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Securitizing IP – Consider Accounting Traps as Structure is Being Developed

BY ERIN GANNON APSTEIN AND ANDREW M. SROKA (BROWN RUDNICK)

Securitization presents an opportunity for reporting companies that own intellectual assets to achieve off-balance sheet treatment. Securitization provides a potential vehicle for realizing the value of unearned intellectual property royalties by allowing companies to move such assets and related liabilities off their balance sheets and to report the proceeds of the sale of such assets as income. Off-balance sheet financing improves a company's financial statements and key financial ratios. Additionally, securitization allows companies to establish performance objectives for their intellectual property portfolios, manage the realization risk of expected cash flows and obtain a lower cost of funds. Companies can achieve these benefits without losing any of their rights and benefits in the underlying trademarks, patents, and copyrights.

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Lands of Opportunity - Why Cayman and Delaware Entities Rule in Structured Finance

BY MARLA NORTON, KEITH PARNELL (THE BAYARD FIRM) AND JOHN WOLF (CAMPBELLS)

In recent years, both the Cayman Islands and Delaware have enjoyed steady increases in the number and sophistication of securitization transactions involving entities formed under their laws, due largely to their modern, flexible and business-friendly legal environments. Delaware has long been a favored domicile in US domestic transactions. Similarly, the Caymans have become a preferred jurisdiction for offshore securitizations. This article briefly examines some of the key characteristics of the entities most commonly used in each jurisdiction for structured finance and securitization deals.

A securitization transaction converts a pool of income-producing assets into marketable securities, such as notes, bonds or preference shares. In the simplest form of transaction, a special purpose, bankruptcy-remote issuer ("SPE") is formed to purchase receivables, corporate bonds, loan participations or other assets, which may include derivatives, the cash flow from which funds payments on the securities. The assets are generally pledged as collateral. Collateralized debt obligations ("CDOs") are a securitization structure in which sequential tranches of senior and subordinated debt are backed by a managed pool of underlying assets and/or derivatives.

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In the **UK**, legislation which will enable REITs to be created as of January 07 has caused many land rich companies such as retailers, hoteliers and leisure companies to consider whether to spin off their property assets into REITs. *Page 3*

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To achieve off-balance sheet treatment under Generally Accepted Accounting Principles ("GAAP"), the securitization must be structured to either comply with Financial Accounting Statement 140 ("FAS 140") or avoid Financial Accounting Standards Board ("FASB") Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"). In both cases, the transaction will also have to be characterized as a sale under the Emerging Issues Task Force Issue No. 88-18, *Sales of Future Revenues* ("EITF 88-18"). The applicability of either FAS 140 or FIN 46 depends on the nature of the securitized property. FAS 140 applies only to the transfer of financial assets while FIN 46 applies to non-financial assets as well. Given the nature of intellectual assets, most deals will need to be structured to avoid FIN 46.

There are many accounting rules that have to be overcome to obtain the benefits of off-balance sheet treatment in an intellectual property securitization.

Financial Accounting Statement 140

FAS 140 is the principal accounting standard governing the accounting for transfers of financial assets. In general, to be considered a financial asset, the asset must already be carried on a company's balance sheet. Although many intellectual property assets such as unearned copyright, patent and trademark royalties do not automatically fall under FAS 140, companies may still be able to take advantage of sale accounting treatment under FAS 140 if such assets have been converted into some form that permits them to be reflected under GAAP as an asset on the company's balance sheet. For example, FAS 140 will apply when the company's intellectual assets are held in a subsidiary and are reflected on the company's balance sheet as an asset.

To obtain off-balance sheet treatment under FAS 140, a company must surrender control over the financial assets being securitized to the extent consideration other than beneficial interests in the transferred assets is received in exchange. A company is deemed to have surrendered control if (i) the transferred assets are isolated from the company or transferor; (ii) the transferee (or, if the transferee is a qualified special-purpose entity, each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests); and (iii) the transferor or company does not maintain effective control over the transferred assets. Accordingly, FAS 140 will drive some of the terms and the structure of the securitization.

The transferred financial asset must be isolated, meaning that the transferred asset is presumptively beyond the reach of the transferor, creditors, a bankruptcy trustee and/or a receiver. Isolation is accomplished by (i) structuring the securitization so that the financial assets are transferred into a qualified special-purpose entity (a "QSPE") and (ii) receiving a True Sale and Non-Consolidation Opinion in connection with the transfer. The True Sale and Non-Consolidation Opinion provides the required evidence for an assertion in the financial statements that the transferred financial assets have been isolated.

Second, the financial assets must be transferred into a QSPE and its beneficial holders must have the right to pledge or exchange their interests. A QSPE is essentially a "brain-dead" special-purpose entity. To qualify as a QSPE, the limited liability company, statutory trust or other legal

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UK REITs - The Wait is Almost Over

BY ADRIAN LEVY AND DAVID SALEH (CLIFFORD CHANCE)

Introduction

It is often said that "good things come to those who wait". This certainly seems to be true for the UK real estate industry. For years it has been lobbying the Government for a liquid UK tax transparent vehicle and finally its patience has paid off. After extensive consultation legislation has been passed, in the form of the Finance Act 2006, that will see Real Estate Investment Trusts (REITs) enter the UK property scene as soon as January next year. These REITs will be exempt from UK corporation tax on rental income and capital gains, provided an entry charge is paid and certain conditions satisfied.

The UK is not exactly trail-blazing. The US and Australia have a well-established REIT market. The first US REITs came to market in the 1960s with the market really taking off in the 1990s. The US listed market now comprises approximately 195 REITs with a market value of circa $380 billion, whilst the Australian market comprises 53 REITs (known as listed property trusts) with a market value of circa A$104bn. Other jurisdictions also have REITs (or equivalent offerings) including Japan, France, Spain, Italy, Belgium, The Netherlands, Luxembourg, Turkey and some of the countries in Asia and the Pacific.

Many are speculating that REITs will change the face of the UK listed real estate sector, which in recent years has seen scores of companies taken private as share prices failed to reflect net asset value. Some anticipate that the advent of REITs will result in this sector doubling to over £100 billion in the next five years, with new listed companies coming to market and existing companies converting.

REIT Conditions

So what are the conditions that would allow a company to become a UK REIT? Broadly speaking the entity will need to be:

- a Company that is closed-ended (i.e. not an OEIC) with only one class of ordinary shares in issue (although non-voting fixed rate preference shares will also be permitted);
- tax resident in the UK and not dual tax resident in the UK and another jurisdiction; and
- listed on a recognized stock exchange, which in the context of the UK means the Official List (and not the Alternative Investment Market), but could also be certain overseas exchanges such as NASDAQ, the Luxembourg Stock Exchange, the Irish Stock Exchange and others.

The entity must not be;

- a "close company" (which is basically defined for tax purposes as a company that is controlled by five or fewer participants); or
- a party to a loan that carries profit linked, asset linked or excessive interest or that provides for repayment of an excessive amount.

The REIT will also need to satisfy certain conditions in relation to its business activities. It will need to:

- hold at least three properties, with no single property exceeding 40% of the fair value of the properties. For these purposes a property is treated as a single property if it is going to be rented out as a single unit, so, by way of example, a shopping centre would not be treated as one property - it would be treated as multiple properties. Any property occupied by the REIT will not count;
- derive at least 75% of its income from property rental. As a result of this condition property development companies will not be eligible for REIT status;
- hold 75% (in value) of its assets for property rental business. This is another reason why property development companies will not be eligible for REIT status; and
- distribute 90% of income profits (computed under tax not accounting rules) to shareholders annually. This is to be distributed by way of dividend (subject to any corporate law prohibitions).

REITs will need to be listed on a recognised stock exchange and so will need to be broadly held and suffer the associated cost and regulatory burden.

Furthermore, once a company has become a REIT there are two key limitations which, if breached, will result in it paying a "tax charge". First, if the REIT's gearing results in it exceeding the ratio of income profits of the tax-exempt business (before financing costs and capital allowances) to interest of 1.25, then there will be a tax charge on the amount of profit that causes the ratio to be exceeded. Second, if a person is beneficially entitled to 10% or more of the share capital, voting power or dividend entitlement of a REIT, and a dividend is paid to such shareholder, then a tax charge can be levied on the REIT.

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There has been some concern in relation to the 10% shareholder rule which, although it covers all shareholders, is only intended to prevent significant overseas shareholders claiming double tax treaty relief and thereby reducing the Treasury's take. In response to these concerns, the Treasury has clarified that a REIT may avoid the penalty if it takes "reasonable steps" to prevent paying a dividend to a substantial shareholder. Guidance Notes are expected on what will constitute these reasonable steps. The practical effect of the 10% shareholder rule is that significant shareholders will have to dividend strip and sell down their dividend entitlement. This will be inconvenient and add an additional cost to substantial shareholders. The 10% shareholder rule will also increase the compliance burden on property investment companies.

Some of the largest retailers, hoteliers and leisure companies have been looking at the structure and considering whether to spin off their property assets into REITs as an alternative to sale and leaseback arrangements that have been so popular over recent years.

Elective Process

A company does not automatically become a REIT. The company must serve a written notice on the UK Tax Authority (HMRC) before the beginning of the accounting period from which it wants to be treated as a REIT. REIT status generally continues (provided the "conditions relating to the company" are met) until the company serves a further written notice on HMRC terminating REIT status.

HMRC will however have the power to issue a notice disapplying REIT status from the end of a previous accounting period where the REIT has made repeated or serious breaches of the "conditions relating to the business" or has embarked on repeated or serious attempts at tax avoidance.

Entry Charge

Throughout the consultation process the Treasury has made it clear that it expects a fair level of taxation to continue to be paid by the real estate sector. So to achieve REIT status a company will need to pay an entry charge that will be collected in the same way as UK corporation tax. The entry charge will be 2% of the gross market value of the rental properties held by the REIT. The entry charge will be payable when a company elects to become a REIT although, at an increased overall cost, payment of the charge could be spread over 4 years (at the rate of 0.50%, 0.53%, 0.56% and 0.60%). If a REIT acquires a company that owns a property, a further entry charge will be payable based on the value of the property indirectly acquired.

