws. Foreigners may invest as much as 100 percent equity in export enterprises and certain domestic activities, including retail trade enterprises. Following the Supreme Court's decision in December 2004 on the constitutionality of foreign ownership in the Philippine Mining Act, the under-performing mining industry is expected to revive as a result of projected investments in large-scale metallic and mineral exploration activities.

ANNEX I

THE PHILIPPINES: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004	1Q 2004	1Q 2005
GDP AND MAJOR COMPONENTS (percent change, year over year, except as noted)								
Nominal GDP (billion US$)	76.0	74.7	70.9	76.7	79.3	86.5	19.5	22.1
Real GDP [a/]	3.4	4.4	1.8	4.4	4.5	6.0	6.3	4.6
Total Consumption								
Private Consumption	2.6	3.5	3.6	4.1	5.3	5.8	5.7	5.0
Government Consumption	6.7	6.1	-5.3	-3.8	2.6	0.0	4.1	0.6
Total Investment	-2.0	5.5	-7.3	-4.3	1.5	9.6	7.7	-7.4
Exports of Goods and Services	3.6	17.7	-3.4	4.0	3.7	14.1	11.6	3.4
Imports of Goods and Services	-2.8	4.0	3.5	5.6	8.9	5.9	4.5	-3.5
FISCAL AND EXTERNAL BALANCES (percent of GDP)								
Budget Balance	-3.7	-4.0	-4.1	-5.3	-4.7	-3.9	-5.2	-5.2
Merchandise Trade Balance	6.5	5.1	-1.0	0.5	-6.9	-7.4	-8.9	-7.8
Current Account Balance [b/]	9.5	8.3	1.9	5.7	1.8	2.4	0.6	2.5
Capital Account Balance	-3.1	-5.5	-1.8	-2.1	-1.9	-2.0	-2.7	2.9
ECONOMIC INDICATORS (percent change year over year earlier period, except as noted)								
GDP Deflator (Implicit Price Index)	324.2	344.8	366.8	383.3	397.6	421.4	406.5	433.1
GDP Deflator (percent change)	8.0	6.3	6.4	3.5	3.6	6.0	3.8	6.5
CPI (percent change) 1994=100	6.7	4.4	6.1	3.0	3.0	5.5	4.1	8.5
M2 (percent change)	19.3	4.8	6.9	9.5	3.3	9.4		12.2
Short-term Interest Rate (percent)	10.2	9.9	9.9	5.4	6.0	7.3	6.7 (April '04)	7.0 (April '05)
Exchange Rate (P/US$)	39.1	44.2	51.0	51.6	54.2	56.0	56.0	55.0
Real Effective Exchange Rate Index	74.0	68.8	64.1	63.4	56.9	54.5	53.3	56.6
Unemployment Rate (percent)	9.8	11.2	11.1	11.4	11.4	11.8	13.7 (April '04)	8.3 (April '05)
Population (millions)	75.0	76.8	78.6	80.2	81.8	83.5	83.3 (Jun '04)	85.0 (Jun '05)

- Revised as of 22 September 2005.

a/ - Gross Domestic Product Statistics were revised in August 2005 to reflect corrections in the computation of gross value added in the agricultural subsector of the National Accounts.
b/ - Balance of Payment Statistics were revised in 2004 to incorporate results of data improvement activities, revised classifications and treatment, and new methodologies to make the compilation practices more consistent with internationally recommended concepts.

Sources: National Statistical Coordination Board
Bangko Sentral ng Pilipinas

ANNEX II

THE PHILIPPINES: FORECAST SUMMARY

	2004					2005				
	Official	IMF	Link	ADB	OECD	Official	IMF	Link	ADB	OECD
Real GDP	4.9-5.8	4.5		4.5		5.3	4.7		5.0	
Exports[/a]	3.4-4.4			7.0		7.4			7.5	
Imports[/b]	7.0-8.0			5.8		2.9			6.5	
CPI	4.0-5.0	3.9		4.5		7.6-8.0	8.2		6.5	

/a - Forecast based on real exports of goods and services
/b - forecast based on real imports of goods and services

ANNEX III

THE PHILIPPINES: MEDIUM TERM FORECAST

	2004	2005	2006	2007
Real GDP	4.9-5.8	5.3	5.7-6.3	6.1-6.5
GDP Deflator	n.a.	n.a.	n.a.	n.a.

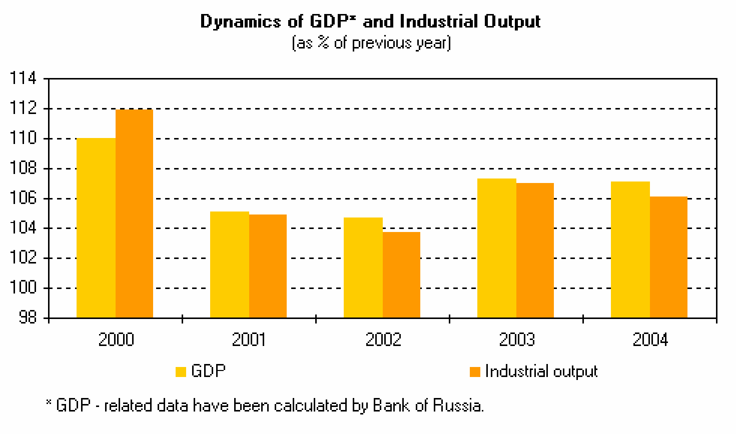
Preliminary Forecasts

THE RUSSIAN FEDERATION (RUSSIA)

PREAMBLE

The dynamics of the most important macroeconomic indicators of the Russian economy's development was positive in 2004. Growth in the output of goods and services surpassed the official forecast made on the basis of the budget projections for 2004 and investment and household real money income increased at rapid rates. A rapidly growing demand for services, in particular from households, served as a significant factor in the increase in domestic demand and the maintaining of economic growth as a whole.

Government finance remained stable and although real inflation (valued as an index of consumer prices) exceeded the target set for 2004, consumer prices' growth was smaller than in 2003 rising 11.7 percent in December 2004 y-o-y as against 12 percent in the same period of 2003.

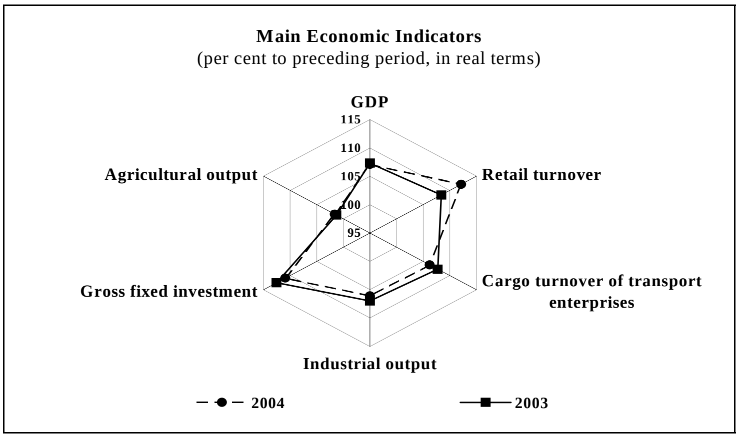


The fact that in 2004 Russia continued to enjoy a current account surplus serves to show that there was a balance between domestic demand and supply, which contained price growth and created the favorable macroeconomic expectations, considered to be a major factor of moderate price growth.

The favorable external economic situation stimulated the development of the export-oriented industries and the expansion of consumer and investment demand also contributed to economic growth. Output grew in industry, transport, the construction sector and agriculture, and there was a significant expansion in retail trade turnover. The key sector output index registered 106.6 percent in 2004 as compared with 2003.

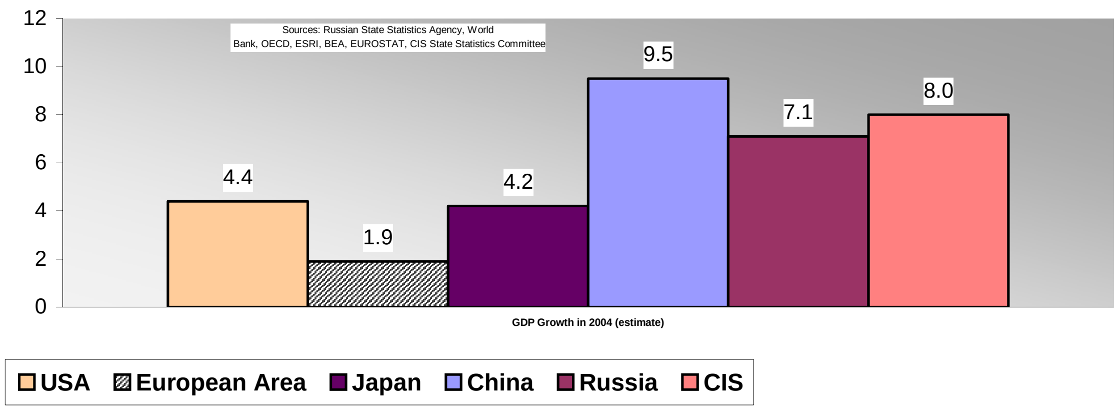
The share of foreign investment in the Russian Federation's gross fixed investment was 5.0 percent in 2004 compared to 3.9 percent in 2003. Last year Russia's economy received US$40.5 billion in foreign investment (36.4 percent more than in 2003). As a consequence of this, the accumulated foreign capital in the Russian economy amounted to US$82 billion, 43.8 percent more than in the same period of the previous year.

In 2004, Russia's federal budget income has considerably surpassed the scheduled level, with national debt serviced in accordance with the envisaged schedule. The surplus budget policy (at a level over 4.0 percent of GDP) ensured sterilization of a portion of excessive money supply and accumulation of significant funds in the Stabilization Fund (over RUR520 billion). In addition the scaling up of currency reserves of the Central Bank of Russia (that exceeded US$124 billion as of the year-end) ensured sufficient opportunities to prevent crises in the financial sphere. The external debt was repaid in accordance with the adopted schedule, with rather limited external borrowings. Since September 2004, there was net capital inflow in the private sector, though net capital outflow from that sector during the entire 2004 quadrupled as compared with 2003 and amounted to some US$8 billion.



The rouble gained 5.4 percent against the US dollar in nominal terms on the domestic FX-market in December 2004 as compared with December 2003. In real terms, the rouble gained 14.0 percent against the dollar in December 2004 y-o-y and 6.0 percent against the euro.

In *cross-economy comparison*, Russia outperformed the world's leading developed economies in terms of economic growth rates (GDP growth) in 2004, but yielded to a number of developing and transition economies, including China and a majority of CIS[1] economies. In 2004 Russia's GDP grew by 7.1 percent, while, according to revised estimates, economic growth in the Eurozone was 1.9 percent, in the United States 4.4 percent, in Japan 2.6 percent, and in China 9.5 percent.



The rate of Russian industrial output growth also outstripped industrial output growth in the top developed economies last year, even though this lead is a little smaller than for GDP. However, Russia occupies one of the lowest places among the CIS economies in terms of economic growth rate in 2004 (the average GDP growth rate in CIS in 2004 was estimated at 8 percent, including 12 percent for Ukraine).

REAL GROSS DOMESTIC PRODUCT

In spite of 2004 being the sixth year of economic growth in Russia, the growth rate slowed down to some extent as compared with 2003. In 2004, GDP increased by 7.1 percent from the previous year, compared to an increase of 7.3 percent in 2003. GDP amounted to RUR16,778.8 billion

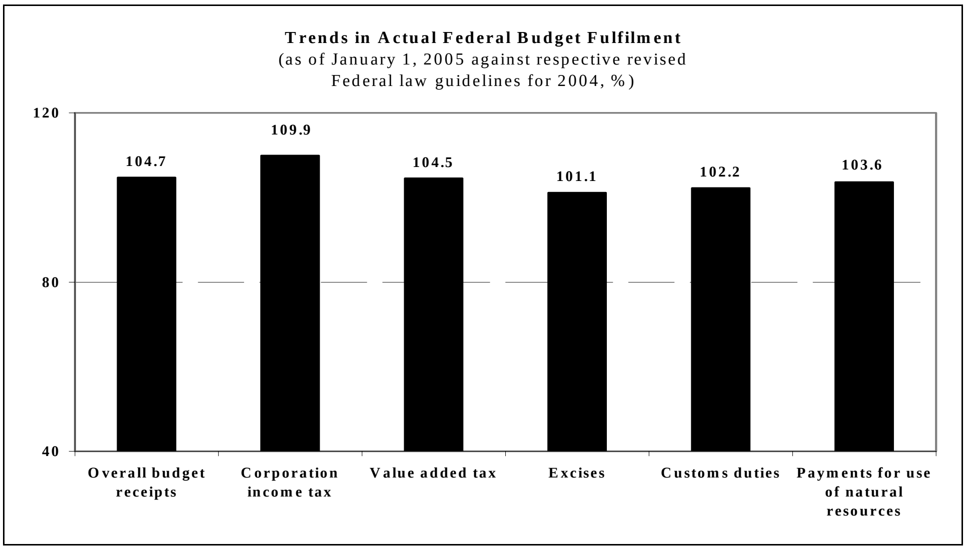
[1] **The Commonwealth of Independent States** including together with Russia 12 countries, which were the parts of the former USSR previously, - Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

(US$582.3 billion) in current prices compared to RUR13,201.1 billion (US$430.3 billion) in 2003. The GDP deflator index amounted to 18 percent in 2004 as compared with 14 percent in 2003.

Industrial output expanded by 7.3 percent in 2004 as against 7.0 percent in 2003. The freight transport turnover of transport companies rose by 6.2 percent, y-o-y, as compared with 7.7 percent in 2003. Virtually all types of transport registered growth in their freight turnovers: railways by 8 percent, automobile transport by 5.2 percent, pipeline transport by 6.2 percent, and air transport by 9.4 percent.

Among other sectors of Russia's economy the communication sector expanded by an impressive 27.3 percent in 2004 (27.8 percent in 2003). The number of people using mobile telephones reached approximately 70 million by 1 January 2005 an increase of 34.5 million as compared with 1 January 2004.

Retail turnover rose in 2004 by 12.1 percent as against 8.4 percent in 2003, while the growth of real disposable incomes and real wages was 8.2 percent and 14.9 percent, accordingly. This means Russian consumers, mostly from the top and middle income brackets, preferred spending money on buying goods to saving it. The volume of services rendered to natural entities went up by 7.0 percent in 2004 compared to 6.7 percent in 2003.

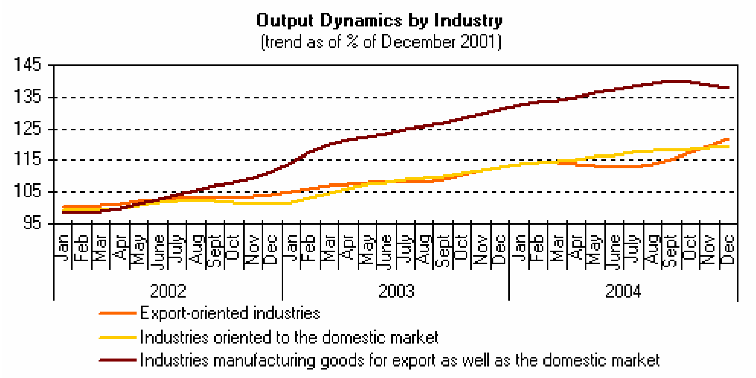


PRODUCTION

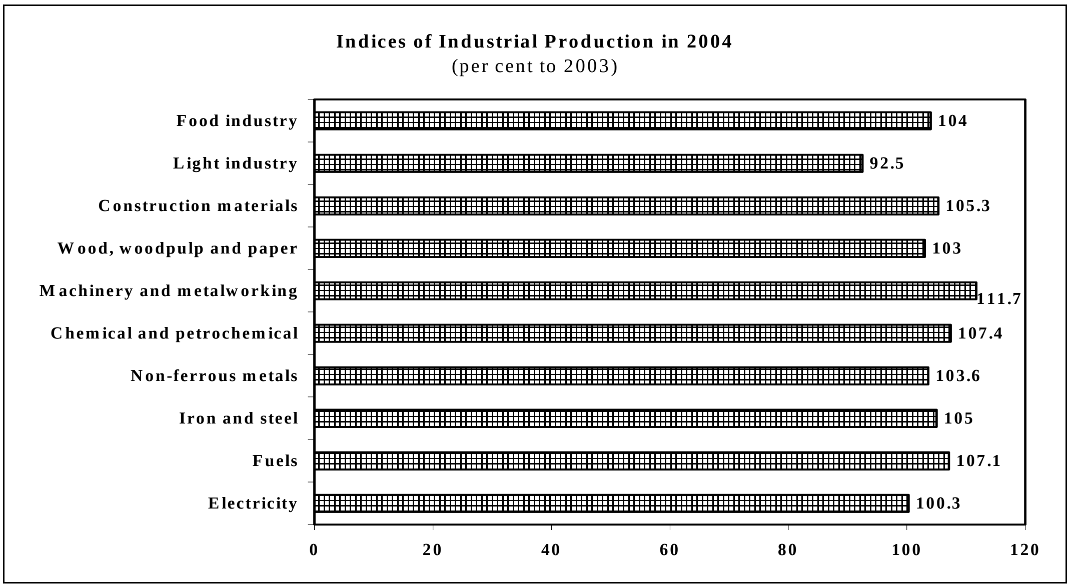
Industrial output reached RUR11,209.1 billion (US$389.1 billion) in 2004, an increase of 6.1 percent compared to 2003 (7.0 percent growth in 2003 compared to 2002).

According to estimates, the biggest contribution to industrial production growth was made in 2004, as it was in 2003, by the machine-building and metal-working industries, the fuel sector and the food industry.

Year-on-year output grew 0.3 percent in the electric-power industry, 7.1 percent in the fuel sector, 5.0 percent in the ferrous metallurgy sector, 3.6 percent in the non-ferrous metallurgy sector, 3.0 percent in the wood-paper industry, 11.7 percent in machine-building and 4.0 percent in food industry. At the same time production in the light, medical and microbiological industries fell compared to 2003, with light industry output declining 7.5 percent. Electricity and thermal energy output remained almost at the level of 2003 (falling only slightly by 0.3 percent).



The structure of industrial production in 2004 was as follows: fuel industry 21.4 percent, ferrous metals 12.1 percent; non-ferrous metals 7.2 percent; electric power 10.5 percent; chemical and petrochemical 5.4 percent; machinery and metal working 18.6 percent; wood, wood pulp and paper industry 3.8 percent; construction materials 2.9 percent; light industry 1.1 percent; food, flour and feedstuffs industry 14.5 percent; and other industries 2.5 percent.



Output of some sophisticated household goods produced with the use of imported parts, or on the basis of licensing agreements, went up in 2004: refrigerators and freezers 2.9 times; color TV sets 48.2 percent; washing machines 32.6 percent; microwave ovens 13.7 times; and vacuum cleaners 47.1 percent; while kitchen appliances fell 14.8 percent compared to 2003.

The backlog of orders received by industrial companies by the end of 2004 ensured the utilization of their production capacity for 1.9 months at the current utilization rate, which represents a slight decrease compared to 2003 (2 months). Construction activity was valued in 2004 at RUR1,468.0 billion (US$50.9 billion) compared to RUR1,164.8 billion (US$38.0 billion) in 2003, demonstrating an increase of 10.6 percent in constant prices. The backlog of construction orders was 0.8 months as of 1 January 1 2005 compared to 0.9 months a year ago.

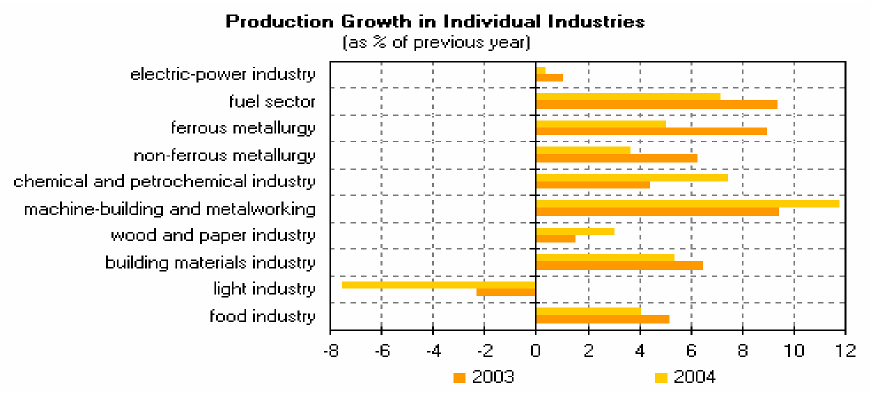
According to the polls conducted by the Russian Government's Centre for Economic Studies, the overall situation in industry in 2004 was good. Most of the respondents (over 80 percent) described the situation in the major companies as "good" and "satisfactory".

The average utilization rate increased from 56 percent in December 2003 to 58 percent in

December 2004. The highest utilization rate (59 percent) in the entire period of observations was registered in September and October 2004.

Russian agricultural output in 2004 reached RUR1,366.3 billion (US$47.4 billion), an increase of 1.6 percent compared to 2003, when the rise at 1.3 percent had been fixed despite a fall in the production of meat, milk and eggs.

The harvest of grain in 2004 amounted to 78.0 million tonnes (weighed after processing) or 16.2 percent more than in 2003, due to a rise in grain crop productivity and the expansion of the harvest area. Production of sunflower seeds was 4.7 million tones a fall of 2.6 percent The Russian Federation customs statistics fixed exports of wheat at 4.717 thousand tonnes in 2004 compared to 7.787 thousand tonnes in 2003.



By 1 January 2005 the overall number of cattle in all types of farms was estimated at 23.1 million (6.7 percent fewer than a year before), including 10.3 million cows (6.4 percent fewer). There were 14.2 million pigs (11.1 percent fewer than 2003) and 17.9 million sheep and goats (0.5 percent more). The share of small individual farms in the overall numbers was: cattle 44.1 percent, pigs 47.1 percent, sheep and goats 57.7 percent (as of 1 January 2004: 42.3 percent, 44.5 percent, and 58.5 percent, respectively). Russia's livestock farming no longer meets domestic requirements. However, in 2004 total imports of meat (2.145 million tonnes) went down by 7 percent as compared with 2003 due to the imposition of quotas on imports of poultry, beef and pork on 1 April 2003. As a result, meat imports equaled 46 percent of Russia's total meat output in 2004 compared to 49 percent a year ago.

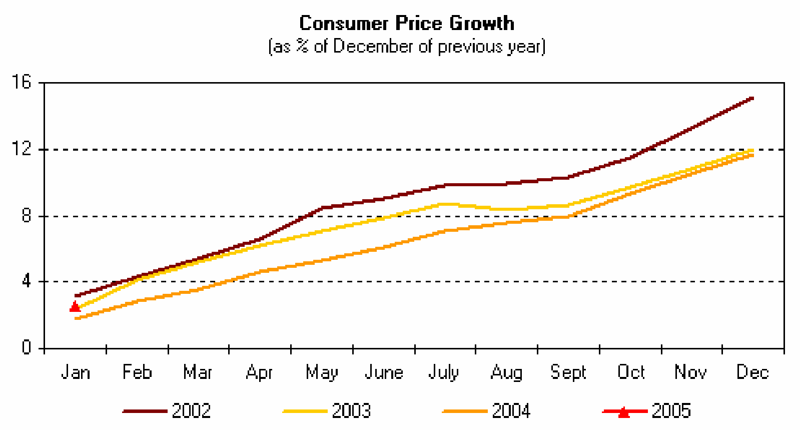
INFLATION

In 2004, consumer price inflation exceeded its target by 1.7 percent. Over 2004, consumer prices grew by 11.7 percent versus 12 percent in 2003.

The most significant influences on inflation in 2004 were produced by:

- Mark up of domestic prices for fuel and lubricants (pricing for which is closely connected with global price trends). Price increases for gasoline, diesel fuel and other lubricants which outstripped inflation, resulted in an additional rise in the consumer price index of approximately 1.2 percent, according to the MEDT estimate;
- Accelerated upswing of prices for staples. In 2004, prices for meat, meat products and eggs advanced much faster, as supply lagged behind demand from the population, among other things, due to reduced imports. Double-digit growth was also noticeable in prices of grain products (bread, flour, macaroni) due to persistently high prices for grain from the 2004 harvest, which stiffened late in 2003.

A high level of production and investment activity influenced the price dynamics in the consumer goods market in 2004. Increases in the employment rate and household money incomes contributed to larger consumer spending, with demand exerting pressure on consumer prices. The price growth in the consumer goods market was affected by volatile factors unrelated in their short-term aspect to monetary policy, including the sharp increase in world energy prices and the unstable supply of some foodstuffs in domestic and foreign markets.



In 2004, a considerable price growth was observed in the cost-creating sectors, which have a direct impact on enterprises' costs. However, despite higher costs, the growth of producer prices in the industries, which make goods directly for the consumer goods market, did not accelerate and this factor restrained inflationary pressure on the consumer goods market.

Exchange rate dynamics had a significant role to play in slowing inflation in the consumer goods market in 2004. The ruble's nominal rise against the dollar contained growth in the prices of imported consumer goods and, consequently, their domestic analogues.

Although M2 velocity slowed down more considerably in the first half of 2004 than expected, and the rate of growth in cash (the most liquid component of the M2 aggregate) fell to almost half as compared to January-November 2004, these factors failed to intensify inflationary processes. The stable macroeconomic situation observed throughout 2004 reduced the inflationary expectations of economic agents.

Core inflation equaled 10.5 percent in 2004 as compared to 11.2 percent in 2003. A major factor in the reduction of core inflation in 2004 year-on-year was the slowing of increases in non-food prices. At the same time, rapid increases in prices of foodstuffs (excluding vegetables and fruit), especially the prices of: meat and poultry: bread and bakery products; pasta and some other foodstuffs, had an adverse effect on core inflation dynamics.

The consumer prices of foodstuffs, excluding vegetable and fruit prices, rose 13.1 percent in 2004 (11.8 percent in 2003).

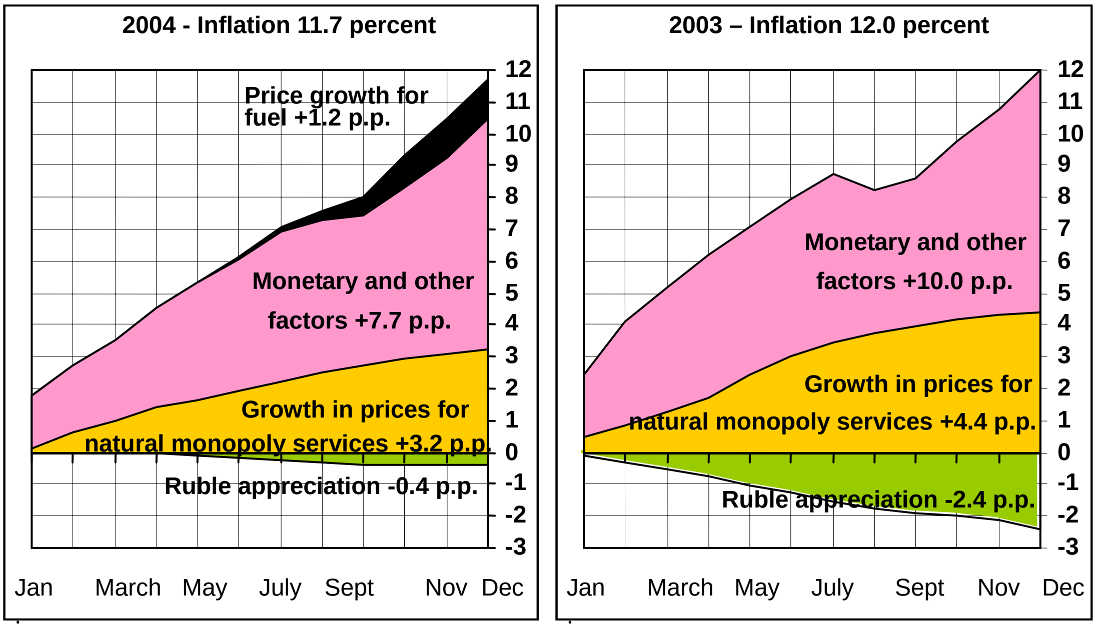
The highest increases in food prices in 2004 were registered for meat and poultry, which went up 19.6 percent (8.9 percent in 2003) largely due to increases in world meat prices and reduced meat supply in the domestic market. The prices of bread and bakery products rose 16.7 percent in 2004 (30.4 percent in 2003) and the price of pasta was up 14.6 percent (14 percent in 2003). The price dynamics of these foodstuffs were affected by Russia's poor grain harvest in 2003. Consumer prices of fish and seafood rose 11.5 percent in 2004, an increase of 1.6 percent on 2003. The price of granulated sugar went up 7.5 percent in 2004, whereas in 2003 it fell 5.6 percent. Consumer prices of other staple foodstuffs (cereals and legumes, milk and dairy products, butter, etc.) increased slower in 2004 than a year earlier. Overall, fruit and vegetable prices increased 3.3 percent in the consumer goods market in 2004, whereas in 2003 they dropped 4.2 percent.

