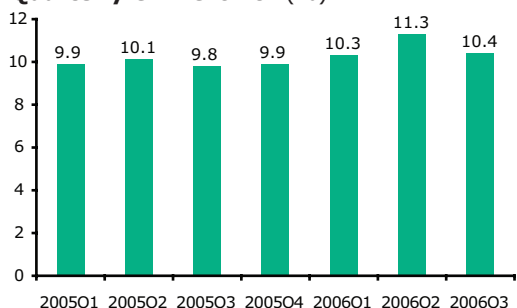


PRC

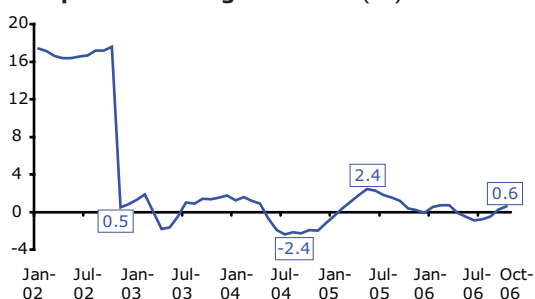
Accelerating investment drove economic growth higher in 2006 to an estimated 10.4%. Policy measures to restrain investment and slow the expansion appeared to be taking effect late in the year. GDP growth is thus expected to ease to 9.5% in 2007. Rebalancing the sources of economic growth away from exports and investment toward private consumption while ensuring an orderly transition to a more manageable pace of GDP growth is a key challenge.

Quarterly GDP Growth (%)



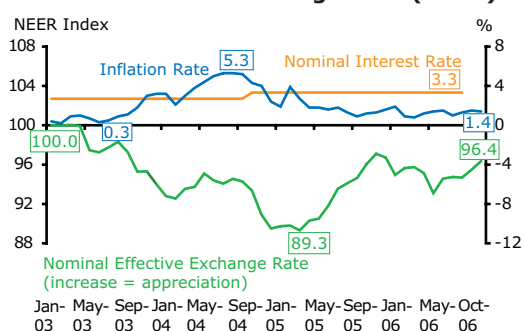
Source: OREI staff calculations based on National Bureau of Statistics of China data.

Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI. Source: National Bureau of Statistics of China.

Nominal Interest Rate¹, CPI Inflation, and Nominal Effective Exchange Rate (NEER)²



¹Rate charged by the People's Bank of China on 20-day loans to financial institutions.

²Jan 2003=100.

Sources: Bank for International Settlements and *International Financial Statistics* (IMF).

Economic Outlook—GDP growth accelerated in the first half of 2006 before easing in the third quarter. With strong and stable consumption and rebounding export growth, a drop in growth of fixed asset investment—from an average of 32% in 2006Q2 to 23% in 2006Q3—slowed the economy by about one percentage point. As export growth tapers, 2007 GDP growth should gradually ease to 9.5%. Inflation, however, remains quiescent, with a combination of bumper harvests, rapid growth in production capacity, and administrative control of energy prices, where there has been limited pass-through effect.

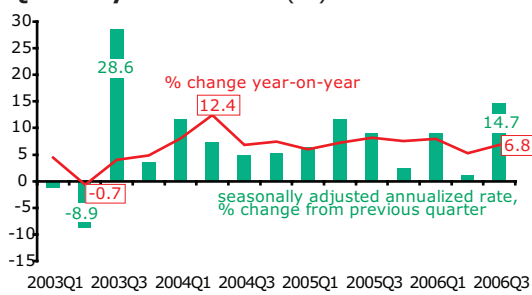
Risks—The key near-term risk is domestic: despite recent policy tightening, a reacceleration of investment cannot be ruled out as a large part is financed out of retained earnings, which are rising, and local governments continue to actively promote investment. Further problems could result in the medium term as the economy slows, such as the creation of overcapacity and a rise in NPLs. However, there is also the possibility that the tightening measures taken could slow economic growth more than expected, especially if combined with a sharper-than-expected US economic slowdown.