Exit Charge

As well as an entry charge there can be financial implications on leaving the REIT regime which could be characterized as an "exit charge". Where a company elects to leave the REIT regime within 10 years of joining, and disposes of any property which was involved in its tax exempt business within 2 years of leaving, financial consequences may follow. Broadly, any uplift in the base cost of the property which occurred under the regime will be disregarded, which could potentially result in a higher capital gain or lower allowable loss than would otherwise be the case. In addition there will be no rebate of the entry charge in such cases.

Also, if a company leaves the REIT regime involuntarily within 10 years, HMRC have wide powers to direct how they are to be taxed, including in relation to the period during which they qualified as a REIT. HMRC's intention is to prevent companies from attaining a tax advantage by deliberately breaching a condition (for example by crystallizing a tax loss in a non tax-exempt environment).

Market Reaction

The UK real estate sector has reacted positively to the proposed REIT regime. Many of the concerns that existed a year ago have been put to rest and there is overwhelming relief that the entry charge was not pitched at a higher level or based on a percentage of contingent capital gains. On the day the draft legislation was announced, the share price for the listed real estate sector rose by approximately 10%. Since then a number of listed companies have stated that subject to reviewing the regulations and understanding the detailed risks, they will convert to a REIT. Such companies include some of the largest UK listed property companies, such as British Land plc, Land Securities plc and Hammerson plc.

The regime has also provided land rich companies with food for thought. Some of the largest retailers, hoteliers and leisure companies have been looking at the structure and considering whether to spin off their property assets into REITs as an alternative to sale and leaseback arrangements that have been so popular over recent years. Whether this route will prove useful will depend, in part, on a company's willingness to relinquish control of its property, and finding ways around the restriction that a REIT may not be owner-occupied (as defined by accounting standards) or occupied by a company whose shares are "stapled" to a REIT.

The new REIT regime is also being considered by the private equity market as an additional structure for realizing the real estate value of an investee company. Currently, private equity players in the UK make good use of the PropCo-OpCo structure, where the property ownership and operational activities of a company are separated into two enti-

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ties with the property owning company (the PropCo) ultimately being securitized or joint ventured. REITs could add a new dimension to this structure with a REIT taking the place of the PropCo.

Conclusion

Not withstanding the enthusiasm with which REITs have been greeted in the UK, they are not without certain drawbacks. REITs will need to be listed on a recognized stock exchange and so will need to be broadly held and suffer the associated cost and regulatory burden. There are technical difficulties with dividends from overseas subsidiaries not being tax exempt REIT income and the 10% shareholder rule is, at best, inconvenient. However, listed REITs will be an on-shore vehicle that is a welcome addition to some of the other existing tax transparent property owning structures. ❏

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vehicle must satisfy the following general conditions: (i) it must be demonstrably distinct from the transferor (i.e., transferor can only hold ninety percent (90%) of the fair market value of the beneficial interest ("beneficial interest" also includes the securitized debt issued by the entity) and cannot unilaterally dissolve the entity); (ii) its activities must be significantly limited and entirely specified in the legal documents; (iv) it can hold only passive financial assets and passive derivatives; and (iv) it can only sell or dispose of the transferred financial assets in automatic response to certain limited events or circumstances. Accordingly, to achieve off-balance sheet treatment in an intellectual property securitization, the organization documents as well as the transactional documents must be drafted in compliance with the QSPE criteria.

Lastly, the company or transferor cannot maintain effective control over the transferred assets. A transferor maintains effective control over the assets when there is an agreement entitling and obligating the transferor to repurchase or redeem the transferred financial assets from the transferee or where the transferor possesses the ability to unilaterally cause the return of the specific transferred assets. Therefore, the transfer documents governing the sale of the financial asset to the QSPE must not include repurchase rights or call rights (other than limited "clean-up" calls).

FASB Interpretation No. 46

FIN 46 emerged post-Enron and is now the principal accounting standard governing consolidation of special-purpose entities ("SPEs"). Pre-Enron, the accounting rules allowed companies to evade consolidating SPEs in their financial statements so long as the company did not hold a majority of the voting interests in the SPE. This held true even if the company was exposed to substantial losses incurred by the SPE. In response to companies' abusive use of off-balance sheet entities, FIN 46 changed the rules of consolidation from a bright-line voting interest test to a flexible three part test requiring a considerable number of judgment calls based on an analysis of the facts and circumstances of each case.

FIN 46 emerged post-Enron and is now the principal accounting standard governing consolidation of special-purpose entities ("SPEs").

The three part consolidation test requires that (i) the special-purpose entity be determined to be a variable interest entity; (ii) the company have a variable interest in the special-purpose entity; and (iii) the company be considered the primary beneficiary of the special-purpose entity. Although the rules appear to be relatively straightforward, FIN 46 is a very complex rule where the nuances of a transaction can likely cause it to fall into a gray area. As highlighted below, each condition will impact the structure of an intellectual property securitization.

FIN 46 provides that the "distinction between

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variable interest entities and other business enterprises is based on the nature and amount of the equity investment and the rights and obligations of the equity investors." Generally, a variable interest entity is an entity whose equityholders do not bear the hallmarks of typical equity investors because, for instance, (i) equity makes up a very small portion of the entity's capital structure, (ii) the equityholders do not have voting control of the entity or (iii) the equityholder's exposure to gains or losses is limited (i.e., it is guaranteed a fixed return). The purpose of this condition is to capture entities for which the traditional majority vote test would not be appropriate but which are otherwise controlled by another entity. In a typical securitization, the organizational documents of the SPE provide for independent directors with significant voting rights. It is possible that limiting the independent director's vote to certain circumstances may prevent the SPE from being considered a variable interest entity under FIN 46, but the presence of other factors could still cause the SPE to be treated as a variable interest entity.

The second condition looks to whether the company has a variable interest in the variable interest entity, i.e., the SPE. A variable interest is an ownership, contractual or other financial interest in the variable interest entity that fluctuates with changes in the fair market value of the variable interest entity's net assets. Since the equity investors in a variable interest entity may not have the same types of rights and obligations as typical equity investors, this condition aims to uncover those entities which through contract or otherwise are exposed to the gains and/or losses experienced by the variable interest entity. Thus, a variety of arrangements involving the SPE, including guarantees, subordinated loans and other contracts tied to the performance of the SPE, will each have to be analyzed. Securitizations of intellectual property will often provide for servicing agreements in which the transferring company is obligated to service the underlying assets and facilitate the transfer of royalties. The servicing agreement will need to be closely analyzed to avoid treatment as a variable interest.

Lastly, the reporting company must be considered the primary beneficiary of the SPE. FIN 46 describes a primary beneficiary as "the party that absorbs a majority of the variable interest entity's expected losses, receives a majority of its expected residual returns or both." In determining whether a company would be considered the primary beneficiary, FASB has emphasized that exposure to losses of the variable interest entity is the most important of the two factors. As a result, this condition requires looking at which company, whether an equity investor, guarantor or other contractually obligated party, is exposed to a majority of the SPE's potential losses. If the company transferring its intellectual property is deemed to have a variable interest in the SPE, the extent of company's exposure will need to be analyzed to determine whether the company will be treated as the primary holder of the variable interest and thus will be required to consolidate.

Emerging Issues Task Force Issue No. 88-18

In addition to satisfying FAS 140 or avoiding FIN 46, any intellectual property securitization must be structured to meet the requirements of EITF 88-18 to obtain sale (off-balance sheet) treatment. The purpose of EITF 88-18 is to gauge whether the risks and rewards of the transferred asset are actually being shifted to the buyer/SPE. EITF 88-18 creates the presumption of debt treatment rather than sale treatment where the entity receives cash from the investor in return for an agreement to pay to an investor income from, *interalia*, any intellectual property royalties, where certain factors are present. Factors which create a presumption of debt treatment, rather than sale, include: (i) minimum guaranteed payments to the investor with recourse to the seller or the collateral; (ii) the right of the seller to cancel the transaction by making a lump sum payment to the investor; (iii) caps on payments to the investors; (iv) receipt of payments by investors under a formula based on revenue rather than income; (v) short-term duration of the cash flow stream; (vi) variations in revenue having a "trifling impact" on investor's return; (vii) expected return to the investor approximating the seller's borrowing rate; and (viii) the legal form of the transaction being debt. Therefore, achieving off-balance sheet treatment or sale treatment requires the final structure of the securitization to avoid each of these "debt-factors."

The Big Picture

There are many accounting rules that have to be overcome to obtain the benefits of off-balance sheet treatment in an intellectual property securitization. Although accounting professionals will be necessary in the final analysis and accountants should be brought into the transaction early while the legal structures are being developed, a basic understanding of the applicable accounting rules will aid in making key business decisions in structuring the transaction. The added complexity of the accounting rules should not be a deterrent to reporting companies con-

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sidering taking advantage of securitizing their intellectual property assets; but some knowledge of the applicable accounting rules may prevent false starts and wasted efforts in developing intellectual property securitization transactions. ❑

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Structured Finance

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A number of factors drive the situs decision for the issuer. The most attractive domiciles offer a variety of entity forms adaptable to the needs of a particular deal, predictable legal outcomes and favorable tax treatment. Rating agencies generally require that the issuer and any SPE parent are insulated from the risk of substantive consolidation in the event of an affiliates' bankruptcy or insolvency. Finally, the parties seek high-quality, sophisticated local service providers to establish and manage the SPE. As discussed below, both Delaware and the Cayman Islands have successfully capitalized on the needs of the marketplace and become the optimal location for SPEs.

Delaware

Delaware's reputation as a preeminent jurisdiction for entity formation is well-deserved. Delaware alternative entities are popular for structured finance and securitization transactions, largely because of Delaware's policy to promote flexibility and freedom of contract, ensuring that Delaware entities can be adapted to a myriad of transactions. Rating agencies are familiar with Delaware entity laws and the legal opinions that Delaware lawyers can issue. Moreover, Delaware entity laws are continually updated to ensure that the legislation remains state-of-the-art and that market concerns (including rating agency concerns) are addressed as they develop.

Delaware is also appealing because it does not aggressively tax non-Delaware source income. Alternative entity statutes piggyback on federal tax rules, thus ensuring that the Delaware tax treatment will yield no surprises. Most alternative entities can issue interests without requiring a capital contribution.