Manufacturers' prices rose by 28.3 percent on average for the industry in 2004, having exceeded the consumer inflation rate by almost 2.5 times. (in 2003, any difference from the consumer price index was minimal). The highest price growth rate was noted in industry sectors influenced by global environment and distinguished by strong monopolistic trends: iron up 65.8 percent, coal up 51.4 percent, oil refining up 48.9 percent, and chemical up 29.4 percent. A double-digit growth in prices established by manufacturers of primary goods exerted pressure on the costs of processing industries that mostly target the domestic market. Under conditions of strong import pressure it was impossible to considerably mark up prices for their products and this caused a decline in the profitability in these industries.

Full year growth in industrial producer prices stood at 28.3 percent as against 13.1 percent in 2003. The acceleration of industrial producer price growth in 2004 was largely due to increased prices in the fuel, energy, and ferrous metallurgy sectors. The biggest price rise was registered in the gas industry (88.5 percent as against a fall of 22.9 percent in 2003). Producer prices went up 65.4 percent as against 1.6 percent in 2003 in the oil-extracting industry, 48.9 percent as against 14.8 percent in the oil refining industry and 51.4 percent as against 10.1 percent in the coal industry. Producer prices in the ferrous metallurgy sector increased 65.8 percent in 2004 as against 28.8 percent in 2003. In the chemical and petrochemical industry, machine-building, woodworking and pulp-and-paper industry producer price increases in 2004 were also higher than in 2003. Producer prices in light industry rose 8.1 percent as against 15.2 percent in 2003.

The growth of passenger transport fares and pre-school tuition fees accelerated month-on-month. Overall, the prices of paid services increased 17.7 percent in 2004 (22.3 percent in 2003).

Contribution of Key Factors to Inflation
(Increment of consumer price index in percentage points)



Year-on-year, there was a more considerable increase in passenger transport fares (18.0 percent as against 13.7 percent) and pre-school tuition fees (21.6 percent as against 15.1 percent).

Rent and community amenities charges grew 23.5 percent in 2004 (28.7 percent in 2003) and communications service fees rose 9.9 percent (18.7 percent in 2003).

EMPLOYMENT

According to the Federal Statistics Service of Russia, in 2004 the economy had an economically active population of 73.4 million, of which 67.4 million, or 91.8 percent, were employed in the economy and 6 million, or 8.2 percent, were classified as unemployed by the International Labor Organization (ILO) methodology. The number of jobs in large and medium-sized companies decreased 0.8 percent in 2004 as compared with the same period of 2003. The most significant decline in job numbers was registered in machine-building, the non-ferrous metallurgy sector, and the flour and cereals and mixed fodder industries. Full-time workers and employees of large and medium-sized companies accounted for 58 percent of the employed in the economy and 1.8 million people, or about 2.7 percent, worked in these companies on a part-time basis or by contract (an equivalent of full employment).

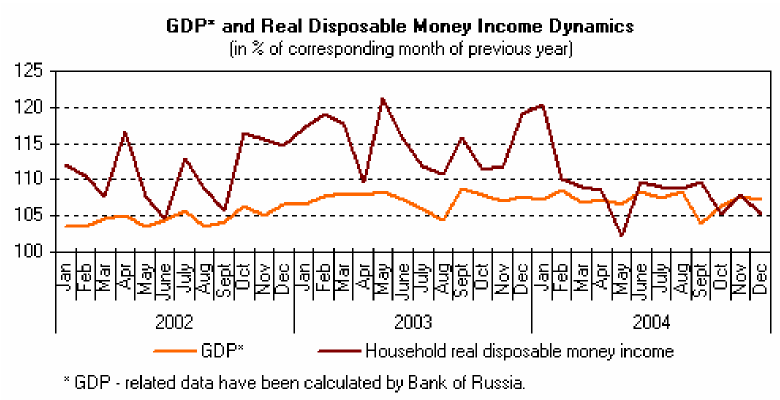
The number of officially registered unemployed has been rising since 2002 due to job cuts at large and medium-sized enterprises and the raising of the minimum unemployment allowance in pace with the increase of the subsistence minimum. The number of officially registered jobless rose 6.4 percent in 2004 year on year to 1.7 million.

2.1 million jobless were registered with the government employment service at the end of 2004, of whom 1.9 million had unemployed status according to Russia's Federal Labor and Employment Service.

Household income and savings. Household real disposable money income rose 7.8 percent in 2004 year-on-year as against 14.9 percent in 2003.

Wages, including unreported earnings, continued to account for a large portion of household money income, even though its share contracted by 0.9 percent year-on-year to 63 percent. The average monthly nominal imputed wage increased 10.8 percent in real terms in 2004 year-on-year as against 10.9 percent in 2003 and stood at 6,828 rubles.

As of 1 January 2005, wage arrears decreased by half over the year and totaled 12,206 million rubles, while the wage debt accumulated as a result of under financing from budgets of all levels contracted 55.5 percent. By the beginning of 2005, the number of workers and employees who were owed a debt on their wages and salaries amounted to 1.9 million, or 2.8 percent of the total number of people employed in the economy. This represents a decrease of 3.4 percent on the previous year.



The average imputed monthly pension rose 5.5 percent in real terms in 2004 year-on-year as against 4.5 percent in 2003 and stood at 1,915 rubles.

For the first time since 2000, the public propensity to consumption increased in 2004, building up inflationary pressures on the consumer market. At the same time, real-term growth in consumer spending exceeded growth in real money income. In 2004, real consumer expenses increased by an estimated 11.3 percent in real terms year-on-year as against 7.9 percent in 2003. Spending on goods and services accounted for 70.2 percent of household money income use in 2004, an increase of 1.2 percent on 2003.

Spending on the purchase of foreign exchange accounted for 8.4 percent of household income in 2004 as against 7.3 percent in 2003. The public propensity for organized savings decreased by 2.5 percent year-on-year to 10.2 percent, owing to banking sector instability in 2004 Q3.

As of 1 December 2004, the value of personal deposits with credit institutions increased 30.5 percent year-on-year.

Real disposable money income of the population in 2004 was 7.8 percent year-on-year, a relatively high growth rate, but lower than the growth rate in 2003[2]. Besides the effect of the high base of 2003 (including that of salary indexation for employees paid from the state budget in 4Q), the relatively more modest growth rates in 2004 are accounted for by the increase in statutory payments by the population (under the influence of significant increase in consumer loans and, consequently, accrued interest on provided loans in 2004) as well as to the slowdown in growth of revenues from property and from business operations. The growth rate for real population income, with the exception of seasonal and calendar factors, has been steadily positive since April 2004. However, with rather high inflation, these rates have slowed down to some extent in recent months, from 0.6 percent in October to 0.4 percent and 0.2 percent in November and December, respectively.

In 2004, the **poverty level** was notably reduced. Whereas there were 29.3 million people with income lower than required by the cost of living (20.3 percent of total population), this figure dropped to 25.5 million people (17.8 percent) in 2004, according to preliminary estimates. A negative aspect of the population poverty structure is that, besides the persons most frequently included into this group (large families or incomplete families with children, single retirees, the disabled, the unemployed), a significant portion of employees of the budget-funded sector of the economy has fallen into this group in recent years (in particular workers in education, health care, culture, science, etc.)

A smaller portion of the population's earnings was deposited in ruble accounts in 2004 as compared with 2003, according to estimates (4.2 percent versus 5.5 percent).

BALANCE OF PAYMENTS

The positive national balance on **current account** (excluding unilateral capital transfers) in 2004 grew 1.7 times as compared with 2003: US460.1 billion and US$35.4 billion, respectively, mainly due to an increasing trade balance. Surplus value in merchandise trade was augmented by more than 45 percent from US$59.9 billion in 2003 to US$87.1 billion in 2004, while the negative balance in non-factor services rose by 23 percent from US$10.9 billion in 2003 up to US$13.4 billion in 2004.

The Russian Federation's foreign trade turnover of goods grew in 2004 by 32.0 percent to US$279.8 billion and the positive balance of trade in goods rose by US$27.3 billion. Export prices grew by 14 percent more than imports in 2004.

[2] The Russian Federal Statistics Service, simultaneously with publication of data for 2004, adjusted the basis for 2003 towards its further increase: growth rate for real population income amounted to 114.9 percent on 2002.

The turnover of goods in QI 2005 reached US$76.5 billion. Merchandise exports value amounted to US$183.5 billion and rose by 35.0 percent in 2004 or by US$47.5 billion in absolute terms (US$14.5 billion due to increasing physical volume and by US$33.0 billion owing to the price factor) compared to 2003. In 2004 fuel exports made up 54.7 percent of the total exports value as in 2003. In 2004 fuel exports increased by US$26.7 billion and shipments of other commodities went up by US$20.8 billion

The value of imports in 2004 reached US$96.3 billion and went up by 26.6 percent or by US$20.2 billion in absolute terms (US$14.3 billion due to growing physical volumes and US$5.9 billion due to rising average contract prices). Rapid growth of imports was based on expanding internal consumption due to rising real disposal incomes of Russian population (8.4 percent), the GDP (7.1 percent) and real effective ruble appreciation at 6.1 percent in 2004 as compared with 2003.

Merchandise imports from non-CIS economies were growing at a high and stable rate (25.2 percent) in 2004 compared to 2003. The share of machines and equipment in total imports of goods increased to 41.2 percent in 2004 compared to 37.4 percent in 2003. At the same time the share of foodstuffs and raw materials for their production fell from 21.0 percent to 18.3 percent in 2004, while the share of chemical products (15.8 percent) was slightly less than in 2003.

The negative balance of trade in non-factor services increased by 23.0 percent and reached US$13.4 billion in 2004 compared to US$10.9 billion in the base period, at the same time turnover in these services expanded by 24.5 percent up to US$54 billion.

Exports of non-factor services amounted to US$20.3 billion in 2004 and went up by US$4.1 billion or by 25.0 percent against 2003. This growth was provided mainly by expanding provision of non-factor services to non-residents (increased by 29.7 percent up to US$7,272 million), including insurance services (up 1.6 times), financial and construction services (up 1.5 times).

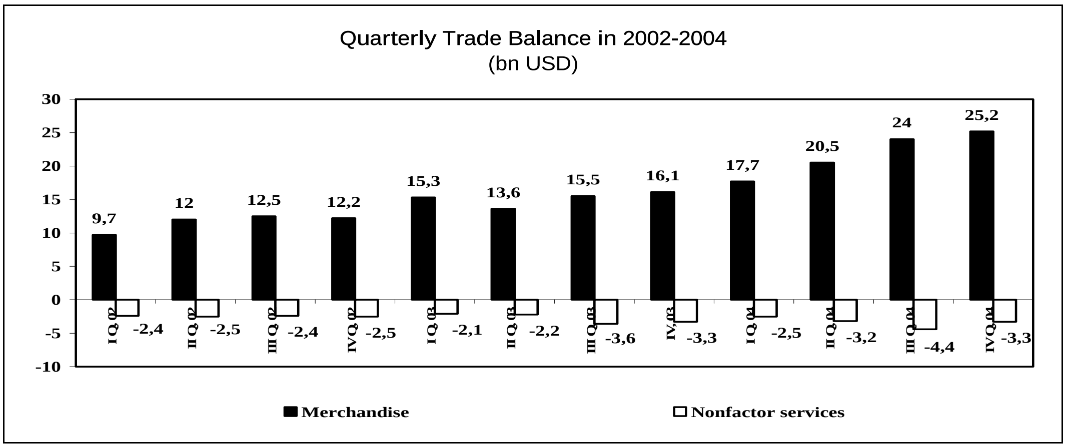
Exports of transport services went up by 27.3 percent up to US$7.8 billion (the increment was achieved mainly due to growing transport tariffs).

Meanwhile services involved with tourism, private and business trips, and rendered to non-residents were estimated at US$5.2 billion in 2004. This indicator is 16.1 percent more than in the base period (US$4.5 billion) and the rising prices of services rendered to foreign visitors compensated for the slight fall in inbound flows (by 2.1 percent).

Transport (38.4 percent) and travel (25.8 percent) services still dominated total exports of non-factor services in 2004, though the share of business services increased to 19.4 percent and that of construction services rose to 7.7 percent.

Imports of non-factor services amounted to US$33.7 billion in 2004 and increased by 24.3 percent compared to the base period due to expanding internal demand. Expenses of residents on traveling abroad reached US$15.7 billion in 2004 and rose by 22.1 percent against 2003 due to the 19 percent growth in the number of Russian residents' trips abroad.

Mainly due to rise in prices of air transport services, imports of transport services increased by 25.2 percent up to US$3.9 billion in 2004 compared to US$3.1 billion in 2003.



Higher growth rates were achieved in 2004 in imports of financial services (2.2 times), cultural services (1.6 times) and royalty and license fees (1.5 times).

In the structure of non-factor services' imports, travel and transport services are responsible for 46.7 percent and 11.5 percent, respectively, of total imports in 2004, while the share of other services was 41.8 percent, including business services (15.7 percent) and construction services (9.1 percent).

The negative balance on factor services was US$12.8 billion in 2004 as compared with US$13.2 billion in 2003.

The negative balance of labor payments rose sharply in 2004 up to US$0.6 billion compared to US$0.6 billion in the base period. Payments to foreign labor force were estimated at US$1.8 billion, while payments received by Russian Federation residents abroad totaled US$1.2 billion. As compared with 2003, income earned by residents abroad increased by 48 percent (mainly due to the increased number of labor emigrants), while labor payments made to non-residents in Russia went up 1.9 times due to the increasing number of labor immigrants and the rise in their average wages.

The negative balance of investment incomes fell 6 percent to US$12.2 billion in 2004 from US$13.0 billion, in the base period. Incomes due to investment abroad dropped to US$8.4 billion (18 percent less than in 2003) mainly owing to falling interest payments and dividends received abroad by the Russian Federation’s private non-financial sector. At the same time non-residents' incomes from investment in Russia equaled US$20.7 billion, a fall of US$2.6 billion compared to the base period because of decreasing payments from Russia’s non-financial sector and the Russian authorities.

The burden of servicing current debt liabilities by the Russian Federation public management sector diminished in 2004 by US$271 million compared to 2003. Its interest payments due to external credits in 2004 amounted to US$2,879 million including US$467 million due to new Russian debts and US$2,411 million due to the ex-USSR debts.

Balance of Payments of Russia, 2003–2004
(neutral presentation of the Bank of Russia, US$ million)

	2003	2004
Current account	**35 905**	**59 935**
Goods and Services	**49 401**	**73 735**
Export	151 959	203 742
Import	- 102 558	-130 007
Goods	60 493	87 145
Export	135 929	183 452
Import	-75 436	-96 307
Investment income and compensation of employees	**- 13 132**	**- 12 397**
Investment income	- 12 988	-12 397
Receivable	5 487	9 175
Payable	- 18 620	-21 572
Current transfers	**- 363**	**- 799**
Capital and financial account	**- 28 706**	**- 6 315**
Capital account (capital transfers)	**- 993**	**- 1 624**
Financial account (excl. reserve assets)	**- 27 713**	**- 4 691**
Change in reserve assets (‘+’ – decrese, ‘-‘ - increase)	**- 26 365**	**- 45 235**

Source: Bank of Russia, updated on 1 July 2005

Payments of public management sector due to portfolio investment increased from US$2,216 million in 2003 to US$2,333 million in 2004.

The Russian Federation’s banking sector investment payment liability to non-residents went up by 39 percent to US$1,354 million, while that of the sector of non-financial companies fell by 17 percent in 2004 compared to 2003, to US$13,933 million.

Fifty four percent of total investment incomes paid by non-financial companies were due to foreign direct investment in Russia. They amounted to US$7,466 million in 2004 as against US$12,220 million in the base period, or a fall of nearly 40 percent. Investment incomes paid by the non-financial sector due to portfolio investment increased by 12 percent and that due to credits by 77 percent.

The balance of current transfers was negative (US$0.8 billion) in 2004 as compared with the deficit of US$0.4 billion in 2003. Current transfers to Russia rose from US$2,537 million in 2003 to US$3,540 million in 2004, while current transfers from the Russian Federation increased from US$2,922 million to US$4,339 million.

The balance of capital transfers was a negative US$1.6 billion in 2004 as compared with a deficit at US$1.0 billion in 2003, mainly due to increasing cancellation of external debts by Russia. In 2004 the Russian Federation cancelled debts of foreign economies to the amount of US$1,434 million and foreign economies wrote off Russian Federation debt in the sum of US$499 million as compared with US$640 million and US$276 million in 2003, respectively. The deficit of migrants' transfers rose from US$630 million in 2003 to US$689 million in 2004 mainly as a result of reduced immigration to Russia. Property and financial assets of immigrants had an estimated value of US$364 million, while those of emigrants were US$1,052 million in 2004 as compared with US$339 million and US$969 million, respectively, in 2003.

The Financial account was noteworthy for its rising deficit in 2004. Without debt cancellation and a change of official reserves the respective negative values were US$7.8 billion in 2004 against US$0.2 billion in 2003, while the foreign liabilities of Russia's economy increased by US$31.6 billion in 2004 compared to their rise of US$28.2 billion in 2003 and assets grew by US$38.4 billion in 2004 as compared with their rise of US$28.4 billion in 2003.

Foreign liabilities of the public sector, including repayment of debts to the IMF and external debt cancellation, went down by US$2.35 billion in 2004 compared to their fall of US$5.45 billion in 2003; while the rise in foreign liabilities of the private sector was same as in 2003, US$33.3 billion

Other investment (credits, loans, deposits, etc.) became the major channel of net capital inflow to the Russian Federation (US$15.4 billion surplus in 2004), while liabilities on foreign direct investment registered a US$11.7 billion increase and on portfolio investment there was US$3.8 billion growth.

Structure of Foreign Assets and Liabilities of the Russian Federation (1997–2004, USS billion)

Period	Assets[1]				Liabilities			
	Direct	Portfolio	Other	Total	Direct	Portfolio	Other1	Total
1997	3.2	0.2	28.5	31.9	4.9	17.8	20.8	43.5
1998	1.3	0.3	14.4	16.0	2.8	8.9	9.0	20.7
1999	2.2	-0.2	13.2	15.2	3.3	-1.2	-0.9	1.2
2000	3.2	0.4	17.6	21.2	2.7	1.1	-4.2	-0.4
2001	2.5	-0.1	10.6	13.9	2.7	-0.7	-4.8	-2.8
2002	3.5	0.7	16.9	21.1	3.5	2.3	4.6	10.4
2003	9.7	1.5	17.1	28.4	8.0	-2.7	22.9	28.2
2004	**9.6**	**2.8**	**26.9**	**39.4**	**11.7**	**2.9**	**17.0**	**31,6**

1. Excluding official reserves and debt cancellation.
Source: Balance of payments statistics

New loans to the federal government made up only US$704 million in 2004 (US$785 million in 2003) and were received within the frameworks of the former agreements with the official creditors. The federal authorities also issued long-term government bonds amounting to US$0.9 billion in 2004 compared to US$28 million a year before.

Actual payments by the Russian Federation public sector on the principal debt, including payments of the Russia's Central Bank to the IMF, totaled US$8.5 billion in 2004. In 2004 payments due to the ex-USSR main debt were made at the amount of US$2.9 billion, including US$2.1 billion on the ex-USSR main debts covered by the agreement with the Paris Club.

The new Russian federal main debt, in the form of loans and credits, was being repaid at the amount of US$5.6 billion, including payments of US$2.5 billion to the international financial organizations (IFOs). The overall indebtedness to the IFOs decreased from US$11.7 billion by 1 January 2004 to US$9.7 billion by 1 January 2005 (IMF debt fell from US$5.1 billion to US$3.6 billion).

Total actual payments due to state foreign debt fell from US$14.41 billion in 2003 to US$13.36 billion in 2004. Thus the debt burden on Russia's economy decreased to a certain extent: the coefficient of external debt servicing (actual foreign debt payments divided by exports of goods and non-factor services) went down from 9.5 percent in 2003 to 6.6 percent in 2004, while the ratio of actual public foreign debt payments to consolidated budget revenues decreased from 10.7 percent to 7.1 percent.

Actual Payments on State Foreign Debt (USD billion)

	2003			2004		
	Main debt	Interest	Total	Main debt	Interest	Total
New Russian debt	**6.35**	**2.41**	**8.77**	**5.64**	**2.55**	**8.18**
Federal authorities	6.18	2.30	8.47	5.01	2.40	7.41
Credits of international financial organizations	2.66	0.31	2.97	2.46	0.26	2.72
IMF	1.90	0.14	2.04	1.65	0.11	1.76
IBRD	0.72	0.17	0.89	0.78	0.13	0.91
Other credits	1.66	0.21	1.88	1.24	0.16	1.40
Securities in foreign currency (including Eurobonds on debts to London Club)	1.53	1.73	3.25	1.25	1.97	3.23
Securities in Rubles	0.33	0.04	0.37	0.06	0.01	0.07
Local authorities	0.17	0.12	0.29	0.63	0.15	0.77
Ex-USSR debt	**3.40**	**2.25**	**5.65**	**2.85**	**2.33**	**5.18**
Paris Club	1.64	2.12	3.76	2.09	2.17	4.26
Other credits	0.56	0.06	0.61	0.76	0.10	0,86
Securities	1.20	0.07	1.27	0.00	0.05	0.05
Total	**9.75**	**4.66**	**14.41**	**8.49**	**4.87**	**13.36**

Source: Balance of payments statistics.

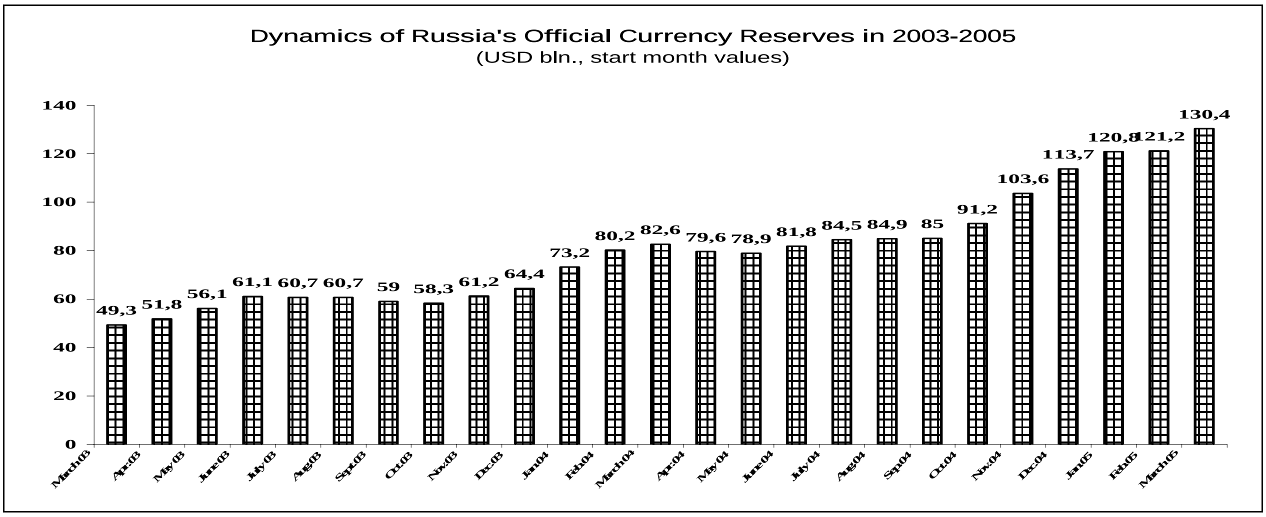
The foreign liabilities of the Russian Federation banking sector rose by US$7.4 billion in 2004 (they rose US$11.2 billion in 2003) and reached US$37.1 billion as of 1 January 2005 (of which 49 percent was short-term compared to 60 percent a year before). Eighty-one percent of the overall liabilities (without equity participation and financial derivatives) were nominated in US dollars, 11 percent in rubles, and 76 percent in euros.

The increment of liabilities of non-financial companies was still very considerable at US$25.9 billion in 2004 or 17.2 percent more than a year before. In 2004 about 54 percent of net capital inflow in this sector was loans and credits (US$14.1 billion in 2004 as compared with US$15.1 billion in 2003). Net inflow of foreign direct investment in this sector increased from US$7.5 million in 2003 to US$11.0 billion in 2004. Net portfolio investment increased by US$0.8 billion in 2004 compared to its fall by US$0.4 million in 2003.

In 2004 the registered increase of residents' foreign assets (excluding Russia's official foreign currency reserves and operations on canceling debts) made up US$39.4 billion (US$28.4 billion in 2003).

The value of foreign assets of the banking sector went up by US$3.6 billion in 2004 compared to their rise by US$1.0 billion in 2003 and totaled US$26 billion (excluding reserve assets of the Russia's Central Bank) by 1 January 2005 with short-term financial instruments forming 77 percent. The assets' currency structure (without equity participation and financial derivatives) included 71 percent of assets nominated in US$, 5 percent in rubles and 16 percent in euros. The indicator of net international financial position of the banking sector (the difference between foreign assets, excluding reserve ones, and foreign liabilities, excluding the IMF credits to the Russia's Central Bank) fell from US$6.0 billion at the start of 2004 to US$11.1 billion by 1 January 2005.

The increase of the public management sector foreign assets, excluding the Russia's Central Bank assets, by US$0.1 billion in 2004, was caused mainly by an accumulation of claims related to non-paid interest payments on credits granted by the ex-USSR. The net assets on the Russian Federation credits to the other economies went down by US$1.2 billion in 2004 mainly because of canceling debts, while overdue indebtedness to the Russian Federation rose by US$0.9 billion, and other assets rose by US$0.4 billion. At the same time the Central Bank of Russia’s foreign assets rose by US$1.3 billion compared to US$0.6 billion in 2003.



Foreign assets of resident non-financial companies and households rose by US$32.8 billion, more than the increase of US$25.9 billion in 2003. This growth is significant due to rising "non-repatriation of export earnings and non-arrival of prepaid import goods and services" by Russian Federation companies. This item, usually associated with illegal capital outflow, indicated an increase ofUS$25.9 billion in 2004 compared to US$15.4 billion in 2003. This amounted to 7.8 percent of total foreign trade turnover of goods and services in 2004 against 6.0 percent a year before.

Foreign direct and portfolio investment of Russian non-financial companies grew by US$9.3 billion in 2004 as compared with US$10.1 billion a year before, while export credits granted by Russian companies in 2004 increased by US$2.0 billion against their rise ofUS$4.0 billion in 2003.

In 2004 Russian non-financial companies and households reduced their assets held as cash foreign exchange by US$3.4 billion due to its lowering investment effect, while these assets’ value in 2003 fell by US$6.6 billion

As a result of a high positive trade balance Russia's **gold and foreign exchange reserve assets** increased by US$47.6 billion over 2004 and reached US$120.8 billion by 1 January, 2005 (US$143.7 by 1 June 2005).

Russia's official reserve assets depend on fluctuations of the world markets of oil, oil products and natural gas etc., as before, and they increased greatly from US$76.9 billion as of 1 January 2004 to US$124.5 billion by 1 January 2005 (US$147.4 billion by 1 June 2005).

Russia's foreign exchange reserves accumulated by 1 January 2005 were sufficient to finance 11.5 monthly volumes of imports of goods and services (8.9 months a year before). The coefficient of wide money supply coverage by official gold and foreign exchange reserves rose from 1.18 at the start of 2004 to 1.45 by 1 January 2005.

GROSS EXTERNAL DEBT

According to the revised data, the **overall external debt of the Russian Federation** residents increased from US$186.0 billion at the start of 2004 to US$215.1 billion by 1 January 2005 and made up 36.9 percent of the Russian Federation GDP as on 1 January 2005 as against 42.8 percent a year ago. Inherited ex-USSR debts make up 24.1 percent of the Russian Federation overall foreign indebtedness; 52.9 percent of the Russian Federation total public debt; and 58.4 percent of the Russia's federal government foreign liabilities. Of the Russian federal government liabilities, 44.5 percent belong to the Paris Club of creditors (as on 1 April 2005). The Russian Federation's overdue foreign debt decreased by US$3.9 billion in 2004 because of debt cancellation and other settlement operations rescheduling debts of the former USSR.

Credits from the international financial organizations were equal to 5.9 percent of the Russian Federation total public foreign debt as on 1 April 2005. In Q1 2005 Russia paid off its debt to the IMF completely, ahead of schedule.

The Russian Federation External Debt (USD billion)

	as of 1 January 2005
Total	**215.1**
State management sector	**97.4**
Federal Government	**95.7**
New Russian debt	*39.6*
Credits of international financial organizations[1]	6.2
IBRD	5.7
Other organizations	0.4
Other credits	4.2
Securities in foreign currency (including Eurobonds on debts to London Club)	28.9
Securities in Rubles	0.0
Other indebtedness	0.2
Ex-USSR debt	*56.1*
Paris Club	43.3
Credits of former socialist economies	2.7
Securities	1.9
Other indebtedness	8.2
Regional authorities	1.6
Credit and Monetary authorities[2]	**8.2**
Credits of the IMF	3.6
Banks	**32.5**
Non-financial companies	**77.0**

1. Credits received from the IMF are indicated in liabilities of the Russian Federation credit and monetary authorities.
2. The Russian Federation credit and monetary authorities include debts of the Central Bank of Russia and debts of the Russia's state management sector to the IMF.
Source: Balance of payments statistics.

