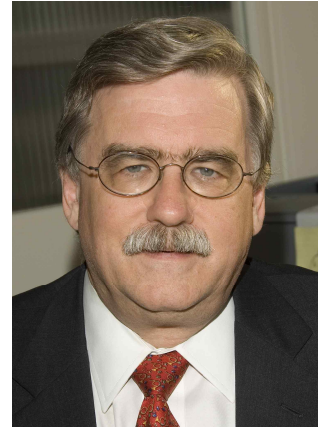


## **James W Adams**

Regional Vice President, East Asia and Pacific Region

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Mr. Adams is Vice President for the East Asia and Pacific Region of the World Bank. In this capacity, he has overall responsibility for World Bank strategy, operations, and partnerships in one of the world's most dynamic regions, covering more than a dozen states, ranging from the world's most populous country to the smallest and most remote Pacific Islands states. In FY10, the World Bank provided US\$7.5 billion in loans, credits and grants to governments in the region for development projects designed to mitigate the economic and social impacts of the global economic crisis, to increase intraregional integration, and improve governance.



Previously, Mr. Adams was Vice President and Head of Network, Operations Policy and Country Services, at the World Bank. In this capacity, he was responsible for operational policy development, procurement and financial management activities, relations with United Nations and nongovernmental organizations, and support to Regional staff working in all these areas.

Since joining the Bank in 1974, he has held a variety of operational positions in East Asia, Latin America, and Sub-Saharan Africa, including as Country Director for Tanzania and Uganda, as Director for Operations Policy, and as a Division Chief of several departments.

Before joining the Bank, Mr. Adams worked for Merchants Bank, in Syracuse, NY, and with the General Agreement on Tariffs and Trade, in Geneva, Switzerland.

Mr. Adams studied at Colgate University, and holds an MPA from Princeton University.



# Regional Strategy Update 2010

## East Asia and Pacific Region

*Supporting Inclusive and Sustainable Globalization*





# Outline

- I. Regional Context and Development Challenges
- II. The Global Economic Crisis and the Road to Recovery
- III. Short- and Long-Term Operational Response
- IV. How We Manage Our Work to Deliver Results





# Part I.

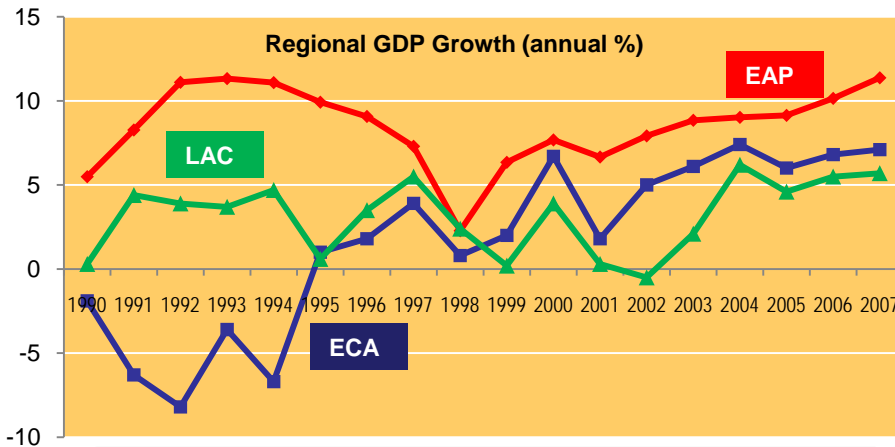
## Regional Context and Development Challenges



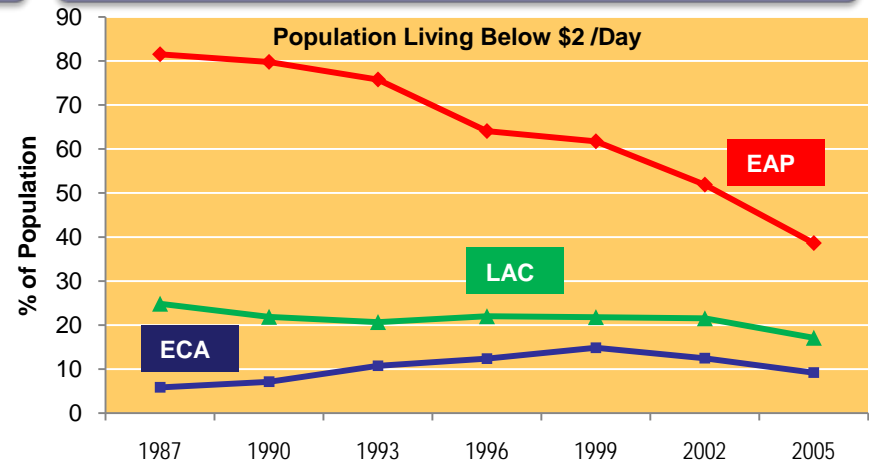
# Regional Context: East Asia on the Rise



Fastest growth of any region in past 2 decades

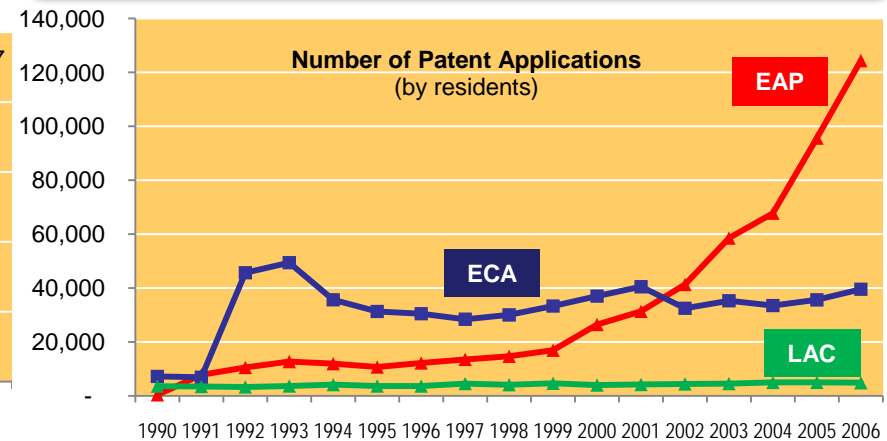
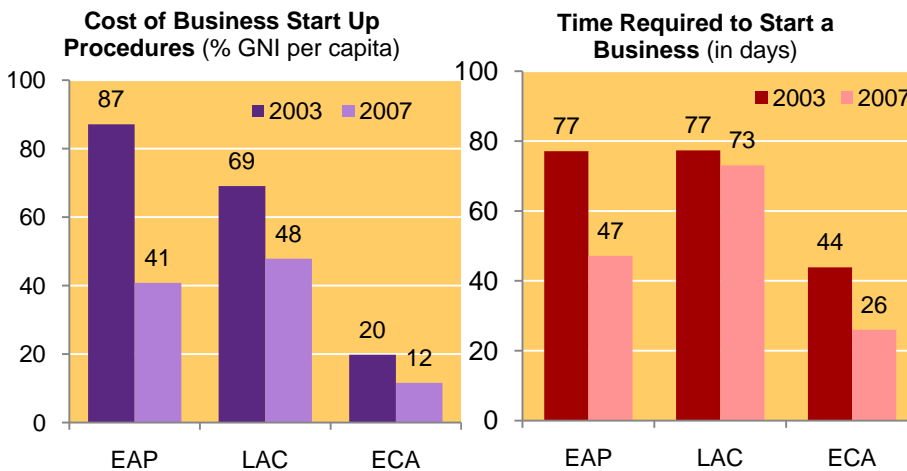


...and fastest rate of poverty reduction



Rapidly improving investment climate

Increasingly a source of global growth, investment, knowledge, innovation & aid

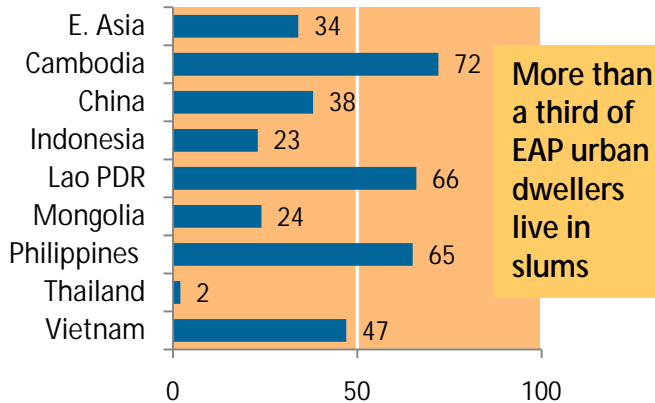


# Regional Context: Vulnerabilities

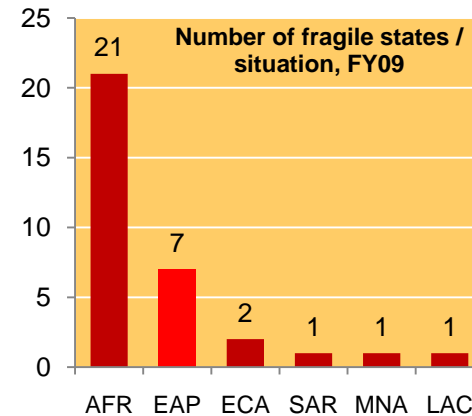


Rising inequality within and across countries;  
gender gaps in labor and in HD indicators in LICs