The Delaware judiciary, particularly the Court of Chancery (a business and equity court), is well respected for its sophistication. A U.S. Chamber of Commerce annual poll of judges and lawyers has ranked Delaware courts as the best and fairest in the country for five consecutive years. In addition, the Delaware Division of Corporations (the "Division") strives to remain technologically advanced and customer-service oriented, offering expedited processing within hours.

A summary of the features and benefits of the Delaware entities most commonly-used in securitizations follows:

Delaware Statutory Trust

Delaware statutory trusts ("DSTs") are often used as issuers in securitization transactions. A DST is created pursuant to the Delaware Statutory Trust Act, 12 Del. C. 3801 et seq. (the "DST Act"). The DST Act (originally, the Delaware Business Trust Act) was drafted to ensure predictability of treatment and separate legal existence of issuers in deals previously using Delaware common law trusts. The DST Act acknowledges that a statutory trust need not conduct active business, thus ensuring that a passive trust nonetheless has entity status. Accordingly, a DST has the power to contract in its own right and to sue and be sued in its own name, and assets can be titled in the trust's name.

Both Delaware and the Cayman Islands have successfully capitalized on the needs of the marketplace and become the optimal location for SPEs.

A DST is formed pursuant to a governing instrument by filing with the Division a certificate of trust signed by all trustees. The governing instrument may be entitled "declaration of trust," or "trust agreement," or may be composed of several instruments (including bylaws) providing for the creation, governance and/or operation of the trust. The governing instrument is not publicly filed, so the only data of record is the name of the DST and the name and address of a Delaware resident trustee. Every DST (other than an investment company registered under federal securities laws) must have at least one trustee that is an individual residing in Delaware or an entity with its principal place of business in Delaware. A trustee that is not a natural person must also have appropriate trust powers. The Delaware trustee may actively manage the business and affairs of the trust, or may be a passive trustee, with management performed by an agent or a co-trust-

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ee. The DST Act confirms that a non-Delaware entity serving as a trustee of a DST need not qualify to do business in Delaware.

The DST Act permits a broad spectrum of protections and control mechanisms in a governing instrument. Many of the DST Act's provisions may be varied by contract, so the parties may arrange rights, priorities and obligations as appropriate within the boundaries of public policy. In the absence of an applicable provision in the DST Act or the governing instrument of a DST, general trust law serves as a "gap filler."

While management authority is vested in the trustee(s), a DST offers much greater governance flexibility than a common law trust. The governing instrument may authorize a beneficiary or other person to direct the trustee in management without becoming a de facto trustee or assuming liability to the trust or its beneficiaries. Finally, a trustee may delegate its authority to manage the business and affairs of the trust, by agreement or otherwise.

Delaware provides an income tax deduction to resident trusts for accumulated income to be distributed in future years to non-resident beneficiaries.

Neither beneficial owners nor trustees have personal liability for the obligations of the DST unless so specified in the governing instrument. While the DST Act does not adopt a standard of care for trustees or others managing the business and affairs of the trust, the Act exculpates a trustee or agent acting in good faith in reliance upon the terms of the governing instrument. Additionally, the DST Act permits the governing instrument to expand, restrict or eliminate the duties (including fiduciary duties) and liabilities of trustees and agents (except the implied duty of good faith and fair dealing) and acknowledges a DST's power to indemnify in accordance with the governing instrument.

The DST Act also permits a governing instrument to vary the rights and obligations of trustees and beneficiaries by class or series. A DST may segregate and protect assets associated with a series from the liabilities associated with other series or the trust generally. In order to insulate assets and related income from interseries liabilities, a DST's certificate of trust must contain specific disclosure language. The assets associated with each series must be held and accounted for separately from other property of the trust, with separate and distinct records being maintained for each such series. The DST Act provides little guidance on implementing these requirements, other than acknowledging that series assets may be held directly or indirectly through a nominee. The DST Act contains verbiage tailored to registered investment companies, to ensure that they comply with applicable law. The series provisions can ensure that, with proper structuring, the cash flow generated by a pool of income-producing assets remains dedicated to the obligations intended to be paid from that source.

From a tax-planning perspective, the classification for federal tax purposes controls the treatment of the DST for state and local tax purposes. Accordingly, the parties structuring a transaction can determine whether the DST should be taxed as a corporation, a partnership or a trust (including a grantor trust) in reliance upon the advice of their U.S. federal tax advisor without concern about inconsistent state tax treatment. Delaware provides an income tax deduction to resident trusts for accumulated income to be distributed in future years to non-resident beneficiaries.

Various provisions of the DST Act support use of a DST as a bankruptcy-remote SPE. By adopting perpetual life as the default term, the DST Act eliminates concerns about the "rule against perpetuities," which required complicated drafting to avoid the trust's invalidation under common law principles. In addition, under the DST Act, no person may cause the termination or revocation of a DST in violation of the governing instrument, and the creditors of beneficial owners or trustees (in their individual capacities) have no recourse to the assets of the DST for claims unrelated to the trust. The death, incapacity, dissolution, termination or bankruptcy of a beneficial owner does not cause the dissolution or termination of the DST. Because the trustee is generally unrelated to the sponsor and its affiliates, eliminating control by the sponsor or its affiliates helps a nonconsolidation analysis. Finally, while a "business trust" is an eligible debtor under federal bankruptcy law, a DST not actively conducting a trade or business may not satisfy the definition of a "business trust" under federal law, thus further insulating the DST from bankruptcy risk

Limited Liability Company

The Delaware limited liability company ("DLLC") offers limited liability and unparalleled structuring flexibility. Like the DST Act, the Delaware Limited Liability Company Act ("LLC Act") provides default rules applicable when the LLC agreement is silent, but permits the parties to contractually alter most standards applicable to the DLLC's internal affairs. The agreement binds the DLLC, even if it is not a party.

A DLLC is formed by filing a certificate of formation with the Division and adoption of an LLC agreement. The public filing must include only the name of the DLLC and the name and address of its agent for service of process. The LLC agreement is not filed, ensuring that deal terms can be easily altered and that the terms of nonpublic deals remain private.

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Management and operational matters are determined by the LLC agreement. There are no eligibility limits for members (i.e., owners) of DLLCs, except by contract. No members, managers, place of business or records need be in Delaware.

Unless the LLC agreement states otherwise, a DLLC is managed by its members in proportion to their interests in profits. However, members may delegate some or all of their authority to one or more managers. The parties must contractually address the authority of the managers, including the manner of exercising such powers. A manager has the power to delegate its authority to agents, officers and employees, as permitted by the agreement. No member, manager or agent has liability for DLLC debts or obligations, unless otherwise agreed. Similarly, members, managers and agents are protected for good faith reliance on the LLC agreement. The agreement may expand, restrict or eliminate common law duties (including fiduciary duties) other than the implied duty of good faith and fair dealing. DLLCs also have broad inherent indemnity powers, subject to the LLC agreement terms.

A DLLC may have separate series of members, managers or interests, and may limit interseries liabilities similarly to a DST provided that notice of this limitation is disclosed in the certificate of formation, separate and distinct records are maintained and the assets are segregated.

For Delaware tax purposes, a DLLC is treated as a partnership unless it is regarded differently for federal income tax purposes, in which case the federal classification controls. U.S. federal law currently taxes a DLLC as a partnership, unless the DLLC elects corporate tax treatment. Partnership tax treatment results in items of income, gain, deduction, credit and loss being passed through to the members. The State of Delaware imposes nominal annual fees on DLLCs.

Several unique features of the Delaware LLC Act afford comfort to rating agencies that the DLLC will withstand attack by creditors of other parties. A judgment creditor of a member cannot execute upon the member's interest in a DLLC. A member's creditor can only obtain a charging order, which entitles the creditor to distributions to which the member would have been entitled in respect of its interest. The creditor cannot compel a distribution or exercise remedies with respect to the assets of the DLLC.

The LLC Act's dissolution provisions preserve the integrity of the deal structure should an affiliate suffer a disabling event. A DLLC has perpetual existence unless the LLC agreement provides otherwise. In addition, unless otherwise agreed, the death, incapacity, dissolution, bankruptcy or termination of a member does not dissolve the DLLC, unless it terminates the membership of the last remaining member. The parties can draft to prevent or cure the unintended dissolution of a DLLC, leading to the evolution of several rating agency-approved drafting approaches providing for the automatic admission of a member.

U.S. federal law rather than state law controls which entities are eligible for bankruptcy protection. An LLC agreement can provide that a bankrupt or insolvent member is not disqualified from membership. DLLCs used in structured finance transactions are typically structured with one or more independent managers, whose participation is required in order for the entity to voluntarily seek bankruptcy protection or implement certain other changes to the DLLC or LLC agreement. This mechanism has been upheld and enforced in the few litigated cases involving such provisions.

The Cayman Islands

Cayman Islands law is based on English common law; as a result it is appealing not just to U.S., U.K. and Canadian parties, but also more broadly due to the general acceptability of English common law in international business transactions. Additionally, the Cayman Islands has developed an overlay of progressive, business-friendly statutes resolving problematic features of English common law. For instance, the law concerning directors' responsibilities and corporate capacity is analogous to English common law, but restrictions on share capital, particularly regarding the return of capital, have been substantially relaxed.

The Cayman Islands is tax neutral (there is no income tax, capital gains tax or corporation tax). Furthermore, to ensure that Cayman Islands entities, once established, will remain free from taxation the Cayman Islands government will issue a tax exemption certificate guaranteeing freedom from taxation for a period normally exceeding the life of the transaction (see below as to details). Likewise, there are no foreign exchange controls and there is no particular form required for financial statements, so parties may choose the most appropriate accounting standards.

The Cayman Islands are a creditor friendly jurisdiction. There is no equivalent to U.S. bankruptcy protection, reorganization, or administrative receivership. Cayman Islands insolvency proceedings do not interfere with the rights of secured creditors. Rights of contractual subordination, contractual netting and set off are statutorily confirmed, both prior to and after insolvency, ensuring that the rank-

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To ensure that Cayman Islands entities, once established, will remain free from taxation the Cayman Islands government will issue a tax exemption certificate guaranteeing freedom from taxation for a period normally exceeding the life of the transaction.

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***Lands of Opportunity*, from Page 9**

ing of senior and junior debt and the integrity of payment waterfalls will be enforced.