EXCHANGE RATE

In 2004, Russia continued to pursue its policy of a floating exchange rate for the ruble. Over the year the ruble exchange rate remained relatively stable. On the whole, the supply of foreign exchange on the market prevailed over the demand.

For the most part of the year the dynamics of the ruble exchange rate were characterized by a growth trend.

Analytical Ruble exchange rate indicators in January–December 2004

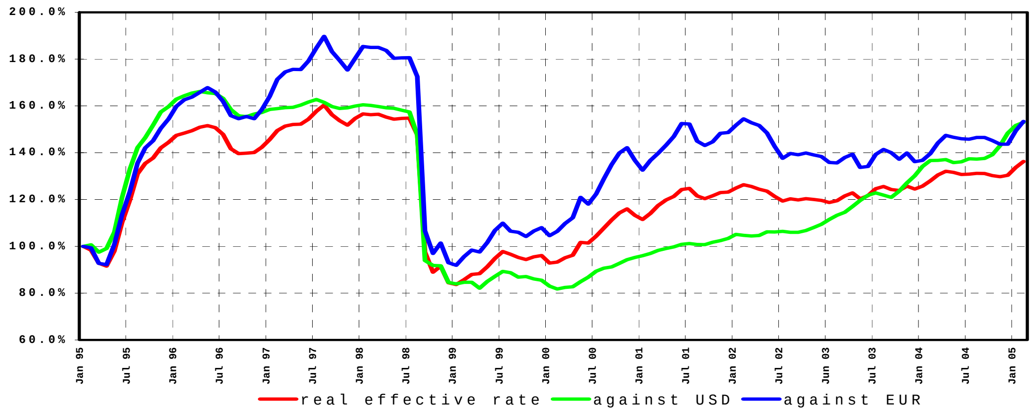
	Jan.	Feb.	Mar.	Q1*)	Apr.	May	June	Q2*)	1st half year*)	July	Aug.	Sept.	Q3*)	Jan. - Sept.*)	Oct.	Nov.	Dec.	Q4*)	Average annual exchange rate
Official exchange rate of USD against Ruble, period averages	28.92	28.52	28.53	28.66	28.68	28.99	29.03	28.90	28.78	29.08	29.21	29.22	29.17	28.91	29.08	28.58	27.92	28.52	28.81 (28.75**))

Source: The Bank of Russia (http://www.cbr.ru), updated 8 February, 2005
*) period averages; **) end of period.

During 2004 the official RUR/USD exchange rate fixed by the Bank of Russia (CBR) went up by 5.8 percent or from RUR 29.45 per USD as on 31 December 2003 up to RUR 27.75 per USD as on 31 December 2004.

DYNAMICS OF RUBLE'S AVERAGE MONTHLY REAL EXCHANGE RATES

In 2004 the official RUR/EUR exchange rate went down by 2.7 (or from RUR 36.82 per EUR as on 31 December 2003 up to RUR 37.81 per EUR as on 31 December 2004.



On the whole, real ruble appreciation against the dollar USD amounted to 15.0 percent in 2004 as compared with 2003, while real ruble appreciation against the euro was 5.6 percent in the same period. As a result the real ruble effective exchange rate (as compared with the basket of foreign currencies used in Russia's foreign trade) rose by 6.1 percent in 2004 as against 2003 and by 4.6 percent compared to December 2003.

FISCAL POLICY

According to the Russians Federal Treasury's data, federal budget revenue continued to increase in December 2004 and stood at 351.1 billion rubles as against 330.8 billion Rubles in November. Relative to GDP, federal budget revenue increased to 22.0 percent as against 21.8 percent in November. Absolute growth in revenue was due, equally, to tax and non-tax revenues, while the structure of revenues remained virtually unchanged over the month. In December 2004, the Federal Tax Service of Russia accounted for 56.6 percent of federal budget revenue and the Federal Customs Service of Russia contributed 38.1 percent. In November, the respective ratios were 57.4 percent and 35.6 percent.

Overall, the federal budget revenue in 2004 increased 1.3 times in absolute terms year-on-year and aggregated 3,426.3 billion rubles, or 20.4 percent of GDP as against 19.6 percent in 2003. Relative to the revised budget plan, federal budget revenue stood at 104.7 percent as against 100.9 percent in 2003. The Federal Tax Service accounted for 57.3 percent of total federal budget revenue and the Federal Customs Service contributed 35.6 percent for the year. (In 2003, the respective contributions were 64.8 percent and 29.3 percent).

Year-on-year growth in federal budget revenue in 2004 was due to the increase in tax revenues, which accounted for 79.2 percent of total budget revenue as against 78.5 percent in 2003. The taxes on foreign trade and foreign economic operations accounted for almost a half of overall revenue growth owing to high oil prices and the expansion of foreign trade turnover in 2004. The ratio of non-tax revenues contracted to 6.5 percent in 2004 as against 6.8 percent in 2003, mainly as a result of a fall in revenues from foreign economic operations that decreased by one-third in absolute terms, mainly due to interest on government loans.

The structure of federal budget revenue changed significantly in 2004 as compared with 2003. The taxes on foreign trade and foreign economic operations accounted for 25.1 percent of federal budget revenue as against 17.5 percent in 2003 and the severance tax accounted for 12.7 percent as against 9.6 percent a year earlier due to the increase in the tax rate. At the same time, the contribution of the value added tax contracted from 34.1 percent to 31.2 percent owing to a cut in the VAT rate and that of excise duties decreased from 9.8 percent to 3.4 percent as a result of the lifting of the excise duty on natural gas.

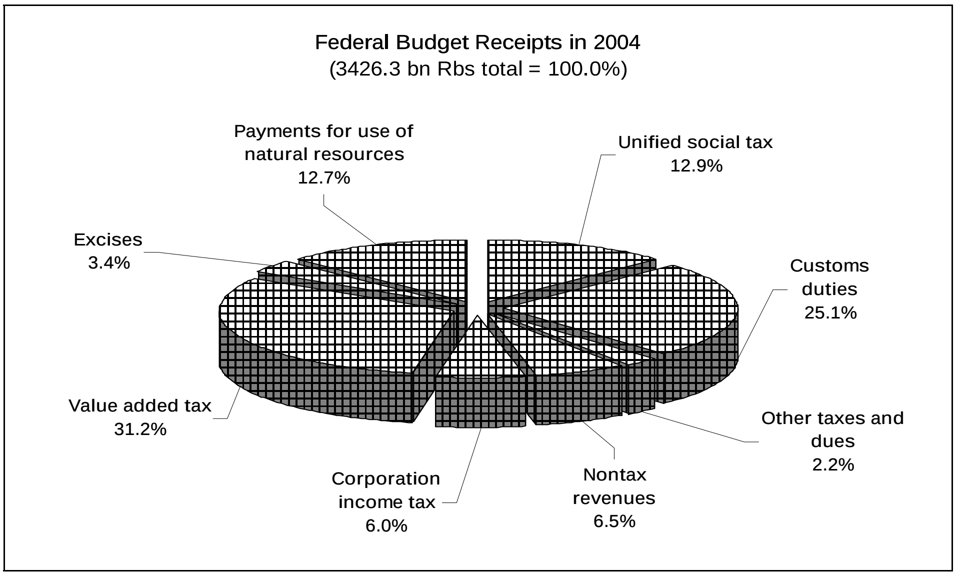
Federal budget expenditure stood at 406.8 billion rubles in December 2004 as against 234.5 billion in November. This represents an increase of 70 percent year-on-year, which caused a surge of inflation at the beginning of 2005. Growth in expenditure was due to an increase in both non-interest expenditures (by 158.5 billion rubles), especially the financing of the security and armed forces, the real sector and social services and financial assistance to lower-level budgets, and interest expenditures (by 13.8 billion Rubles) due to significant year-end foreign debt payments. The major changes in the budget expenditure structure in December as compared with November occurred in two areas: industry, power engineering and construction, whose share in total expenditure more than doubled due to compensation of the under-financing of the previous months; and government and municipal debt servicing.

In 2004, the federal budget expenditure aggregated 2,695.6 billion rubles, or 16.0 percent of GDP as against 17.9 percent in 2003. The federal budget expenditure performance stood at 97.4 percent of the revised full-year amount as against 97.7 percent in 2003, mainly due to a saving of expenditures made on government debt servicing.

The federal budget expenditure increased 10 percent in absolute year-on-year terms in 2004. The increase was, entirely due to growth in non-interest expenditures (whose share in total expenditure expanded from 90.6 percent in 2003 to 92.4 percent), especially expenditures on funding the security and armed forces and on financial aid to lower-level budgets, which accounted for more than 70 percent of growth. Interest expenditures decreased by 16.1 billion rubles and their share in total budget expenditure contracted from 9.4 percent in 2003 to 7.6 percent.

The most significant changes in the expenditure structure occurred in the financing of law enforcement and national security, whose share in total expenditure increased from 10.5 percent to 11.7 percent, and national defense, whose share expanded from 15.1 percent to 16.0 percent.

The following expense items of the 2004 revised budget received the most funding increased funding, which shown as a percentage of **the original budget allocation**: fundamental research and assistance to scientific and technological progress (102.8 percent); education (102.0 percent); culture, the arts and cinema (101.2 percent); financial assistance to lower-level budgets (100.7 percent); national defense (100.6 percent); and transport, communications and informatics (100.6 percent). The most under-financed sectors were agriculture and fishing (84.2 percent); and industry, power engineering and construction (94.0 percent). A major saving was made on expenditures on government and municipal debt servicing (17.0 percent of the planned amount) as a result of the ruble's rise against the currencies in which Russia's foreign debt in denominated.



Significant growth in cash expenditures in December 2004 led to a federal budget deficit of 55.7 billion rubles. However, in 2004 as a whole, Russia had a federal budget surplus of 730.7 billion rubles, or 4.4 percent of GDP as against 1.7 percent in 2003. Exceptionally high oil prices throughout the year were the principal reason.

The Russian Government's Stabilization Fund stood at 522.3 billion rubles at the end of 2004. It increased by 59.7 billion rubles in December and by 416.3 billion rubles in 2004 as a whole.

MONETARY POLICY

In 2004, Russia's monetary credit and foreign exchange policy was in accordance with the "Basic Directions of General State Monetary and Credit Policy for 2004". Priority was given to slowing down inflation since the stable lowering of inflation is the main goal of the policy. The target inflation growth rate in 2004 was set at 8 to-10 percent.

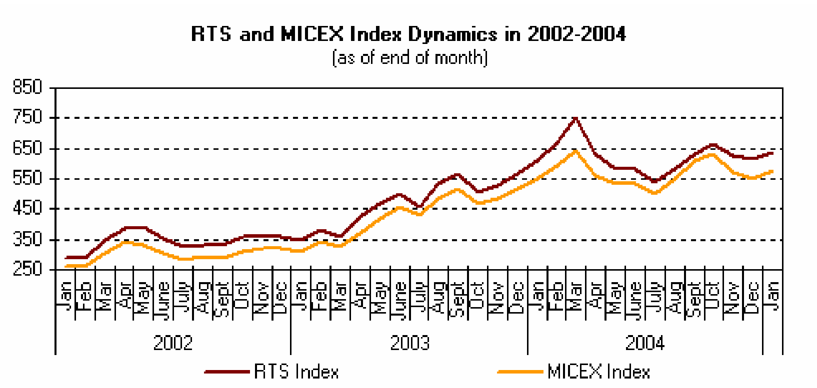
To neutralize excessive ruble held by commercial banks, the Ministry of Finance of Russia (Minfin of Russia), together with the Central Bank of Russia (CBR) held auctions of state short-term obligations (GKO) and federal official bonds (OFZ). The sales of federal securities by the Minfin of Russia amounted to 184.5 billion rubles in 2004 compared to 135.9 billion rubles in 2003.The total repayments of these securities from the federal budget reached 108.5 billion rubles in 2004 against 134.6 billion rubles in 2003. The size of the net sale of the above-mentioned state securities by the CBR equaled 6.3 billion rubles in Q4 2004 as compared with 2.6 billion rubles in Q3 2004.

The high level of the commercial banks' ruble liquidity along with the continued rally of the ruble against the US dollar in December 2004 stimulated Russian financial market participants' interest in investing in ruble-denominated assets.

The US dollar mostly declined against the ruble in 2004. As of the end of December 2004, it lost 5.1 percent against the ruble year-on-year in nominal terms in STS "today" trades and 5.6 percent in "tomorrow" trades. The MICEX average daily ruble/dollar spot trade turnover (calculated excluding currency swap transactions) stood at US$966 million in 2004, which represents a year-on-year increase of 110 percent. The official US dollar/ruble rate stood at 27.75 on 31 December 2004, as against 29.45 on 31 December 2003.

Yield fluctuations on the **ruble-denominated government securities** market stayed within 1.5 percentage points in 2004. Over the year, the market portfolio yield declined by 0.04 percent to 7.86 percent per annum (p.a.), while the portfolio duration increased by 1.8 times, to 4.8 years.

The yield on the OFZ-PD, OFZ-FD and OFZ-ADfk[2] bonds fell by 0.73 percent, 0.72 percent and 0.21 percent to 7.84 percent p.a., 6.10 percent p.a. and 7.77 percent p.a., respectively, as of 30 December. In 2004, the government stopped issuing GKO bonds and started to issue variable coupon-income OFZ-AD bonds, whose portfolio yield stood at 9.86 percent p.a. at the end of the year. The secondary government bond market turnovers expanded 32 percent in 2004, to 1.26 billion rubles per day as against 950 million rubles per day in 2003.



The **stock** market in 2004 saw the major Russian stock indices both fall and rise. Over the year, the MICEX index gained 7 percent as against 61 percent in 2003 and the RTS index was up 8 percent as against 58 percent a year earlier. At the end of 2004, the MICEX index stood at 552 points and the RTS index registered 614 points. The average daily volume of stock trade on the two trading floors expanded 26 percent in 2004 year-on-year and reached 11.7 billion rubles.

On the **corporate bond** market yields changed within the range of from 7.8 percent to 11.2 percent p.a. in 2004 and at the end of December they declined by 1.0 percent year-on-year to 9.3 percent p.a. The average daily volume of secondary trade in corporate bonds (including over-the-counter transactions registered on MICEX) expanded 67 percent in 2004 year-on-year to 1.7 billion rubles.

The level of commercial banks' **ruble liquidity** rose significantly in 2004. During the year, the balances in commercial banks' correspondent accounts with the Bank of Russia ranged from 126 billion rubles to 684 billion rubles and the average monthly balance increased 84 percent year-on-year to 220.7 billion rubles. As the ruble liquidity of commercial banks expanded, Interbank lending rates continued to decline and the average weighted overnight Moscow Interbank Actual Credit Rate (MIACR) on ruble loans fell to 3.7 percent p.a. in 2004 from 4 percent p.a. in 2003.

On the basis of the "Basic Directions of General State Monetary and Credit Policy for 2004" the CBR has been implementing its policy of a controlled floating ruble exchange rate without fixing limits to its deviations. At the same time the CBR was trying to prevent the rise of the effective ruble exchange rate to more than 7 percent in 2004. There was nominal ruble revaluation in comparison with the US dollar and its slight devaluation as compared with the euro in 2004.

In November 2004 the Government of the Russian Federation and the CBR passed "Basic Directions of General State Monetary and Credit Policy for 2005". Its goals and methods were similar to the "Basic Directions … for 2004". In particular, the target for inflation is 7.5 to 8.5 percent. The increasing real effective ruble exchange rate of 10 percent was revised downwards in August 2005, to not more than 8 percent.

The CBR worked out a sample scheme of bank operations which have a high degree of risk. These risky operations may be associated with money-laundering operations. The following are signs of the operations aimed at getting cash from the account (of a resident or a non-resident): 1) daily null or insignificant (not more than 5 percent of non-cash monetary turnover during a working day) balances on accounts of the participators of the scheme at the end of a working day, if non-cash turnover is significant within one working day; 2) crediting accounts of persons (non-residents or residents) and getting cash from them on one and the same working day; 3) presence of one and the same participators, at one and the same addresses of persons making these operations; 4) significant amounts of cash got regularly by persons from their accounts in one internal division of a bank; 5) closing of accounts of participators of the scheme after making a number of these operations—or sharp suspension of operations on these accounts.

The 2004 ruble **supply** dynamics by **and** large reflected the objective process of growth in the **demand for money**. As ruble supply growth in 2004 was considerably slower than in 2003, the expansion of the M2 aggregate amid the current inflation dynamics was at the level of 21.6 percent in 2004 as against 34.4 percent in 2003.

The intra-year seasonal fluctuations of the key monetary indicators in 2004 were similar to those registered in the previous years: M2 growth rates in Q1 and Q3 of the year (6.5 percent and 1.1 percent respectively) were lower than in Q2 and Q4 (7.8 percent and 17.1 percent respectively). The tendencies of the past years were also manifest in the year's highest rate of growth in the money supply in December, which was largely due to increased year-end budget expenditures.

At the same time, as a result of the significant dependence of ruble supply dynamics on the nominal rate of the ruble against the dollar, the rates of growth in the M2 aggregate in Q2 and Q3 were markedly slower than in the average quarterly rates in the same periods of the past years, while economic agents' demand for foreign exchange soared at the height of last summer's banking sector crisis of confidence.

The rates of growth in cash in 2004 were, on the whole, considerably lower than in 2003 (33.8 percent as against 50.3 percent). Fluctuations in the household sector's demand for foreign exchange and the slight slowing of growth in household income had the most marked effect on cash dynamics. According to a preliminary balance of payments estimate, the value of cash in the non-financial enterprise and household sectors in 2004 decreased by US$3.4 billion as against US$6.6 billion in 2003. As a result, foreign exchange purchases accounted for 8.4 percent of household income in 2004, which represents a significant increase on the past five years. This led to the slowing of household sector's cash on hand. Cash dynamics in that period were accompanied by a slight contraction in the cash ratio in the M2 aggregate (as of 1 January 2005, it stood at 35.2 percent as against 35.7 percent a year earlier).

In 2004, ruble bank deposits increased more rapidly than cash (36.9 percent as against 33.8 percent). The non-cash component of the M2 money supply expanded, mainly due to growth in household sector's deposits.

The monetary developments described above facilitated the further reduction of the velocity of money in 2004. Calculated by the M2 aggregate, the velocity of money slowed from 5.2 to 4.6 in 2004.

The rate of monetization of the economy, measured by the M2 aggregate, accelerated to 21.5 percent as of 1 January 2005, against 19.1 percent a year earlier.

In 2004, foreign currency corporate and individual deposits rose about 33 percent in dollar terms, that is, a little more slowly than ruble deposits. At the same time, the rate of growth in foreign currency deposits almost tripled year-on-year. It should be noted that corporate foreign currency deposits increased several times faster than personal foreign currency deposits. This may be the result of the decline of the nominal rate of the ruble against the dollar, rapid growth in exporter enterprises' foreign currency accounts and a significant increase in the non-financial enterprise sector's foreign debt.

The money supply in the monetary survey definition in 2004 grew more slowly than the M2 aggregate (33.7 percent as against 35.8 percent), whereas in 2003 the difference between the rates of growth of these two indicators was far more significant at 38.5 percent as against 50.5 percent. This indicates that economic agents are undecided about the asset currency they prefer. As of 1 January 2005, foreign currency deposits accounted for 17.6 percent of the money supply in the monetary survey definition as against 18.9 percent a year earlier.

Domestic credit was the prime source of growth in the money supply, including foreign currency deposits, in December 2004. Its expansion was due to an unprecedented increase (for that month and for the year as a whole) in banks' claims on the non-financial sector of the economy and seasonal growth in net credit to the government. In December 2004, the value of government deposit accounts with the Bank of Russia decreased by 289.1 billion rubles, that is, 2.3 times larger than the fall in December 2003.

In 2004, money supply growth of 1,336.6 billion rubles, was due to the increase (by 1,346.8 billion rubles) in credit institutions' claims on the non-financial sector of the economy. Although the banking sector's foreign net-assets also expanded significantly (by 1,127.3 billion rubles), a large part of the money supply formed through the external channel was absorbed by growth in government accounts, including the Stabilization Fund accounts, and the use of monetary regulation instruments by the Bank of Russia. The banking sector's foreign net-assets increased by more than a half in 2004 (in 2003, they grew by one-third). As was the case in the previous year, the main contributor to this growth was the increase (by 1,231.1 billion rubles) in the monetary authorities' foreign assets, which was due to the expansion of international reserves. At the same time, credit institutions' foreign net-assets decreased by almost 104 billion rubles in 2004.

Differing from the previous years, 2004 saw a tremendous growth in banking sector's claims on the non-financial enterprises and households: for most of the year these claims were the main source of growth in the money supply. Their average monthly rate of growth was 50 percent faster than in 2003 and the full-year increase stood at 47 percent as against 43 percent a year earlier.

Despite significant growth in credit to the non-financial sector, domestic credit in 2004 grew less than in 2003 (18.7 percent as against 26.5 percent). This was mainly due to the significant contraction of net-credit to the government, which was caused by the accumulation of the Stabilization Fund and the corresponding increase in general government accounts with the Bank of Russia. In 2004 as a whole, the value of government deposit accounts with the Bank of Russia increased by 601.9 billion rubles, or 130 percent, and stood at 1,047.9 billion rubles as of 1 January 2005.

The Stabilization Fund amounted to 522.3 billion rubles as of that date and its share in total government deposits expanded to 49.8 percent from 18.5 percent a year earlier.

As a result, the ratio between government deposits and the money supply was 24.0 percent as of the end of December 2004 as against 13.9 percent a year earlier.

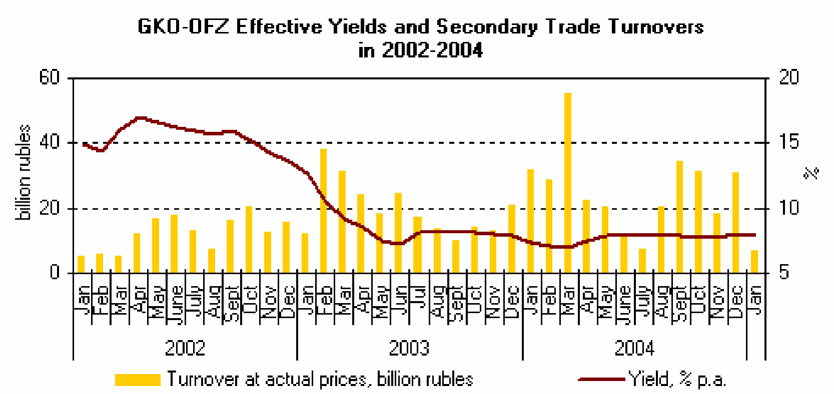
In 2004 the rate of growth in the notional broad money supply, which comprises the money supply in the monetary survey definition and the estimated foreign exchange held by non-financial agents, was a little faster than in 2003. At the same time, it was slower than the rate of M2 growth. As for the foreign currency component of the notional broad money supply, it contracted by almost 6 percent over the past year.

Although international reserves in 2004 increased far more than in 2003 (US$47.6 billion as against US$29.1 billion), the money supply created by the monetary authorities in 2004 increased considerably less than in 2003. As a result, the broad monetary base expanded 24.7 percent in 2004 as against 55.3 percent in 2003.

*Domestic government bonded debt***.** The main objective of the Ministry of Finance bond issuing policy in 2004 was to increase the circulation of the government bond issues that sold best on the market.

Implementing the government's principal debt strategy, the Ministry of Finance intends to continue to replace foreign debt by domestic debt in 2005, partly repaying foreign debt with funds raised on the domestic government securities market. In addition to GKO and OFZ bonds, the Finance Ministry is to issue government savings bonds (GSO) that will become a new kind of government securities in which the Pension Fund will invest funded pension.

The Finance Ministry of Russia allocated 36.1 billion rubles to the servicing of domestic government debt in the form of government securities in 2004. In 2004, it issued 176.2 billion rubles of government securities. As a result, the amount of budget funds raised by the Ministry of Finance by placing government securities on the domestic market in 2004 virtually equaled the value of the issue, or more than 68 percent of the initial full-year plan. Overall, in 2004, the principal amount of the debt (80 billion rubles) was redeemed as follows: 6.5 billion rubles of GKO bonds, 400 million rubles of OFZ-PD bonds, 59.8 billion rubles of OFZ-FK bonds, 1.8 billion rubles of OFZ-AD bonds and 11.5 billion rubles of OGNZ bonds.



Situation in the Banking Sector. The total number of operating credit institutions in the Russian Federation contracted from 1329 as of the beginning of 2004 to 1299 as of 1 January 2005.

Over 2004 the credit institutions received a profit (net financial result) of 177.9 billion rubles, 38.6 percent more than over 2003 and 1,276 credit institutions (98.2 percent of the total number as of 1 January 2005) posted an aggregate profit of 178.5 billion rubles. Twenty two credit institutions (1.7 percent of the total number) sustained an aggregate loss of 0.6 billion rubles. *For comparison*: 1,286 credit institutions (96.8 percent of the total number as of 1 January 2004) closed 2003 in the black, posting an aggregate profit of 133.4 billion rubles, and 39 credit institutions (2.9 percent of the total number) sustained an aggregate loss of 5 billion rubles. Based on the 2004 performance, ROA in the banking sector stood at 2.9 percent and return on capital was 20.3 percent (for 2003, 2.6 percent and 17.8 percent, respectively).

The banking sector's assets over 2004 grew by 27.4 percent and amounted 7,136.9 billion rubles. The share of the currency component in the total banking assets decreased by 3.4 percent compared with the beginning of the year (26.5 percent as of 1 January 2005). Own funds (capital) of credit institutions grew by 16.2 percent to 946.6 billion rubles.

The balances on customer accounts[3] over 2004 increased by 38.4 percent to 4151.5 billion rubles, and their share in the banking sector's liabilities from 53.6 percent to 58.2 percent. The trend toward the growth of household deposits with banks continued, but at a slower rate. Household deposits over 2004 increased by 29.7 percent (against. 47.1 percent over 2003). At the same time household ruble deposits grew by 37.6 percent, foreign currency deposits[4] increased by 18.5 percent. The share of household deposits in the banking sector's liabilities slightly increased (from 27 percent to 27.5 percent).

The share of the Russian Savings Bank (or Russia's *Sberbank*) on the market of household deposits continued to go down: from 63.3 percent as of 1 January 2004, to 60.3 percent as of 1 January 2005, triggered by sharpened competition on the bank services market for depositors' money.

The amount of funds attracted by credit institutions from enterprises and organizations over 2004 increased by 43.4 percent (against 26.9 percent over 2003), and their share in the banking sector's liabilities went up from 24.7 percent to 27.8 percent. Corporate deposits grew 1.8-fold, enterprises' and organizations' funds in the settlement, current and other accounts increased by 30.1 percent, while their shares in the banking sectors' liabilities went up from 5.6 percent to 7.9 percent and from 17.5 percent to 17.8 percent, respectively.

The resources mobilized by credit institutions through the issue of debt obligations increased by 1.5 percent over the year. As of 1 January 2005, the debt obligations issued accounted for 9.0 percent of the banking sector's liabilities (11.3 percent as of 1 January 2004).

In 2004, lending institutions maintained high growth rate of loans granted to non-financial enterprises and organizations. Their scope was up by 37.1 percent, and their share in the banking sector's assets reached 45.8 percent (42.6 percent as of 1 January 2004). The share of overdue debt in the credits to the non-financial sector over the year slightly decreased, from 1.56 percent to 1.51 percent.

The steadily high growth rate of retail lending became a distinctive feature in bank's lending transactions. Their number grew 2.1-fold over 2004. The share of loans to individuals in the banking sector's assets over 2004 increased from 5.3 percent to 8.6 percent, while their share in total bank loans went up from 9.8 percent to 13.9 percent, respectively.

Banks' investments in securities in 2004 grew by 8.4 percent while their share fell in the banking sector's, from 17.9 percent to 15.2 percent.

Investments in debt obligations by credit institutions increased by 20.4 percent. Debt obligations of the securities portfolios held by credit institutions grew from 62.4 percent to 69.2 percent, but in the banking sector's assets their share slightly decreased from 11.2 percent to 10.5 percent. In the structure of investments in debt obligations, the share of investments in debt obligations of the Russian Federation stood at 58 percent (against 71.5 percent as of 1 January 2004). Over 2004, their number contracted by 2.5 percent, and their share in the banking sector's assets dropped from 8 percent to 6.1 percent. Investments in debt securities of constituents of the Russian Federation and local authorities stepped up by 1.6 times, in those of Russian companies, by 1.8 times, and in those of resident lending institutions, by 3.3 times. As of the end of 2004, they accounted for 10.5 percent, 14.3 percent and 3.1 percent of total investments in debt securities, respectively.