Share of urban population living in slums



Second largest region of fragile states

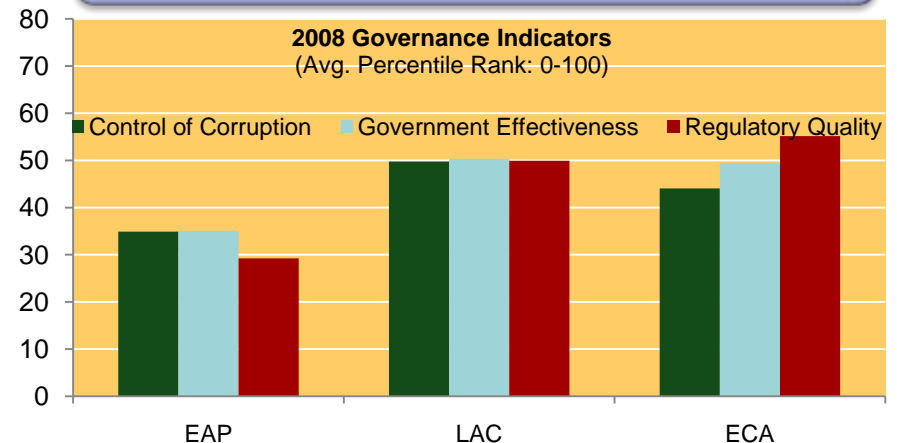


Rapid urbanization, environmental  
damage, vulnerability to natural disasters  
& climate change



13 EAP countries  
among 30 most  
vulnerable to  
climate change-  
related threats

Institutional capacity and governance  
lag economic growth



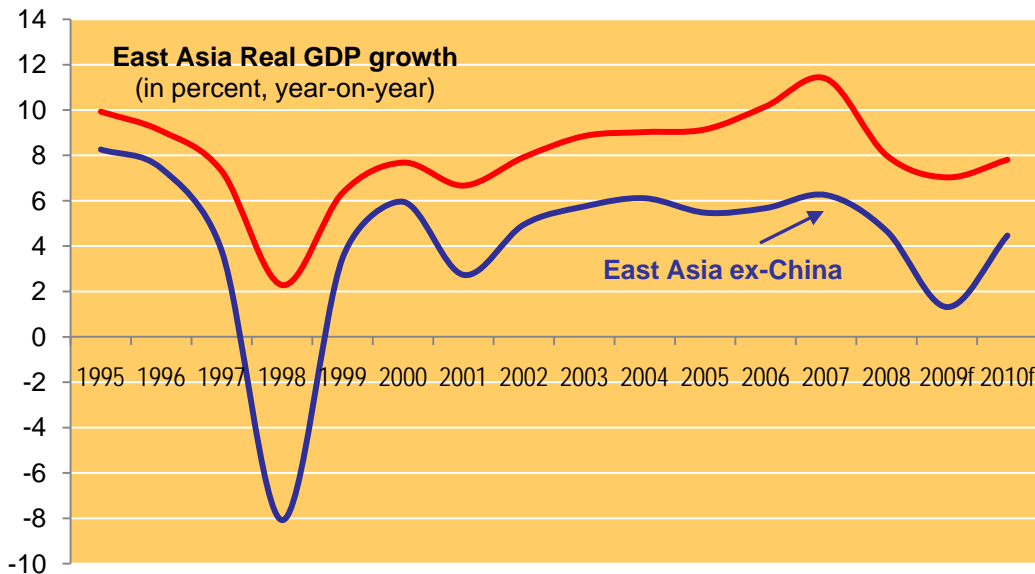


# Part II.

## The Global Economic Crisis and the Road to Recovery



# The Region's rebound has been swift



## The crisis in EAP

- Growth in the region slowed in 2009 but less than in the 1997-98 regional crisis
- **China, Indonesia & Vietnam** did not experience a quarter of negative growth
- **Thailand, Malaysia & Singapore** fell into recession but emerged from it by mid-2009
- **Cambodia and Mongolia** slowed the most in 2009
- Crisis highlighted vulnerability of the **Pacific** which was still reeling under commodity price hikes

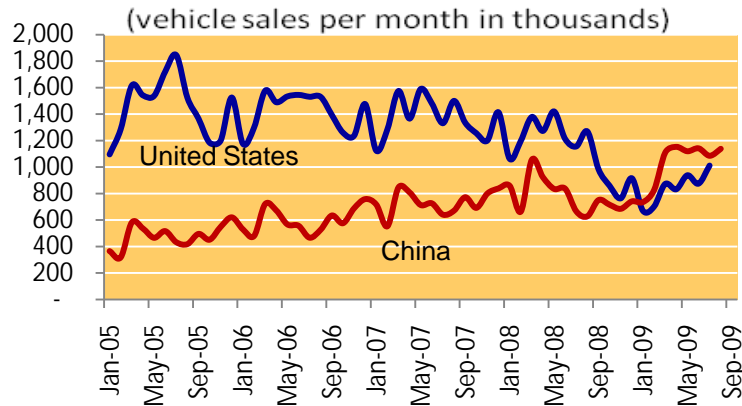
## Robust rebound in E. Asia attributable to...

- Timely & large **fiscal /monetary stimulus** in most countries, notably China
- A marked pickup in **imports in China** for domestic consumption and investment
- Powerful process of **inventory restocking** beginning in mid-2009
- Underlying solid **macroeconomic fundamentals**:
  - ü High foreign exchange reserves
  - ü Large private and corporate savings
  - ü Low corporate and government debt
- Well **capitalized banks** and improved banking **supervision** helped limit contagion

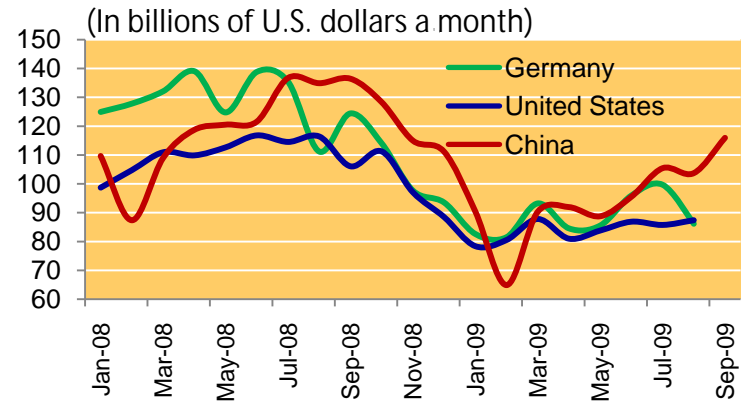
# ...and driven largely by China



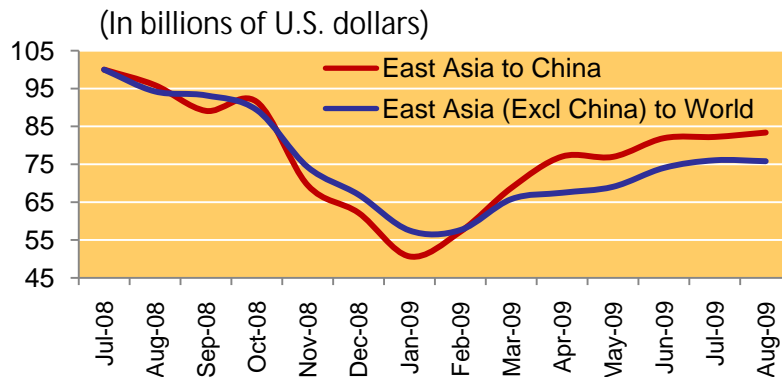
China is now a bigger automobile market than the U.S.