Rating agencies are comfortable with Cayman Islands entities and the required associated legal opinions. Standard & Poor's has published structured finance criteria for Cayman Islands special-purpose entities. An added attraction is the Cayman Islands Stock Exchange ("CSX") with streamlined rules for listing CDOs and exempted company preference shares. Since the U.K. Board of Inland Revenue granted the CSX status as a "recognized stock exchange," companies with securities listed on the CSX can pay interest on their securities without deduction of U.K. tax pursuant to the "Eurobond Exemption."

Below is a summary of the benefits and characteristics of commonly-used Cayman entity forms:

Cayman Islands Exempted Company

The Cayman Islands exempted company is a corporate entity that generally serves as the issuer in a securitization. An exempted company can be established under the Companies Law within one working day by filing memorandum and articles of association with the Registrar of Companies. No statutory minimum capital is required. The register of shareholders need not be held in the Cayman Islands, although doing so avoids the risk that the jurisdiction in which the register is maintained will interfere with the rights or priorities of shareholders.

Several unique features of the Delaware LLC Act afford comfort to rating agencies that the DLLC will withstand attack by creditors of other parties.

Proper structuring ensures that the SPE issuer's assets and liabilities are excluded from the originator's balance sheet. The traditional method is for the SPE issuer's shares to be held by a Cayman Islands trustee under a charitable trust. Alternately, to provide greater structuring flexibility, Cayman Islands law has developed a unique vehicle known as a "STAR Trust," which permits use of residual profit for the benefit of noteholders while ensuring off-balance sheet treatment.

Experienced company managers or corporate administrators are available in the Cayman Islands to provide independent directors to ensure that SPEs are independently managed and controlled from the Cayman Islands. This helps preserve the integrity of the structure and ensure that the SPE is not consolidated with the originator.

A tax-transparent SPE known as an exempted limited duration company may be created. Two of its defining characteristics are that it is required to have at least two members and its duration is limited to a maximum of 30 years. An exempted limited duration company qualifies for pass-through treatment for U.S. tax purposes.

Typically, the exempted company applies for and secures an undertaking from the Cayman Islands Government that it will remain exempt from income tax, capital gains tax or corporation tax for a period of 20 years (with a possible 10-year extension). Although the Cayman Islands imposes stamp duty, duties can be avoided by keeping the original documentation outside the Cayman Islands. Even where stamp duty applies, for instance, when original documentation is brought to or executed within the Cayman Islands, it is normally capped at relatively low levels.

Exempted companies are popular in CDO transactions due to favorable provisions of the Companies Law. Following an FASB ruling denying off-balance sheet treatment where the junior tranche is a debt instrument, parties began structuring CDO issuers as exempted companies issuing redeemable preference shares as the junior tranche. These subordinated preference shares have traditional equity features, but are redeemable from capital, provided the company is solvent. However, two recent European initiatives, the Prospectus Directive and the Transparency Directive which place additional burden on issuers of preference shares, may cause the reversal of this trend in Europe.

Cayman Islands Limited Partnership

A Cayman limited partnership is another tax-transparent issuer sometimes used as an alternative to an exempted limited duration company, for instance, where the applicable tax laws of another jurisdiction do not recognize or afford the desired treatment to a limited duration company. A limited partnership is constituted by agreement between one or more general partners (with unlimited liability for the obligations of the limited partnership) and one or more limited partners (with limited liability). Limited partnerships may be either a limited partnership registered pursuant to the Partnership Law ("CLP") or an exempted limited partnership registered pursuant to the Exempted Limited Partnership Law ("ELP"). Certain factors influence which is preferable in a particular transaction. Examples follow. If the partnership will be tax resident in the U.K., the Inland Revenue has recognized a CLP as qualifying for tax transparent treatment, but the treatment of an ELP is less clear. However, an ELP may apply to the Cayman Islands Government for an undertaking that it will remain free of income tax, capital gains tax or corporation tax for a 50-year period. Also, a limited partner in an ELP may play a greater role in managing the ELP than its counterpart in a CLP. Finally, while return of capital is permitted in a solvent ELP not rendered insolvent as a result of the payment, a limited partner in a CLP may not draw or receive return of any part of his contribution during the life of the partnership.

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A limited partnership, whether a CLP or an ELP, is managed exclusively by the general partner. The general partner is typically a corporate vehicle specially formed for the purpose of acting as general partner, such as a Cayman Island exempted company or a foreign limited liability entity registered in the Cayman Islands.

The Cayman Islands Exempted Trust

A Cayman Islands exempted trust is advantageous where investors and the originator will have an interest in the asset pool. Notably, a Cayman Islands trust is not a separate legal entity; consequently, all documentation is executed by the trustee, in its capacity as trustee for the trust. To deny noteholders and other involved parties recourse to the trustee's assets, the documentation must contain language limiting recourse for trust obligations to the assets of the trust.

To form an exempted trust, the trustee, generally a Cayman Islands corporate trustee licensed pursuant to the Banks and Trust Companies Law, executes a trust deed, declaring a trust over certain assets in favor of the unit holders. The resulting "unit trust" then becomes an exempted trust by registering with the Registrar of Trusts. An exempted trust, like an exempted limited partnership, may apply to the Cayman Islands Government for an undertaking that it will remain free of income tax, capital gains tax or corporation tax for a 50-year period.

Conclusion

The foregoing factors make Delaware and Cayman Islands entities superior choices in structured finance and securitization transactions. As long as they continue to remain on the cutting edge, improving and innovating their entity laws, these jurisdictions will continue to predominate in the jurisdictional competition for structured finance transactions. ❑

The foregoing factors make Delaware and Cayman Islands entities superior choices in structured finance and securitization transactions.

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Taxation

Structuring Implications of the New Double Tax Arrangement Between Mainland China and Hong Kong

BY ERNST & YOUNG CHINA

Hong Kong has been the main source of foreign direct investments into Mainland China, implying that most foreign investors hold their mainland subsidiaries and operations through Hong Kong companies. This phenomenon runs counter to a pure tax analyses, which suggests places like Mauritius or Barbados are better choices due to tax treaty benefits. However, Hong Kong offers many other advantages, such as proximity to operations and logistic efficiency that override tax treaty considerations.

The new or extended double taxation arrangement ("the Arrangement") signed on August 21, 2006 between Hong Kong Special Administrative Region ("Hong Kong") and the Mainland ("China") goes further to reinforce the position of Hong Kong as the gateway to China; it is also a reemphasis of Hong Kong's advantage for firms on the Mainland looking for opportunities overseas. This note looks at its structuring implications for inbound activities.

On Flows of Know-How and Capital (Including Equities, Loans, Properties)

The more noticeable benefits of the Arrangement are reduction or exemption of withholding tax on dividends, interest, royalties and capital gains.

Dividends received by foreign investors from a foreign invested enterprise are now tax exempt in China. If this exemption is uplifted, Hong Kong incorporated recipients of such dividends are only subject to 5% withholding tax, while unincorporated recipients, 10%, as compared to the standard rate of 20% and most other treaty rates of 10%.

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Structuring Implications, from Page 11

Withholding tax on interest and royalties is reduced to 7% in general, where such income is not connected with a permanent establishment in China. Note that interest is defined as income from debts-claims of every kind; accordingly, premiums, prizes attaching to securities and profits attributed to hybrid loans are all interest by definition. Also royalties are broadly defined to cover payments of any kind for the use or right to use of a wide spectrum of intellectual properties and know-how.

There are in effect transfer pricing provisions in the Arrangement relating to interest and royalties. The provisions govern the allocation of taxing rights between China and Hong Kong where such payments are made between parties with a "special relationship" but not made in accordance with the arm's length standard. An adjustment would be made to determine what would have been an arm's length payment and the corresponding "excess part". The arm's length payment and the excess part are then taxed according to respective domestic rules.

The literal interpretation of Article 13 with the assistance of Article 3 suggests gains from the disposal of shares in any body corporate whose assets are comprised mainly, directly or indirectly, of immovable property in China.

The taxation of capital gains is more complex in that the nature of property first must be identified for determining the effect of the Arrangement. For the purpose of the Arrangement, properties are classified as follows:

1. Immovable property (in China);
2. movable property that forms part of a permanent establishment (in China);
3. means of transport including ships, aircraft, land transport and pertaining movable properties (probably used in and outside China);
4. shares in a company whose assets comprise mainly, directly or indirectly, immovable property (in China);
5. a non substantial (less than 25%) holding of shares in a company (in China and companies mentioned in 4 excepted);
6. other properties not mentioned above.

Gains made by a Hong Kong resident from the disposal in China of assets in categories 1, 2, 4 are taxable in China. The right to tax gains from the disposal of assets in categories 3, 5 and 6 is allocated to Hong Kong. Since Hong Kong does not tax capital gains, it is most likely such gains are not taxable in both jurisdictions.

Complexities Relating to Gains from Sale of Shares

When structuring the above flows, one must pay particular attention to the following matters: (1) the existence of a permanent establishment; and (2) flows involving properties in categories 4 and 5. We shall deal with the issue of permanent establishment later. Let's firstly look at issues relating to the sale of properties in categories 4 and 5.

Shares in Companies Holding Immovable Properties

Article 13, paragraph 4 states:

"Gains derived from the alienation of shares in a company the assets of which are comprised, directly or indirectly, mainly of immovable property situated in One Side (i.e. China, in the context of this note) may be taxed in that Side (i.e. China)"

Article 3, under General Definitions:

"the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes"

The literal interpretation of Article 13 with the assistance of Article 3 suggests gains from the disposal of shares in any body corporate whose assets are comprised mainly, directly or indirectly, of immovable property in China are taxable in China. In other words, it does not matter whether the body corporate is a company incorporated in China or outside China; and it does not matter how the corporate relations are formed as long as the interest in such shares relates ultimately to immovable properties situated in China.

If the Chinese tax authorities pursue the above line of argument, gains from a sale of shares in any companies, including foreign companies, indirectly holding immovable properties in China are taxable in China, enforcement issue aside. One logical response to this conclusion is foreign investors should never use a Hong Kong company to hold shares in a company that in turn owns however indirectly immovable properties in China as primary assets; it is because this issue arises from the interpretation of Article 13 of the Arrangement.