---

[3] Balances on the accounts of enterprises, organizations (including the funds of budgets of all levels and government extra-budgetary funds), funds of individuals, customers' receivables, customers' receivables under factoring and forfeiting arrangements, and the amounts that have been debited to customer accounts but have not been posted to credit institutions' correspondent accounts.

[4] In USD equivalent

The amount of bills discounted by banks decreased by 26 percent over the year, and their share in the banking sector's assets dropped from 4.7 percent to 2.7 percent. Investments into promissory notes issued by Russian non-financial entities fell significantly (by 44.2 percent). Reduction in these investments was largely noted in 3Q (by 36 percent) in major banks that made a wide use of promissory notes in daily management of their liquidity.

Investments into shares were up by 21.7 percent over 2004, but their share in the banking sector's assets was still insignificant at 2 percent (2.1 percent as of the start of the year). Seventy six percent of all investments are into shares of Russian non-financial entities.

Claims on the Interbank loans, deposits and other placements in the banking sector as whole increased by 61.5 percent over the year, and their share in the banking sector's assets expanded from 4.7 percent to 6.0 percent. The loans placed in the domestic Interbank market grew by 60.7 percent with their share in the assets increasing from 2.6 percent to 3.2 percent over the year. The amount of loans placed with non-resident banks increased by 62.4 percent, and their share in the banking sector's assets from 2.2 percent to 2.7 percent. The loans and deposits attracted in the Interbank market over 2004 increased by 40.3 percent, while their share in the banking sector's liabilities amounted 10.3 percent against 9.4 percent as of the beginning of 2004. At the same time, the loans and deposits attracted in the domestic Interbank market grew by 49.8 percent, and in non-resident banks by 36.6 percent.

MEDIUM-TERM OUTLOOK (2006–2008)

The main priorities of economic policy for 2005 are to increase the income level of population, work out and realize measures to support economic growth, form the potential of economy stable development.

According to the last government assessment (as of August 2005), the growth rate of GDP in 2005 will amount to 5.9 percent (5.8-6.0 percent in 2006-2008), of industrial production – 4.5 percent (with growth up to 5 - 5.5 percent in 2008), agricultural production – by 1.4-1.5 percent (by 2008), investment averages in fixed capital – 10-10.4 percent in the years of 2006-2008, inflation (in terms of CPI) will be reduced from 8.5 percent in 2006 to 5.5 percent by the end of 2007. Real wages and salary will growth in average of 9.6 percent.

STRUCTURAL REFORM

On the medium-term program. Analyzing the course of reforms in Russia, the legal basis which established the new principles of functioning of the respective economic spheres, should be assessed. However, efforts in creating the required legal basis were combined with inefficient law enforcement practice in the spheres undergoing reforms. The development and implementation of the institutional reforms needs a full-fledged project approach.

In July, basing on the law On State Forecasting and on Programs for Social and Economic Development of the Russian Federation, the Government made a decision to develop a medium-term program. The Program was adopted by the Russian Government in August 2005.

The general government activities vector drawn in the program refers to the reduction of government interference in competitive business processes, to the formation of efficient market institutes and to the creation of a strict enforcement system.

Those, however, are the aspects directly related to business. At present, other problems come to the fore, which must be solved immediately as they constitute the areas that will determine Russia's competitiveness in the long run: the quality of the public administration in the widest sense and the industries related to human competitiveness, improvement of the human capital.

As regards the specific features of the program, they include the following:

1. Apart from institutional reforms, this is the first program to formulate specific mechanisms for economic development, including individual sector development strategies as well as measures aimed at:
   - the development of small business;
   - systems innovation; and
   - the infrastructure and housing sector.
2. The program is aimed at specific targets and includes indicators which demonstrate whether these are achieved. In our view, it is the fundamental point not only enabling estimates of public authorities' efficiency but moving our plans to a new level of execution.
3. The measures included in the program will enable the creation of conditions to drastically reduce the poverty level to single-digit figures.
4. Implementation of the present program will expand the ranks of the middle class and improve their opportunities.
5. The incomes of the public sector employees will approach those of the people employed in the private sector.

The main goal of the program is to form conditions for improving the nation's well-being and reduce poverty on the basis of a dynamic and steady economic growth.

By our estimates, the implementation of the actions envisaged in the program will create the necessary prerequisites for the formation of a broad middle class in Russia by 2015. The percentage of the population categorized as poor will shrink from 18 to 10 percent in 2010 and to 5 percent in 2015. Real earnings and labor productivity throughout the economy will grow 2.2 times by 2015. Implementation of the government's medium-term program will lay the foundation for achieving the average per capita GDP as measured by purchasing power parity (PPP) equal to the upper limit of the range characteristic of moderately developed economies.

Key Sections of the Mid-Term Program. To provide global competitiveness, we must, first of all, promote progressive structural shifts in the Russian economy. Hence, the program pays special attention to the **reform of the sectors related to human potential development**, primarily, education and health care. This is the obvious pressing demand of the post-industrial era.

In the **education system** it is necessary to introduce new organizational and economic mechanisms that would enhance efficient use of the available resources and promote raising additional funds. The quality of education can only be improved on the basis of renovation of its structure, content and teaching technologies, raising its innovation potential.

As for **health care** reform, it is suggested that we clearly define the state guarantees of providing free medical care, create conditions for easy access to effective medication, raise the efficiency of the compulsory health care insurance and promote the development of voluntary insurance.

The program also includes several new sections which are most important from the point of view of the economy's social and economic progress. In particular, for the first time ever, the program contains a section devoted to **reduction of the poverty rate**. It is worthwhile noting that the measures to overcome poverty are also contained in sections on education, health care, housing availability, regional policy. The said section focuses on the measures to reform the welfare system. Specifically, it deals with the necessity to reorient the welfare agencies towards work with poorer people. It is envisaged that the efficiency of programs for providing aid to the poor will be improved when they are fully adapted to local conditions. Approaches to reducing the poverty rate will be differentiated according to territories:

- for moderately developed regions: programs for the social integration of able-bodied poor people; and

- for depressed regions: retraining and qualification upgrading, promotion of small business and other measures enhancing the economic activity of able-bodied poor people.

Another new section of the program deals with the development of a **civil society**. Being of key significance for the development of a democratic system, the institutions of civil society have fundamental importance for the formation of market mechanisms which would win the citizens' confidence. Nowadays, a whole range of activities under state regulation lack guidelines ensuring effective representation of public interests.

The section devoted to **improving the efficiency of the public administration** is rather specific about the system of measures aimed at improving the state authorities' efficiency and creating the system of public administration corresponding to the needs of the society. The following key measures may be noted:

- further steps in abolishing redundant functions of the state authorities;
- regulation of control and surveillance functions and reforming the control and surveillance bodies;
- establishment of standards (compulsory requirements) for the quality, terms and procedure for providing public services;
- introduction of administrative regulations, i.e., compulsory requirements for the procedures and administration processes ensuring execution of the public authorities' powers; and
- legislative regulation of the procedure of disclosing and non-disclosure of information on the activities of the public authorities.

The section on the **private-public partnership** outlines the areas of interaction between the government and business. More active utilization of the mechanisms of the private-public partnership will be stimulated by the development of legislation on concession, expanding the practice of granting budget guarantees on non-commercial risks, which should provide an inflow of private capital to the development of social and production infrastructure: construction and maintenance of roads; electrical grids; ports; pipelines; and utilities.

It is envisaged to expand the scope of programs aimed at improving the competitiveness of domestic enterprises, namely to stimulate exports of finished goods, develop venture funding, promote technology commercialization, and raise the level of industrial design. The success of such programs will be ensured due to introduction of the norm of compulsory inclusion of industry and business associations in solving the problems of the programs preparation, co-funding and evaluation.

Another section is devoted to the **development of small businesses**. Currently the proportion of small businesses in the GDP is nearly half that of its share of the GDP of developed economies. The main measures in this area must be focused on the support of small entrepreneurship start-ups, on the formation of favorable lending conditions for small business, on promoting internal demand for the products of small businesses, and providing them with easier access to commercial property.

In the area of **foreign economic relations**, the main policy target is the creation of proper conditions for Russian enterprises to be involved in international production processes. This will be provided by lifting barriers to the foreign economic relations of Russian companies, encouraging export and investment activities, and by system-defined participation in developing the rules of international trade.

This will create the prerequisites for industry diversification and expanding the ways Russian business can participate in the international labor market and cooperation, for stimulating direct foreign investments, and for increasing the range of trading partners.

Important innovations relate to **regional policy**. It is necessary to turn from mechanical leveling of the territories' social and economical development and to move to stimulating use of the economic growth internal resources. Measures must be taken to monitor the fundamental limitations and realization of reforms, and to promote dissemination of best practice in reform implementation. Inter-budget transfers must be redirected to stimulate transformation on the sub-federal level. Requirements regarding administration quality must be raised; formation and development of regional economic clusters must be promoted. Entrepreneurial activity in "non-raw material" industries must be encouraged by the development of financial markets, of the banking and insurance sectors, by the development of the land and property markets, by changes in environmental management mechanisms, and by labor market development. Implementation of a range of institutional changes supported by the government's actions within the framework of individual infrastructure and high-technology industries will positively affect the economic structure, and the rate of economic growth, even in the medium-term.

An important innovation of the presented program is the section devoted to the elimination of structural limitations of economic growth with the help of the **development strategies**.

The Russian Government's Medium-Term Program is oriented on an innovation development scenario that is characterized by active economy diversification and structural shifts in favor of processing industries, science intensive services and a knowledge economy. This scenario stipulates a dramatic rise in the efficiency of state administration institutes and rapid creation of new "development institutes". The share of government investments is increasing to at least 5 percent of the GDP, which is comparable with the figures in economies solving the tasks of economy modernization.

The innovation scenario is based on the following three development strategy groups:

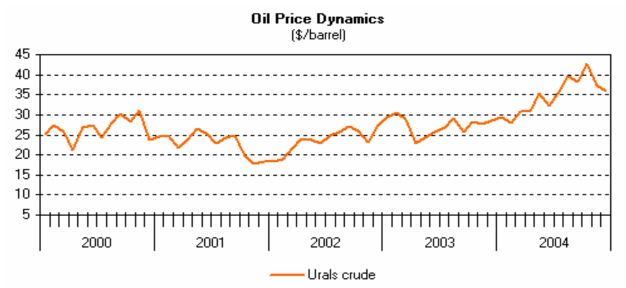
1. The development strategy of the traditional economy sectors or competitiveness improvement *strategy* for those sectors which constitute the basis of economic growth and life-supporting infrastructure. These include:
   - the oil and gas complex development strategy;
   - the Russian Federation transport development strategy till 2010; and
   - the agribusiness and fishery strategy.
2. The development *strategy for innovation sectors*, or the ***New Economy Development Strategy***, is one which will determine transition from the raw material-oriented to the innovation-oriented approach and the formation of new movers in areas of economic growth. Sectors include:
   - science and innovation development;
   - development and use of information and communication technology (ICT)
   - aircraft industry development;
   - aerospace industry development; and
   - defense industry development for the period to 2015.
3. *Human capital development strategy*:
   - housing market formation and development of residential construction and utilities in the Russian Federation for the period 2005 to 2010;
   - education system improvement; and
   - health care and that part of the social and labor sphere with links to health care.

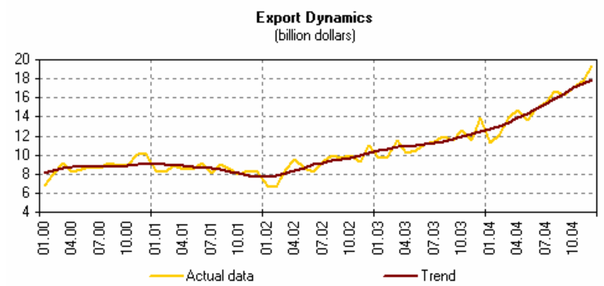
FOREIGN TRADE

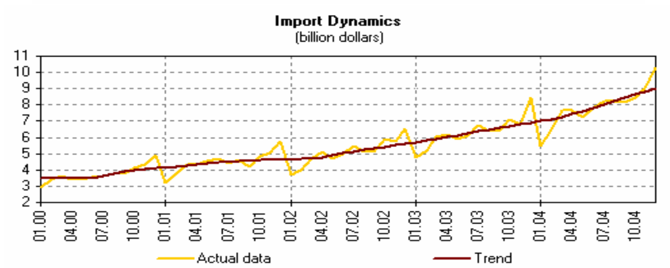
The situation on the world commodity market in 2004 was considerably better for Russian exporters than in 2003. According to a Bank of Russia estimate, world prices of major Russian export commodities in 2004 rose 20 percent on average y-o-y. The price of Urals crude went up 26.8 percent in 2004 y-o-y to US$35.6 per barrel. The price of natural gas in Europe rose 9.5 percent, petrol 37 percent, diesel fuel 36 percent, and fuel oil 3 percent. In the period under review, energy prices grew 20 percent on average, while non-energy prices increased 19 percent, of which non-ferrous metal prices gained 30 percent (aluminum rose 20 percent, and nickel 44 percent). The terms of Russia’s trade with foreign economies in 2004 were better than in 2003 due to the accelerated growth in export prices.

Exports and imports in 2004 reached the highest levels since observations began in 1994.

According to the customs statistics, Russia's **foreign trade turnover** amounted to US$257.1 billion in 2004 and increased in value terms by 34.6 percent against 2003 (in 2003 it grew by 24.7 percent compared to 2002), inclusive of the foreign economies US$210.0 billion (up by 33.5 percent) and the CIS member economies’ US$47.1 billion (up by 40.0 percent). The rise of foreign trade in value terms in 2004 was called forth by considerable increase of exports due to the favorable situation in the world energy goods market and a substantial growth of imports because of growing internal demand. The growth rates in value terms increased considerably (1.4 times compared to 2003) owing to a more substantial rise in prices of Russia's main export commodities and higher physical volumes of imports in comparison with 2003.







Russia's **foreign trade surplus** totaled US$105.9 billion and surged by US$29.6 billion or increased by 38.8 percent in 2004 as compared with 2003. The surplus balance of 89.0 percent was formed in trade with the foreign economies. The ratio of imports coverage by exports rose from 233 percent to 240 percent. The ratio of imbalance (the share of net balance in total trade turnover) went up slightly, from 40.0 percent to 41.2 percent. Net balance of the Russian Federation’s foreign trade exceeded imports to the Russia in 2004 by nearly 1.4 times; that is a very rare phenomenon in world trade. The share of the foreign economies in the Russian Federation total foreign trade turnover was equal to 81.7 percent in 2004 (82.4 percent in 2003), while that of the CIS was 18.3 percent (17.6 percent). The EU-25 accounted for 48.8 percent (49.5 percent) of Russia’s foreign trade turnover and **APEC economies for 16.8 percent (16.1 percent)**. Russia's top trade partner is Germany with 9.3 percent of the total trade turnover in

2004 (9.7 percent in 2003) followed by Belarus with 6.8 percent (6.5 percent), Ukraine with 6.6 percent (6.3 percent), Netherlands with 6.5 percent (5.2 percent), Italy with 5.9 percent (5.7 percent), **China with 5.8 percent (6.1 percent)**, **USA with 3.8 percent (3.8 percent)**, Turkey with 3.4 percent (3.0 percent), Switzerland with 3.3 percent (3.3 percent), and Finland with 3.2 percent (3.2 percent).

Russia's Foreign Trade in 2004 (US$ billion)

	Turnover	Exports	Imports	Balance
Total	**257.1**	**181.5**	**75.6**	**105.9**
Growth rates (percent)	*34.6*	*35.8*	*31.8*	*38.8*

Source: Russia's Federal Customs Service (http://www.customs.ru).

Under pressure from seasonal fluctuations in the markets of many commodities and political and economic instability in different regions of the world, Russia's foreign trade activity was uneven in nature and reached maximal indicators in December 2004.

Growth in **exports** was due to a significant increase in contract prices as well as the expansion of export volumes. There was an expansion in the export volumes of oil, petrol, fuel oil, natural gas, aluminum, timber products, some ferrous metals, chemical raw materials, mineral fertilizers, and cars. As for the commodity structure of exports, the share of energy products, chiefly oil, slightly increased in 2004 as compared with 2003, while the share of ferrous metals expanded significantly. The share of machinery, equipment and transport vehicles contracted in the value of exports. According to Russian Federation customs statistics, Russia's merchandise exports in 2004 grew in value terms by 35.8 percent compared to 2003 (compared to 25.1 percent a year earlier) mainly due to improvements in the markets of energy sources and some other commodities. Overall exports totaled US$181.5 billion, inclusive of exports to the foreign economies of US$52.1 billion (up by 34.5 percent) and to the CIS economies of US$29.4 billion (up by 43.3 percent).

The share of the foreign states in the Russian Federation exports was 83.8 percent in 2004 (84.7 percent in 2003). As before, the EU-25 remained the major export market with 50.3 percent of Russia's total exports (50.9 percent in 2003). The **APEC economies** accounted for 14.8 percent of Russia's total exports compared to 14.5 percent a year before. Russia's main export partners in 2004 were Netherlands with 8.4 percent of the Russian total exports (6.5 percent in 2003), Germany with 7.3 percent (7.8 percent), Italy with 6.7 percent (6.4 percent), Belarus with 6.1 percent (5.7 percent), Ukraine with 5.9 percent (5.7 percent), **China** with **5.6 percent (6.2 percent)**, Switzerland with 4.3 percent (4.3 percent), Turkey with 4.1 percent (3.6 percent), **USA** with **3.6 percent (3.2 percent)**, and Finland with 3.2 percent (3.2 percent).

Russia's exports were stimulated by the favorable situation in the world energy markets, where average prices of Russia's export commodities rose by 23.2 percent in 2004 as compared with the same period of 2003. High growth of export values is largely due to the exceptional price environment in global markets in 2004, especially starting from Q2. The growth rate for export contractual prices in 2004 was almost twice as high as that for export volumes. Exports in natural terms were up by 10.7 percent (index of value), 9.8 percent (quantum index) and 15.8 percent (unit value index).

In general, foreign economic factors are estimated[5] to have accounted for more than half of economic growth in 2004, or 3.9 percentage points of GDP growth, including 2.5 percentage points due to the oil price factor (2.8 percent and 1.5 percent, respectively, in 2003).

Exports' share in output rose for oil, oil products, coal, natural gas, round wood, plywood, and trucks, while it went down for wood pulp, newsprint, mineral fertilizers, rolled flat steel and cars.

[5] As estimated by the Ministry for Economic Development and Trade (MEDT of Russia).

Russia's export structure did not experience any positive changes. The share of fuel and energy carriers in 2004 was 57.1 percent (an increase of 0.4 percent from 2003), that of metals and metal products, 16.8 percent (increase of 2.9 percent), chemical products, 6.6 percent (reduction of 0.2 percent), and machinery and equipment, 7.8 percent (a reduction of 1.2 percent).

The Share of Exports in Output of Major Commodities (percent)

	1999	2000	2001	2002	2003	2004
Crude oil	44.2	44.8	46.5	49,7	53.1	56.1
Oil products	33.7	36.3	35.5	40.8	40.9	42.1
Natural gas	34.6	33.2	31.2	31.2	32.7	33.9
Coal	16.7	25.7	22.2	23.8	29.3	35.1
Mineral fertilizers	83.2	82.9	81.8	78.1	76.1	75.2
Roundwood	40.1	42.4	53.4	51.0	46.1	54.1
Plywood	69.2	65.8	64.5	64,2	60.9	64.4
Wood pulp	79.1	82.4	83.7	85.1	82.9	77.6
Newsprint	70.6	69.0	67.4	68.6	66.0	65.5
Rolled flat steel	60.6	55.3	43.0	50.5	47.1	46.1

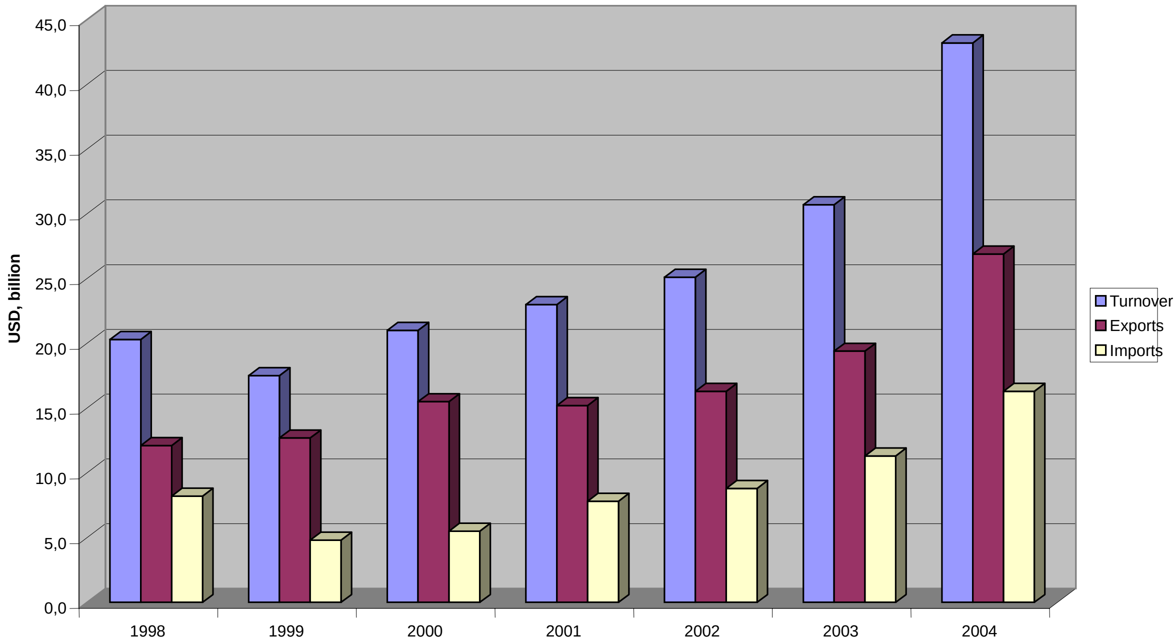
Source: Customs statistics and data of the Russia's State Statistics Service.

In 2004 the share of mineral fuel and electricity in the commodity structure of the Russian Federation exports went up by 0.4 percent as compared with 2003, while the share of ferrous and non-ferrous metals increased by 2.5 percent; machinery, equipment and vehicles decreased by 1.1 percent; and timber, wood pulp and paper fell by 0.3 percent.

The composition of major export commodities did not change in 2004 in comparison with 2003 and includes energy sources (oil, natural gas, oil products, coal), metals (rolled steel and steel semi-products, unwrought aluminum and nickel, refined copper), precious metals and stones (mainly raw diamonds), round wood and manufactured timber. When the export concentration is too high, such as when about 60 percent of the Russian Federation's total exports belong to five commodities, it is not possible to meet world market fluctuations flexibly.

Russia's merchandise **imports** in 2004 amounted to US$75.6 billion according to the customs statistics and grew by 31.8 percent as compared with 2003 (up by 24.0 percent in 2003 against 2002) mainly due to growing physical volumes. Imports from the foreign economies reached US$57.9 billion (a rise of 30.9 percent). The share of the foreign economies in total imports equaled 76.5 percent and went down by 0.6 percent compared to 2003. In 2004, the EU-25 accounted for 45.0 percent of the Russian Federation's total imports (46.3 percent in 2003), the **APEC economies 21.5 percent (19.8 percent)**. Russia's main import partners in 2004 were Germany with 14.0 percent (14.1 percent in 2003), Belarus with 8.6 percent (8.5 percent), Ukraine with 8.1 percent (7.7 percent), **China** with **6.3 percent (5.8 percent), Japan** with **5.2 percent (3.3 percent),** Kazakhstan with 4.6 percent (4.3 percent), Italy with 4.2 percent (4.2 percent), **USA** with **4.2 percent (5.2 percent),** France with 4.1 percent (4.1 percent), and Finland with 3.1 percent (3.2 percent). The physical volume of total imports increased by 24.2 percent, inclusive of the foreign economies by 28.6 percent. More than 76 percent of total value increase of imports was caused by a rise in imports in real terms.

Trade of Russia with APEC, 1998-2004



Growing imports were promoted by expanding internal demand, since average real wages increased by 10.9 percent and retail trade turnover rose by 12.1 percent in 2004 compared to 2003; real effective appreciation of ruble against foreign currencies reached 6.1 percent in 2004 against 2003 and stimulated imports, too. The largest increments in total imports in natural terms were in imports of dry milk (1.3 times), wheat (2.1 times), barley –(1.6 times), maize –(2.1 times), fish –(by 19.1 percent), meat conserves (1.3 times), citrus fruits –(by 10.2 percent), white sugar (1.4 times), medical goods –(1.2 times in value terms), alcohol and non-alcohol drinks (1.7 times in value terms), ferrous metals (1.6 times), steel tubes (by 5.6 percent), oil products (3.1 times, cars –(2.5 times), furniture (1.3 times in value terms), apparel – (by 31.0 percent). Imports in natural terms went down for the following goods: frozen meat –(by 6.0 percent), poultry meat (by 7.6 percent), butter (by 9.9 percent), coffee (by 7.8 percent), cigarettes (by 23.3 percent), raw sugar (by 37.1 percent), leather footwear (by 9.2 percent).

In 2004 imports of machinery, equipment and vehicles amounted to US$31138.6 million and rose in value terms by 46.3 percent, inclusive of imports from the foreign economies at 46.6 percent. Imports of cars were 525.3 thousand units (up 2.5 times), trucks 38.7 thousand units (up 22.0 percent). The share of machines, equipment and vehicles in Russia's total imports amounted to 41.2 percent in 2004 against 37.4 percent in 2003, and total imports from the foreign economies were 45.7 percent (40.8 percent) according to customs statistics. The rise in imports of engineering goods by 3.8 percent was caused mainly by growing imports of investment goods which accounted for more than two-thirds of total imports of machines, equipment and vehicles.

There was growth in imports of most of enlarged commodity groups in 2004. Most rapidly growing were imports of foodstuffs and agricultural raw materials, chemicals, and engineering goods. The highest rates of growth were demonstrated by imports of these goods from the foreign economies. Russian Federation imports by commodity were as follows: machines, equipment and vehicles (41.2 percent), foodstuffs and raw materials for their production (18.3 percent), and chemical products (15.8 percent). According to the data of the Russian Central Bank, the share of imports in total resources to be used in the internal market was 21.6 percent in November 2004 at current prices. In 2004 Russia's export prices were rising more than a year ago. Russia’s terms of trade became more favorable to Russia and increased in comparison with 2003, to 1.16 from 1.10.

The share of machinery and equipment in product imports soared from 37.4 percent in 2003 to 41.2 percent in 2004, with a reduction in the share of a majority of the other most important items: the share of industrial goods and raw materials for their production stood at 18.3 percent (a decrease of 2.7 percent), that of chemical products, at 15.8 percent (a decrease of 1.0 percent), that of textiles and footwear, at 4.3 percent (a reduction of 0.6 percent).

As a result of the double-digit growth of exports as compared with that of imports, the *external surplus* in 2004 reached a record mark of US$88.4 billion against US$59.9 billion in 2003.

INVESTMENT

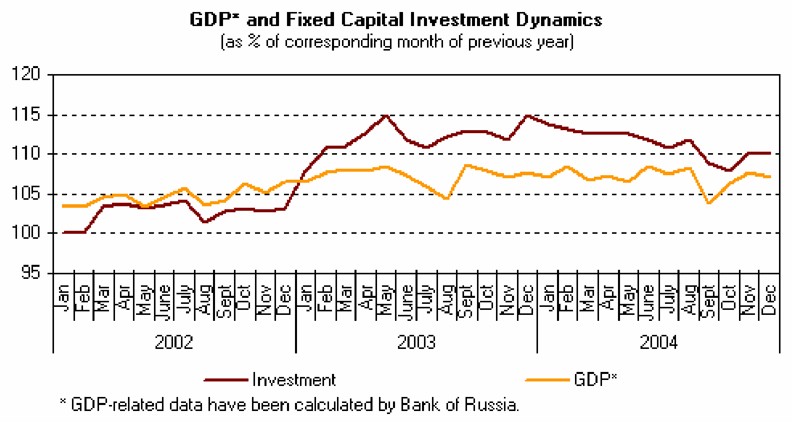
The favorable macroeconomic situation and the expansion of demand for domestically manufactured products in 2004 encouraged potential investors' expectations of further production growth, while the financial stability of enterprises stimulated investment activity.

Fixed capital investment expanded 10.9 percent in 2004 year-on-year as against 12.5 percent in 2003. Monitored without taking into account seasonal and random factors, last year's fixed capital investment dynamics indicate that its growth slowed down in 2004.

A high level of business activity was registered in the construction sector in 2004. The volume of construction work done by contract expanded 10.1 percent year-on-year as against 14.4 percent in 2003.