China has overtaken Germany as the world's largest exporter



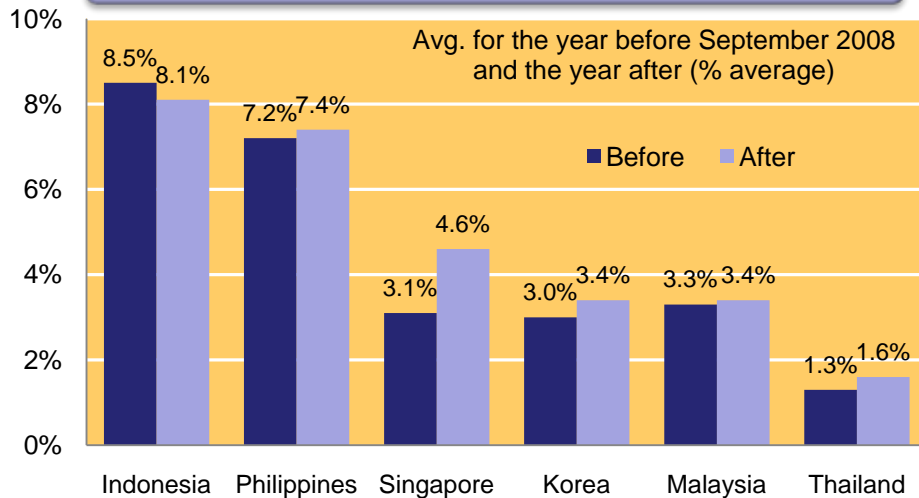
China has provided a stronger boost to regional exports than the rest of the world



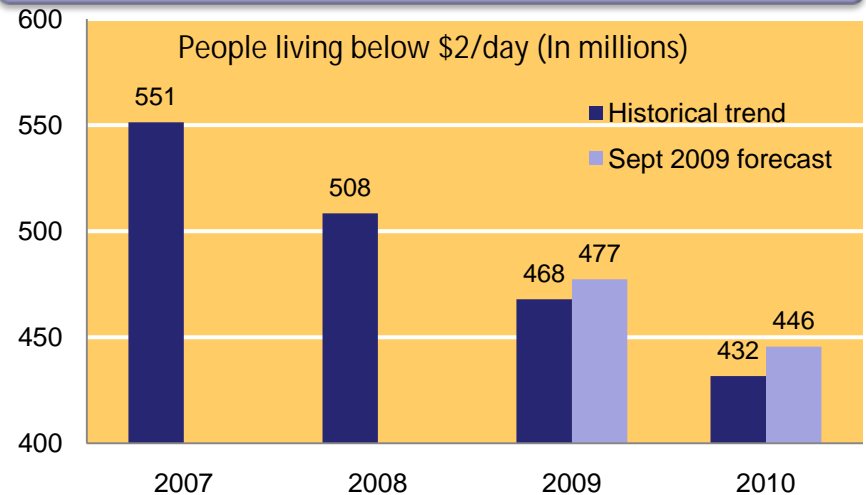
# Poverty impact of the crisis



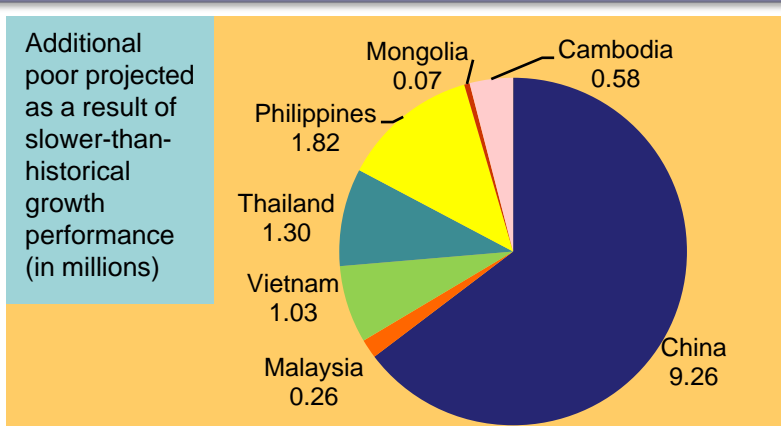
## Limited increases in unemployment...



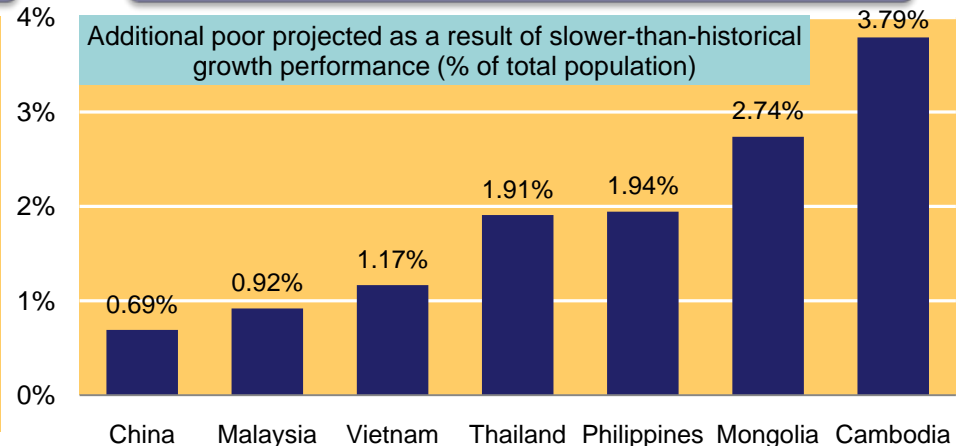
## ...and fewer additional poor than expected



## Most additional poor will be in MICs...



## ...but relative impact greater in LICs



# Going forward: will the rebound translate into recovery

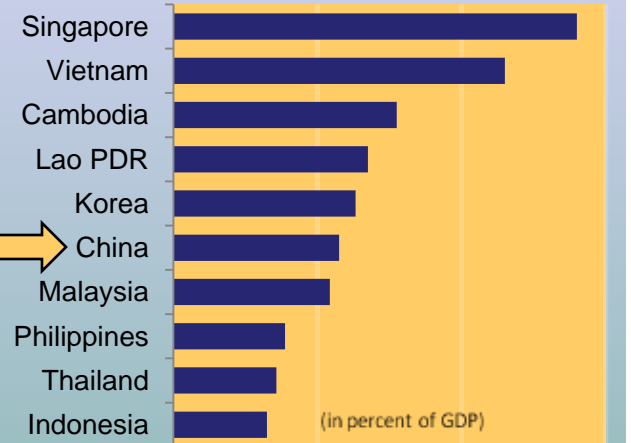


- China has led the global recovery, but cannot yet offset the reduced demand in advanced economies
- Deleveraging, high unemployment and fragile housing markets in industrialized countries pose substantial downside risks
- Financial reform in developed economies may reduce availability of capital & risk taking

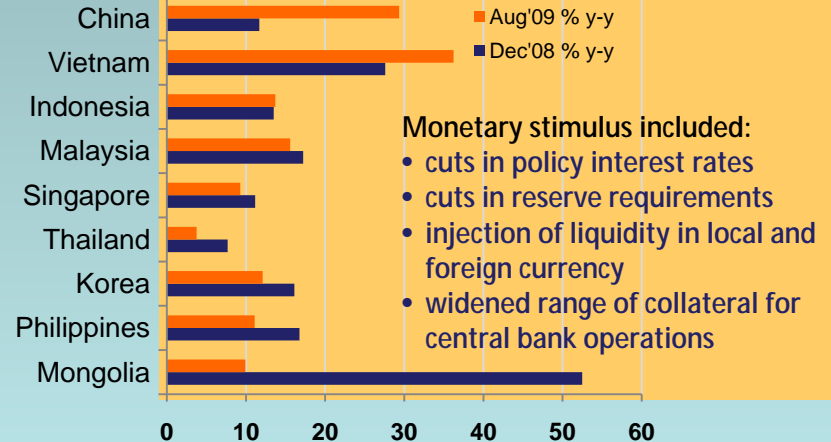


## Key challenges for 2010

Unwinding the large 2009 fiscal stimulus & monetary stimulus



### Credit growth, in percent, year on year



- Monetary stimulus included:
- cuts in policy interest rates
  - cuts in reserve requirements
  - injection of liquidity in local and foreign currency
  - widened range of collateral for central bank operations

# Key longer-term challenges



## Rethinking growth strategies:

**Can East Asia grow as fast as before?**

*Yes, but it is not automatic:*

- More openness and integration with global markets.
- More trade within region, especially in services.
- But challenges vary in a region of diverse economies:

### Country Group

**China**



### Single biggest challenge

Rebalancing

**Other MICs**



Moving up value chain

*(Indonesia, Malaysia, Philippines,  
Thailand, Vietnam)*

**LICs** *(Lao PDR, Cambodia)*



Improve investment climate

**Commodity exporters**



Sound fiscal rules

*(Mongolia, PNG, Timor-Leste)*

**Pacific Islands**



Deeper integration with  
international markets

## Underlying long-term challenges affecting East Asia:

- Growing infrastructure and service delivery needs from **rapid urbanization**
- Demands of **aging populations** in some countries and the labor market expectations of large **youth populations** in others
- Increased commodity **price volatility**
- Risks from **environmental** degradation, natural **disasters & climate change**
- Growing **inequality**; **HD indicators** in LICs; **gender** gaps in the labor market
- Institutional capacity & **governance** challenges





# Part III.

## Short- to Long-Term Operational Responses



# WBG plays a unique role in EAP: Linking the **World to the Region...**



## Our Comparative Advantage



The WBG collaborates with the IMF, ADB and bilateral donors. What sets the WBG in EAP apart is our global reach which allows us to:

- § Exchange and apply development experience from other regions to ensure world quality assistance
- § Provide conduits, via “Hubs”, through which local expertise is shared across the region & beyond
- § Share and apply world class research / analytic work with clients and to underpin sector programs
- § On the ground expertise to address natural and other crises in real time
- § Collaborating with China and other emerging development partners on south-south knowledge exchange and joint work in Africa and Pacific