Policy Issues—In addition to several direct measures taken to restrain investment (see B1), monetary conditions were again tightened in November with a further increase in reserve requirements—after a rise in August, when lending and deposit rates were also increased. Despite these measures, overall monetary conditions remain generally accommodative. While capital inflows have dissipated, a strong current account surplus continues to exert pressure for reserve accumulation (international reserves surpassed the \$1 trillion mark in October 2006) and a nominal exchange rate appreciation. Greater exchange rate flexibility would not only make monetary adjustments easier, but also make room for an expected modest fiscal expansion ahead of the Olympic Games in 2008. The capacity to bring about an orderly transition to a slower but still high pace of economic growth, while rebalancing its sources away from exports and investment toward private consumption, is a near-term challenge for the authorities.

Hong Kong, China

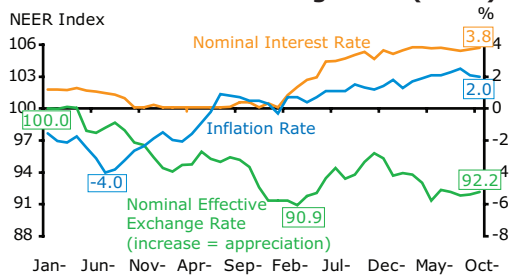
Strong domestic demand and double-digit GDP growth in the PRC should support 6.5% GDP growth this year, while the pace of expansion is expected to ease to 5.2% in 2007 due to a slowdown in major export markets, including the PRC. Meanwhile, recent years' fiscal consolidation has increased economic resilience.

Quarterly GDP Growth (%)



Source: Census and Statistics Department of Hong Kong, China.

Nominal Interest Rate¹, CPI Inflation, and Nominal Effective Exchange Rate (NEER)²



¹Refers to the overnight HK interbank offered rate.
²Jan 2003=100.
 Sources: Bank for International Settlements and Hong Kong Monetary Authority.

Fiscal and Monetary Indicators

	2002	2003	2004	2005	2006
Government fiscal balance (% of GDP)	-4.8	-3.3	-0.3	1.0	0.4 ¹
HK Interbank Offered Rates (average)	1.6	0.8	0.1	2.4	3.7 ²
Current account balance (% of GDP)	7.6	10.4	9.5	11.4	11.3 ³

Source: Asian Development Outlook and ADO Update 2006 (ADB) and Hong Kong Monetary Authority.
¹Government forecast for FY 2006/07.
²Denotes average through Oct 2006.
³ADO Update 2006 forecast.

Economic Outlook—Buoyant domestic demand and double-digit growth in the PRC will likely sustain a 6.5% economic expansion in 2006. However, growth is expected to ease to 5.2% in 2007 as external demand softens and the lagged effect of rising US interest rates play on the local economy, with a slowdown in growth of investment activity and private consumption. Inflation, on an upward trend this year, mainly due to rising housing costs, is expected to moderate in 2007, as the effect of a tightening labor market and a strengthening capital market are tempered by the lagged effect of increasing interest rates.

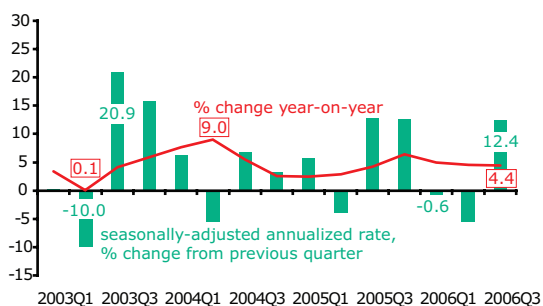
Risks—The high degree of openness of the economy to both trade and capital flows creates a particular vulnerability to sudden corrections of global payments imbalances and to an economic slowdown in major trading partners. A sharp downturn in the US will thus have a negative impact on exports to the US and, to a lesser extent, exports to the PRC for products destined to the US. Moreover, as companies continue to relocate to the PRC and the economy becomes more service-oriented, a mismatch is intensifying between available skills and jobs, where older and less skilled workers are finding it difficult to find jobs matching their qualifications.