The backlog of contract agreements signed by construction companies as of the end of 2004 guaranteed for them the implementation of their production programmes (at the current utilization rate) for another 0.8 months as against 0.9 months in 2003.

Russian companies demonstrated a **high level of investment activity** in 2004. The favorable macroeconomic situation and the expansion of demand for domestic products encouraged potential investors into expecting further production growth and the financial stability of companies stimulated investment activity.



Housing construction continued at a rapid rate in 2004: housing with a total floor space of 41 million square meters was built last year, an increase of 12.5 percent on 2003. A large part of this housing (39.4 percent) was built by dwellers at their own expense. The housing built in 2004 exceeded the 2003 level in 58 regions of Russia.

The total sum of attracted **foreign capital in Russia**'s economy amounted in 2004 to US$40.5 billion, an increase of 36 percent in comparison with 2003. As before, the majority of foreign capital inflow: 76 percent of total foreign investment in 2004 or US$30.8 billion compared to US$22.5 billion in 2003, relates to the category of "other investment". Foreign direct investment in

2004 amounted to US$9.4 billion, growing by nearly 40 percent over 2003. Portfolio investment in 2004 reached US$333 million, a fall of 17 percent as compared with 2003.

Inflow of Foreign Investments into the Russian Federation (1997-2004)

	1997	1998	1999	2000	2001	2002	2003	2004	2004/2003
US$ million									
Total	***12 295***	***11 773***	***9 560***	***10 958***	***14 258***	***19 780***	***29 699***	***40 509***	***--***
Direct	5 333	3 361	4 260	4 429	3 980	4 002	6 781	9 420	--
Portfolio	681	191	31	145	451	472	401	333	--
Other	6 281	8 221	5 269	6 384	9 827	15 306	22 517	30 756	--
percent									
Total	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***136.4***
Direct	43.4	28.6	44.6	40.4	27.9	20.2	22.8	23.3	138.9
Portfolio	5.5	1.6	0.3	1.3	3.2	2.4	1.4	0.8	83.0
Other	51.1	69.8	55.1	58.3	68.9	77.4	75.8	75.9	136.6

Source: Federal Service of State Statistics.

Foreign investment inflow to the Russian Federation in 2004 was distributed as follows (percent of the total influx):

- *Direct investment*: gross fixed investment (18.0 percent); credits from foreign co-owners of joint ventures (4.2 percent); leasing (0.1 percent); other 1.0 percent).
- *Portfolio investment*: shares and stocks (0.7 percent); debt obligations of legal entities (0.1 percent.
- *Other investment*: trade credits (9.5 percent); other credits (65.2 percent); other (1.2 percent).

After getting a positive rating from the Moody's internal agency instead of its ‘stable’ one in October 2004, demand for Russia's debt instruments has grown considerably. However some experts think the number of their new buyers has hardly risen, and that investment in them has been made mainly by old owners of the securities.

On 18 November 2004, Fitch Ratings, another international rating agency, raised Russia's rating up to the ‘investment’ level of BBB-. This is likely to increase the list of potential investors in the Russian economy. Experts expect that major US institutional investors (insurance companies, foreign investment funds and so called cross-over investors playing with instruments having border ratings) to buy Russia's government and corporate securities more actively.

Another category of foreign investors are index funds forming their portfolios in accordance with indices of major international investment banks. The basic reference point for these investors at the developing markets is index EMB1+ of J.P. Morgan Chase Bank. Investors buying Russian securities pay attention just to this index.

Conservative investors prefer debt indices of the other two banks, Lehman Brothers and Merrill Lynch. Both banks calculate indices of two categories. Their high grade index is fixed for investment rating securities and their high yield index relates to corporate securities not having an investment rating but working in the economies owning this rating. Merrill Lynch Bank was the first to respond to the decision of Fitch agency. So, since 1 January 2005 most of the Russian government’s Eurobonds have been included in several high grade indices and the Eurobonds of some Russian companies joined high yield indices of the bank. However Lehman Brothers Bank has not hurried to follow Merrill Lynch Bank’s lead. The matter is that Lehman Brothers orients at Moody's and Standard & Poor's ratings, and Standard & Poor's agency did not give an ‘investment’ rating to Russia in 2004 (this happened only in early 2005). Besides, Lehman Brothers Bank’s requirements to borrowers include registration of their securities by the US Securities and Exchanges Commission. Nevertheless there are opportunities to get a further improvement in the ratings of all the agencies. The grounds for re-estimating Russian investment risks are stable macroeconomic indicators, huge gold and foreign exchange reserves, and a low debt level—as well as the Russian Federation's strict budget policy.

The accumulated foreign investments by the end of 2004 were estimated at US$82.0 billion,44 percent more than a year before. The volumes of accumulated foreign investment in the Russian economy and foreign investment received in 2004 are illustrated in the following figures.

Accumulated Foreign Investments, by Donor Economies (US$ million)

	Accumulated		***Including***			***For reference***
	Total	***percent, of total***	***direct***	***portfolio***	***other***	***received in 2004***
Total investment	**81 997**	**100.0**	**36 147**	**1 593**	**44 257**	**40 509**
of which main investor economies including:	71 150	86.8	30 450	1 372	39 328	35 088
Cyprus	13 790	16.8	10 094	585	3 111	5 473
Netherlands	11 996	14.6	8 805	43	3 148	5 107
Luxembourg	11 880	14.5	263	1	11 616	8 431
Germany	9 324	11.4	2 550	8	6 766	1 733
U.K.	8 673	10.6	1 602	142	6 929	6 988
USA	6 624	8.1	4 310	418	1 896	1 850
France	3 874	4.7	433	0.3	3 441	2 332
British Virgin Islands	1 902	2.3	1 144	59	699	805
Switzerland	1 684	2.1	957	95	632	1 558
Austria	1 403	1.7	292	21	1 090	811

Source: Russia's Federal Service of State Statistics.

Foreign capital was incoming in 2004 from 113 economies. The largest accumulated foreign investments belonged to companies of Cyprus (US$13.8 billion), the Netherlands (US$12.0 billion), Luxembourg (US$11.9 billion), Germany (US$9.3 billion), the UK (US$8.7 billion), and the USA – US$6.6 billion These economies as well as some others were among the top ten investors that for more than 85 percent of total foreign investment and 78 percent of total FDI in 2004.

Top Ten Investor States (percent of total)

2002			**2003**			**2004**		
No	**Total**	**100.0**	**No**	**Total**	**100.0**	**No**	**Total**	**100.0**
1.	**Germany**	**20.2**	**1.**	**Great Britain**	**15.6**	**1.**	**Luxembourg**	**20.8**
2.	**Cyprus**	**11.8**	**2.**	**Germany**	**14.5**	**2.**	**Great Britain**	**17.2**
3.	**Great Britain**	**11.5**	**3.**	**Cyprus**	**14.2**	**3.**	**Cyprus**	**13.5**
4.	Switzerland	6.8	4.	France	12.5	4.	Netherlands	12.6
5.	Virgin Islands (UK)	6.6	5.	Luxembourg	7.5	5.	France	5.8
6.	Luxembourg	6.4	6.	Netherlands	5.9	6.	USA	4.6
7.	France	6.0	7.	Virgin Islands (UK)	4.9	7.	Germany	4.3
8.	Netherlands	5.9	8.	USA	3.8	8.	Switzerland	3.8
9.	USA	5.7	9.	Switzerland	3.6	9.	Austria	2.0
10.	Finland	3.0	10.	Japan	3.4	10.	Virgin Islands (UK)	2.0

Source: Federal Service of State Statistics.

By accumulated foreign direct investments the leaders were as follows: Cyprus (US$10.1 billion), Netherlands (US$8.8 billion), USA (US$4.3 billion), Germany (US$2.6 billion), UK (US$1.6 billion), and Virgin islands (UK) (US$1.1 billion).

Foreign investment in 2004 was distributed as follows: cross fixed investment (US$6.9 billion); capital repair of fixed assets (US$49 million); investment in intangible assets (US$84 million); investment in other non-financial assets (US$98 million); purchase of securities (USD2.0 billion); granting credits (US$2.0 billion); repayment of credits and loans (US$4.2 billion); repayment of interest payments due to credits and loans (US$681 million); purchase of raw materials, completing parts, etc. (US$6.5 billion); taxes, dues and other obligatory payments (US$1.7 billion); rent payments (US$35 million); payment of services (US$1.0 billion); vocational training (US$1 million).US$34.3 billion (84.7 percent) of total foreign investment in 2004 was used in this way according to the Russian Federation's official statistics. It was interesting that the so-called non-used funds amounted to US$6.6 billion or 66 percent of total direct investment in 2004.

In 2004 foreign direct investment was made mainly in output of minerals, production of metals and ready-made metal wares, wholesale trade, and real estate operations. The total direct investment in these economic sectors amounted to US$6.8 billion or 72.5 percent of total FDI in 2004. Russia's fuel and energy complex remains one of the most attractive sectors of the economy for large foreign capital investment.

Major Investment Attraction Industries for Foreign Investment in Russia in 2004
(US$ million)

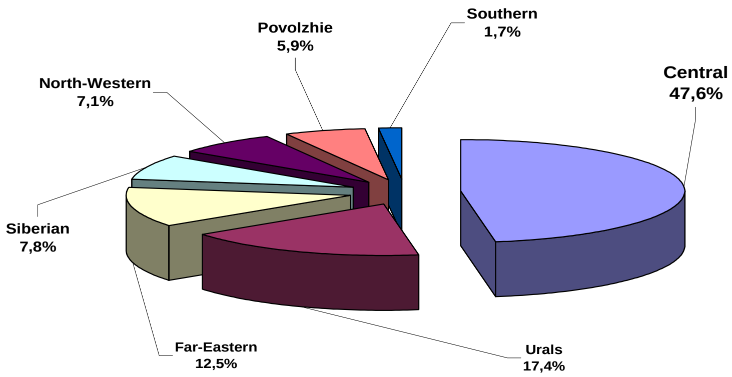
Economy sectors	Total	Direct[1]	Portfolio	Other
Total, of which:	40 509	9 420 (23.2)	333	30 756
Output of minerals, including	99 34	4 080 (43.3)	2	5 852
Output of fuels	8 766	3 984 (42.3)	2	4 780
Manufacturing, including	10 236	2 911 (30.9)	129	7 196
∗ production of foodstuffs, beverages and tobacco	936	336 (3.6)	82	518
∗ woodworking and output of wooden wares	680	326 (3.5)	0.5	354
∗ output of wood pulp and paper, publishing activities	253	44 (0.5)	4	205
∗ chemical production	765	238 (2.5)	19	508
∗ output of other non-metallic mineral products	618	449 (4.8)	0.3	169
∗ production of metals and metal wares	5 102	1 142 (12.1)	11	3 949
∗ output of machines and equipment	344	60 (0.6)		284
∗ output of vehicles and transport equipment	834	114 (1.2)	1	719
Construction	234	87 (0.9)	0.5	147
Wholesale and retail trade, including	13 037	958 (10.2)	7	12 072
Wholesale trade, except trade in vehicles	12 142	824 (8.7)	7	11 581
Transport and communication	2 033	196 (2.1)	60	1 777
Financial activities	1 001	356 (3.8)	64	581
Real estate operations, including rent and related services	2 572	650 (6.9)	11	1 911
State management, military security, obligatory social maintenance	1 059			1 059

1. In brackets - share of direct investments in sector's total investments, in percent.
Source: Federal Service of State Statistics.

Based on the amount of foreign investment attracted in 2004, Russia's regions may be arranged in the following order:

- *Central federal district*: US$19,277 million (47.6 percent of the Russian Federation total investment), of which 20.9 percent was (FDI), 78.2 percent was other investment and 0.9 percent was portfolio investment;
- *Urals federal district* – US$7,033 million (17.4 percent), 13.4 percent FDI, 86.5 percent other investment;
- *Far Eastern federal district* – US$5,072 million (12.5 percent), 67.0 percent FDI, 33.0 percent other investment;
- *Siberian federal district* – US$3,154 million (7.8 percent), 3.6 percent FDI, 96.0 percent - other investment and 0.4 percent- portfolio investment.

Regional Breakdown of Foreign Investments in Russia (2004)
(percent of the total)



The federal bill "On Special Economic Zones in the Russian Federation" that was given in our previous issue was passed in 2005. The selection of territories where special economic zones (SEZ)[6] will be set up is to be completed by the end of 2005 with implementation of SEZ investment projects beginning in 2007. The Russian Federation is to spend up to 3 billion rubles on each SEZ. A special federal (state) agency for SEZ operation has been set up to manage the zones.

Meanwhile a new variation of the federal bill, "On [a] free economic zone in [the] Kaliningrad region" has been submitted for discussion. The bill is expected to come into force in 2006. The Kaliningrad free economic zone (FEZ) was set up in 1996. However all FEZ activity was actually based on clause 7 of the law. It permits the use of a preferential customs regime for imports of definite goods that will be manufactured later, (e.g., for imports of automobile components for assembling cars and trucks). The new version of the bill pays attention to the development of "serious" production and not only to assembly. So, any enterprise shall have a right to get tax and customs reliefs, if its investment amount within the first three years reaches not less than 150 million rubles. Thus, the Kaliningrad zone is supposed to attract not less than 20 new investors a year. The preferential tax and customs regimes are planned to remain for the existing enterprises in the region only for the next ten years. Imported aircrafts and ships registered in Kaliningrad shall be exempted from payment of customs duties and taxes. Their owners will also get privileges relating to the payment of profit tax and property tax.

[6] The zones will be of two types. An ***industrial and production zone*** is to have a territory up to 10 square kilometers. Investment not less than EUR10 million is permitted in an industrial and production zone to be located on state land only. Infrastructure units in a zone of this type are to be constructed at the expense of the state budgets of all levels. An ***innovation and technological zone*** may have a territory 10 times less, i.e. 1 square kilometer, and the minimal size of an investment project in it may be EUR 1 million. These zones may be set up on the territory of the existing scientific centers and institutions. According to the law these zones are to permit to carry out any activities, except extraction of minerals, production of metals, processing of scrap and output of excisable commodities.

ANNEX I

RUSSIA FEDERATION: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	196.1	259.8	306.7	345.7	430.3	**582.3**
Real GDP	6.4	10	5.1	4.7	7.3	7.1
Consumption	-1.2	5.6	6.8	7.0	6.2	9.2
Private Consumption[1]	-2.9	7.3	9.5	8.5	7.5	11.3
Government Consumption	3.1	2	-0.8	2.6	2.3	2
Gross capital formation	-6.6	75.2	16.7	-2.6	13.2	13.9
Fiscal and External Balance (percent of GDP)						
Budget Balance (The General Government)	-0.9	2.8	2.9	0.8	1.3	4.5
Merchandise Trade Balance	18.4	23.2	15.7	13.4	13.9	15
Current Account Balance	12.6	18	11.1	8.4	8.2	10.3
Capital and Financial Non-reserve Assets Balance	-7.3	-8.3	-5.3	-3.3	-0.2	-1.5
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	72	37.3	16.5	15.4	14.2	18.0
CPI	36.5	20.2	18.6	15.1	12.0	11.7
M2[2]	57.5	61.6	39.7	32.4	50.5	35.8
M2[3]	41.1	60.0	48.1	35.4	42.7	41.7
Short-term Interest Rate (percent)[4]	39.7	24.4	17.9	15.7	13.0	11.4
Real Effective Exchange Rate (level, January 1995=100), by the end of the year	96.1	113.3	123.2	119.6	124.5	130.4
Unemployment Rate (percent), ILO type measure	12.7	10.4	9.0	8.0	8.6	8.2
Population (mln.)	145.9	145.2	144.4	145.2	144.6	143.8

Notes:

[1] without the sector of non-commercial, servicing households
[2] the growth rate of M2 (national definition), the end of the year to the end of the previous year
[3] the growth rate of M2 (national definition), annually average to annually average for the previous year
[4] interest rate on 1 year ruble credits to entities

ANNEX II

RUSSIA FEDERATION: FORECAST SUMMARY (percent change from previous year)

	2004						2005 (2006)					
	Official	IMF	World Bank	OECD	EBRD	Link	Official	IMF	World Bank	OECD	EBRD	Link
Real GDP	7.2	7.1	7.2	–	–		5.9	6.0 (5.5)	6.2	–	5.2	
Exports	35.0	29.4	34.8	–	–		34.0	33.1 (27.7)	–	–	–	
Imports	26.6	–	26.5	–	–		24.9	–	–	–	–	
CPI	11.7	10.9	11.7	–	–		10.0-11.0	11.8 (9.7)	11.8	–	–	

ANNEX III

RUSSIA FEDERATION: MEDIUM-TERM TREND FORECAST (percent)

	2006	2007	2008
Real GDP	5.8	5.9	6.0
GDP Deflator	8.5	7.5	5.5

ANNEX IV

The Central Bank of the Russian Federation

RUSSIA's Key Economic Indicators in 2004
(as percent of corresponding period of previous year)

		Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
1	Industrial output index	106.4	108.5	107.4	105.4	106.9	109.3	106.9	109.7	106.1	104.6	112.5	104.6	107.3
2	Agricultural output index	98.7	98.7	98.5	98.9	98.8	98.8	111.8	108.3	97.1	100.1	103.9	99.3	101.6
3	Transport freight turnover	106.5	109.3	106.6	109.0	106.8	105.3	105.6	106.4	106.8	104.2	105.4	103.8	106.3
4	Fixed capital investment	112.7	113.8	112.8	111.6	111.3	113.2	110.0	110.8	109.4	107.8	111.1	110.0	110.9
5	Retail trade turnover	109.9	111.2	111.3	111.9	112.1	111.8	112.8	112.8	112.6	113.3	114.1	114.2	112.5
6	Consumer price index													
	last month of period as percent of December of previous year	101.8	102.8	103.5	104.6	105.3	106.1	107.1	107.6	108.0	109.3	110.5	111.7	111.7
7	Industrial producer price index													
	last month of period as percent of December of previous year	104.0	107.5	108.9	111.2	113.5	116.7	118.1	120.3	124.0	126.2	128.7	128.8	128.8
8	Total number of unemployed (calculated by ILO methodology)													
	as percent of economically active population	9.1	9.5	8.9	8.2	7.6	7.5	7.4	7.3	7.7	8.0	8.4	8.5	8.2
9	Real disposable money income	119.7	109.1	108.5	107.9	101.7	109.2	109.8	107.7	106.7	105.4	108.0	108.7	108.4
10	Real imputed wage	112.1	116.7	115.7	113.9	112.8	113.8	111.7	111.6	110.9	104.6	104.3	106.3	110.9
11	Exports*													
	$ billion	11.3	12.1	14.0	14.7	13.6	14.9	15.4	16.8	16.3	17.2	17.9	19.4	183.5
12	Imports*													
	$ billion	5.5	6.5	7.7	7.6	7.3	7.8	8.3	8.2	8.2	8.8	9.3	11.1	96.3
13	Ruble/Dollar official exchange rate (as of end of period)	28.49	28.52	28.49	28.88	28.99	29.03	29.10	29.24	29.22	28.77	28.24	27.75	27.75

** Based on the balance of payments methodology (as of April 8, 2005).*

Source*:* Federal State Statistics Service, the Bank of Russia.

Updated May 25, 2005.

ANNEX V

GDP of Russia, by utilisation components: 1998-2004
(in current prices, percent)

	1998	1999	2000	2001	2002	2003	2004
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0
of which:							
Final consumption expenditures	77.8	68.0	61.3	65.5	68.9	68.0	65.7
Households	56.8	52.2	45.2	48.0	50.1	49.7	48.5
Governmental organisations	19.1	14.6	14.9	16.3	17.6	17.5	16.4
Non-commercial organisations	1.9	1.2	1.2	1.2	1.2	0.8	0.8
Gross capital formation	15.4	15.0	18.6	21.9	20.3	20.6	21.6
Gross fixed capital formation	16.5	14.5	16.9	18.8	18.0	18.3	18.3
Change in business inventories	-1.1	0.5	1.7	3.1	2.2	2.3	3.3
Net exports of goods and services	6.8	17.0	20.1	12.6	10.9	11.4	12.7

Source: Federal Service of State Statistics.

ANNEX VI

Consolidated State budget receipts and outlays, by source and function: 1998-2004
(cover both Federal budget and budgets of territories – the subjects of the Russian Federation)

	1998[1]	1999[1]	2000[1]	2001[1]	2002[1]	2003[1]	2004
Total receipts, bn. roubles at current prices	686.8	1 213.6	2 097.7	2 683.7	35 19.2	4 138.7	5 427.3
of which (percent):	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Corporation income tax	14.5	18.2	19.0	19.1	13.2	12.7	16.0
Individual income tax	10.4	9.7	8.3	9.5	10.2	11.0	10.6
Value added tax	24.8	23.8	21.8	23.8	21.4	21.3	19.7
Excise taxes	10.5	9.0	7.9	9.1	7.5	8.4	4.5
Customs duties	4.2	7.2[2]	10.9[2]	12.3[2]	9.2[2]	10.9[2]	15.8[2]
Payments for utilisation of natural resources	3.3	3.7	3.7	5.1	9.4	9.6	10.7
Receipts from external economic activities[3]	2.7	3.0	1.8	1.9	1.9	1.3	0.7
Receipts from state and municipal property or from activities	2.0	2.0	3.4	4.3	4.6	5.8	6.1
Total Outlays, bn. roubles at current prices	842.1	1 258.0	1 960.1	24 19.4	34 22.3	3 964.9	4 665.4
of which (percent):	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Public administration[4]	9.1	9.6	10.5	12.2	11.4	12.3	13.0
International affairs	2.1	4.7	0.6	1.2	1.0	…	…
National defence	7.7	9.2	9.8	10.2	8.6	9.0	9.2
National economy[5]	19.8	26.2	18.0	24.7	21.8	19.1	18.8
Social policies[6]	29.2	29.2	27.4	30.1	39.7	29.6	31.4
State and municipal debt service payments	17.7	15.1	14.1	10.1	7.1	6.1	4.9
Deficit as percent to GDP	5.9	0.9	1.97	2.97	0.97	1.37	4.5

1. Denominated roubles.
2. Taxes on foreign trade and external economic operations excluding excise taxes and VAT.
3. Including receipts from centralised exports, transactions with precious metals, mobilisation of official reserves.
4. Comprising law enforcement and security safeguard measures.
5. Including housing and communal facilities. In 2001-2003 – excluding science.
6. Including outlays on culture and mass media, healthcare and sports, education, training, employment and social security.
7. Proficit.

Source: Federal Service of State Statistics.

ANNEX VII

Capital and financial accounts of Russia: 1998–2004 (in USD million)

Type of transaction	1998	1999	2000	2001	2002	2003	2004
Exports of Goods & Services	**91 117**	**88 499**	**119 351**	**120 095**	**120 912**	**163 016**	**213 376**
Merchandise, fob[1]	74 444	75 551	105 033	101 884	107 301	135 929	183 452
Non-factor services	12 372	9067	9 565	11 441	13 611	16 030	20 290
Factor services[2]	4 301	3881	4 753	6 800	5 677	11 057	9 635
Imports of Goods & Services	**-90 562**	**-64 485**	**-73 957**	**-83 927**	**96 960**	**-126 786**	**-152 469**
Merchandise, fob[1]	-58 015	-39 537	-44 862	-53 764	-60 966	-75 436	-96 307
Non-factor services	-16 456	-13 351	-16 230	-20 572	-23 497	-27 122	-33 700
Factor services[2]	-16 091	-11 597	-11 489	-11 038	-12 260	-24 228	-22 462
Unilateral transfers, net[3]	-719	273	11 024	-10 173	-13 138	-1 378	-2 423
Direct investments, net	1 492	1 102	-463	216	-72	-1 768	2 072
Assets	-1 270	-2 208	-3 177	-2 533	-3 533	-9 727	-9 061
Liabilities	2 761	3 309	2 714	2 748	3 461	7 958	11 672
Portfolio investments, net	8 618	-946	-10 334	-653	2 973	-4 240	496
Assets	-257	254	-411	77	-716	-1 526	-3 343
Liabilities	8 876	-1 199	-9 923	-730	3 689	-2 715	3 841
Other investments, net	-5 434	-14 108	-21 831	-6 449	-1 754	6 180	-9 419
Assets, of which:	-14 463	-13 219	-17 659	80	2 120	-16 472	-24 835
Loans granted	5 435	4 855	5 365	-739	-2 816	4	1 626
Overdue payments	-7 285	-5 759	-7 350	9 120	15 992	-2 661	-832
Liabilities, of which:	9 029	-889	4 172	-6 528	-3 874	22 652	15 416
Loans attracted	7 325	-2 880	-3 603	-6 339	-1 747	18 550	19 797
Overdue payments	5 342	2 027	-1 637	-1 036	-2 790	-7	-2 837
Official reserve assets, net	5 305	-1 778	-16 010	-8 212	-11 375	-26 365	-45 235
Other capital, net[4]	-9 817	-8 558	-9 156	-9 481	-6 501	-8 658	-6 400
Balance on merchandise trade	16 429	36 014	60 172	48 121	46 335	60 493	87 145
Balance on non-factor services	-4 083	-4 284	-6 665	-9 131	-9 886	-11 093	-13 410
Balance on factor services	-11 790	-7 711	-8 736	-4 238	-6 583	-13 171	-12 827
Balance on goods and services	556	24 014	46 771	34 752	29 866	36 229	60 908
Unilateral transfers, net	-719	273	11 024	-10 173	-13 138	-1 378	-2 423
Balance on current account (excluding balance on capital transfers)	219	24 616	46 839	33 935	29 116	35 845	60 109

1. Customs data adjusted for scope; including estimates on humanitarian aid and non-organised shuttle trade, property of migrants, other adjustments for scope. Also including adjustments for non-equivalent barter and value of fuels' exports.
2. Services of labour and capital, covering income from direct investment abroad, interest, dividends, property and labour income.
3. Official and current private transfers, including contributions to international organisations, humanitarian aid, transfers by migrants, capital transfers etc. In the third quarter 2000 also included writing off part of Russia's debt to London Club of Creditors to the tune of US$10 982 mln reflected as receipt of capital transfer against decreasing liabilities on portfolio investments and overdue indebtedness. In third quarter 2001 reflected gratuitous writing off part of least developed economies' debt before Russia on the assets of the ex-USSR in the framework of Paris Club to the tune of US$9.9 bn. In 2002 included debt restructuring operations, i.e. declining Russia's indebtedness before former socialist economies (by US$6.4 bn.) and liquidation of poorest economies' indebtedness before Russia (to the tune of US$13.0 bn.).
4. Including net errors and omissions, adjustment to reserve assets, other adjustments.

Source: Balance of payments statistics.

ANNEX VIII

Foreign trade of Russia, by basic region and economies: 2004 (USD million)

	2004			rate of growth, percent			
	Turnover	Exports	Imports	Share in turnover, percent	Turnover	Exports	Imports
Total	**257 122.1**	**181 532.1**	**75 589.9**	**100.0**	**134.6**	**135.8**	**131.8**
EU	**125 387.4**	**91 392.8**	**33 994.6**	**48.8**	**132.6**	**134.3**	**128.2**
Cyprus	5 702.5	5 680.1	22.4	2.2	126.6	126.5	161.1
Finland	8 157.3	5 825.8	2 331.5	3.2	132.1	134.9	125.7
France	7 496.4	4 425.0	3 071.4	2.9	128.4	126.7	130.9
Germany	23 874.2	13 299.6	10 574.6	9.3	128.8	127.6	130.3
Italy	15 274.5	12 075.6	3 198.9	5.9	139.9	141.8	132.9
Netherlands	16 622.9	15 248.7	1 374.1	6.5	167.4	175.8	109.2
Poland	8 008.0	5 698.5	2 310.3	3.1	126.4	123.4	134.7
United Kingdom	7 703.9	5 638.8	2 065.2	3.0	121.1	114.6	143.1
APEC	**43 209.4**	**26 929.3**	**16 280.1**	**16.8**	**140.9**	**139.3**	**143.5**
Australia	173.6	21.8	151.7	0.1	156.0	117.2	163.8
Brunei	0	0	0	0	0	0	0
Canada	835.0	500.0	334.5	0.3	147.0	188.3	111.3
Chile	85.3	3.1	82.3	0.03	156.5	34.4	180.9
China	14 850.6	10 103.0	4 747.0	5.8	128.4	122.3	143.5
Hong Kong, China	328.2	318.1	10.2	0.1	99.6	98.9	134.2
Indonesia	366.4	145.4	221.0	0.1	87.6	61.7	120.8
Japan	7 363.3	3 422.7	3 940.6	2.9	171.1	141.3	209.3
Korea, Rep. of	3 986.0	1 961.2	2 024.8	1.6	150.2	148.2	152.2
Malaysia	538.1	113.7	424.4	0.2	74.2	26.7	141.3
Mexico	243.6	180.4	63.1	0.1	149.4	183.1	97.8
New Zealand	77.9	22.1	55.8	0.03	110.0	269.5	89.1
Papua-New Guinea	9.1	7.3	1.8	0.004	193.6	228.1	120.0
Peru	76.4	61.7	14.7	0.03	86.6	103.5	51.2
Philippines	266.9	217.1	49.8	0.1	119.9	118.4	127.0
Singapore	353.3	189.8	163.5	0.1	142.0	120.0	180.5
Vietnam	807.8	707.5	100.3	0.3	186.0	198.1	130.1
Chinese Taipei	2 337.9	1 995.4	342.6	0.9	212.8	238.5	130.8
Thailand	727.4	372.5	3 54.9	0.3	168.3	285.6	117.6
USA	9 782.7	6 586.2	3 196.5	3.8	136.3	156.2	107.9
CIS	**47 108.0**	**29 375.0**	**17 733.1**	**18.3**	**140.0**	**143.3**	**135.0**
EurAsEC	**26 405.4**	**16 237.2**	**10 166.2**	**10.3**	**141.2**	**145.3**	**135.1**
Belarus	17 605.5	11 142.5	6 463.0	6.8	141.0	146.6	132.4
Kazakhstan	8 124.8	4 645.4	3 479.4	3.2	141.2	141.6	140.6
Ukraine	16 867.6	10 771.1	6 096.5	6.6	140.2	141.8	137.4
Other economies							
India	3 153.3	2 502.0	651.3	1.2	95.0	91.5	111.4
Turkey	8 673.1	7 445.7	1 227.4	3.4	151.2	154.9	132.3
Switzerland	8 379.9	7 732.6	647.3	3.3	132.1	133.0	122.1

Source: Statistics of Federal Customs Service.