# Responses to the crisis and lessons learned



## Social Protection



- **Safety Nets:** Improve targeting system, policies & expanded / strengthened safety nets (*Philippines, Lao PDR, Cambodia, Indonesia, Mongolia, Vietnam*)
- **Health systems:** Provide technical support on health insurance, coverage, basic services for poor and links to employment (*China, Thailand, Mongolia, Vietnam*)
- **CDD:** community public works, employment, capacity building (*China, Indonesia, Philippines, Lao PDR, Timor-Leste*); IFC microfinance

## Food Security



- **Agricultural inputs:** Improving input quality (*Cambodia, Vietnam*)
- **Services:** Strengthen / expand agricultural extension services (*China, Philippines*)
- **Productivity:** Enhance sustainable farming practices (*Vietnam*)
- **Infrastructure:** Improve agricultural assets & infrastructure (*Philippines, Vietnam, Lao*)
- **Regulatory framework:** Enhance rural investment climate (*Vietnam*)

## Public Works



- **Stimulus packages:** Fast-track highway, railway, water, urban and energy infrastructure projects (*China, Indonesia*)
- **Institutional framework:** Improve regulatory framework & local capacity, identify sound projects, facilitate PPP (*Indonesia, Vietnam, Tonga*)
- **Local infrastructure:** Community level infrastructure (*Indonesia, Lao, Philippines*)

## Private Sector



- **Financial sector:** Reassure financial markets; strengthen regulatory framework (*Indonesia, Vietnam, Mongolia*)
- **Regulatory framework:** Reduce transaction costs for businesses, trade facilitation (*Indonesia, Laos, Vietnam*)
- **Institutional framework:** Improve interagency coordination & capacity (*Indonesia*)

## Public Sector



- **ESW:** Analysis & dissemination of financial crisis and its multi-sectoral impacts through semiannual *Economic Update* (*Regionwide*)
- **Public expenditure:** Sustain key public expenditure while maintaining budget discipline (*Indonesia, Vietnam, Mongolia, Laos PDR, Philippines*)

## How we did it

- § Increased lending from \$4.5b to \$8.2b in FY09
- § Mix of policy-based DPLs, investments, AAA, policy advice (45% DPLs)
- § Reduced preparation time from 19 to 16 mos.
- § Ramped up donor coordination

## Lessons Learned

- § Move quickly to support client-led response
- § Utilize fast disbursing / preparation instruments & procedures (DPLs, additional finance, emergency response, portfolio restructuring)
- § Undertake just in time AAA: macro, social protection, poverty
- § Balance crisis & long term priorities, e.g., energy, PSD, education

# EAP's long-term priorities support the WBG's overall vision of development



**WBG Goal: Inclusive and Sustainable Globalization**

Create opportunities for growth

Target the poor and the vulnerable

Strengthen Governance

Promote collective global action

Manage risk and prepare for crises

**WBG Strategic Priorities**

**EAP's challenge** is to create opportunities for further growth & poverty reduction, **tailored** to country circumstances, based on our **comparative advantage** & using effective cooperative models and **partnerships**. All clients need support to **strengthen governance** and **manage risk** effectively.

**EAP Region's Four Pillar Strategy**

Help MICs move up the value chain and achieve rapid, inclusive, sustainable growth.

Support the **poorest and fragile states & regions** achieve peace, stability, inclusive growth & poverty reduction.

Strengthen assistance for **global public goods**

Support knowledge exchange, regional cooperation and the global role of **regional institutions**

# EAP's **Four Pillar Strategy** for 2010 and beyond



Help **MICs** move up the value chain and achieve rapid, inclusive, sustainable growth.

Support the **poorest and fragile states & regions** achieve peace, stability, inclusive growth & poverty reduction.

Strengthen assistance for **global public goods**

Support **knowledge exchange, regional cooperation** and the global role of **regional institutions**

- Shift from **labor- to knowledge intensive** production, and from **manufactures to services** beyond tourism & transport
- Improve the **investment climate / PSD**
- Improve **governance & anticorruption**
- Expanded **social protection**, efficient **labor markets** and **higher education**, with attention to **gender gaps**
- **Urban** services, transport **infrastructure** and **green energy / climate change** investments, especially through **PPPs**

- Improve targeting & **social protection** systems
- Improve the **investment climate / PSD**
- Improve **governance & anticorruption**
- Support for **food productivity** programs & monitoring of **food prices**
- Support **Cairns Compact** on donor coordination in Pacific
- Intensify support for **CDD**
- Improve capacity to manage **public finances, natural resources & service delivery**
- Enhance analysis of **peace and conflict risks**, and ways to mitigate them
- Reduce persistent **gender gaps** and support women's economic empowerment

- Substantially boost **climate change** assistance in both **adaptation and mitigation** and accelerate access to Climate Investment Funds
- Integrate **climate change** perspective into on-going programs, e.g., **agriculture, infrastructure**
- Continue to scale up support for **trade and financial integration**
- Strengthen **health systems** to deal with **communicable disease**
- Avail of opportunities to use disaster responses as entry points to engage in **disaster risk mitigation**

- Support analytic work on **new growth strategies** (domestic oriented, low carbon) for MICs
- Turn **Singapore Urban Hub** into a global center for knowledge sharing
- Support regional cooperation through **ASEAN & APEC**
- Better alignment of knowledge services with CASs, more effective **dissemination of messages** from flagship reports
- Support **Korea's contribution** to global development and engagement in G-20
- Facilitate **Chinese partnership** and joint work in Africa & Pacific

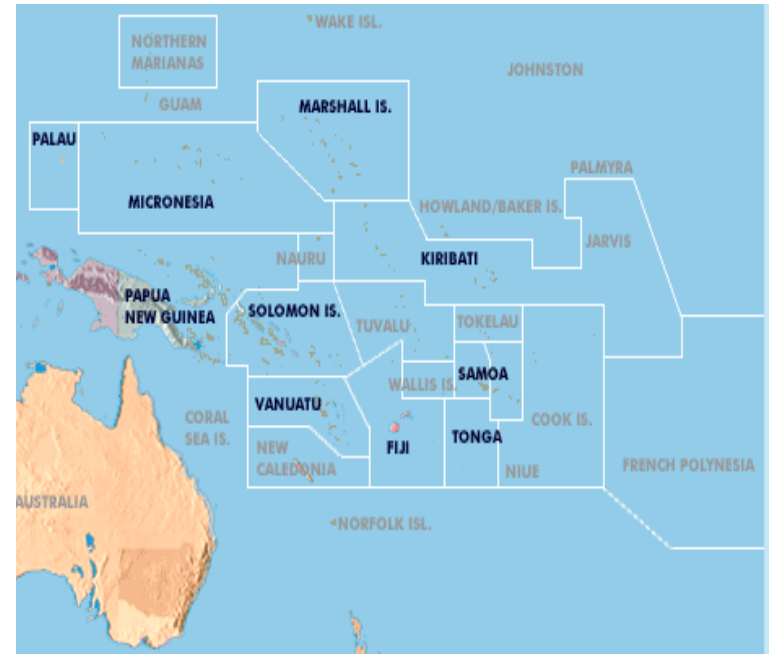
# The special case of the Pacific Islands: Overcoming the challenges of size and distance



Highly diverse but share common systemic Volatility and Vulnerability

- Global slowdown only the latest manifestation
- Commodity price spikes hurt food / fuel importers.
- Persistent gender gaps in health, education, labor
- Tsunami in Samoa and Tonga highlights regular risk of natural disasters.

“Cairns Compact”: Better coordination of all development resources (external and domestic) needed to accelerate progress toward MDGs.



## Transforming Bank Engagement

- A growing program: Knowledge and dollars
  - Ø Challenge: reaching non-traditional clients
- Building Resilience Against Shocks
  - Ø Quick and coordinated tsunami response
  - Ø Economic reform and counter-cyclical measures to mitigate slowdown, create jobs
  - Ø Structural reform: sustainable energy, agriculture, climate change adaptation
- Opportunities from deeper integration
  - Ø Longer-term options to enhance revenue streams (remittances, tourism, natural resources)
  - Ø The telecoms revolution, PPP, SOE reform



# Highlighting our work: Gender



## Key Issues

- § Gender inequalities costs the region an estimated US\$42-\$47 billion per year
- § EAP performs better than other regions (highest primary school enrollment for girls (99%); no major gaps in education, health, political participation
- § But big gaps across the region in female to male wage ratio, labor policy and practice, with acute disparities seen for ethnic minorities

## What we've done

Quality **diagnostics** (6 Country Gender Assessments), **operations, capacity building**, and **partnerships** to mainstream gender issues

## How to Move Ahead?

A regional workshop provided input to an action plan which will prioritize specific core gender entry points

Increase gender mainstreaming in **LICs** (female education, violence, skewed asset ownership key issues).

In **MICs**, address key issues which are mainly related to the labor market.