This response is problematic in two respects: one, similar provisions exist in most other double tax arrangements China has entered into; two, even for a company formed in a jurisdiction that does not have double tax arrangement with China, China may still claim that gains from the sale of such shares are China sourced under the usual territorial principle. The question then is whether China can enforce the claim. With immovable properties in China, that should provide sufficient nexus for enforcement.

This is a matter property funds or real estate investment trusts ("REIT") designed to invest in and hold properties in China should clarify.

Shares of Non Substantial Holding in a Company (below 25%)

When announcing the signing of the Arrange-

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ment, the Hong Kong SAR Government states in the announcement:

> *"The taxing right for gains received by a Hong Kong resident or a Hong Kong business from the transfer of shares in a Mainland enterprise is allocated exclusively to Hong Kong. If the income does not amount to a trading receipt or is not sourced in Hong Kong, no profits tax will be charged in Hong Kong."*

The announcement continues:

> *"In the case where...the shares transferred are equal to or exceed 25% of the shareholding of the Mainland enterprise, the income may be taxed in both jurisdictions. However, a tax credit arrangement will effectively ensure that the same income will not be taxed twice."*

Wording in the above announcement does not correspond exactly to Article 13, paragraph 5 of the Arrangement, which reads:

> *"Gains derived from the alienation of shares, other than the shares referred to in paragraph 4 (see above), of not less than 25% of the entire shareholding of a company which is a resident of One Side (i.e. China in the context of this note) may be taxed in that Side (i.e. China).*

It appears Paragraph 5 is to benefit the holding of a portfolio of shares in companies in China; typically such investments involve non substantial holdings. The line of demarcation is set at 25% of the entire shareholding of a company.

However, the language of paragraph 5 appears to have given investors argument for a greater advantage; that is, the threshold of 25% applies to the quantity of shares being alienated. Accordingly, one may avoid the tax on gains by disposing of a substantial holding of shares piecemeal. This argument is actually supported by wording used in the above announcement.

Nevertheless, as we understand it, at least some Chinese tax officials resist this interpretation on the basis that it was not the intention of the provision which refers to alienation of "shares of not less than 25% of the entire shareholding of a company". No wording used in the Arrangement (both in the Chinese and in the English version) refers to "shares transferred" which is the wording used in the announcement.

Permanent Establishment

Permanent establishment ("PE") is one of the most difficult concepts in international taxation. The main questions one should look at in this respect include: how a PE may come into existence as a result of the cross border flows of capital, goods, personnel and associated activities; whether a transaction is connected with a PE if its existence does occur; how income from a transaction is attributed to the PE; and how tax liability is determined and settled.

The application of the PE concept is even more difficult in the context of Hong Kong and Mainland cross border business because a large number of such business are carried out in the form of hybrid structures, being a combination of foreign entities and domestic entities, involving a large number of people with dual residence. Complexities in this regard are dealt with under Article 4 (Residence) and Article 5 (PE) and Article 7 (Business Profits) of the Arrangement.

On dual residence, Article 4 uses a number of concepts to clarify the status of a person including permanent home, center of vital interests, habitual abode and place of effective management which is also regarded as PE by definition.

Definition, Inclusions and Exclusions

On PE, Article 5 defines it as a "fixed place of business" through which the business of an enterprise is wholly or partly carried on. It should be noted from the outset that despite this definition, a fixed place of business may not give rise to a PE due to exclusions in paragraph 4 and a place not normally considered fixed can be a PE by way of inclusions in paragraphs 2 and 3. Paragraphs 5 and 6 discuss the circumstances in which agents are or are not treated as PE of the principal. In general, non exclusive independent agents acting in the course of normal business escape the charge. These provisions have significant implications for cross border structuring.

Determination of Profits

On the extent of liability, Article 7, paragraph 1 says, a Hong Kong enterprise carrying on business through a PE in China is only taxable to the extent its profits are attributable to the PE. In determining the quantum of attributable profits, for a long time, as a matter of practice, PE is generally taxed on a deemed profit basis. At times, this may be favorable where a taxpayer can by way of negotiation obtain a low deemed profit rate or a generous proxy for a small tax base. However, a proxy based deemed profit tax does not allow taxpayer to obtain the full benefit of tax deductible expenses such as interest and does not allow tax losses. One problem of this practice is that the result of negotiation is often not well documented and hence subject to reopening, a risk that taxpayers may not like to live with.

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One may avoid the tax on gains by disposing of a substantial holding of shares piecemeal.

The application of the PE concept is even more difficult in the context of Hong Kong and Mainland cross border business because a large number of such business are carried out in the form of hybrid structures, being a combination of foreign entities and domestic entities, involving a large number of people with dual residence.

Structuring Implications, from Page 13

Paragraph 3 makes it clear that a PE may choose to be taxed on a net income basis, allowing expenses incurred in and outside China for the purpose of the business of the permanent establishment. In general, however, the mutuality principle applies to disallow internal charges except for banking enterprises. This is not unfair and can be managed with well reasoned and documented inter-company, as opposed to intra-company charges.

The more noticeable benefits of the Arrangement are reduction or exemption of withholding tax on dividends, interest, royalties and capital gains.

Reviewing Practice of Hybrid Structures

Paragraph 4 provides a most interesting element: allowing profits attributable to PE to be determined by apportioning the total profits of an enterprise and most importantly, the result of such apportionment should be in accordance with principles in Article 7. This must be referring to, in the main, the principle in Paragraph 2, which is in effect the arm's length principle.

> *"...there shall in each side be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

This is an important departure from a long established practice, closely guarded by the Hong Kong Inland Revenue. The Hong Kong Revenue has been taxing HK-Mainland hybrid structures on a profit apportionment basis but apportionment can only be made on a 50/50 basis irrespective of the proportion of activities and resources deployed in Hong Kong and on the Mainland. While this broad brush approach to apportionment is arguably time-saving, it is not necessarily cost-saving from the taxpayers' perspective. And, more importantly, it is not necessarily economically optimal; it is because attributing one-half of the total profits to a small operation would result in exceptionally high effective tax burden on the small operation. The result is economic distortion and involuntary capital shift resulting in unnecessary destruction of jobs. We therefore applaud the change.

This change calls for all enterprises using hybrid structures for conducting cross border operations to reevaluate this option. On one hand, the Hong Kong profits tax filing position should be revisited to determine what could be the result of an economically rational apportionment that reflects the arm's length principle. On the other hand, the current tax filing position on the Mainland should also be reviewed considering the effect of a net income based PE assessment. One should also anticipate that the Mainland tax administration may become more assertive applying the net income based assessment, given the provisions on exchange of information in the Arrangement.

It is advisable to have the review done before the enactment of the integrated corporate income tax law, which may take place in early 2007 while implementation is speculated to be in 2008. It is because under the current foreign enterprise income tax regime, foreign investors including Hong Kong operators have a better chance of preserving their favorable China tax positions under the hybrid structure.

General & Special Advantages of the Arrangement

To conclude, we would highlight a number of advantages offered by the Arrangement. In general, the generously low withholding tax rates provided by the Arrangement make Hong Kong a favorable choice as a base for managing the flows of capital, know-how and creativity between Hong Kong and Mainland China. As Hong Kong is an open economy that does not tax capital gains and offshore investment income with very limited transaction tax exposure, Hong Kong is uniquely positioned as gateway to China for the rest of the world.

The Arrangement also offers special advantages to certain industries, using Hong Kong as a base to hold and manage investments and operations in China.

In particular, the logistics industry enjoys complete exemption from income tax of profits from the operation of ships, aircraft and land transport vehicles and the exemption extends to profits derived from partnership, joint venture and international agency. As mentioned above, capital gains from the disposal of transport assets are also tax exempt in China. The territorial based Hong Kong profits tax, capital gains exemption and accelerated depreciation would provide further advantag-

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es to a Hong Kong based structure for cross border logistics operations.

While the intended effect of the Arrangement on the sale of shares in a Chinese company need clarification, it is clear that gains from the sale of portfolio shares of non substantial holding are not taxable in China and in Hong Kong. This tax advantage makes Hong Kong possibly the best place as the base for managing funds and assets in China, considering Hong Kong's proximity to the investments and Hong Kong's excellent infrastructure in this regard. One thing fund managers should find out is whether gains from sale of shares and securities in an offshore REIT are subject to tax as income sourced in China, as explained.

Finally, the effect of remodeling the practice of taxing PE in China should not be underestimated. The Arrangement provides generous exclusions to what may constitute a PE. Together with rules on determination of income attributable to a PE and Hong Kong's unique cross border operational capability, structuring transactions and operations through a Hong Kong entity is a choice no planners can ignore. ❑

All enterprises using hybrid structures for conducting cross border operations need to reevaluate this option.

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Foreign Exchange

Foreign Exchange Rates and Forecasts for the Asia/Pacific Region

CURRENCY FORECASTS ©
AND THE ECONOMIST INTELLIGENCE UNIT

(Editor's Note: This is a consensus forecast of 60 corporate treasurers.)

Australia

The Australian dollar averaged around A$1.34:US$1 in the first half of 2006. There has been a strengthening of the currency in recent months, however, with an exchange rate of around A$1.30:US$1 prevailing in early September. The trade-weighted index of the Australian dollar has also firmed in recent months. Because of this, we have revised our forecast for the 2006 annual average exchange rate to A$1.34:US$1 (from our previous forecast of A$1.36:US$1). However, the currency is still likely to weaken again in 2007, to an average of A$1.38:US$1. By historical standards the Australian dollar exchange rate has been remarkably stable so far in 2006, but a number of factors—notably light trading volumes in the Australian dollar, its links to commodity prices, vulnerability to shifts in global sentiment and the large current-account deficit—will continue to make the currency susceptible to sharp short-term movements. Some short-term volatility could also arise from the normalization of monetary policy now under way in Japan. Japanese investors have been keen investors in uridashi bonds—bonds issued in Japan (where interest rates have remained ultra-low for some years now) but denominated in high-yielding currencies such as the Australian dollar. These bonds may become less attractive as Japanese interest rates begin to rise.