ANNEX IX

Foreign investments into Russia, by type: 2004

	Inward investments (USD million)					
	2004		2004 to 2003, percent	2003		2003 to 2002, percent
	Value	percent		Value	percent	
Investments - total	**40 509**	**100.0**	**136.4**	**29 699**	**100.0**	**150.1**
of which:						
FDI	9 420	23.3	138.9	6 781	22.8	169.4
Portfolio	333	0.8	83.0	401	1.4	84.9
Other	30 756	75.9	136.6	22 517	75.8	147.1

Source: Federal Service of State Statistics.

Annex X

Foreign investments into Russia, by industry and economies: 2004

	Inward investments (USD mln.)				
	Total		FDI	Portfolio	Other
	Value	percent			
Investments – Total	**40 509**		**9 420**	**333**	**30 756**
Agriculture, hunting, forestry	**121**	**100**	**89**	**1**	**31**
of which:					
Cyprus	30	25.1	26	-	4
Switzerland	27	22.7	27	-	6
Output of minerals	**9 934**	**100**	**4 080**	**2**	**5 852**
of which:					
Luxembourg	3 814	38.4	-	-	3 814
The Netherlands	3 296	33.2	3 279	-	17
of which output of fuels	**8 766**	**100**	**3 984**	**2**	**4 780**
of which:					
Luxembourg	3 514	40.1	-	-	3 514
The Netherlands	3 282	37.4	3 280	-	2
Manufacturing industries	**10 236**	**100**	**2 911**	**129**	**7 196**
of which:					
The UK	1 796	17.6	47	2	1 747
Cyprus	1 690	16.5	1 324	12	354
The USA	1 103	10.8	81	18	1 004
of which output of foodstuffs, beverages, tobacco	**936**	**100**	**336**	**82**	**518**
of which:					
Switzerland	145	15.5	37	79	29
Germany	120	12.8	47	-	73
The Netherlands	119	12.7	12	-	107
chemical industry	**765**	**100**	**238**	**19**	**508**
of which:					
Switzerland	343	44.8	26	0.2	317
Germany	161	21.1	73	0.0	88
China	101	13.2	77	-	24
metallurgy and metal wares	**5 102**	**100**	**1 142**	**11**	**3 949**
of which:					
The UK	1 386	27.2	2	0.1	1 384
Cyprus	1 175	23.0	1 100	6	69
The USA	927	18.2	0.0	0.1	927
Construction	**234**	**100**	**87**	**0.5**	**147**
of which:					
The UK	82	35.2	2	-	80
Wholesale and retail trade, repair services	**13 037**	**100**	**958**	**7**	**12 072**
of which:					
The UK	3 729	28.6	49	0.0	3 680
Luxembourg	2 988	22.9	4	-	2 984
Transport and communication	**2 033**	**100**	**196**	**60**	**1 777**
of which:					
Luxembourg	784	38.6	6	-	778
of which communication	**1 377**	**100**	**41**	**22**	**1 314**
of which:					
Luxembourg	784	56.9	6	-	778
Finance	**1 001**	**100**	**356**	**64**	**581**
of which:					
Cyprus	370	37.0	257	44	69
India	131	13.1	0.0	-	131
Real estate operations, including services	**2 572**	**100**	**650**	**11**	**1 911**
of which:					
Cyprus	580	22.6	179	1	400
The UK	471	18.3	17	0.0	454

	Inward investments (USD mln.)				
	Total		FDI	Portfolio	Other
	Value	percent			
Management	**1 059**	**100**	**-**	**-**	**1 059**
of which:					
The Netherlands	1 000	94.4	-	-	1 000
Housing and communal services	**107**	**100**	**62**	**0.0**	**45**
of which:					
Cyprus	65	60.5	46	-	19

Source: Federal Service of State Statistics.

Annex XI

Foreign investments into Russia, by recipient region (subjects of the RF): 2004

	Inward investments (USD, thousand)				
	Total		FDI	Portfolio	Other
	Value	percent			
Russian Federation, USD mln.	**40 509**	**100**	**9 420**	**333**	**30 756**
of which subjects of the RF (federal districts):					
Central	**19 276 636**	**47.6**	**4 038 122**	**166 348**	**15 072 166**
Moscow	15 356 502	37.9	1 857 211	61 438	13 437 853
North-Western	**2 869 123**	**7.1**	**376 906**	**35 343**	**2 456 874**
St. Petersburg	985 084	2.4	111 909	24 709	848 466
Southern	**688 688**	**1.7**	**128 493**	**22 997**	**537 198**
Privolzhsky	**2 415 474**	**5.9**	**421 969**	**91 876**	**1 901 629**
Urals	**7 032 922**	**17.4**	**943 718**	**2 538**	**6 086 666**
Tyumen oblast	5 832 736	14.4	776 637	347	5 055 752
Siberian	**3 153 563**	**7.8**	**114 570**	**13 126**	**3 025 867**
Buryatia Rep.	9 866	0.0	-	3 065	6 801
Khakassia Rep.	738	0.0	504	234	-
Altay kray	1 505	0.0	1 486	-	19
Krasnoyarsk kray	1 621 589	4.0	25 682	371	1 595 536
Irkutsk oblast	194 063	0.5	3 108	8 289	182 666
Kemerovo oblast	52 739	0.1	4 193	36	48 510
Novosibirsk oblast	24 110	0.1	13 826	179	10 105
Omsk oblast	1 085 559	2.7	15 113	952	1 069 494
Tomsk oblast	66 120	0.2	84	-	66 036
Chita oblast	97 274	0.2	50 574	-	46 700
Far Eastern	**5 072 485**	**12.5**	**3 396 473**	**233**	**1 675 779**
Yakutia-Sakha Rep.	834 398	2.1	7 519	-	826 879
Primor'ye kray	97 895	0.2	60 814	233	36 848
Khabarovsk kray	96 212	0.2	12 997	-	83 215
Amur oblast	42 724	0.1	42 569	-	155
Kamchatka oblast	39 645	0.1	7	-	39 638
Magadan oblast	33 996	0.1	13	-	33 983
Sakhalin oblast	3 927 138	9.7	3 272 077	-	655 061
Yevrey A.O.	477	0.0	477	-	-

Source: Federal Service of State Statistics.

Annex XII

Foreign investments into Russia: accumulated as of 1 January, 2005

	Inward investments (USD mln.)				
	Total		FDI	Portfolio	Other
	Value	percent			
TOTAL[1]	**81 997**	**100**	**36 147**	**1 593**	**44 257**
Top 10 economies	71 150	86.8	30 450	1 372	39 328
of which:					
Cyprus	13 790	16.8	10 094	585	3 111
The Netherlands	11 996	14.6	8 805	43	3 148
Luxemburg	11 880	14.5	263	1	11 616
Germany	9 324	11.4	2 550	8	6 766
The UK	8 673	10.6	1 602	142	6 929
The USA	6 624	8.1	4 310	418	1 896
France	3 874	4.7	433	0.3	3 441
Virgin Isl. (UK)	1 902	2.3	1 144	59	699
Switzerland	1 684	2.1	957	95	632
Austria	1 403	1.7	292	21	1 090

1. Including investments from CIS economies.

Source: Federal Service of State Statistics.

Annex XIII

Russia's investments abroad: accumulated as of 1 January, 2005

	Outward investments (USD mln.)				
	Total		FDI	Portfolio	Other
	Value	percent			
TOTAL	**6 973**	**100**	**4 190**	**429**	**2 354**
Top 10 economies	5 145	73.8	2 951	416	1 778
of which:					
The UK	1 300	18.6	1 283	5	12
Cyprus	761	10.9	65	0.0	696
The Netherlands	611	8.8	564	29	18
Ukraine	452	6.5	58	382	12
Iran	431	6.2	431	-	-
Bahama Isl.	370	5.3	-	0.2	370
Virgin Isl. (UK)	362	5.2	0.2	-	362
The USA	317	4.6	277	-	40
Gibraltar	274	3.9	273	0.1	1
Maine Isl.	267	3.8	0.1	-	267

Source: Federal Service of State Statistics.

Annex XIV

Official exchange rate dynamics in 2003-2004
(end of month)

	RUR/USD
December, **2002**	31.78
January, **2003**	31.82
February	31.58
March	31.38
April	31.10
May	30.71
June	30.35
July	30.26
August	30.50
September	30.61
October	29.86
November	29.74
December	29.45
January, **2004**	28.49
February	28.52
March	28.49
April	28.88
May	28.99
June	29.03
July	29.08
August	29.21
September	29.22
October	28.77
November	28.24
December	27.75
January, **2005**	28.08

1. 2002-2004 exchange rates given in denominated roubles.
Source: Federal Service of State Statistics.

SINGAPORE

REAL GROSS DOMESTIC PRODUCT GROWTH

The Singapore economy expanded by 8.4 percent in 2004, after a 1.4 percent gain in 2003. This was led by a turnaround in the growth of domestic demand as well as a continued expansion of external demand. At the sectoral level, all major sectors saw improvement compared to 2003. The manufacturing, and wholesale and retail sectors were the best performing sectors with growth of 13.9 percent and 14.6 percent respectively, a marked improvement over the 2.7 percent and 6.7 percent registered in 2003.

INFLATION

The strength of economic activity in 2004, both in Singapore and foreign economies, led to upward pressures on prices. Commodities prices, in particular, saw significant gains.

The consumer price index (CPI) edged up to 1.7 percent from 0.5 percent a year earlier. The rise in CPI was attributed to both domestic and imported sources. Both sources of inflation rose by similar amount in 2004. Items that contributed most to inflation for the year were cigarettes, food, petrol, and tuition and other fees. The category that saw the largest gains in prices was expenditure on healthcare. The 6.0 percent increase in such costs was largely on account of a sizeable increase in charges in certain segments of healthcare services. Costs of education and stationery rose by 4.2 percent in 2004, supported by higher prices of newspapers as well as higher tuition fees charged by foreign universities. Prices of recreation and others rose by 2.3 percent, reflecting mainly higher cigarette prices. Food, transport and communications, and clothing prices saw gains of 2.0 percent, 1.2 percent and 0.1 percent respectively. The cost of housing declined slightly in 2004, coming down by 0.1 percent.

EMPLOYMENT

The labour market improved in 2004. Total employment grew by 71,400, which exceeded the cumulative job losses of 35,900 over the preceding three years. Employment gains were largely due to the services-producing industries. In tandem with the economy's strong performance, retrenchments slowed to 10,200 workers in 2004, a marked decline from the 16,400 retrenched in 2003. Consequently, the overall seasonally adjusted unemployment rate fell to 3.0 percent in December 2004, a significant drop from the 3.8 percent registered a year ago. For the whole year, the unemployment rate averaged 3.4 percent compared to 4.0 percent in 2003.

BALANCE OF PAYMENTS

Singapore's overall balance of payments registered a larger surplus of S$20 billion in 2004, compared to S$12 billion in the preceding year. This largely reflected the decline in outflows from the capital and financial account and the slight improvement in the current account surplus. Consequently, Singapore's official foreign reserves rose by S$21 billion to reach S$184 billion as at end 2004 (equivalent to 8.0 months of current imports).

GROSS EXTERNAL DEBT

Singapore has no official foreign debt.

EXCHANGE RATE

The general decline of the US dollar in the second half of 2004 was the main factor affecting the bilateral exchange rates between the Singapore dollar and the currencies of its major trading partners. The Singapore dollar appreciated by 4.1 percent against the US dollar over the year. Currencies pegged to the US dollar also weakened against the Singapore dollar, which rose 4.1

percent against the Malaysian ringgit and 4.2 percent against the Hong Kong dollar. It also appreciated by a marginal 0.3 percent against the Australian dollar and was virtually unchanged against the Japanese yen.

With the Singapore dollar nominal effective exchange rate (NEER) only slightly up over the year, the Singapore dollar weakened against most other major currencies in 2004. It weakened by 2.7 percent against the New Taiwan dollar, 3.7 percent against the pound sterling, 3.8 percent against the euro and 9.8 percent against the Korean won.

FISCAL POLICY

Fiscal policy was slightly expansionary in 2004. Total operating revenue was up by 6.9 percent to S$26.3 billion in 2004 due to the strong economic recovery. Total expenditure rose by 4.5 percent to S$28.4 billion. The government seeks to run a balanced budget, or achieve a modest surplus, over the medium- and long-term.

MONETARY POLICY

In view of the general improvement in economic conditions and rising inflationary pressures, the Monetary Authority of Singapore (MAS) shifted its policy stance in April 2004. The S$NEER, which had been allowed to follow a zero percent appreciation path prior to this change, began to be guided to permit a modest and gradual appreciation. Nevertheless, until the middle of August 2004, the S$NEER actually trended lower within the MAS' policy band. Soon after its return to an appreciating trend, the MAS announced in October 2004 the continuation of the policy to allow the appreciation of the S$NEER.

MEDIUM-TERM OUTLOOK

The Singapore economy registered high growth in 2004 on the back of a recovery from a SARS-afflicted 2003. However, as it rebounded from a low base, there had already been early indications towards the end of 2004 of an expected moderation in 2005. Moving forward, there are a number of factors that will influence the extent of moderation in 2005. These include concerns over external demand from key trading partners, the pace of recovery of the global electronics cycle, and lingering high oil prices. The Singapore economy is expected to grow between 3.5 and 4.5 percent in 2005.

STRUCTURAL REFORM

Technological advances and globalisation have intensified competitive pressure in the global economy. To address these challenges, the Singapore economy is restructuring towards being more diversified, globalised, and entrepreneurial.

Manufacturing and services will continue to be the twin engines propelling Singapore's growth, supported by a strong base in science and technology and cost competitiveness. As a major trading economy, Singapore is also committed to globalisation. Expanding external ties through the multilateral framework of the World Trade Organisation (WTO), regional co-operation and bilateral Free Trade Agreements will link Singapore to foreign markets and investment opportunities. The government will also further encourage entrepreneurship, creativity, and innovation, as these will be key in the knowledge-based, innovation-driven economy.

ANNEX I

SINGAPORE: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	82.5	92.6	85.8	88.5	92.4	106.8
Real GDP	6.8	9.6	-2.0	3.2	1.4	8.4
Consumption	8.3	14.8	3.5	3.6	-0.1	6.4
Private Consumption	8.7	14.0	3.2	3.0	0.6	8.6
Government Consumption	6.6	18.2	4.5	5.5	-2.2	-1.6
Investment	-4.9	8.7	-4.5	-10.7	-4.6	8.4
Private Investment	-7.5	10.9	-7.4	-8.9	-4.2	13.9
Government Investment	4.4	1.2	5.9	-16.2	-6.0	-10.6
External Demand	7.9	14.8	-6.5	4.3	10.9	19.6
Fiscal and External Balance (percent of GDP)						
Merchandise Trade Balance	15.1	13.8	18.3	19.8	30.4	29.2
Current Account Balance	17.9	12.9	16.8	17.7	29.2	26.1
Capital and Financial Account Balance	-16.8	-6.2	-19.8	-11.7	-21.5	-12.3
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	-4.6	4.1	-1.7	-0.2	0.2	3.5
CPI	0.0	1.3	1.0	-0.4	0.5	1.7
M2	8.5	-2.0	5.9	-0.3	8.1	6.2
Short-term Interest Rate (percent p.a.) (3-month Interbank Rate)	2.75	2.81	1.25	0.81	0.75	1.44
Unemployment Rate (percent)	2.8	2.7	2.7	3.6	4.0	3.4
Population (millions)	4.0	4.0	4.1	4.2	4.2	4.2

ANNEX II

SINGAPORE: FORECAST SUMMARY (percent change from previous year)

	2004				2005			
	Official	**IMF**	**ADB**	**Asia Pacific Consensus Forecast**	**Official**	**IMF**	**ADB**	**Asia Pacific Consensus Forecast**
Real GDP	8.4	8.4	8.4	8.4	3.5-4.5	3.9	4.0	4.1
CPI	1.7	1.7	1.7	1.7	0-0.5	0.7	0.8	0.5

CHINESE TAIPEI

In 2004, the four main features of Chinese Taipei's economic performance were as follows: First, strong private investment and exports were the two key driving forces of economic growth. Second, with the creation of 213,000 new jobs, unemployment fell steadily through the year. Third, the consumer price index (CPI) increased 1.6 percent to dispel the specter of deflationary pressure. And fourth, technology and innovation gave added momentum to knowledge-based economic development.

REAL GROSS DOMESTIC PRODUCT

The Chinese Taipei economy improved steadily during 2004. With a pick-up in export growth and private investment, economic growth rebounded to 5.7 percent, 2.4 percent higher than its 2003 growth performance. Per capita increased to US$14,032. The recovery was spurred by global as well as short-term and long-term domestic forces.

In its mid- to long-term industrial development policy, Chinese Taipei has been vigorously promoting the expansion of knowledge-intensive industries, the upgrading of traditional industries, and the adjustment of certain IT industries, with a view to achieving the optimum blend of competitive advantages in the industrial sector. The bolstering of domestic innovation and the establishment of sunrise industries has largely offset the exodus of less-competitive industries to offshore locations, enabling industrial production to grow at a sound pace and promising to sustain the recent falling trend in unemployment.

In 2004 domestic demand increased 6.35 percent, contributing 5.69 percent to the overall economic growth rate of 5.71 percent. Private consumption and private investment grew 3.13 percent and 28.20 percent respectively, contributing 1.91 and 3.07 percent to overall growth. The need to implement spending cuts reduced government consumption by -0.69 percent, for a contribution of -0.09 of a percent to overall growth, while government investment shrank 4.22 percent, contributing -0.16 of a percent. Exports of goods and services climbed 15.27 percent, largely due to surging demand for electrical machinery and precision instruments. Imports grew 18.56 percent on the back of rising export-induced and domestic demand. Exports and imports translated into a 0.02 percent contribution by net foreign demand.

Both industry and services were in better shape in 2004. Industrial output rose 8.25 percent and accounted for 29.54 percent of GDP, with a surge in the manufacture of information and electronic products. Information and high-tech industries dominated the manufacturing sector, accounting for 35.8 percent of total manufacturing value added (at 1996 prices), far above the next-largest share of 8.2 percent for the chemical industry. The services sector grew 4.85 percent to generate 68.72 percent of GDP. The communications industry posted an expansion of 5.81 percent, due largely to the opening of the domestic fixed-network telecommunications market, while financial, insurance and securities services grew a robust 3.68 percent. Agricultural production declined 7.06 percent and accounted for 1.74 percent of GDP.

INFLATION

Intensifying competition in the domestic market, the damage wreaked by typhoons and other extreme weather conditions on fruit and vegetable production, and the falling prices of residential rents caused Chinese Taipei's consumer price index (CPI) to increase slightly at 1.6 percent in 2004. The core CPI, excluding fresh food and energy prices, increased by 0.7 percent, but the wholesale price index rose by 7.0 percent, owing to the rising international prices of oil, raw materials and steel products.

EMPLOYMENT

The recovery in economic conditions has also led to an improvement in labor market conditions. During 2004 Chinese Taipei created 213,000 new jobs. Employment rebounded to a growth of 2.2 percent. The unemployment rate fell back to 4.4 percent from 4.99 percent in 2003. Among the unemployed, 34.8 percent had lost their jobs due to business closures or downscaling. The average monthly earnings of labor in industry increased 2.3 percent.

In Chinese Taipei, knowledge-based employment has been growing in line with the development of the knowledge-based economy, with its ratio of total employment rising from 29.5 percent in 2004 to 30.1 percent in 2005. Between 1992 and 1997, such employment increased at an average annual rate of 4.4 percent. Although it slowed to 2.7 percent between 1998 and 2003, that was still above the economy-wide average.

BALANCE OF PAYMENTS

Chinese Taipei's merchandise exports and imports both registered double-digit growth rates in 2004. The value of merchandise exports grew by 20.7 percent to US$173.2 billion, mainly driven by persistently steady growth in the global economy and in the information technology (IT) industry worldwide. The value of merchandise imports rose by 32.2 percent to US$156.7 billion, primarily led by stronger derived demand arising from the expansion in exports and the recovery in domestic investment, along with surging international oil and commodity prices. The trade surplus on goods decreased to US$16.5 billion for the year, a fall of 33.9 percent from the previous year.

In 2004, Chinese Taipei's service-trade deficit widened to US$5.0 billion from the previous year's US$2.5 billion. Services exports increased by 11.3 percent over the year to US$25.8 billion, due to the increase in receipts of travel and international freight. Services imports increased by 20.1 percent to US$30.8 billion, due to the increase in international freight expenses paid to foreign vessels, coupled with the expansion in imports and the increase in overseas visits by residents.

The narrowed trade surplus of goods and the widened deficits in services and current transfers caused the current account surplus to decrease to US$19.0 billion in 2004, which was equivalent to 6.0 percent of GDP.

The financial account recorded a net inflow of US$6.4 billion. Within the financial account, direct overseas investment by residents rose by 24.7 percent from US$5.7 billion in 2003 to US$7.1 billion in 2004. Direct investment in Chinese Taipei by non-residents posted a net inflow of US$1.9 billion, a significant increase of US$1.4 billion (3.19 times the increase of the previous year), indicating a recovery of foreign direct investment (FDI).

Portfolio investment exhibited a net outflow of US$6.4 billion in 2004. This net outflow was mainly attributable to the increase in investment in foreign securities with the aim of improving earnings. Other investment exhibited a net inflow of US$18.0 billion in 2004. This inflow mainly resulted from the borrowings from abroad by the local non-bank private sector and the banking sector in expectation of the New Taiwan dollar's (NT dollar) appreciation against the US dollar.

The overall balance of payments posted a surplus of US$26.6 billion in 2004, due to a current account surplus and a financial account inflow.

GROSS EXTERNAL DEBT

External debt covers both public and private debt, broken down into long-term and short-term debt. Total external debt increased by 28.3 percent from US$63.0 billion at the end of 2003 to US$80.9 billion at the end of 2004. Most of the increase was in private debt, mainly attributable to an increase in banks' foreign borrowings. External public debt jumped to US$5.0 billion from US$0.2 billion in the same period, mainly because the Central Bank engaged in repurchase agreements (repos) involving government securities with foreign financial institutions. Long-term and short-term external private debt grew by 25.3 percent and 19.3 percent, respectively, in 2004.

EXCHANGE RATE

Due to an increase in the US trade deficit and a recovery of the Japanese economy, coupled with foreign capital inflows to the Chinese Taipei stock market, the NT$/US$ exchange rate appreciated from 33.976 at the beginning of 2004 to 32.798 in mid-April. In late April, the NT dollar started to depreciate under the impact of China's macroeconomic adjustments to slow its economy, expectations of rising US interest rates, and higher oil prices. The NT dollar declined to 34.199 against the US dollar on 28 July 2004, the lowest level of the year. After mid August, with the US trade deficit reaching historic highs, international funds returned to Asian economies, and foreign funds flowed into the Chinese Taipei stock market. Consequently, foreign exchange supply was larger than demand, and the NT dollar appreciated. In December, due to further weakness in the US dollar, and the devastating tsunami in South and Southeast Asia on 26 December, funds flowed to Northeast Asia. Therefore, the NT dollar finished 2004 at its yearly high of 31.917. Compared with the rate of 33.978 registered at the end of 2003, the NT dollar appreciated by 6.46 percent against the US dollar in 2004.

FISCAL POLICY

In recent years, in order to stimulate economic development, the government has implemented various tax-exemption measures. This has caused the ratio of tax revenue to GDP to decline year by year, to just 13.6 percent in 2004. As government expenditure has not been reduced proportionally, a growing fiscal deficit has occurred. To improve the fiscal situation, the government has been taking measures to tap new sources of revenue and cut unnecessary expenditure. In September 2001, the government also established a Fiscal Reform Committee to actively review tax revenue, non-tax revenue and expenditures. After research and discussion for over a year, the Committee's conclusions were incorporated into a Fiscal Reform Plan implemented by the government on 22 April 2003. Since then, all government authorities have been required to take appropriate measures to put the plan into effect with the aim of achieving a balanced budget within five to ten years. To this point, the Fiscal Reform Plan has achieved certain preliminary results. Moreover, with the steadying and continued recovery of the domestic economy, government tax revenues in 2004 exceeded the estimated figure by NTD53.2 billion, the first time in six years that such a budget goal had been attained. To sum up, although the government still had a fiscal deficit in 2004 (excluding local government), the ratios of fiscal deficit to expenditure and fiscal deficit to GDP were 12.6 percent and 1.9 percent respectively, which is an improvement compared to the figures of 15.3 percent and 2.5 percent for 2002, and 18.6 percent and 3.0 percent for 2003. At present, Chinese Taipei is placing emphasis on tax reform to properly adjust the tax structure and achieve tax equality and efficiency.

MONETARY POLICY

In the wake of sustained economic expansion, rising prices and negative real interest rates, the Central Bank changed its low interest rate policy, adopted at the end of 2000, to a neutral monetary stance in October 2004. By the end of March 2005, the Central Bank had raised the discount rate in three successive quarters to 1.875 percent, with a total increase of 50 basis points, guiding market rates gradually upwards. Furthermore, to enhance the transparency of the financial institutions' pricing process, the Central Bank has urged banks and community financial institutions to implement Adjustable Rate Mortgages (ARMs) and the base rate system. At the end of March 2005, all domestic banks and around half of community financial institutions had adopted ARMs and the base rate system.

Given a combination of the increase in demand for funds driven by economic expansion and banks' active promotion of consumer finance business, loans and investments by major financial institutions grew by 8.65 percent in 2004. The expansion of bank credit, together with net capital inflows, led to an annual increase of 7.45 percent in the M2 monetary aggregate in 2004.

To foster sound development of financial markets, the Central Bank helped set up the Bills Depository and Clearing System and promoted the electronic processing of check payments by the Taiwan Clearing House, greatly improving payment efficiency. The Central Bank also continued its efforts in financial liberalization and globalization. It introduced more foreign exchange products, streamlined foreign investment application procedures, and eased restrictions on direct financial transactions across the Taiwan Strait.

MEDIUM-TERM OUTLOOK

To prepare Chinese Taipei to meet the needs of economic development in the new century, in 2002 the government unveiled the *Challenge 2008* Six-Year National Development Plan. To speed the implementation of *Challenge 2008*, in 2003 key related projects were designated as the *Ten New Major Construction Projects*. These projects are designed to enhance Chinese Taipei's competitive strength, maintain its number-one competitiveness ranking in Asia, and make Chinese Taipei one of the world's three strongest economies.

In 2005, international trade is expected to cool from its exceptionally rapid growth to more sustainable levels following signs of weaker global expansion. Domestically, the launch of the *Ten New Projects* to complement and speed up the implementation of the *Challenge 2008* six-year national development plan, should deliver a powerful stimulus effect. As the upswing in domestic demand gains strength, Chinese Taipei's GDP growth rate is projected to rise to 3.65 percent in 2005, accompanied by continued price stability.

The value of merchandise exports is expected to grow by 6.9 percent, slower than the 20.7 percent in 2004 because of weak global demand. The value of merchandise imports is forecast to grow 9.5 percent, mainly driven by a steady growth of domestic demand. The balance of trade is likely to show a trade surplus of US$2.2 billion in 2005.

The positive wealth effect from the warming-up of the stock and real-estate markets, together with the lowering of the unemployment rate, will give a boost to business and consumer confidence, and is likely to result in a strong rebound in consumer spending in the near future. Therefore, in 2005, private consumption is projected to show a real growth rate of 3.1 percent for the year.