## EAP Story: Rural Electrification Project

- § In parts of Lao PDR, up to 40% of poor, primarily women-headed rural households cannot pay fees to connect to the electricity grid, leaving them without access to electricity.
- § An interest-free credit plan allows households to borrow \$80 to connect to the grid & repay the loan over three years from money saved on traditional fuels.
- § Connection rates in the 20 pilot villages increased from 63% to 90% for female-headed households. The project is being rolled out to three other provinces and has the potential to reach 50,000 direct beneficiaries by end-2010.



# Highlighting our work: Climate Change



## EAP Achievements and Priorities

- EAP has 40% of active WB climate change portfolio & 63% of carbon offset commitments
- **Mitigation** programs emerging on energy efficiency, renewables, urban transport
- **Adaptation** operations emerging more slowly
- Active **analytic program** on climate change
- Need to apply climate change lens to all major programs & be alert to opportunities to assist

### Key message from regional energy analysis

Energy efficiency & low carbon technology can stabilize CO<sub>2</sub> emissions by 2025 and improve local environment and energy security without compromising economic growth

But **EAP Governments** will need immediate support with policy advice, knowledge sharing and financing to transform energy sectors

**World Bank / IFC** cooperating to scale up support in sustainable energy and energy efficiency, e.g., renewable energy, green buildings

## EAP Story: Addressing Climate Change in China

- § China's efforts to manage resource constraints, environmental challenges & to address climate change impacts not only reaps domestic benefits but has important positive global spillovers.
- § Climate change is a key part of the environmental portfolio in China: more than 40% of the WB project pipeline has positive climate change impacts, and China comprises the Bank's largest climate change investment program.
- § China recently completed the phase-out of ozone-depleting substances (ODS). \$500 million in Montreal Protocol funds helped lead to 329 million tCO<sub>2</sub> equivalent in emissions reductions.
- § WB also supervises 17 carbon finance projects in China, totaling \$1.3 billion, and representing over 1/3 of the value of the total world-wide Kyoto Protocol "Clean Development Mechanism".



# Highlighting our work: Improving Governance

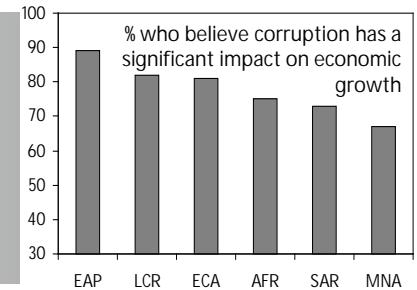


## EAP Story: Improving Governance in Mongolia

- § Impact of global crisis in Mongolia exposed shortcomings in a number of governance-related policies, including tax and fiscal regimes limiting the country's ability to effectively manage volatile commodity prices.
- § During boom years, high mining commodity prices led to a rapid expansion of expenditures, including public investment & social transfer programs.
- § Fiscal shortfall in 2008 led to WB-supported reforms: a fiscal responsibility law, consolidation & retargeting of social transfers, financial & mining sector reforms, & agreement with an international firm to develop world-class copper-gold mines.

## Since the 1997 crisis...

Improved economic governance, higher profile on corruption, greater empowerment of local government, but perceptions of corruption risks still high



## EAP GAC work: Results so far

- Defined strategies in GAC countries with defined teams
- Governance hub established in Bangkok, supporting country & sector teams jointly with regional partners, networks
- Good progress in mainstreaming GAC in selected areas (safety nets, natural resource mgt., financial sector)
- Increased attention to corruption risks, greater use of enhanced monitoring and demand-side approaches
- Impacts on country systems & institutions still emerging



## Next steps:

- § Enhanced dialogue with country clients on long-term development impacts of governance improvements (e.g., service delivery, national competitiveness)
- § Build on existing sectoral engagements and partnerships to identify opportunities for further practical assistance

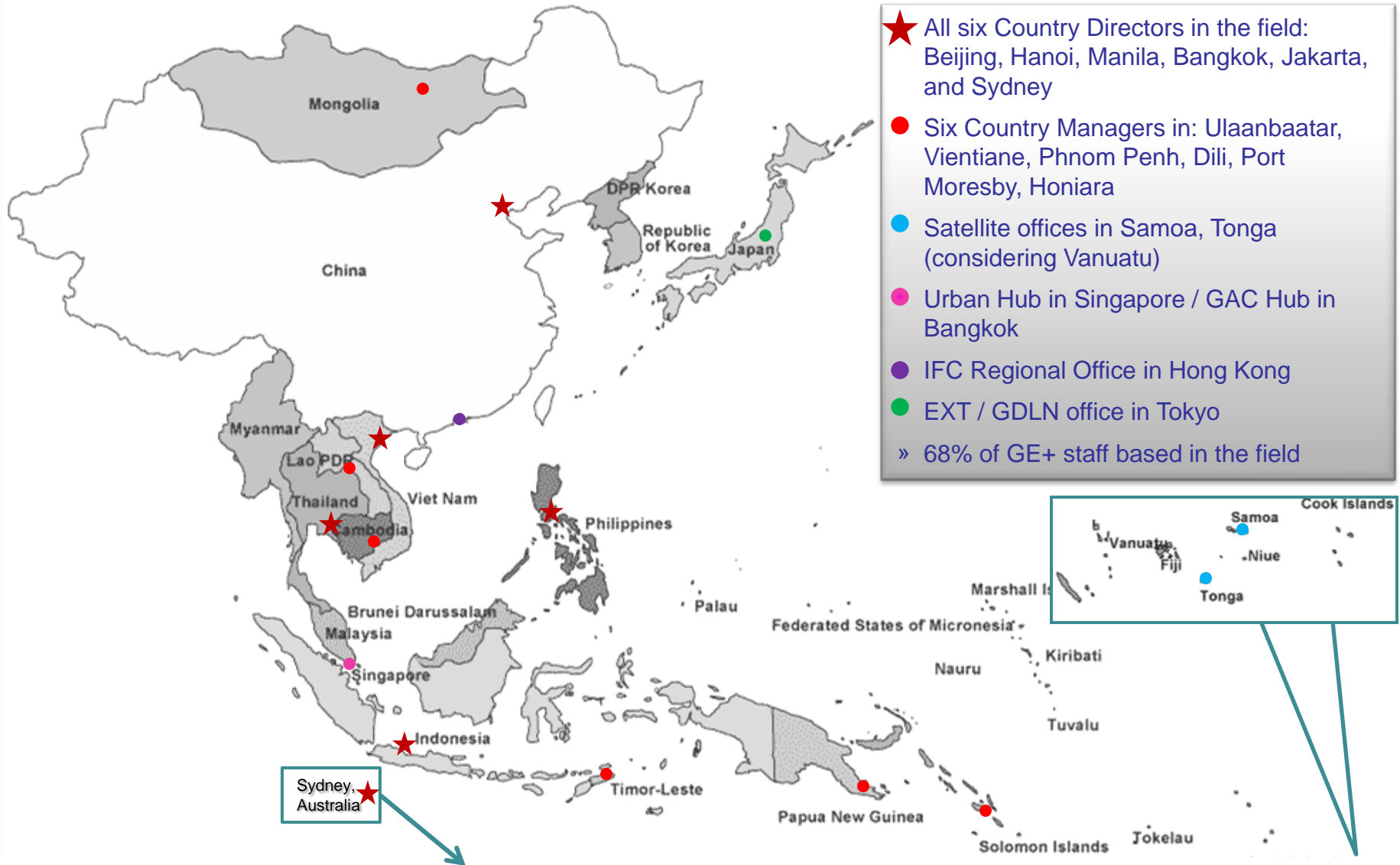


# Part IV.

## How We Manage Our Work to Deliver Results



# WBG in the EAP Region



# One World Bank Group: Synergy with IFC



- Regular senior management discussions to ensure **joint, programmatic approaches** to key challenges in client countries:
  - Finalizing a **joint private sector development strategy** for EAP, focusing on : export diversification, strengthening internal markets, supporting SME growth and private participation in infrastructure (with particular focus on climate change and urbanization)
  - **Joint country strategies, supported by joint sector work:** to develop shared analysis of policy/institutional challenges and investment needs and identify opportunities for complementary sector programs
  - Over 20 joint country / sector exercises in EAP in 2009, leading to **more collaboration on transactions** (e.g., Indonesia infrastructure, financing local SMEs in PNG, Mongolia banking)



# Partnerships and Trust Funds



## Our Partnerships

- § Leverage additional resources and budget
- § Promote harmonized policy dialogue, operations and reduced transaction costs
- § Enable effective analytical /policy support to clients
- § Ensure wide stakeholder participation in development efforts

### Key Partners include:

- § ADB (co-financing e.g. CTF investments; shared offices in Pacific; regular dialogue between VPs and operations staff)
- § Bilateral donors (including UK, Japan, Netherlands, Korea, Australia) and EU
- § Private sector, with IFC
- § Regional organizations (ASEAN, APEC, Pacific Islands Forum/RAMSI)
- § Community, civil society, professional and other coalitions for improved governance (e.g. EITI)

## Trust Funds

Largest trust fund portfolio of any region, attracting substantial additional resources for climate change, disaster response and reconstruction, governance, social protection, conflict affected areas and responses to food, fuel and global economic crises