Policy Issues—Despite a currency board system anchored on the US dollar, a discount of the HIBOR relative to US interest rates persists as liquidity continues to surge on recycled corporate earnings, lingering yuan speculation, and the buoyant performance of the stock market (the Hang Seng Index reached a record high in November 2006, growing by about 30% over its end-2005 value). Overall, monetary conditions this year remained mildly accommodative, with an increasing nominal interest rate offset by a depreciating nominal effective exchange rate. On the fiscal front, performance has improved due to cuts in government expenditures and increased revenues boosted by high investment income and strong land premium. Through continued fiscal tightening, authorities are expecting to achieve a budget surplus in 2006/07. The combination of successful fiscal consolidation, low government debt, and expanding foreign exchange reserves provides a certain degree of resilience to external shocks.

Taipei,China

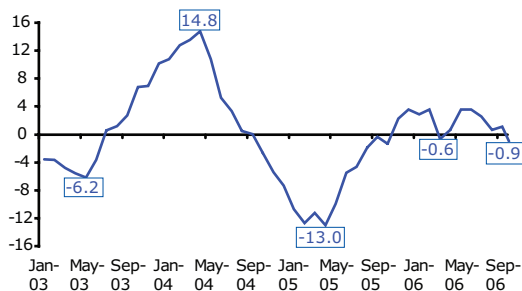
Robust exports supported an estimated 4.3% GDP growth in 2006. Next year, the projected slowdown in demand from major export markets is expected to slow the pace of economic growth to 4.0%. A major policy challenge is to reverse the deflationary trend and stimulate private investment.

Quarterly GDP Growth (%)



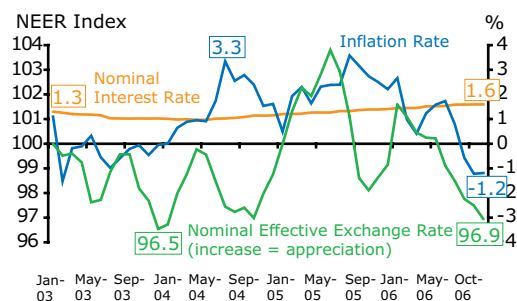
Source: Taiwan Directorate General of Budget, Accounting and Statistics.

Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.
Source: Council of Economic Planning of Taipei,China.

Nominal Interest Rate¹, CPI Inflation, and Nominal Effective Exchange Rate (NEER)²



¹Interbank overnight rates (period average).
²Jan 2003=100.
Sources: Bank for International Settlements (NEER) and Central Bank of China (Taipei,China).

Economic Outlook—Robust exports supported an estimated 4.3% GDP growth this year, while domestic demand fell as public consumption and investment contracted. Growth in private consumption decelerated as sustained energy prices and mounting credit-card defaults more than offset the favorable effects of a decline in employment rates. Inflation decelerated throughout the year, turning into deflation since August, with CPI declining by 1.2% y-o-y in October. Economic growth is forecast to moderate to 4.0% in 2007 due to the expected slowdown in major export markets, although domestic demand will recover somewhat as consumer and business sentiment improve.

Risks—As growth in industrialized countries softens, the major external risk is a sudden export slowdown that, given the economy’s high degree of economic openness, may seriously affect growth. Increasing competition from neighboring economies, especially the PRC, in key industries such as electronics may also lower production and exports. A key internal risk is increased political uncertainty from allegations of corruption of prominent political figures and issues relevant to the mainland in the run-up to parliamentary and presidential elections. This may erode consumer and business sentiment, depressing household spending and investment.

Policy Issues—Although policy rates were raised three times in 2006, mainly to limit capital outflows, overall monetary conditions loosened during the year, with the nominal effective exchange rate depreciating substantially, while the nominal interest rate remained generally stable at 1.5%–1.6%. However, with the general price level falling, real interest rates increased, reaching approximately 2.8% toward the end of the year. These trends suggest that loosening policy rates may help reverse the deflationary trend and stimulate private investment. To facilitate the pass-through effect on inflation, the government removed control over energy prices at end-September. On fiscal policy, the government is acting to broaden revenue sources, with the expected abolishment of an income tax exemption on civil servants, school teachers, and military personnel by end-2006 and an increase in the energy tax early next year. To reduce expenditures, the government announced that it would stop subsidizing housing loans once existing funds for that purpose are depleted. However, a plan to consolidate the fiscal deficit by 2011 could be difficult owing to pressures to increase social security spending to address income inequalities and the aging population.