Chinese Taipei is making its great efforts to improve its domestic investment environment for both local and foreign investors. Rising investor confidence, combined with a wave of expansion in the opto-electronic and semiconductor industries and the implementation of large-scale projects such as the high-speed railway, 12-inch wafer plants and the sixth naphtha plant, will push up private investment sharply. As a result, the real growth rate of private investment is projected to reach 9.9 percent for the year.

With salary increases for public servants and the implementation of the *Ten New Projects*, government consumption and investment will both expand by 0.5 percent. Fixed investment by public enterprises will increase 6.6 percent as the Taiwan Power Company speeds up investment expansion.

Under the impact of the rising trend in international crude-oil and raw-material prices, the growth rate of Chinese Taipei's wholesale price index is projected to climb to 0.81 percent in 2005. The consumer prices index is forecast to show a yearly increase of 1.97 percent.

In the medium term, the Chinese Taipei economy is forecast to improve steadily in line with the favorable outlook for the global economy. To move toward more knowledge-based, equitable and sustainable socio-economic development, the government drafted the "Second-Term Plan for National Development in the New Century: Four-Year Plan for 2005-2008 and Outlook for 2015."

The three features of its designated macroeconomic goals are as follows: First, utilizing domestic and foreign resources, and innovative strengths, nurture economic growth and narrow the difference between potential and actual GDP. Second, with accelerating ecological development, and slowing the depletion of ecological and environmental resources, green competitiveness will be strengthened and the sustainable gap will also be reduced. And third, stressing humanistic and life values, and emphasizing institutional and social trust will reduce the national welfare gap. During 2005-08 Chinese Taipei's potential average GDP growth rate is projected to be 4.9 percent. Nominal per capita GDP will increase to US$18,000 in 2008.

STRUCTURAL REFORMS

As part of its efforts to speed up the liberalization and internationalization of its financial markets, Chinese Taipei established a Financial Supervisory Commission (FSC) on 1 July 2004. The FSC's major goals and functions are to consolidate the supervision and examination of the banking, insurance, and securities and futures industries, including financial holding companies, under a single supervisory authority with greater independent power. However, the Central Bank still retains the power to carry out target examinations to monitor financial activities that may weaken the effectiveness of monetary policy or jeopardize financial stability.

Following the successful privatization of nine state-owned banks, Chinese Taipei's government has drawn up plans to sell more of its stakes in financial institutions. Under these plans, the government is targeting the reduction of its shareholdings in six financial institutions to no more than 20 percent of their total shares by August 2006, and the completion of the privatization of the remaining four state-owned financial institutions by the end of 2006.

The government has also been taking active measures to help financial institutions dispose of non-performing loans, including the enactment of laws for the establishment of asset management companies and the setting up of a Financial Restructuring Fund. As a result, the non-performing loans ratio of domestic banks declined sharply from its peak of 8.04 percent in March 2002 to 2.79 percent in February 2005.

Meanwhile, Chinese Taipei's Central Bank is pressing for the amendment of the Central Bank of China Act. Once approved, members of the Bank's board of directors will serve on a full-time basis and have their tenures staggered to further enhance the professionalism and independence of the Central Bank.

To improve the efficiency of financial market, Chinese Taipei launched the Second Phase of Financial Reform. The key targets are as follows: First, the market shares of the top three banks will be over 10 percent by the end of 2005. Second, the number of state-owned banks will be reduced to six or fewer by the end of 2005. Third, at least one financial institution will be run by a foreign company or listed on an overseas market by the end of 2006, and fourth, the current 14 financial holding companies will be reduced by half by the end of 2006.

Moreover, to achieve equality of taxation and improve the fiscal situation, the government will abolish the exemption from personal income tax of military personnel and elementary and junior high school teachers and push for the implementation of an Alternative Minimum Tax. The government also will raise the business tax by 1 to 2 percent, and push for the adjustment of commodity taxation toward a green-oriented system. To attract foreign investment, Chinese Taipei plans to decrease the marginal rates of estate and gift taxes from their current 50 percent to 40 percent.

As it will be difficult to substantially raise the growth rates of agriculture and manufacturing in the future, Chinese Taipei is stepping up efforts to promote the development of the services sector. To this end, it has launched the Guidelines and Action Plans for Service Industry Development, targeting a compound annual growth rate of 6.1 percent for the whole of the services sector and of 8 percent for knowledge-intensive services during the period 2004 to 2008. The basic strategies for carrying out this initiative are deregulation, pushing for modernization of services, adopting a negative-list approach, and improving the legal and regulatory system. Its anticipated benefits include creating a large number of jobs to lower the unemployment rate, improving quality of life, and speeding up knowledge-based economic development.

ANNEX I

CHINESE TAIPEI: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	289.3	312.3	285.1	288.5	295.6	316.7
Real GDP	5.32	5.78	-2.22	3.94	3.33	5.71
Consumption	3.14	4.02	0.73	1.97	0.82	2.48
Private Consumption	5.35	4.84	1.00	2.07	0.84	3.13
Government Consumption	-5.87	0.28	-0.55	1.47	0.71	-0.69
Investment	1.77	8.38	-21.14	-1.61	-2.05	15.40
Private Investment	-0.80	15.12	-29.12	3.12	-1.62	28.20
Government Investment	3.95	-4.21	-6.35	-13.02	-1.76	-4.22
Exports of Goods and Services	11.86	18.14	-8.08	10.48	10.94	15.27
Imports of Goods and Services	4.54	14.23	-13.51	5.71	6.72	18.56
Fiscal and External Balance (percent of GDP)						
Budget Balance of General government	-0.5	-2.5	-4.0	-3.7	-3.6	-3.8
Merchandise Trade Balance (BOP Basis)	5.13	4.43	7.11	8.59	8.71	5.39
Current Account Balance	2.79	2.88	6.53	9.10	10.23	6.23
Capital and Financial Non-reserve Assets Balance	3.16	-2.70	-0.20	3.06	2.64	2.06
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	-1.37	-1.70	0.52	-0.87	-2.14	-1.93
CPI	0.17	1.26	-0.01	-0.20	-0.28	1.62
M2	8.33	7.04	5.79	3.55	3.77	7.45
Short term Interest Rate (percent) **	4.77	4.73	3.69	2.05	1.10	1.06
Real Effective Exchange Rate (level, 1994=100)	87.95	90.94	86.70	85.80	82.67	84.86
Unemployment Rate (percent)	2.92	2.99	4.57	5.17	4.99	4.44
Population (millions)	21.96	22.13	22.28	22.40	22.49	22.57

**: O/N Call-Loan Rate

ANNEX II

CHINESE TAIPEI: FORECAST SUMMARY (percentage change from previous year)

	2004						2005					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**Link**
Real GDP	5.71	5.7	6.0	-	-	5.7	3.65	4.0	4.8	-	-	3.9
Exports	16.57	–	16.2	-	-	–	3.05	–	9.2	-	-	–
Imports	18.56	–	19.6	-	-	–	2.44	–	10.5	-	-	–
CPI	1.62	–	1.5	-	-	–	1.97	–	2.0	-	-	–

ANNEX III

CHINESE TAIPEI: MEDIUM-TERM TREND FORECAST (percent)

	2005–2008
Potential Real GDP	**4.9**
GDP Deflator	–

THAILAND

ECONOMIC OUTLOOK IN 2005

A. Macroeconomic Development

- **Real Sectors**

The economic data for Thailand in recent years have shown the direction for strong economic growth despite there being risks along the way. In 2005, the economy's growth will be driven mainly by an expansion in domestic demand. Real GDP is forecast to grow by 6.0 percent year-on-year. The growth is supported by:

(1) Investment from private and public sectors, especially mega projects with value of 340 billion baht to construct infrastructures such as a mass transit system, a water grid, and a new government office center;
(2) The supplemental budget of 50 billion baht;
(3) The rate of capacity utilization which will fuel private investment to push economic growth, and
(4) A hike in private credit expansion in a low interest rate environment to smooth increase in private consumption and investment. Particularly, investment in machinery and equipment is anticipated to pick up strongly from replacement and new investment in manufacturing sectors.

In 2005, private consumption and investment is expected to grow by 5.1 and 16.3 percent respectively, year-on-year. Meanwhile, public sector expenditure is forecast to accelerate, by 6.9 percent in public consumption and 24.0 percent in public investment. However, there are economic challenges from risks ongoing from last year. External risks include the high oil price and global tightening, and possible exchange rate realignment. Internal challenges consist of avian influenza, the southern unrest, and the tsunami, which directly impacted the tourism sector, Thailand's main foreign currency service income earner. However, the adverse impact from the tsunami is limited as there is a minimal contribution from the six disaster-affected provinces to overall GDP. However, it is expected the government will launch various alleviation programs which could return the affected provinces' economies to normal economic growth. On February 2005, Thai-Rak-Thai party won a landside general election. The majority is likely to assure political stability, and therefore will directly benefit economic stability and continuation of the administration's economic policy.

- **Economic Stability**

The recent economic data have shown that Thailand's internal and external stabilities are well maintained. Inflation remained very low. Headline inflation in 2004 stood at 2.8 percent, compared to 1.8 percent last year. An increase in inflation was pushed by a rise in the prices of raw foods and fuel. In 2005, headline inflation will be expected to be 4.1 percent, higher than that of last year, taking into account: (1) the continually high price of crude oil in the world market; (2) the gradual lifting of the domestic retail price ceiling for diesel at the end of Q2 2005; and (3) the rise in the minimum wage rate. Meanwhile, the employment situation has improved continuously. As of December 2004, the number of employed persons stood at 34.7 million, more than the 33.8 million in 2003. With the strong economic recovery, the unemployment rate has remained impressive, being lower than 3.0 percent since 2002. In 2004, the unemployment rate was as low as 2.1 percent. In 2005, it is expected that Thailand's economy will be expanded strongly, therefore employment conditions have improved with the number of employed workers expected to increase by 743,000.

External stability also remains solid. The external debt position has improved continuously. As of December 2004, gross external debts amounted to US$50,592 million, declined from US$51,783 million in 2003. The decline in external debts was result of repayment from public sector, while private sector relied on more external financing source. Of which, public sector decreased significantly from US$16,959 million in 2003 to US$14,848 million in 2004, while private sector in 2004 stood at US$35,744 million, slightly higher than US$34,824 million in 2003. Alternatively, external debts consisted of the long term debts of US$39,285 million and the short term debts of US$11,307 million. In addition, international reserve has improved significantly by increasing from US$42.1 billion in 2003 to US$49.8 billion in 2004, which is the result of consecutive balance of payment surplus since after the crisis in 1998.

- **External Sector**

With benefit of the world economic recovery, especially in Thailand's trading partners such as the United States, Japan and the EU, international trade exhibited a strong performance. Export values have improved continuously. In 2002, export values amounted to US$68.6 billion, but in 2004, exports have exceeded US$90 billion reaching 96.1 billion. The factors of successful export expansion come from the improvement in trading partners' economies such as China; Chinese Taipei; Japan and the USA, and aggressive bilateral trade negotiation. Thailand has already signed free trade area agreements? with one economic group and six economies, namely, China, India, Australia, New Zealand, Peru and Bahrain. Meanwhile, imports increased in line with exports as economic recovery raises the demand for imports of consumer and capital goods for private consumption and investment. Import values in 2002 stood at US$64.3 billions while in 2004, it reached US$94.4 billions. The trade balance has remained in surplus since the crisis year of 1997,but its trend is a reducing of the surplus following strong internal demand from economic expansion. In 2004, the trade surplus registered a surplus of US$1.7 billion.

In 2005, the Ministry of Finance expects that exports value will grow by 11.8 percent to US$107.5 billion, while imports will increase by 15.6 percent to US$109.1 billion. The main factor accelerating imports is upward demand for raw materials, capital goods, and energy to support new investment as well as a rise in commodity prices. Consequently, the trade balance in 2005 will register a deficit of US$1.6 billion. However, the trade deficit, which arises from importing capital goods to support economic development is common for developing economies in the recovery phase. Although the trade account will be in a deficit of US$1.6 billion, the current account will record a surplus of US$3.0 billion of GDP, mainly due to a strong surplus in the services account.

After the exchange rate regime changed from a currency basket system to a managed floating exchange rate regime within a pre-determined band, the Thai baht has continuously depreciated, which could partly explain the high growth of exports since 1997 to 2001. With successful export performance and a continuous balance of payments surplus, the average value of the baht has appreciated along with other Asian currencies led by the Japanese yen. It averaged 41.53 baht/USD in 2003 and 40.27 baht/USD in 2004. In addition, the other key factors fuelling the baht appreciation is the falling value of the US dollar, which has been pressed by its fundamental problem of a long period in current account deficit.

- **Fiscal Sector**

The budget outturn for fiscal year 2004 (FY2004) had some positive outcomes thereby contributing to the government's policy to sustain Thailand's economic growth and ensuring that fiscal consolidation would be underway before entering FY2005 with a balanced budget. Performance has been above most expectations, leading the government to execute the supplementary budget in mid-year starting in April 2004 and worth 135,500 million baht.

For the entire FY2004, the total revenue collected was 1,127,153 million baht (17.6 percent of GDP) which exceeded the expected revenue outturn of 1,063,600 million baht, including the supplementary budget. Expenditure on the current fiscal year, excluding carry-overs budget for FY2004, was 1,052,660 million baht (equivalent to 16.5 percent of GDP) out of the total budgeted expenditure of 1,163,500 million baht and represents a 90.5 percent disbursement rate). This is a substantial improvement from FY2003, when the disbursement rate was 87.4 percent. The carry-overs disbursement was 87,450 million baht. The budget balance was in deficit of 12,957 million baht or 0.2 percent of GDP, much lower than the expected deficit amount 99,900 million baht. Including the extra-budgetary deficit of 55,018 million, the fiscal balance went into deficit by 67,974 million baht.

Unit: million Baht

	Budgeted Amount	Fiscal Year 2004		Comparison	
		Million Baht	% of GDP	Million Baht	% Change
1. Revenue	1,063,600	1,127,153	17.6	63,553	5.6
2. Expenditure		1,140,110	17.8		
-Current Fiscal year	1,163,500	1,052,660	16.5	(110,840)	(10.5)
(Percentage)		91			
-Carry-over		87,450	1.4		
3. Budgetary Balance	(99,900)	(12,957)	(0.2)	86,943	(671.0)
4. Extra-budgetary Balance	-	(55,018)	(0.9)		
5. Cash Surplus/Deficit	(99,900)	(67,974)	(1.1)	31,926	(47.0)
6.Borrowing	(99,900)	(90,000)	1.4	9,900	(11.0)
7.Change of Cash Holding	-	22,025	0.3		
8.Primary Fiscal Balance		60,375	0.9		

With the weak domestic demand in the past, the accommodative fiscal stance was the main engine to stimulate the economy to grow at a suitable level and revive its demand. In addition, the recent economic figures have been already shown that Thailand was on a successful economic track with the growth rate above 6.0 percent for 2003 and 2004. Therefore, the economic stimuli from fiscal policy will be lessened. The government plans for the FY2005 budget to be the first balanced budget since the economic crisis in 1997. In 2005, it is expected that the Thai economy's real GDP will grow by 7.5 percent with a 2.5 percent inflation rate. Private investment and exports are expected to be the key drivers of growth. The total budget is 1,200,000 million baht (16.8 percent of GDP). The budget structure comprises of 847,597 million baht for current expenditure; 302,326 million baht for capital expenditure; and 50,076 million baht allotted for principal repayment.

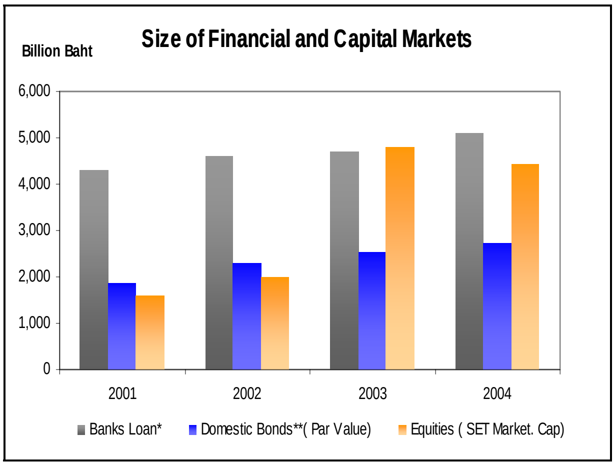
Budget Structure	**FY 2005**	
	Amount	+/- (%)
Total Expenditures	**1,200,000.00**	**3.1**
- *Percentage to GDP*	*16.8*	
1. Current Expenditures	847,597.20	1.3
- *Percentage to total budget*	*70.6*	
2. Capital Expenditures	302,326.50	3.3
- *Percentage to total budget*	*25.2*	
3. Principal Repayment	50,076.30	46.6
- *Percentage to total budget*	*4.2*	
4. **Total Tax Revenue**	**1,200,000.00**	**3.1**
- *Percentage to total budget*	*16.8*	
5. Financing	0	-100.0
- *Percentage to total budget*	*0*	
6. **GDP**	**7,123,710.00**	**10.0**

With regards to public debt, as of December 2004, outstanding public debt was at 3.1 trillion baht or 48.2 percent of GDP, less than 50.6 percent of GDP at the end of FY2003 (October 2003). However, within the fiscal sustainability framework, it is expected that public debt will reduce following the balanced budget starting in FY2005.

B. FINANCIAL SECTOR DEVELOPMENT

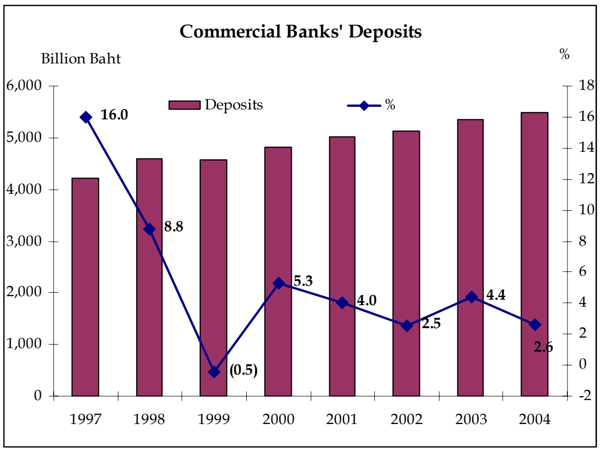
▪ OVERVIEW

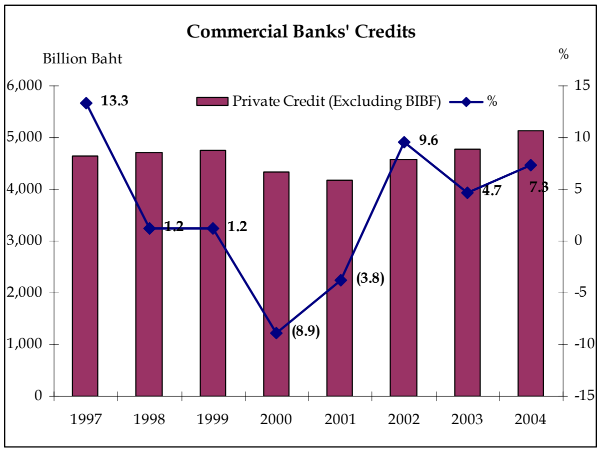
In order to sustain economic growth, recovery in exports and policy stimulation packages carried out by the government are called for. To ensure that Thailand is on track to achieve economic sustainability, the government has introduced a number of key reform policies. The financial sector reform has been continuously implemented and the capital market development, with emphasis on good governance, is given a high level of priority.



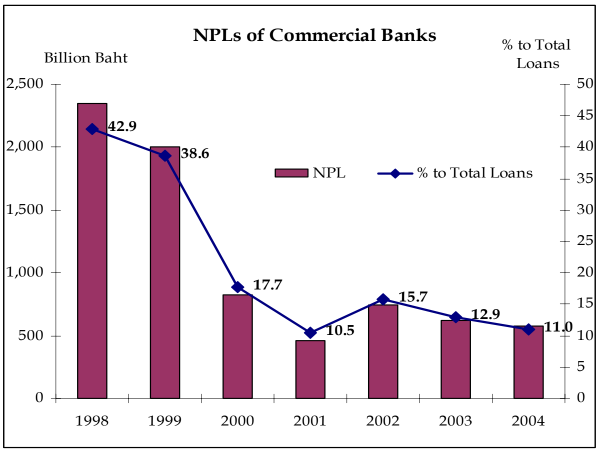
The health of Thai financial institutions was improved as the government implemented several measures to restructure and strengthen the troublesome financial sector. In the past, Thailand's economy was based on bank financing. In 1996, bank loans stood at 4.8 trillion baht, higher than value of GDP in that year, while market capitalization and the value of domestic bonds were relatively lower valued at 2,559.6 and 519.3 billion baht respectively. At present, the size of bank-based and capital market-based financing is well balanced following the significant increases in the size of the stock exchange and domestic bond market. The capital market for both stocks and bonds has become an increasingly important alternative financing source for the private sector.

▪ Banking Sector





Deposits in commercial banks rose strikingly during the crisis due to the high interest rate. But in the recent year, the nominal interest rate decreased sharply, resulting in a slowdown in the growth rate of deposits. In 2004, total deposits with commercial banks stood at 5,497.3 billion baht an increase of 2.6 percent from the previous year. Meanwhile, commercial bank credits increased markedly by 7.3 percent in 2004, due to robust economic growth and a boost in private investment that increased the demand for finance and borrowing from the commercial banks.



The problem of non- performing loans (NPLs) declined continuously. In 1998, NPLs of commercial banks amounted 2,350 billion baht or 42.9 percent of total outstanding loans. However, in 2000 NPLs fell sharply from 38.6 percent to 17.7 percent of total loan due due to a transfer of NPLs to the Thai Asset Management Corporation (TAMC). In 2004, the size of NPLs fell to 11 percent of total loans following the better economic situation. And it is expected that NPLs will return to the level posted before the crisis within 2–3 years.

In order to improve the domestic banking system's efficiency, the Financial Sector Master Plan, jointly collaborated upon by the Ministry of Finance (MOF) and the Bank of Thailand (BOT), aims to improve efficiency, stability and competition within the financial institutions system, and to broaden accessibility of financial services to all potential users. The rationale of the plan is to improve the structure and roles of financial institutions system to enhance business flexibility, competitiveness and accessibility of services to users such as improving financial services to small and medium enterprises (SMEs) and retail customers. An appropriate agency will be designated to assume a developmental role to provide support for community financial organizations. For that reason, further increases in accessibility of financial services to the public, particularly at the grass-roots level, will also strengthen the efficiency of the Thai financial institutions system. There will be two types of Thai financial institution that will mobilize public savings.

- Commercial banks: offering a full range of financial services (except insurance underwriting) to all groups of customers, as well as brokering, trading and underwriting of equity securities.
- Retail banks: offering financial services for SMEs and low-income customers, subject to a lending limit per customer. Retail banks may provide virtually all types of financial transactions with the same exceptions as commercial banks, and are not permitted to conduct business related to foreign exchange and derivatives products.

In relation to foreign-owned financial institutions, there will be two types of foreign-owned financial institution:

- Full branches: enjoying the same scope of business as Thai commercial banks, yet not permitted to open any branch.
- Subsidiaries: enjoying the same scope of business as Thai commercial banks and allowed to open three to five branches.

However, the Financial Master Plan is still in progress and is planned to be completed during 2005.

- **Monetary Policy**

Thailand's monetary policy formulation is set by the Monetary Policy Committee. It aims to attain price stability conductive to sustainable economic growth by utilizing the 14-day repurchase rate as the key policy rate. Its target is core inflation within a designated range. With weak internal demand and a low inflation rate environment before 2003, Thailand adopted an accommodative monetary policy in order to maintain supportive economic conditions. The Bank of Thailand (BoT) reduced the 14-day repurchase rate, a policy instrument, from 2.25 percent per annum in 2002 to 1.25 percent per annum in June 2003. As the inflation rate remained low there was no negative effect likely from further easing of the monetary policy to safeguard against uncertainties in economic conditions and support the growth process.

As the economic environment has been changed following the economic expansion, and rising oil and farm prices, headline inflation started to take off, increasing to 3.1 percent year-on-year in August 2004. This signaled an inflationary pressure for the Thai economy due to continuously increasing capacity utilization, rising domestic oil prices, and a tightening labor market, and would exert pressure on core inflation, the monetary policy's target. Therefore, the Bank of Thailand started to raise the 14-day repurchase rate; by 25 basis points, from 1.25 to 1.50 percent per annum in August 2004. Later, the 14-day repurchase rate was raised twice; by 25 basis points in October and December 2004. In addition, on March 2005, BOT decided to further raise the policy rate from 2.00 to 2.25 percent per annum, in order to strengthen economic stability and sustained growth in the long term.

MEDIUM-TERM ECONOMIC OUTLOOK

In the medium term (2005–09), the Ministry of Finance forecasts that real economic growth rate will stand at 5.9 percent per annum (p.a.) with an inflation rate of 3.2 percent p.a.

Economic growth in 2005–09 will be supported by steady growth in private consumption, improvement in exports, and a surge in investment from both public and private sectors to improve productivity. With superior economic performance, people's disposable incomes increase continuously which results in private consumption growing well and sustaining economic momentum. Meanwhile, the external front will perform well due to the diversified strategy. Horizontally, the government will move aggressively to penetrate the existing export markets by bilateral trade agreements, namely, free trade areas, which will increase Thai products' competitiveness in foreign markets as a result of lower tariffs and elimination of trade barriers. Finding unexposed export markets will sustain export growth and lessen dependence on existing markets. In turn, private investment should pick up more firmly after a high rate of capacity utilization. One crucial factor supporting growth will be an improving productivity, which will enhance the economy's competitiveness and increase investment efficiency. In the next five years, public investment in infrastructure is in the pipeline, which could contribute to maintaining above standard economic performance. Inflation will pick up to average 3.2 percent, driven by the current high commodity prices of crude oil, metal, and agricultural products that are due to higher global demand, especially from developing economies with strong growth such as China and India.

ANNEX I

THAILAND: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	122.5	122.4	115.2	126.3	142.9	161.9
Real GDP	4.4	4.6	1.9	5.2	6.8	6.1
Consumption						
Private Consumption	4.3	4.9	3.7	4.7	6.4	5.6
Government Consumption	3.1	2.6	2.9	0.5	2.0	4.1
Investment						
Private Investment	-3.3	16.8	4.7	13.3	17.9	15.3
Government Investment	-3.1	-9.7	-5.5	-6.8	-2.3	11.7
Exports of Goods and Services	0.9	17.5	-4.2	12.0	7.0	7.8
Imports of Goods and Services	10.5	27.1	-5.5	13.7	7.7	12.1
Fiscal and External Balance (percent of GDP)						
Budget Balance (Cash Basis)	-2.8	-2.3	-2.6	-2.9	-2.1	0.0
Merchandise Trade Balance	9.3	5.5	2.5	3.5	3.8	1.7
Current Account Balance	12.4	9.3	6.2	7.6	8.0	6.3
Capital and Financial Non-reserve Assets Balance	-7.9	-10.2	-5.0	-4.7	-3.6	-3.1
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	-4.0	1.3	2.1	0.7	1.9	4.6
CPI	0.3	1.5	1.6	0.7	1.8	2.7
M2	4.8	5.0	5.2	5.3	4.9	5.4
Interbank Interest Rate (percent)	1.3	2.0	2.2	1.9	1.4	1.3
Real Effective Exchange Rate (level, 1997=100)	89.9	86.4	82.4	84.7	83.4	85.6
Unemployment Rate (percent)	4.2	3.6	3.2	2.2	2.0	2.2
Population (millions)	61.08	61.88	62.31	62.80	63.08	63.35

Sources:
1. National Economic and Social Development Board (NESDB)
2. The Ministry of Labor and Social Welfare.
3. Bank of Thailand

ANNEX II

THAILAND: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	**IMF**	**ADB**	**OECD**	**PECC**	**Link**	**Official**	**IMF**	**ADB**	**OECD**	**PECC**	**Link**
Real GDP	6.1	6.2	6.4	N.A.	N.A.	N.A.	6.0	6.4	6.6	N.A.	N.A.	N.A.
Exports	7.8	N.A.	13.7	N.A.	N.A.	N.A.	4.5	N.A.	8.0	N.A.	N.A.	N.A.
Imports	12.1	N.A.	13.1	N.A.	N.A.	N.A.	6.2	N.A.	8.0	N.A.	N.A.	N.A.
CPI	2.7	2.7	2.6	N.A.	N.A.	N.A.	2.7	1.8	2.6	N.A.	N.A.	N.A

ANNEX III

THAILAND: MEDIUM-TERM TREND FORECAST (percent)

	Period*
Real GDP	5.9
GDP Deflator	5.8

Sources: NESDB, and Ministry of Finance.

UNITED STATES OF AMERICA

The text below, adapted from the 2005 *Economic Report of the President* and *Analytical Perspectives on the Budget of the US Government for Fiscal Year 2006,* refers to the official administration forecast released in December 2004. An updated forecast for the 2005 Mid-Session Review will be released in June.