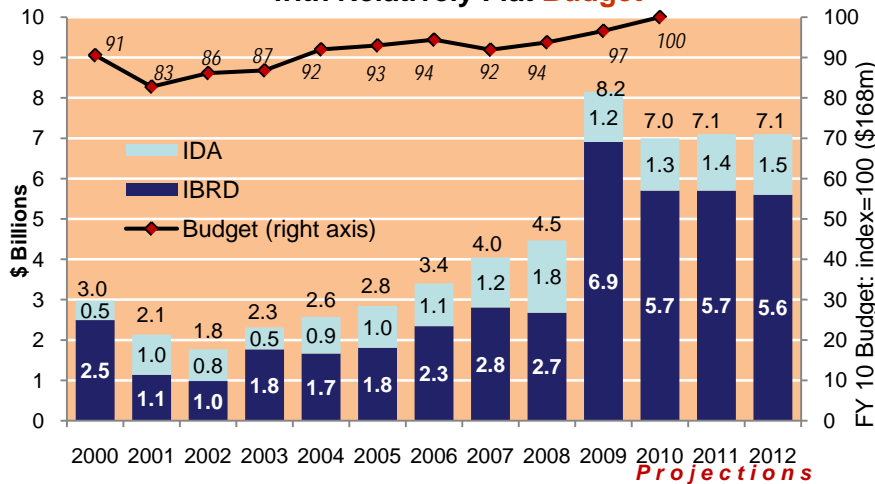
### EAP Trust Fund management plan:

- § aligning TFs with strategies, key areas of engagement and measures of performance
- § integrating TFs in work programs and quality assurance processes
- § promoting innovation while improving efficiency

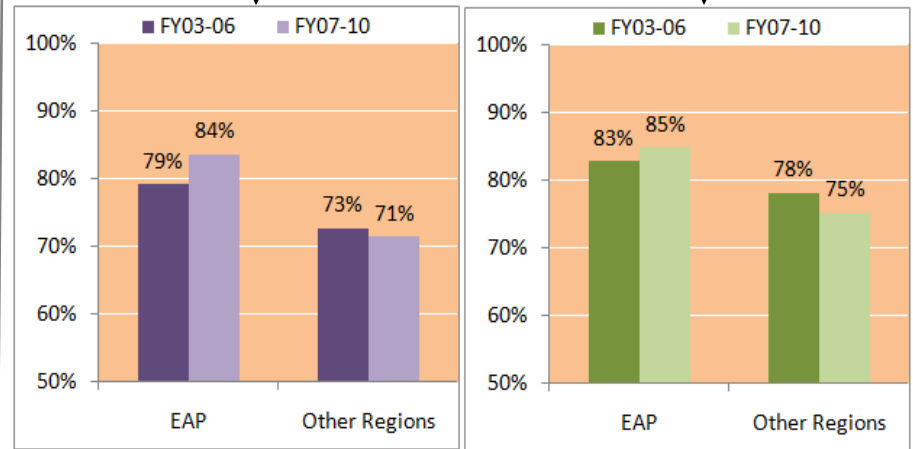
# Client Demand, Improving Quality, Costs, and Timeliness



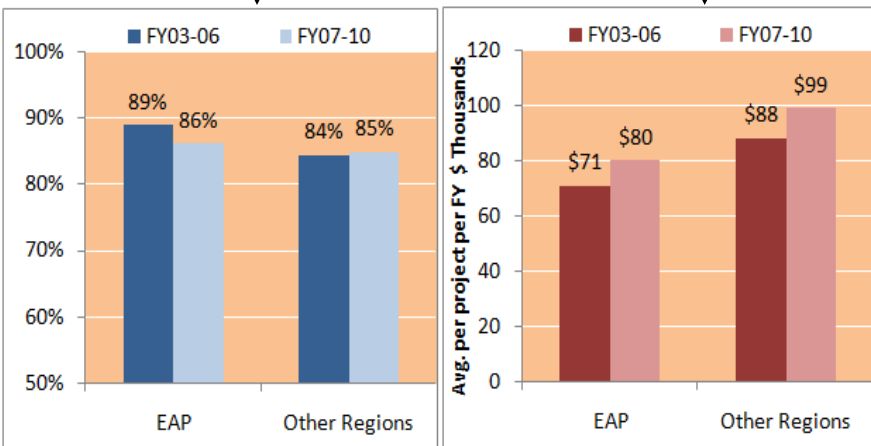
**Responding to Increased Client Demand for Lending with Relatively Flat Budget**



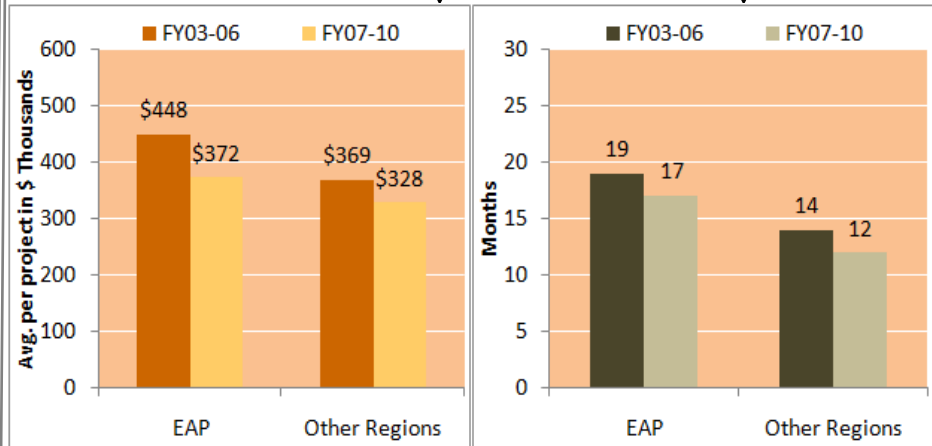
**Improved IEG Quality at Entry & Satisfactory Outcomes Ratings**



**Good Supervision Ratings Despite Lower SPN Costs**



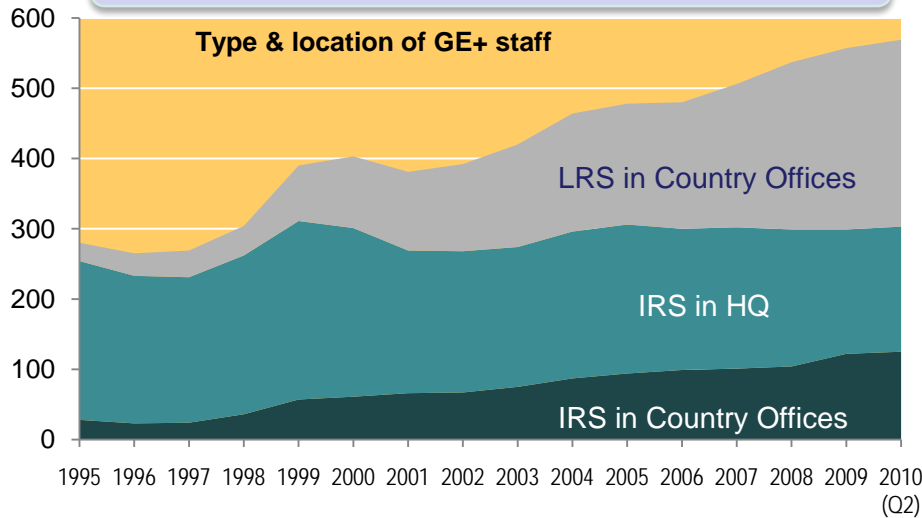
**Scope to Further Reduce Completion Costs and Prep Time**



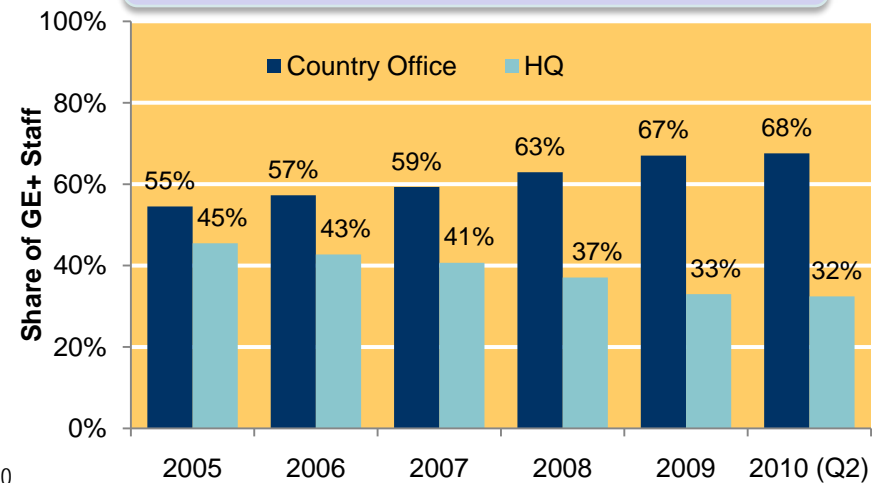
# Staffing and Decentralization Trends



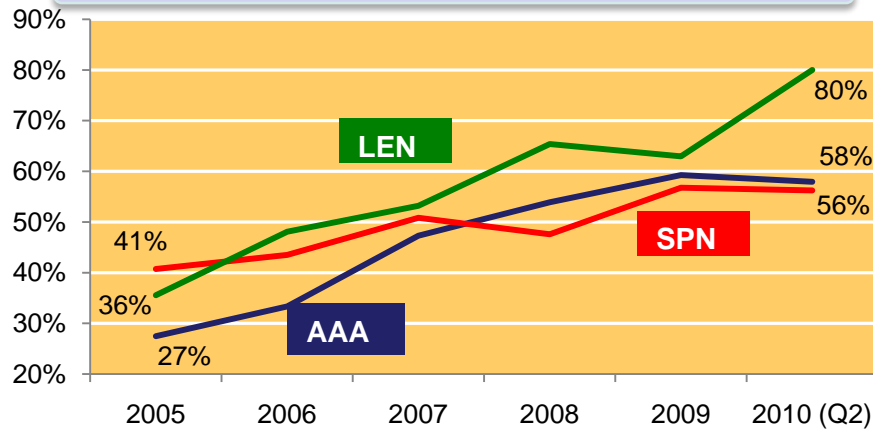
Growth of LRS reflects scale up in fragile states and engagement in new program areas