Australian Dollar	2006	2007	2008	2009	2010
Av'g. units per $	1.34	1.38	1.46	1.52	1.54
Nominal appreciation (%)	– 2.1	– 3.0	– 5.3	– 4.1	– 1.3
Real appreciation (%)	– 1.0	– 2.6	– 5.7	– 4.4	– 1.6
Units per $ (end period)	1.34	1.41	1.48	1.54	1.54
Av'g. units per €	1.68	1.88	1.95	1.96	1.94
Nominal appreciation (%)	– 3.0	– 10.7	– 3.5	– 0.8	1.2
Real appreciation (%)	– 1.5	– 10.0	– 3.0	0.0	1.9
Units per € (end period)	1.75	1.93	1.95	1.95	1.94
Av'g. units per ¥100	1.23	1.28	1.38	1.45	1.48
Nominal appreciation (%)	– 8.2	– 4.1	– 6.6	– 5.0	– 2.2
Real appreciation (%)	– 4.7	– 1.5	– 5.0	– 3.3	– 1.0
Units per ¥100 (end period)	1.24	1.32	1.40	1.47	1.48
Real effective exchange rate (1997=100)	98.1	105.6	109.7	108.6	99.9

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Rates and Forecasts, from Page 15

Chinese Renminbi Yuan	2006	2007	2008	2009	2010
Av'g. units per $	8.0	7.7	7.6	7.4	7.4
Nominal appreciation (%)	2.7	3.4	1.8	1.9	0.9
Real appreciation (%)	1.5	3.2	1.4	1.8	1.2
Units per $ (end period)	7.8	7.6	7.5	7.4	7.3
Av'g. units per €	10.0	10.5	10.1	9.6	9.3
Nominal appreciation (%)	1.8	– 4.8	3.8	5.4	3.6
Real appreciation (%)	1.0	– 4.7	4.3	6.4	4.8
Units per € (end period)	10.2	10.5	9.9	9.4	9.3
Av'g. units per ¥100	7.3	7.2	7.2	7.1	7.1
Nominal appreciation (%)	– 3.7	2.2	0.4	0.9	0.0
Real appreciation (%)	– 2.2	4.3	2.2	2.9	1.9
Units per ¥100 (end period)	7.2	7.2	7.1	7.1	7.1
Real effective exchange rate (1997=100)	94.9	92.4	92.1	94.4	92.7

Hong Kong Dollar	2006	2007	2008	2009	2010
Av'g. units per $	7.8	7.8	7.8	7.8	7.8
Nominal appreciation (%)	– 0.1	– 0.1	– 0.1	0.0	0.0
Real appreciation (%)	– 0.6	– 0.1	– 0.6	– 0.6	– 0.4
Units per $ (end period)	7.8	7.8	7.8	7.8	7.8
Av'g. units per €	9.8	10.6	10.4	10.1	9.8
Nominal appreciation (%)	– 0.9	– 8.0	1.7	3.5	2.6
Real appreciation (%)	– 1.1	– 7.7	2.2	3.9	3.1
Units per € (end period)	10.2	10.7	10.3	9.9	9.8
Av'g. units per ¥100	7.2	7.2	7.4	7.4	7.5
Nominal appreciation (%)	– 6.3	– 1.2	– 1.5	– 0.9	– 1.0
Real appreciation (%)	– 4.2	1.0	0.1	0.5	0.2
Units per ¥100 (end period)	7.2	7.3	7.4	7.5	7.5
Real effective exchange rate (1997=100)	84.3	78.6	77.1	75.6	72.1

Indonesian Rupiah	2006	2007	2008	2009	2010
Av'g. units per $	9,324	9,416	9,617	9,842	10,080
Nominal appreciation (%)	4.1	– 1.0	– 2.1	– 2.3	– 2.4
Real appreciation (%)	15.0	3.4	– 0.5	– 1.2	– 1.6
Units per $ (end period)	9,420	9,416	9,715	9,936	10,174
Av'g. units per €	11,703	12,830	12,862	12,720	12,701
Nominal appreciation (%)	3.2	– 8.8	– 0.3	1.1	0.2
Real appreciation (%)	14.4	– 4.4	2.4	3.3	1.9
Units per € (end period)	12,293	12,901	12,775	12,569	12,843
Av'g. units per ¥100	8,575	8,759	9,072	9,373	9,692
Nominal appreciation (%)	– 2.4	– 2.1	– 3.4	– 3.2	– 3.3
Real appreciation (%)	10.8	4.6	0.3	– 0.1	– 1.0
Units per ¥100 (end period)	8,682	8,842	9,209	9,508	9,783
Real effective exchange rate (1997=100)	86.7	82.4	81.5	104.2	110.4

Indian Rupee	2006	2007	2008	2009	2010
Av'g. units per $	45.5	46.5	47.0	47.5	48.0
Nominal appreciation (%)	– 3.1	– 2.2	– 1.1	– 1.1	– 1.0
Real appreciation (%)	– 0.2	0.1	0.4	0.4	0.5
Units per $ (end period)	46.0	46.8	47.3	47.8	48.3
Av'g. units per €	57.1	63.4	62.9	61.4	60.5
Nominal appreciation (%)	– 3.9	– 9.9	0.8	2.4	1.5
Real appreciation (%)	– 0.7	– 7.5	3.2	5.0	4.0
Units per € (end period)	60.0	64.0	62.1	60.4	60.9
Av'g. units per ¥100	41.8	43.3	44.3	45.2	46.2
Nominal appreciation (%)	– 9.1	– 3.3	– 2.4	– 2.0	– 2.0
Real appreciation (%)	– 3.9	1.2	1.1	1.6	1.1
Units per ¥100 (end period)	42.4	43.9	44.8	45.7	46.4
Real effective exchange rate (1997=100)	102.8	102.1	106.4	105.3	100.6

China

In July 2005 the People's Bank of China (PBC, the central bank) adopted a new exchange-rate regime for the renminbi, scrapping its peg to the US dollar and replacing it with a managed float. The initial central point against the US dollar was set at Rmb8.11:US$1. Since then the renminbi has appreciated only modestly, and the exchange rate stood at Rmb7.97:US$1 on August 24th 2006. The PBC is reported to be in favor of a faster rate of appreciation, but other forces in government are concerned that such a move could have a negative impact on the crucial export sector, as well as increasing pressures on China's farmers by making agricultural imports cheaper. Given the deepening concerns about excessively rapid GDP growth, the rate of appreciation is expected to accelerate in the second half of 2006. The exchange rate is expected to reach Rmb7.82:US$1 by the end of the year, and to average Rmb7.98:US$1 in 2006. Exchange rate volatility will also increase as the PBC encourages firms to become more aware of exchange rate risk. Against a background of continued strong current- and capital-account surpluses, the rate of appreciation is forecast to strengthen in 2007, with the exchange rate averaging Rmb7.72:US$1 in that year.

Hong Kong

No changes in the Hong Kong dollar's peg to the US dollar are expected during the forecast period. In the wake of the July 2005 revaluation of China's renminbi, the Hong Kong Monetary Authority (HKMA, which performs some of the functions of a central bank) reaffirmed its commitment to the peg, and the currency has since continued to trade within the HK$7.75-7.85:US$1 range permitted under a revision of the exchange-rate mechanism introduced in May 2005. The revaluation of the renminbi was minor in scope, and our forecast is that the Chinese currency will firm to an average of Rmb7.72:US$1 in 2007 from the pre-revaluation rate of Rmb8.28:US$1. Our central assumption is that Hong Kong's large foreign-exchange reserves, supplemented by its substantial fiscal reserves and its current-account surplus, make it unlikely that the territory will need to abandon its currency peg.

Indonesia

After a bout of weakness in May-June, the rupiah has stabilized, and the currency appreciated during July and early August, despite the interest-rate cuts enacted by the central bank. Supporting the rupiah is the strong export performance and the fact that, despite the recent rate cuts, the interest-rate differential with the US dollar remains relatively large. This is offsetting the negative impact of high-

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er debt-servicing costs in 2006 and concerns about the government's ability to push through reforms to improve the business environment. On balance, and partly as a result of the weakness of the US dollar, we expect the exchange rate to average Rp9,324:US$1 in 2006, compared with an average of Rp9,705:US$1 in 2005. In 2007 the rupiah is forecast to be broadly stable against the US dollar, at around Rp9,400:US$1, as the negative impact of lower interest rates will be offset by the country's stronger economic growth and higher levels of investment-related capital inflow. One risk to the value of the rupiah, and a potential source of volatility, is monetary tightening in Japan: Japanese investors could withdraw capital held in Indonesia as liquidity conditions tighten at home and higher returns become available domestically.

Japanese Yen	2006	2007	2008	2009	2010
Av'g. units per $	114.3	100.3	95.5	93.5	91.5
Nominal appreciation (%)	– 3.6	14.0	5.0	2.1	2.2
Real appreciation (%)	– 5.7	12.7	3.8	0.5	0.2
Units per $ (end period)	107.5	96.5	94.5	92.5	90.3
Av'g. units per €	143.5	136.6	127.7	120.8	115.3
Nominal appreciation (%)	– 4.4	5.1	6.9	5.7	4.8
Real appreciation (%)	– 6.1	4.2	6.7	5.1	3.7
Units per € (end period)	140.3	132.2	124.3	117.0	114.0
Av'g. units per ¥100	105.2	93.3	90.1	89.0	88.0
Nominal appreciation (%)	– 9.6	12.8	3.5	1.2	1.2
Real appreciation (%)	– 9.1	14.0	4.5	1.6	0.8
Units per ¥100 (end period)	99.1	90.6	89.6	88.5	86.9
Real effective exchange rate (1997=100)	98.0	98.3	93.0	86.8	94.1

New Zealand Dollar	2006	2007	2008	2009	2010
Av'g. units per $	1.57	1.63	1.65	1.71	1.75
Nominal appreciation (%)	– 9.8	– 3.6	– 1.1	– 3.2	– 2.3
Real appreciation (%)	– 8.7	– 2.9	– 1.2	– 3.6	– 2.9
Units per $ (end period)	1.62	1.66	1.68	1.72	1.76
Av'g. units per €	1.98	2.22	2.21	2.20	2.20
Nominal appreciation (%)	– 10.5	– 11.2	0.8	0.1	0.2
Real appreciation (%)	– 9.2	– 10.3	1.6	0.8	0.6
Units per € (end period)	2.1	2.3	2.2	2.2	2.2
Av'g. units per ¥100	1.45	1.52	1.56	1.62	1.68
Nominal appreciation (%)	– 15.4	– 4.7	– 2.4	– 4.1	– 3.2
Real appreciation (%)	– 12.1	– 1.8	– 0.5	– 2.5	– 2.3
Units per ¥100 (end period)	1.49	1.56	1.59	1.65	1.69
Real effective exchange rate (1997=100)	92.3	98.7	104.4	93.2	83.1