Real GROSS DOMESTIC PRODUCT

Real GDP grew a robust 3.9 percent during the four quarters of 2004, above the average historical pace. (Real GDP growth was 4.4 percent on a year-on-year basis comparing GDP for 2004 as a whole with GDP for 2003 as a whole.) Growth was supported by gains in consumer spending, business fixed investment, and, to a lesser extent, housing investment, inventory accumulation and government spending. Net exports (exports less imports) held down growth in all four quarters as the trade deficit set a new record in each quarter as a percentage of GDP. Strengthening economic growth among our trading partners led to an increase in exports, but imports continued to outpace exports as US domestic demand and demand for imported oil remained strong. The rise in crude oil prices reduced growth somewhat during the year.

The administration expects real GDP to grow 3.5 percent during the four quarters of 2005, in line with the consensus of professional forecasters. This growth will be driven by continued gains in consumer spending, investment growth (although slower than in 2004), and stronger net exports.

INFLATION

Following very low inflation during 2003, most measures of inflation increased during 2004, with the largest increases in those price indices that include energy. For example, the consumer price index (CPI) increased 3.3 percent over the 12 months of 2004, well above the 1.9 percent rise during the previous year. Excluding the volatile food and energy components, core consumer prices increased 2.2 percent during 2004, up from 1.1 percent during 2003. About 0.4 percent of the year-to-year acceleration in the core CPI is accounted for by used car prices, which dropped sharply in 2003 before rebounding in 2004. Consumer energy prices increased 17.0 percent in 2004—with particularly large (27.0 percent) increases in petroleum-based energy prices. Food prices increased 2.7 percent during 2004, down slightly from their 3.6 percent rise in 2003.

Last year’s increase in inflation appears likely to have been a temporary phenomenon rather than the beginning of a sustained increase. Inflation, as measured by the CPI, is expected to stabilize at a 2.4 percent annual rate in future years, up only slightly from the 2.2 percent increase in the core CPI during 2004. In 2005 and 2006, the overall consumer price index is projected to be held down by anticipated declines in energy prices consistent with the declines implicit in the futures market for crude oil. The inflation fluctuations during the past year have not affected long-term inflation expectations, which remain stable.

EMPLOYMENT

Non-farm payroll employment increased by about 2.2 million during 2004, the largest annual gain since 1999. The unemployment rate declined to 5.4 percent by December 2004, well below the 6.3 percent peak of June 2003. The unemployment rate in 2004 was below the averages of the 1970s, the 1980s, and the 1990s.

Job gains were spread broadly across major industry sectors in 2004. The service-providing sector accounted for 85.0 percent of job growth during the year, in line with its 83.0 percent share of overall employment. The goods-producing sector accounted for the remaining 15.0 percent of the gains, in line with its 17.0 percent share of overall employment. Within the goods-producing sector, employment growth was concentrated in construction; manufacturing employment also increased, the first such gain since 1997.

The administration projects that employment will increase at a rate of about 175,000 jobs per month on average during the 12 months of 2005—a projection that is in line with the consensus of private forecasters. The unemployment rate is projected to edge down from its December 2004 level of 5.4 percent to 5.3 percent by the fourth quarter of 2005. Employment growth is not expected to slow as much as output growth because productivity (output per hour) is projected to increase at a slower pace than in 2004, and more of the projected output growth may be translated into labor demand and employment in 2005 than in 2004.

BALANCE OF PAYMENTS

The trade deficit expanded substantially during 2004. Real exports increased 4.0 percent, as economic growth strengthened among our major trading partners, but real imports increased even faster (at a 7.2 percent rate), partly due to the more robust recovery in the United States than abroad. The trade deficit on goods and services reached about 5.6 percent of GDP in the fourth quarter of 2004.

The rapid increases in real imports were widespread and included capital goods and industrial supplies, petroleum and consumer goods.

All the major categories of real non-agricultural exports (capital goods, industrial supplies, motor vehicles, consumer goods and services) contributed to the growth of overall exports. Agricultural exports declined, however, as exports of beef fell on concerns about “mad cow” disease (bovine spongiform encephalopathy or BSE). Due to the detection of the first known case of “mad cow” disease in the United States in late 2003, a number of economies that together account for most US beef exports have completely or partially halted purchases of American beef. As a result, beef exports—which were $3.1 billion in 2003—fell by about $0.6 billion in 2004. So far this year, beef exports have been nearly 4 times their level in the first quarter of 2004.

The rapid growth of imports relative to exports largely reflects faster growth in the United States than among our trading partners, as US demand for imports increases faster than others’ demand for our exports. For example, the US economy grew faster than its trading partners in the Organization for Economic Cooperation and Development (OECD) during the four quarters of 2003 (4.4 percent versus 2.2 percent), and the OECD growth estimate for the four quarters of 2004 also shows slower growth elsewhere in the OECD (2.7 percent) than the 3.7 percent official estimate of growth for the United States.

The current account deficit, which primarily reflects the trade deficit but also includes net international flows of investment income and transfers, widened to about 6.3 percent of GDP in the fourth quarter. The current account deficit represents the inflow of capital that is needed to finance any domestic US investment in excess of domestic savings. Over the latter half of the 1990s and the early 2000s, the US current account deficit expanded as domestic investment grew faster than savings. More recently, the current account deficit has expanded as the national savings rate has fallen.

Looking ahead, stronger growth in US trading partners appears to favor continued gains in export growth. Growth among the non-US members of the OECD is projected to increase from 2.7 percent during the four quarters of 2004 to 3.0 percent during the four quarters of 2005. This growth should support growth in US exports. This effect will likely be augmented by a rise in the US share of world exports, owing in part to recent declines in the value of the dollar against other major currencies. Overall, the administration projects real exports will grow substantially faster than GDP in 2005. The projected moderation of US GDP growth in 2005 and 2006 together with the recent change in the exchange value of the dollar suggest that growth in real imports will slow in the future.

FISCAL POLICY

The administration proposed, and Congress enacted, in each of the past four years significant tax relief designed to overcome the shocks that were restraining the economy and restore strong growth of output, income, and jobs. In addition to providing much needed near-term stimulus, the 2001 and 2003 Acts also were designed to raise long-term growth by reducing the disincentives and distortions in the tax system. These acts reduced marginal tax rates on income, dividends, and capital gains. Lower tax rates encourage individuals and businesses to produce more, save more, and invest more. More savings and investment create capital, add to economic growth, and raise the standard of living.

MONETARY POLICY

During the past four years, monetary policy has been focused on overcoming negative shocks and restoring strong, sustained growth. From the beginning of 2001 through mid-2003, the Federal Reserve Bank (Federal Reserve) lowered the target Federal funds rate 13 times, from 6.5 percent to 1.0 percent. That low rate was maintained until June 2004, when the Federal Reserve began to increase the rate gradually. Over the course of 2004, it became increasingly evident that the economy was once again growing strongly and labor markets were improving, which reduced the need for monetary stimulus. By May 2005, the Federal Reserve had raised the funds rate to 3.0 percent, a level that it believed was still accommodative. In its statement accompanying the May increase, the Federal Reserve indicated that it intended to move at a measured pace to reduce the accommodative stance of monetary policy further.

MEDIUM- AND LONG-TERM OUTLOOK

The US economy continues to be well-positioned for long-term growth. The administration thus projects that GDP will expand strongly through 2010, inflation will remain contained, and labor markets will continue to strengthen. The forecast is based on conservative economic assumptions that are close to the consensus of professional forecasters. These assumptions provide a prudent and cautious basis for the budget projections.

The administration projects that real GDP will grow at an average annual rate of 3.3 percent during the four years of 2005 to 2008, roughly in line with the consensus forecast for those years. This pace is slightly above the expected 3.2 percent annual growth in potential GDP (a measure of productive capacity), so the unemployment rate is projected to edge lower from 5.4 percent at the end of 2004 to 5.1 percent by the end of 2006. The unemployment rate is expected to remain flat thereafter as the economy grows at its potential rate of 3.2 percent in 2007 and 2008, and 3.1 percent in 2009 and 2010. Potential GDP growth is expected to slow somewhat after 2008, as labor force growth declines.

ANNEX I

UNITED STATES OF AMERICA: OVERALL ECONOMIC PERFORMANCE

	1999	2000	2001	2002	2003	2004
GDP and Major Components (percent change, year over year, except as noted)						
Nominal GDP (level in billion US$)	9268.4	9817.0	10128.0	10487.0	11004.0	11735.0
Real GDP	4.5	3.7	0.8	1.9	3.0	4.4
Consumption						
Private Consumption	5.1	4.7	2.5	3.1	3.3	3.8
Government Consumption	3.1	1.7	3.1	4.0	2.9	1.7
Investment						
Private Investment	7.8	5.7	-7.9	-2.4	4.4	13.2
Government Investment	7.5	3.6	4.9	6.0	2.1	2.9
Exports of Goods and Services	4.3	8.7	-5.4	-2.3	1.9	8.6
Imports of Goods and Services	11.5	13.1	-2.7	3.4	4.4	9.9
Fiscal and External Balance (percent of GDP)						
Budget Balance	1.4	2.4	1.3	-1.5	-3.5	-3.6
Merchandise Trade Balance	-3.5	-4.4	-4.1	-4.5	-4.8	-5.5
Current Account Balance	-3.0	-4.0	-3.7	-4.4	-4.6	-5.4
Capital and Financial Non-reserve Assets Balance						
Economic Indicators (percent change, year over year, except as noted)						
GDP Deflator	1.4	2.2	2.4	1.7	1.8	2.2
CPI	2.7	3.4	1.6	2.4	1.9	3.3
M2	7.5	6.1	8.7	7.6	6.9	4.5
3 Month CDs	5.3	6.5	3.7	1.7	1.2	1.6
Real Effective Exchange Rate (level, 1995=100)						
Unemployment Rate (percent)	4.2	4.0	4.7	5.8	6.0	5.5
Population (millions)	279.3	282.4	285.4	288.2	291.1	294.0

ANNEX II

UNITED STATES OF AMERICA: FORECAST SUMMARY (percent change from previous year)

	2004						2005					
	Official	IMF	ADB	OECD	PECC	Link	Official	IMF	ADB	OECD	PECC	Link
Real GDP	4.4	4.3		4.4			3.5	3.5		3.3		
Exports	6.9	9.0*		8.9*			12.3	8.1*		9.2*		
Imports	4.9	9.8*		10.1*			9.2	5.0*		7.7*		
CPI	2.7	3.0		2.6			2.7	3.0		2.4		

Note: (*) Denotes import and export volumes.

ANNEX III

UNITED STATES OF AMERICA: MEDIUM-TERM TREND FORECAST (percent)

	Average for 2005–2009
Real GDP	3.3
GDP Deflator	2.0

VIET NAM

GROSS DOMESTIC PRODUCT

According to the economic growth trend in 2004 and in the first four months of 2005 and with the view of an advantageous growth in the rest of 2005, in 2005 the economy of Viet Nam is forecast to increase dramatically. The gross domestic product (GDP) growth rate is forecasted to be 8 percent to 8.5 percent higher than in 2004 when the GDP was 7.7 percent. In this increase, the agricultural, forestry and fishery sector is increased by 4.0 percent, industry and construction sector is increased by 11.0 percent, and the services sector is increased by 8.0 percent. The GDP per capita is US$600.

Positive signals can be seen in this growth, the proportion of production value due to the agricultural, forestry and fishery sector was decreased from 21.7 percent in 2004 to 19.0 percent in 2005 while that due to the industrial and construction sector was increased from 40.1 percent to 42.0 percent and that due to services increased from 38.2 percent to 39.0 percent.

INVESTMENT

Continuing the positive trend since 2000 there has been a significant increase in overall investment in 2005. It is forecast to attain $300 billion Vietnamese dong (US$18–19 billion), an increase of 18.0 percent compared to that of 2004 and equal to 36.5 percent of GDP***.***

The structure of capital mobilization in 2005 is forecast to be as follows: the proportion of investment capital from the government budget and government budget-originated capital is 64.5 billion dong, forming 28.5 percent of the total budget expenditure and 21.8 percent of the total social investment, an increase of 9.9 percent compared with 2004.

State credit capital is forecast to reach 30–31 billion dong, forming 10.2 percent of the total investment capital and increasing by 3.4 percent to 6.9 percent compared with 2004.

The total investment capital of state-owned enterprises is 58.5–59 billion dong, or 19.8 percent of the total investment capital, an increase of 27.2–28.3 percent compared with 2004.

Private and individual investment capital is approximately 85–86 billion dong, forming 28.8 percent of total investment capital, an increase of 26.9 to 28.4 percent compared with that of 2004.

Total foreign direct investment capital is estimated to be 43 billion dong (equivalent to US$2.7 billion), an increase of 6.7 percent compared with 2004.

EMPLOYMENT

In 2005, 1.6 million additional people were employed. The industry and construction sectors attracted 4,448,000 employees, , increasing the number of employees in these sectors to 10.9 million. The number of new employees in the agricultural, forestry and fisheries sector is estimated to be 104,000, while the service sector attracted 748,000 more employees. The total number employed in the services sector is estimated to be 10.9 million. Labour export is forecast to be about 70,000. The urban unemployed accounted for less than 5.4 percent of the work force and in rural areas, the total time spent in employment was over 80.0 percent.

Currency is assumed to continue as dong—but it needs to be checked in case there was a switch to US dollars.

BALANCE OF PAYMENTS

The deficit of the trade balance in 2005 is about 1.4 billion dong (at FOB prices). The services balance will continue to decrease, to 1.1 billion dong. The deficit in net income investment increases by 100 million dong compared with that of 2004 and the estimated income from money transfers (of both private and state-owned enterprises) is 2.6 billion dong.

The capital balance is forecast to achieve a considerable surplus and the disbursement of foreign direct investment is estimated to reach 2.0 billion dong. The net long- and medium-term loans could be around 500 million dong, in which the long- and medium-term loans of 2005 could be 1.6 billion dong, and the repayment is estimated to be 1.1 billion dong.

The total balance of payments in 2005 is forecast to have a surplus of 1.0 billion dong.

FOREIGN DEBT

At the end of 2005, the total foreign debt is estimated to be 16.7 billion dong, 10.4 percent higher than that of 2004. The ratio of government's and enterprises' foreign debt continues to be stable with the gradual decrease in the proportion of government new debt and the increase in the commercial debt of enterprises.

In 2005, new debt will be 2.57 billion dong including 1.57 billion dong of new debt of government and 1.0 billion dong of new debt of enterprises. The government's share of new foreign debt in 2005 falls to 61.1 percent and the enterprises' share increases to 38.9 percent.

The debt payment accounts for 5.5 percent of the value of exports in 2005, increasing by 0.5 percent, compared with 5.0 percent in 2004.

The government payment service accounts for 9.1 percent of the total government budget in 2005, increasing dramatically in comparison with the 7.1 percent of 2004. However, if the debt is subtracted from debt capital via foreign accumulated debt budget (this wasn't included in the government budget), the government debt payment from government budget only accounts for 4.0–5.0 percent of the total government budget.

THE EXCHANGE RATE

In the first four months of 2005, the Viet Nam dong only lost 0.2 percent in value compared to the US dollar. The dong is forecast to lose only 2.0 percent of its value against the US dollar because of the following reasons:

- The overall balance of payments of Viet Nam's economy continues to experience a high surplus
- In the domestic market, the dong interest rate is always higher than the exchange rate of the US dollar.
- The consumer price index is tending to decrease markedly compared to that of 2004
- The US dollar continues to lose its strength compared with other currencies because of the double deficit of the American economy (deficit in national budget and deficit in the balance of trade), because the American government continues to follow its policy of a weak dollar in order to restrain its competitiveness.

TAX POLICY

Thanks to the development of the economy and the comprehensive tax collection method, budget income of 2005 is forecasted to be high despite the cutting of some taxes in accordance with the integration route and the policies of promoting investment. The total budget income in 2005 will be 198 thousand billion dong, an increase of 9.8 percent in comparision with that of 2004.

In 2005, the income and expenditure mechanism of the national budget continues to develop with the trends apparent for years, especially after issuance of the government budget law in 2003, which aims to increase the independent finacial right of budgetary units and to raise the responsibility of budget-using units.

MONETARY POLICY AND INFLATION

In 2005, Viet Nam's national bank continues to execute the floating exchange rate policy, with high consideration paid to controlling the spread of price increases and in alignment with assisting economic development. The total means of payment are to increase by 22.0 percent, the overall mobilized deposits increase by 20.0–21.0 percent and total credit surplus increases by 23.0 percent. Although the credit debt ratio is quite high compared to the consumer price index of 2004 (the average was 9.5 percent in 2004 and 4.3 percent in the first 4 months of 2004), it still does not create a considerable change in the money market. The interest rate in 2005 still increases slightly despite the continuation of the unsecured credit policy as well as the decrease of the inflation. Therefore, the monetary policy applied in 2005 basically contributes an important part in the stabilization of the macro-economic inflation control and economic development. In particular, the stable exchange rate and the increase in the dong interest rate enable the Vietnamese State Bank to buy foreign currency to increase the foreign currency reserves and thus, increase stabilization of the foreign exchange market.

In the monetary policy of 2005, there is better coordination, more flexibility and more frequent use of the mechanisms of monetary policy, such as compulsory reserves, rediscount interest rate and capital replenishment, as well as the open market operations. Based on the consumer price index (at current prices) in the past years and the increase in of the 2005 consumer price index (4.3 percent in the first 4 months of 2005: prices in April compared to December 2004), the consumer price index in 2005 is forecast to reach 6.5 percent.

ECONOMIC STRUCTURE REFORM

a) *Agricultural and rural economic development*

In 2005, Viet Nam will continue to transfer the economic structure in the agricultural and rural area, based on the master plan in which agro-product manufacturing is associated with marketing, and science and technology, The plan aims to: create and cultivate vegetable and animal strains with high yield, quality and value; speed up agricultural and rural industrialization and modernization geared toward forming a large-scale, concentrated commodity agriculture by constructing high-tech zones and applying modern technology; increase the share of animal husbandry and fishery in agriculture; transform the occupational and labor structures; and generate labor-intensive employment in the countryside.

The master plan will continue to be built up to:

- Vigorously develop processing industries linked to raw materials supply zones, agriculture–supporting mechanical engineering industries, and subcontracting and services industries;
- Integrate agriculture, industry and services both locally and economy-wide;
- Expand the market for agro-products at home and abroad, and to increase considerably the world market shares of our main agro-products;
- Invest more in rural socio-economic infrastructures development, and to develop the natural calamity protection system;
- Expand and improve the infrastructure of the fishery and services sectors with the emphasis on technology;
- Enhance the competitiveness of agro-product in domestic market and abroad;
- Accelerate the socialization of investment in agriculture, forestry and fishery to release the financial burden on the state budget;
- Develop co-operative sector gearing toward creating a favorable environment to improve farming models;
- Restructure the agricultural and forestry state-owned farms, including dissolving and integrating loss-making units;
- Enhance the management of the forestry sector towards clarifying the forest area,

accelerating the assignment of forest and land to households and communities;
- Develop solutions for forest prevention and development, forest fire prevention;
- Speed up commercial forestation and create a policy for farmers in preventive forest and natural forest areas; and adjust the master plan for cultivation and fishing to develop safe aquatic products, cultivation and epidemic prevention,

b) *Industrial development*

In 2005, Viet Nam endeavor to:
- Concentrate on industries capable of promoting their competitive advantages, capture domestic markets and push ahead exports, along with reducing costs;
- Develop high-tech industrial products as well as agro-supporting industries, especially the processing industry;
- Continue to organize the trading system of certain essential products, to ensure the stability of price, to prevent monopoly in product distribution such as steel in the previous time;
- Gradually establish and complete a long-term contract mechanism between processing enterprises and raw material manufacturers;
- Concentrate on monitoring the rate of progress of large-scale projects and significant industrial development programs;
- Examine industrial projects, finding sufficient funding for projects;
- Execute an industrial development policy in which domestic raw materials are used to increase the value-added in industrial products and to enhance the domestic economy;
- Invest in regional industries especially in difficult and mountainous areas;
- Accelerate the construction of high-tech zones and the rate of progress in applying new technology in manufacturing;
- Enhance the competitiveness of products especially garment, leather wear and foot wear, processing industrial and handicraft products… to satisfy the demand for export;
- Reduce costs, firstly concentrating on the products specified in AFTA;
- Expand markets of certain products including garments and tea… to East Europe, Russia, South America and South Asia; attach special importance to the construction of the public database to assist enterprises in designing business strategy;
- Publicize and clarify the policies and regulations relating to businesses;
- Develop comprehensively the system of financial, credit and insurance and infrastructure system for industries; and
- Attract more investment to industrial zones, processing and high-tech zones.

c) *Services sector development*

In 2005, services with competitive advantage including tourism, air transport, sea transport, finance, banking, etc. have been targeted for development, to gradually improve the quality of services.

Other aims are;
- To complete the regulation of trade and services through the Competition Law;
- To ensure the supply and demand balance of essential goods (petroleum, steel, cement, fertilizer… for the stability of the market; to develop domestic market gearing toward satisfying the diversified demand of manufacturing and consumption in order to assist domestic sales and ensure the supply of goods for export;
- To improve trading toward establishing the connection between manufacturers and consumers and enhancing exports, ensuring the efficient flow of goods and restraining unwanted displacement of prices of sensitive goods. The total retail sale of goods has increased by 17–18 percent in 2005;to increase the effectiveness of the banking service;
- To investigate and issue new regulations and to establish a legal framework for new banking operations (not yet specified in Vietnamese regulations) to suit the agreed

schedule and bilateral and multilateral agreements;

- To complete the legal framework and ensure a balanced and safe business environment for the operation of banks in Viet Nam;
- To reduce considerably preferential treatment to state commercial banks. The state bank shall not intervene in the operation of the commercial banks;
- To modernize the banking system, especially the IT system;
- To develop the insurance market, diversify insurance products, encourage insurance companies to investigate new products, especially products for agricultural, forestry and fishery programs;
- To create a favorable environment for insurance companies to launch new long-term products, namely, education and welfare insurance, retirement insurance, etc.;
- To enhance the capacity of the Viet Nam Insurance Association to act as the arbitrator of its members;
- To improve the quality of the transport service, to gradually apply the multi-transport framework, to increase the market share of marine transport for export and import goods and to satisfy the economy's demand for transport;
- To attach significant attention to the safety and convenience of customers;
- To reduce costs of certain services, simplify the procedures in airports and seaports in order to eliminate delays for customers, especially visitors;
- To gradually lessen traffic jams in urban areas. Priority has been given to the development of bus transport as well as the enhancement and restructuring of the transport system in urban areas;
- To develop and modernize the postal and telecommunications services;
- To develop new services, the mobile phone service, inter-telecommunications, Internet, the postal and financial service;
- To increase the investment in highly profitable areas as well as increase the assistance for difficult regions;
- To achieve 4 million more phone subscribers, (an increase of 40 percent compared to 2004), to reach the rate of 16 phones/100 people;
- To develop 1 more million Internet subscribers. The total number of Internet users to reach 2.6 million. Almost all communes to have phone line, 95 percent of the communes to receive a daily newspaper and 85 percent to have a Post and Cultural Center;
- To further develop tourism and attract tourists from Western Europe, North America and Northeast Asia;
- To strengthen and diversify the publicity methods of Viet Nam Tourism;
- To organize promotion activities abroad such as exhibitions, fairs, and other activities including "Viet Nam Week" and accelerate the progress of visa exemption for tourists from some big markets;
- To develop new tours and new tourism products in accordance with the enhanced quality of services;
- To receive 3.2 million foreign tourist visits, 14.5 million domestic tourist visits with the turnover reaching 30,000 billion dong, an increase of 18.5 percent compared to 2004; and
- To increase the exports of service labor. In 2005 an estimated 70,000 workers will be employed in Malaysia, Chinese Taipei, Laos, Korea, Japan, Singapore and Brunei. To expand to new markets such as United Arab Emirates, Ireland, Iraq etc.

THE MEDIUM-TERM VISION TO 2010

The vision of development to 2010 is under consideration by Vietnamese authorities and shall be submitted to the leaders. The major task in the next five years is to further accelerate the industrialization and modernization process, to lessen the risk of underdevelopment and to gradually achieve the global millennium goal. Some detailed development goals are:

- GDP in 2010, to be 2.1 times of that in 2000 (compared by price). GDP in 2010 to reach 1530–1600 billion dong (at current prices), compared to 85–89 billion dong with per capita GDP an average of 950–1000 dong

- Secondary school attendance will be improved. In 2010, higher education to reach 200 students/1000 people. Skilled labor to form 40 percent of the social labor force in 2010.
- To create 8 million jobs, with the average of 1.6 million jobs each year. To achieve 7.8 million workers with vocational training, including 25–30 percent with long-term training. To reduce the unemployment rate in urban areas to under 5.0 percent.
- To increase the average age expectancy of Vietnamese to 72 years.
- To reduce the infant mortality of children under 1 year old to 20 percent and that of children under 5 to 27 percent. The malnutrition rate of children under 5 to be under 20 percent in 2010.
- To reduce the mortality rate of pregnant mothers to 7 per 10,000 cases. The number of doctor/pharmacists per 10,000 people to reach 4.5.
- To eliminate the number of malnourished households and to reduce the proportion of poor households (according to the new standard, equivalent to international standards) to 15–16 percent in the year 2010.

ANNEX III

ABBREVIATIONS

ABBREVIATIONS

ACE	Automated Commercial Environment
AcSB	Accounting Standards Board
ADB	Asian Development Bank
APEC	Asia-Pacific Economic Cooperation
API	Indonesian Banking Architecture
ARMs	Adjustable Rate Mortgages
ASEAN	Association of South East Asian Nations
ATPDEA	Andean Trade Promotion and Drug Eradication Act [Peru]
BIA	Brunei Investment Agency
BIR	Bureau of Internal Revenue [Philippines]
BOC	Bureau of Customs [Philippines]
BOP	Balance of Payments
BOT	Bank of Thailand
BSP	Bangko Sentral ng Pilipinas [Philippines]
CBR	Central Bank of Russia
CCR	Core Capital Ratio
CEFP	Council on Economic and Fiscal Policy [Japan]
CGI	Consultative Group for Indonesia
CGPI	Corporate Goods Prices Index
CPI	Consumer Price Index
CSI	Container Security Initiative
C-TPAT	Customs-Trade Partnership Against Terrorism
EC	Economic Committee
EFI	Economic Freedom Indices
EPAs	Economic Partnership Agreements
FDI	Foreign Direct Investment
FEZ	Free Economic Zone [Russia]
FSC	Financial Supervisory Commission [Chinese Taipei]
FTO	Fine Tune Operation [Indonesia]
GCE	Government Consumption Expenditure
GDP	Gross Domestic Product
GIR	Gross International Reserves
GMM	Generalized Method of Moments
GNP	Gross National Product
GST	Goods and Services Tax
HDI	Human Development Index
HST	Harmonized Sales Tax [Canada]
ICT	Information and Communication Technology
IFOs	International Financial Organizations
IMF	International Monetary Fund
IMO	International Maritime Organization
ISPS	International Ship and Port Facility Code
IT	Information Technology
ITDS	International Trade Date System
ITERATE	International Terrorism: Attributes of Terrorists Events
KBEs	Knowledge-Based Economies

KLC	Kuala Lumpur Composite Index
M0	Cash in circulation
M1	Money supply of narrow sense
M2	Money supply of broad sense
MAS	Monetary Authority of Singapore [Singapore]
MDBs	Multilateral Development Banks
MFIs	Multilateral Financial Institutions
MIACR	Moscow Interbank Actual Credit Rate
MNCs	Multinational Corporations
MPR	Monetary Policy Rate [Chile]
MST	Manufacturers’ Sales Tax [Canada]
MTDS	Medium-Term Development Strategy
NAFTA	North American Free Trade Agreement
NASDAQ	National Association of Securities Dealers Automated Quotations
NBER	National Bureau of Economic Research
NEER	Nominal Effective Exchange Rate
NFIA	Net Factor Income From Abroad
NPL	Non-Performing Loans
NSYSE	New York Stock Exchange
OBERAC	Operating Balance Before Revaluations and Accounting Changes
OECD	Organization for Economic Cooperation and Development
OFW	Overseas Filipino Workers
OMOs	Open Market Operations
OPR	Overnight Policy Rate
PCE	Personal Consumption Expenditure
PNG’s	Papua New Guinea’s
PPP	Purchasing Power Parities
R&D	Research and Development
RBA	Reserve Bank of Australia
RMB	renmimbi
RWSR	Risk-Weighted Capital Ratio
SARS	Severe Acute Respiratory Syndrome
SBI	Sertifikat Bank Indonesia [Indonesia]
SEZ	Special Economic Zones [Russia]
SME	Small and Medium Sized Business
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific, and Cultural Organization
VAT	Value Added Tax
WPI	Wholesale Price Index
WPI	Wage Price Index
y-o-y	Year-on-Year