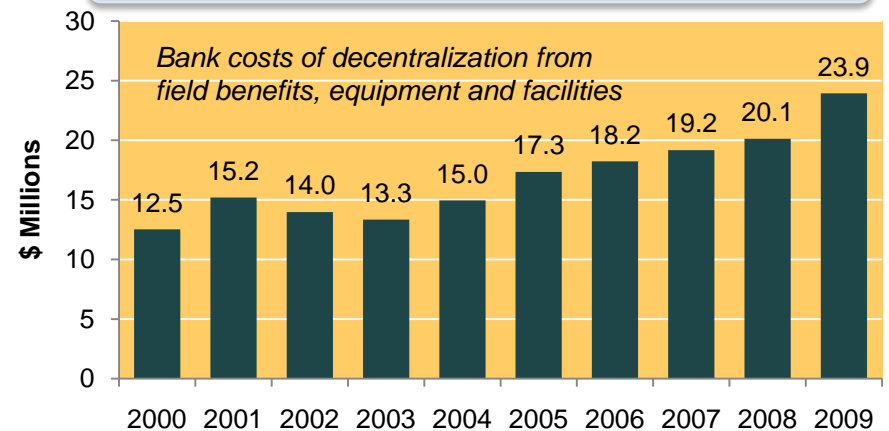
Most decentralized region with 68% of GE+ staff located in country offices



Decentralization of task management remains apace



Cost of decentralization rising due to more field-based IRS and weaker dollar



EAST ASIA AND PACIFIC ECONOMIC UPDATE 2010, VOLUME 2

# Robust Recovery, Rising Risks

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WORLD BANK

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## **PREFACE AND ACKNOWLEDGEMENTS**

The East Asia and Pacific Update was prepared by a team led by Ekaterina Vostroknutova (Senior Economist) with guidance from Ivailo Izvorski (Lead Economist) and Vikram Nehru (East Asia and Pacific Regional Chief Economist and Director, Department for Poverty Reduction, Economic Management, Private and Financial Sector Development). The team included Antonio Ollero, Manohar Sharma, Martin Reichhuber, Andrew D. Mason, and Chul Ju Kim and received significant contributions from Syud Amer Ahmed, Virginia Horscroft, Nataliya Mylenko, Frederico Gil Sander, Ashley Taylor, and Shahid Yusuf. Input was provided by country economists and analysts across the World Bank offices in East Asia and the Pacific, and by Ahmad Ahsan, Kirida Bhaopichitr, Juan Feng, Hironori Kawauchi, Yue Li, and Xiao Ye. Comments were provided by Enrique Blanco Armas, Patchamuthu Illangovan, Milan Brahmhatt, Ardo Hansson, and Linda van Gelder.

East Asia as used in this report includes developing East Asia (China, Indonesia, Malaysia, the Philippines, Thailand, Cambodia, Lao PDR, Mongolia, Papua New Guinea, Timor-Leste, Vietnam and the island economies in the Pacific) and the Newly Industrialized Economies (NIEs). The NIEs include Hong Kong SAR, China; Republic of Korea; Singapore; and Taiwan, China. Middle-income countries, as used in this report, refer to China, Indonesia, Malaysia, the Philippines and Thailand. Low-income countries as used in this report include Cambodia, Lao People's Democratic Republic (PDR) and Vietnam. The ASEAN member countries are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

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**SUMMARY**

**Output has recovered to above pre-crisis levels throughout developing East Asia and, in some countries, is expanding at near pre-crisis rates.** Real GDP is likely to rise 8.9 percent in the region in 2010 (6.7 percent if China is excluded), up from 7.3 percent in 2009 and in line with the average growth rate during 2000-2008. Economic expansion is projected to slow to about 7.8 percent in 2011, as spare capacity becomes scarce, fiscal and monetary stimulus measures are gradually unwound, and economic growth in the advanced economies remains relatively flat. Encouragingly, the private sector is once again becoming the engine of growth, confidence is returning, and trade flows have returned to pre-crisis levels. But the recovery so far has generated little incremental manufacturing employment in some of the middle-income countries.

**With output gaps closing rapidly and private investment recovering strongly, the authorities in most East Asian countries are unwinding their stimulus measures.** But this is being done cautiously, as more evidence is needed to ensure the recovery is firmly entrenched. Fiscal deficits are likely to remain above pre-crisis levels at least through the end of 2011. Their gradual reduction over time allows the authorities to address infrastructure gaps made more urgent by the crisis and maintain social safety nets to protect the poor, and provides an appropriate defense against subdued prospects for advanced economies. Some fiscal space remains in most countries and financing should not pose a burden given current projections for growth and interest rates. Monetary policy has also turned cautious across the region, given rising inflation and a pickup in inflation expectations and policy rates have been raised to discourage imprudent risk taking that may impact financial stability.

**The return of large capital inflows to the region, combined with rising inflationary pressures and climbing asset prices, presents an emerging policy challenge and a growing risk to macroeconomic stability.** The large increase in inflows, driven by abundant global liquidity and low yields in advanced countries, and reflective of foreign investors' confidence in East Asia's growth prospects, has been mainly responsible for a substantial appreciation of exchange rates, despite sustained exchange market interventions by central banks. The surge in inflows, combined with ample domestic liquidity and rising confidence, has boosted equity and real estate prices in some countries. Most monetary authorities have refrained thus far from introducing new capital controls although some have liberalized rules for resident investment abroad. But should inflows remain strong, especially against a background of weak global growth, the authorities will be faced with the challenge of balancing the need for robust capital inflows (especially foreign direct investment) with ensuring competitiveness, financial sector stability, and low inflation.

**Now that the recovery is on a firmer footing, many countries are also turning their attention to addressing medium term growth challenges.** These tend to differ across countries. China's growth prospects over the coming decade continue to look bright, but rebalancing the economy by altering the pattern of growth and investment is becoming increasingly critical to ensure sustainability --- structurally, socially, and globally. Commodity exporters in East Asia (Mongolia, Timor-Leste, Papua New Guinea, and Lao People's Democratic Republic) are expected to benefit from relatively high global commodity prices and robust external demand. Their challenge will be to ensure a clear and transparent framework for using resource-related revenues for development. The low-income countries of Lao PDR and Cambodia are advancing on a well understood agenda of spurring private investment in manufacturing by building infrastructure, strengthening connectivity with their fast-growing neighbors, and improving the climate for private investment. The middle-income countries of the region (China excluded) need to increase investment, raise skills, and encourage innovation if they are to eventually attain high-income status. Fixed investment has been on the rise relative to GDP in Vietnam and, of late, Indonesia. But in Malaysia, the Philippines, and Thailand, fixed investment—although recovering to pre-2008 levels—is still well below the levels reached before the 1997-98 Asian financial crisis, and below the levels of investment in Japan, Singapore and the Republic of Korea during their economic take-offs. Moreover, the stock of capital per capita remains very low. More human and physical capital accumulation will help boost growth, support innovation and technical progress, and help firms move up the value chain. Much will depend on the success with which these economies attract private investment, build logistics and connectivity, increase the numbers of skilled and innovative workers, and transform their urban centers into incubators for new ideas.

## I. THE CONTINUED RECOVERY

**East Asia's growth has rebounded rapidly, in line with our projections presented in the April 2010 Regional Economic Update.** We estimate real GDP growth of 8.9 percent in developing East Asia in 2010, up by 0.2 percentage points from our previous forecast (*"Emerging Stronger from the Crisis,"* April 2010) and compared with 7.3 percent in 2009 (Table 1). China remains the regional leader with an expansion of 9.5 percent. For the first time in a decade, five other countries are projected to expand by 7 percent or more (Thailand, Malaysia, Lao PDR, Mongolia, and PNG).