Philippine Peso	2006	2007	2008	2009	2010
Av'g. units per $	52.3	52.1	52.5	52.5	53.0
Nominal appreciation (%)	5.4	0.3	– 0.7	0.0	– 0.9
Real appreciation (%)	9.5	2.9	2.0	2.7	1.5
Units per $ (end period)	52.3	52.3	52.5	52.8	53.3
Av'g. units per €	65.6	71.0	70.2	67.9	66.8
Nominal appreciation (%)	4.5	– 7.6	1.1	3.5	1.6
Real appreciation (%)	8.9	– 4.9	5.0	7.4	5.1
Units per € (end period)	68.3	71.7	69.0	66.7	67.2
Av'g. units per ¥100	48.1	48.5	49.5	50.0	51.0
Nominal appreciation (%)	– 1.2	– 0.8	– 2.1	– 0.9	– 1.9
Real appreciation (%)	5.5	4.1	2.8	3.8	2.1
Units per ¥100 (end period)	48.2	49.1	49.8	50.5	51.2
Real effective exchange rate (1997=100)	69.2	67.0	71.7	79.7	78.3

India

The rupee has depreciated steadily against the US dollar since the start of 2006, but the sharp fall in the stockmarket in India in May did not lead to a run on the currency. In late August the rupee was trading at Rs46.6:US$1, compared with Rs45:US$1 in early January. We expect India to remain an attractive destination for foreign investment in the forecast period, and Indian exports will grow strongly, supporting the rupee. However, the current account will remain in deficit, owing to the boom in imports. On balance, the rupee is forecast to depreciate gently from an average of Rs44.1:US$1 in 2005 to Rs45.5:US$1 in 2006 and Rs46.5:US$1 in 2007.

Japan

We have revised our yen:US dollar exchange-rate forecast to reflect the yen's weaker than expected performance in July, and now expect the yen to average Y114:US$1 in 2006 and Y100:US$1 in 2007 (compared with Y110.7:US$1 and Y98:US$1 previously). We expect the yen's appreciation to gather pace in 2007, as US interest rates start to ease again while those in Japan continue to rise.

New Zealand

The New Zealand dollar had a rough time in the first half of the year, but has strengthened in recent months. Having fallen to NZ$1.68:US$1 at the end of June, the currency firmed, and was trading around NZ$1.54:US$1 in early September. This recovery, which has owed a lot to high local interest rates, has led to some misplaced hopes that New Zealand's currency woes are at an end. Renewed worries about the country's macroeconomic situation are, however, likely to soon drive the currency down again. As a result, the exchange rate is forecast to average NZ$1.57:US$1 in 2006 and NZ$1.63:US$1 in 2007. We expect that the New Zealand currency will come under particular strain towards the end of 2006 and in 2007 because of worries about the maturity profile of New Zealand dollar-denominated securities in Japan and, more generally, by more bad news on the current account.

Philippines

The peso has recently been very volatile. The currency was one of Asia's strongest performers in 2005, and the strengthening was maintained through the first three months of 2006. The peso then underwent a marked depreciation in the sec-

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Foreign Exchange

Pacific Exchange Rate Services Exchange Rates for the Dollar as of October 12, 2006

The table below gives the rates of exchange for the U.S. dollar against various currencies as of October 12, 2006. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are indicative. They are not intended to be used as a basis for particular transactions. Pacific Exchange Rate Services (http://pacific.commerce.ubc.ca) does not assume responsibility for errors.

Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani	49.579	Georgia	Lari	N/A	Norfolk Islands	Aus. Dollar	1.3338
Albania	Lek	98.21	Germany	Euro*	1.2537	Norway	Krone	6.7408
Algeria	Dinar	71.62	Ghana	Cedi	9159.40	Oman Sultanate	Rial	0.385
Andorra	Euro*	1.2537	Gibraltar	Br. Pound*	1.8562	Pakistan	Rupee	60.6
Angola	Kwanza	78.61	Greece	Euro*	1.2537	Panama	Balboa	1.00
Antigua	E.Car. $	2.685	Greenland	Dan. Krone	5.9466	Papua N.G.	Kina	3.0166
Argentina	Peso	3.1055	Grenada	E.Car. $	2.685	Paraguay	Guarani	5315.00
Armenia	Dram	384.20	Guadeloupe	Euro*	1.2537	Peru	Nuevo Sol	3.245
Aruba	Guilder	1.79	Guam	US$	1.00	Philippines	Peso	50.02
Australia	Dollar	1.3338	Guatemala	Quetzal	7.625	Pitcairn Island	NZ Dollar	1.5133
Austria	Euro*	1.2537	Guinea Republic	Franc	5555.00	Poland	Zloty	3.1172
Azerbaijan	Manat	4592.00	Guinea Bissau	CFA Franc	523.06	Portugal	Euro*	1.2537
Azores	Euro*	1.2537	Guyana	Dollar	200.69	Puerto Rico	US$	1.00
Bahamas	Dollar	1.00	Haiti	Gourde	38.10	Qatar	Riyal	3.641
Bahrain	Dinar	0.377	Heard/McDonald Is.	Aus. Dollar	1.3338	Rep. Yemen	Rial	191.90
Bangladesh	Taka	66.125	Honduras	Lempira	18.895	le de la Reunion	Euro*	1.2537
Barbados	Dollar	2.00	Hong Kong	Dollar	7.7915	Romania	Leu	2.7996
Belarus	Ruble	2141.80	Hungary	Forint	212.65	Russia	Ruble	26.951
Belgium	Euro*	1.2537	Iceland	Krona	68.775	Rwanda	Franc	549.75
Belize	Dollar	1.97	India	Rupee	45.615	Samoa (American)	US$	1.00
Benin	CFA Franc	523.06	Indonesia	Rupiah	9219.50	San Marino	Euro*	1.2537
Bermuda	Dollar	1.00	Iran	Rial	9217.00	Sao Tome/Principe	Dobra	6823.50
Bhutan	Nguitrum	45.615	Iraq	Dinar	1470.60	Saudi Arabia	Riyal	3.7506
Bolivia	Boliviano	7.995	Ireland	Euro*	1.2537	Senegal	CFA Franc	523.06
Bosnia Herzegovina	Konv. Marka	1.512	Israel	New Shekel	4.263	Serbia/Montenegro	Yug. N. Dinar	N/A
Botswana	Pula	6.4103	Italy	Euro*	1.2537	Seychelles	Rupee	5.5505
Bouvet Island	Krone	N/A	Jamaica	Dollar	66.135	Sierra Leone	Leone	2978.00
Brazil	Real	2.1581	Japan	Yen	119.55	Singapore	Dollar	1.587
Brunei	Dollar	1.5883	Johnston Island	US$	1.00	Slovakia	Koruna	29.43
Bulgaria	Lev	1.5586	Jordan	Dinar	0.7085	Slovenia	Tolar	191.12
Burkina Faso	CFA Franc	523.06	Kazakhstan	Tenge	127.75	Solomon Is.	Solomon$	7.63
Burundi	Franc	1057.30	Kenya	Shilling	72.432	Somali Rep.	Shilling	1371.70
Cameroun	CFA Franc	523.06	Kiribati	Aus. Dollar	1.3338	South Africa	Rand	7.644
Canada	Dollar	1.1364	Korea, North	Won	130.03	Spain	Euro*	1.2537
Cape Verde Islands	Escudo	87.91	Korea, South	Won	957.85	Sir Lanka	Rupee	105.5
Cayman Islands	Dollar	0.82	Kuwait	Dinar	0.292	St. Helena	Br. Pound*	1.8562
Cent. Af. Republic	CFA Franc	523.06	Kyrgyzstan	Som	39.164	St. Kitts	E. Car. $	2.685
Chad	CFA Franc	523.06	Laos	Kip	10020.00	St. Lucia	E. Car. $	2.685
Channel Islands	Br. Pound*	1.8562	Latvia	Lat	0.5553	St. Pierre/Miq'lon	Euro*	1.2537
Chile	Peso	533.95	Lebanon	Pound	1512.30	St. Vincent	E. Car. $	2.685
China	Renminbi	7.9143	Lesotho	Maloti	7.644	Sate of Cambodia	Riel	4193.00
Christmas Islands	Aus. Dollar	1.3338	Liberia	Dollar	59.50	Sudan	Dinar	207.64
Cocos Islands	Aus. Dollar	1.3338	Libya	Dinar	1.3082	Suriname	Dollar	2.745
Columbia	Peso	2385.50	Liechtenstein	Sw. Franc	1.2711	Swaziland	Lilangeni	7.644
Comoros Rep.	Franc	392.05	Lithuania	Litas	2.7541	Sweden	Krone	7.3814
Congo Republic	CFA Franc	523.06	Luxembourg	Euro*	1.2537	Switzerland	Franc	1.2711
Congo Dem Rep.	Franc	N/A	Macau	Pataca	8.0287	Syria	Pound	52.21
Costa Rica	Colon	521.80	Macedonia	Dinar	47.28	Taiwan	Dollar	33.236
Cote d'Ivoire	CFA Franc	523.06	Madagascar	Franc	8968.60	Tajikistan	Somoni	N/A
Croatia	Kuna	5.9207	Madeira	Euro*	1.2537	Tanzania	Shilling	1250.70
Cuba	Peso	1.00	Malawi	Kwacha	138.03	Thailand	Baht	37.515
Cyprus	Pound	0.4595	Malaysia	Ringgit	3.6940	Togo Rep.	CFA Franc	523.06
Czech Repub.	Koruna	22.579	Maldive Is.	Rufiyan	12.800	Tokelau	NZ $	1.5133
Denmark	Krone	5.9466	Mali Republic	CFA Franc	523.06	Tonga Island	Pa'anga	1.99
Djibouti	Franc	177.72	Malta	Lira	0.3424	Trinidad/Tobago	Dollar	6.37
Dominica	E.Car. $	2.685	Martinique	Euro*	1.2537	Tunisia	Dinar	1.3396
Domi. Rep.	Peso	33.35	Mauretania	Ouguiya	271.3	Turkey	Lira	1.478
Dronning Maud.	Nor. Krone	6.7408	Mauritius	Rupee	32.891	Turkmenistan	Manat	5200.00
East Timor	US$	1.00	Mexico	New Peso	10.95	Turks & Caicos	US$	1.00
Ecuador	US$	1.00	Moldova	Lei	13.25	Tuvalu	Aus. Dollar	1.3338
Egypt	Pound	5.74	Monaco	Euro*	1.2537	Uganda	Shilling	1855.50
El Salvador	Colon	8.752	Mongolia	Tugrik	1167.00	Ukraine	Hryvnia	5.0285
Eq'tl Guinea	CFA Franc	523.06	Montserrat	E.Car. $	2.685	United Kingdom	Br. Pound*	1.8562
Eritrea	Nafka	12.27	Morocco	Dirham	8.803	Uruguay	Peso	23.835
Estonia	Kroon	12.481	Mozambique	Metical	26125.00	U.A.E.	Dirhan	3.6728
Ethiopia	Birr	8.7463	Myanmar	Kyat	6.42	Uzbekhistan	Som	1207.00
European EMU	Euro*	1.2537	Namibia	Dollar	7.262	Vanuatu	Vatu	111.85
Faeroe Islands	Dan. Krone	5.9466	Nauru Is.	Aus. Dollar	1.3338	Vatican City	Euro*	1.2537
Falkland Islands	Br. Pound*	1.8562	Nepal	Rupee	73.04	Venezuela	Bolivar	2147.30
Fiji	Dollar	1.7422	Neth. Antilles	Guilder	1.79	Vietnam	Dong	16052.00
Finland	Euro*	1.2537	Netherlands	Euro*	1.2537	Virgin Islands BR	US$	1.00
Fr. Pacific Islands	Franc	95.031	New Zealand	Dollar	1.5133	Virgin Islands US	US$	1.00
France	Euro*	1.2537	Nicaragua	Cordoba	17.72	West Samoa	Tala	2.75
French Guiana	Euro*	1.2537	Nieue	NZ Dollar	1.5133	Zambia	Kwacha	3829.50
Gabon	CFA Franc	523.06	Niger Rep.	CFA Franc	523.06	Zimbabwe	Dollar	238.09
Gambia	Dalasi	27.950	Nigeria	Naira	128.32			

(N/A) Not Available * U.S. Dollar per national currency unit

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Rates and Forecasts, from Page 17

ond quarter, before appreciating in July and August. On August 18th the peso stood at P51.1:US$1, its highest level since early April. A number of factors, including the improving fiscal outlook, record levels of workers' remittances and the improving outlook for exports, will support the currency. However, the narrowing interest-rate differential between the US and the Philippines will put downward pressure on the currency. After raising interest rates three times in 2005, the BSP has kept rates on hold since October, while the Federal Reserve (the US central bank) has continued to raise rates. The peso will also remain vulnerable to further political instability. Overall, we forecast that the currency will stabilize over the course of 2006-07 as the current cycle of US monetary policy tightening reaches its end.

Singapore

Sustained economic growth, coupled with signs of upward price pressures, has led the Monetary Authority of Singapore (MAS, the central bank) to pursue a policy of allowing a gradual appreciation of the Singapore dollar. As the economy continues to record healthy growth rates, a tighter monetary policy stance and the continuation of large current-account surpluses will underpin a further appreciation of Singapore's currency against the US dollar during the forecast period. The MAS will intervene in the foreign-exchange market if the Singapore dollar

Singapore Dollar	2006	2007	2008	2009	2010
Av'g. units per $	1.60	1.58	1.56	1.55	1.54
Nominal appreciation (%)	4.2	1.1	1.2	0.7	0.4
Real appreciation (%)	2.7	– 0.3	– 0.6	– 1.1	– 1.2
Units per $ (end period)	1.59	1.57	1.56	1.55	1.54
Av'g. units per €	2.0	2.2	2.1	2.0	1.9
Nominal appreciation (%)	3.3	– 6.8	3.1	4.2	3.0
Real appreciation (%)	2.2	– 7.9	2.2	3.4	2.3
Units per € (end period)	2.1	2.2	2.0	2.0	1.9
Av'g. units per ¥100	1.47	1.47	1.47	1.48	1.49
Nominal appreciation (%)	– 2.3	0.0	– 0.2	– 0.3	– 0.6
Real appreciation (%)	– 1.0	0.8	0.1	0.0	– 0.6
Units per ¥100 (end period)	1.46	1.47	1.47	1.48	1.49
Real effective exchange rate (1997=100)	85.8	84.6	83.6	86.1	83.3

South Korean Won	2006	2007	2008	2009	2010
Av'g. units per $	952.0	899.0	855.0	815.0	780.0
Nominal appreciation (%)	7.6	5.9	5.1	4.9	4.5
Real appreciation (%)	8.0	6.4	4.9	4.3	4.1
Units per $ (end period)	925.5	877.0	835.0	797.5	746.5
Av'g. units per €	1,195	1,225	1,144	1,053	983
Nominal appreciation (%)	6.7	– 2.4	7.1	8.6	7.2
Real appreciation (%)	7.4	– 1.7	7.9	9.1	7.8
Units per € (end period)	1,208	1,201	1,098	1,009	942
Av'g. units per ¥100	875.6	836.3	806.6	776.2	750.0
Nominal appreciation (%)	0.9	4.7	3.7	3.9	3.5
Real appreciation (%)	4.0	7.6	5.6	5.5	4.7
Units per ¥100 (end period)	853.0	823.5	791.5	763.2	717.8
Real effective exchange rate (1997=100)	76.2	77.3	85.6	90.2	90.8

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Thai Baht	2006	2007	2008	2009	2010
Av'g. units per $	38.2	37.1	36.8	36.7	36.5
Nominal appreciation (%)	5.2	3.1	0.8	0.3	0.5
Real appreciation (%)	7.7	4.8	0.9	– 0.1	– 0.1
Units per $ (end period)	37.9	36.9	36.8	36.6	36.4
Av'g. units per €	48.0	50.6	49.2	47.4	46.0
Nominal appreciation (%)	4.3	– 5.0	2.7	3.8	3.0
Real appreciation (%)	7.1	– 3.2	3.8	4.4	3.4
Units per € (end period)	49.4	50.5	48.4	46.3	45.9
Av'g. units per ¥100	35.2	34.5	34.7	34.9	35.1
Nominal appreciation (%)	– 1.4	1.9	– 0.6	– 0.6	– 0.5
Real appreciation (%)	3.7	5.9	1.7	1.0	0.5
Units per ¥100 (end period)	34.9	34.6	34.9	35.0	35.0
Real effective exchange rate (1997=100)	84.5	84.3	86.1	92.2	92.0

Vietnamese Dong	2006	2007	2008	2009	2010
Av'g. units per $	16,037	16,410	16,850	17,250	17,650
Nominal appreciation (%)	– 1.1	– 2.3	– 2.6	– 2.3	– 2.3
Real appreciation (%)	3.6	0.6	– 0.7	– 1.2	– 1.4
Units per $ (end period)	16,174	16,630	17,050	17,450	17,850
Av'g. units per €	20,130	22,359	22,537	22,296	22,239
Nominal appreciation (%)	– 1.9	– 10.0	– 0.8	1.1	0.3
Real appreciation (%)	3.1	– 7.0	2.2	3.3	2.1
Units per € (end period)	21,106	22,783	22,421	22,074	22,531
Av'g. units per ¥100	14,750	15,265	15,896	16,429	16,971
Nominal appreciation (%)	– 7.3	– 3.4	– 4.0	– 3.2	– 3.2
Real appreciation (%)	– 0.2	1.7	0.1	– 0.1	– 0.7
Units per ¥100 (end period)	14,906	15,615	16,161	16,699	17,163
Real effective exchange rate (1997=100)	87.1	86.4	89.9	92.0	88.3

exhibits excessive volatility. However, the central bank's ability to prevent a significant appreciation of the Singapore dollar against the US dollar will be limited by the general weakness of the US currency. Overall, the exchange rate will strengthen from an average of S$1.66:US$1 in 2005 to S$1.58:US$1 in 2007.

South Korea

We forecast that the won will average W952:US$1 in 2006 and W899:US$1 in 2007. In addition to healthy inflows on the current and capital accounts, the won's upward trajectory should receive a boost from the ending of monetary policy tightening in the US in mid-2006 and from likely rises in the renminbi. However, our forecast suggests that in real effective terms the won will remain weaker over the forecast period than it was in 1997.

Thailand

The baht weakened in May, in line with other regional currencies, as the prospect of tighter global liquidity conditions and monetary tightening in Japan led to an exodus from emerging market assets. However, the baht subsequently stabilized in June, and started to appreciate towards the end of July and into August. The recent appreciation has had more to do with a general weakness in the US dollar, but could also reflect optimism about the prospects for a return to political stability following the October election. By 2007 stronger economic growth and slightly lower oil prices will support a modest appreciation of the currency against the US dollar. Throughout the forecast period the BOT's policy of maintaining the current interest-rate differential with the US should prevent significant capital outflows, thereby limiting the likelihood of severe exchange-rate instability. The BOT is more likely to intervene to prevent any excessive appreciation of the currency—for fear of diminishing export-price competitiveness—owing to the bunching together of capital inflows.

Vietnam

The authorities are expected to continue to manage the exchange rate tightly throughout the forecast period. The dong will depreciate steadily against the US dollar in 2006-07 as a result of the country's high rate of inflation (at least in 2006) as well as the government's desire to maintain export-competitiveness. In real effective terms, however, the currency will appreciate slightly in 2006, before depreciating in 2007. Given that we forecast a weaker US dollar over the forecast period, the dong will depreciate more rapidly against the yen and the euro than it will against the dollar. In 2007 the dong is forecast to average D16,410:US$1, compared with an average of D15,859:US$1 in 2005. ❑

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