**The outlook for the global economy has brightened since the last update in April despite continued uncertainties about the sustainability of recovery in advanced countries.** We have upgraded our projections for economic growth in the G-3 (the United States, Japan, and the Eurozone) to 2.5 percent in 2010, reflecting improved conditions in all three economic areas. The upward adjustment to the forecast for Japan was the greatest, thanks to markedly stronger outcome in the first half of the year in an economy that contracted much more sharply than most large industrial countries during the crisis. Our projection for the Eurozone has also been marked up, largely due to the strong expansion in Germany that more than offset continued weakness in peripheral Eurozone economies.

**But risks are mostly on the downside this year for growth in advanced economies, especially in the United States.** These risks reflect lingering concerns about government finances in Southern Europe and other small Eurozone economies and the impact of efforts to repair government finances on economic expansion. Growth prospects in the United States continue to be weighed down by high unemployment, ongoing weakness in the housing market, and slow progress in resolving the bad assets of the banking system. This weak growth is adding to budget pressures. Fears of deflation are also adding to the risks faced by advanced economies. While the probability of a double-dip recession in advanced countries has receded, there remains a high probability that their growth rates will continue to be muted for a few years to come. This presents a difficult medium term global environment for East Asia.

**Table 1. Prospects for East Asia and Pacific continue to be bright, although forecasts for 2011 have been reduced**  
(Growth, percent year on year)

	2008	2009	Forecast 2010	Forecast 2011
<b>Developing East Asia</b>	8.4	7.3	8.9	7.8
China	9.6	9.1	9.5	8.5
Indonesia	6.0	4.5	6.0	6.2
Malaysia	4.7	-1.7	7.4	4.8
Philippines	3.7	1.1	6.2	5.0
Thailand	2.5	-2.2	7.5	3.2
Vietnam	6.3	5.3	6.5	7.0
Cambodia	6.7	-2.0	4.9	6.0
Fiji	0.2	-3.0	1.0	1.4
Lao PDR	7.5	6.7	7.7	7.8
Mongolia	8.9	-1.6	8.5	7.0
Papua New Guinea	6.7	4.5	7.5	5.5
Solomon Islands	7.3	-2.2	3.4	5.2
<b>Developing East Asia excl. China</b>	<b>4.6</b>	<b>1.2</b>	<b>6.7</b>	<b>5.1</b>
East Asia	6.3	4.7	8.4	6.8
East Asia excl China	2.7	-0.2	7.1	4.6

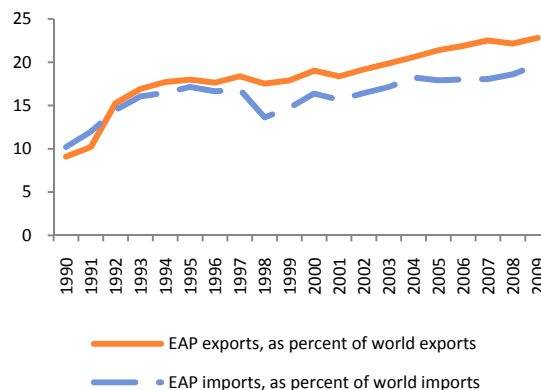
Source: World Bank staff estimates

**East Asia can grow rapidly over the medium term even in a slower global environment, but stronger domestic demand and increased reliance on trade within the region will be needed.** Assuming the G-3 grow at around 2.5 percent a year and developing countries outside East Asia at 5 percent, we estimate that the East Asia and Pacific (EAP) region will need to increase its global market share by 3 percentage points in the next ten years to achieve annual growth of 6.5 percent a year. Our simulations indicate that this growth will come from increased market share as well from growth within EAP itself. This is possible given that East Asia’s world shares of exports and imports have increased by over 5 percent each during the past decade (Figure 1).

**Table 2. Changes in East Asia’s market share required to achieve strong medium-term growth are not large**  
(In percent of world exports)

Assumptions	World market share			
	East Asia growth	East Asia	High-income countries	Other countries
<b>2010</b>	8.9	23.0	57	20.0
<b>2020</b>	6.5	26.1	52.5	21.5

**Figure 1. East Asia’s share in world exports and imports grew steadily over the last decade**  
(In percent of world exports, and in percent of world imports)



Source: Datastream, World Bank staff calculations.

Source: Datastream.

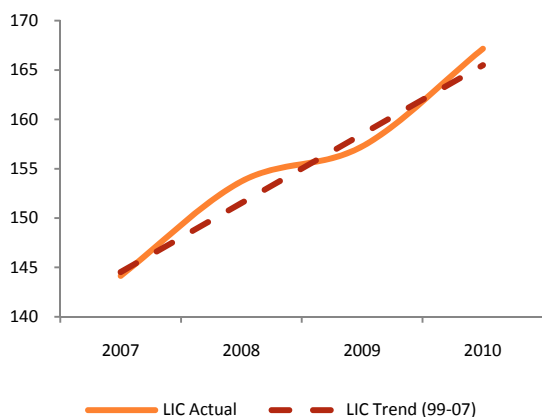
**Robust expansion in private consumption and investment and a recovery in external demand, are supporting East Asia’s rapid recovery.** After accelerating for the better part of three quarters, output has settled to a more moderate expansion path starting with the second quarter of 2010, as spare capacity has become increasingly scarce. Even with the ongoing normalization of the pace of growth to a steadier pace and ongoing concerns about the prospects for advanced economies, East Asia remains the fastest growing world region. And just as monetary policies are becoming more restrictive in response to rising inflation and, in places, concerns about asset price bubbles, capital inflows have surged driven by abundant global liquidity and market perceptions that interest rate and growth differentials between EAP and advanced economies will remain large over the medium term. These short-term challenges to macroeconomic, financial, and banking stability are becoming a key emerging risk, along with the need to ensure progress on structural reforms that will help support strong and sustainable long term growth (see Section II).

**AFTER SHARP INCREASE, GROWTH NORMALIZES**

**Despite lingering uncertainty about the recovery in the G-3, developing East Asia will achieve 2010 growth rates comparable to those before the crisis.** The pre-crisis GDP levels have mostly been overtaken in East Asia, and most countries have come back to their pre-crisis growth rates. Compared to the more moderate pre-crisis growth of 1999-2007, output has exceeded the level predicted by this pre-crisis trend (Figure 2 and Figure 3). Among middle-income economies, however, the record is mixed. China, Indonesia and the Philippines have surpassed their pre-crisis trends; Malaysia just reached the line in the second quarter, but Thailand has yet to reach its past trend.

**Figure 2. Low-income countries have recovered to above their long-term trend**

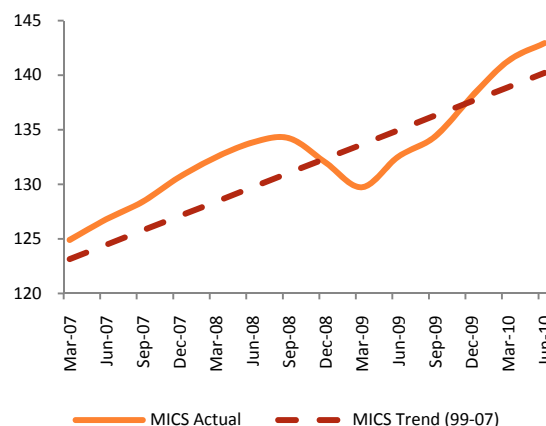
(Real GDP, index 2003=100, estimates for 2010)



Source: CEIC and World Bank staff calculations.  
 Note: Trend is a linear trend in real seasonally-adjusted GDP between 1999 and 2007, compared to the actual seasonally adjusted GDP. Annual data.

**Figure 3. Middle-income countries have recovered to well above their long-term trend**

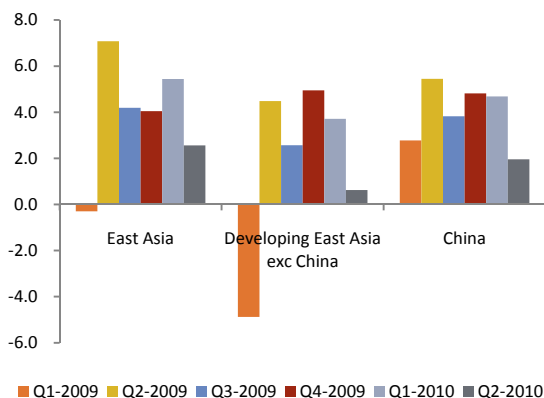
(Real GDP, index 2003=100, estimates for 2010)



Source: CEIC and World Bank staff calculations. Middle-income countries are excluding China.  
 Note: Trend is a linear trend in real seasonally-adjusted GDP between 1999 and 2007, compared to the actual seasonally adjusted GDP. Quarterly data.

**The rapid growth of output and exports during recent months has now normalized.** This was in tune with the unwinding of the stimulus measures, normalization of the inventories and a slowdown in global trade growth. Industrial production growth was already slowing in the second quarter of 2010 after reaching 6 percent in the first quarter, which exceeded pre-crisis growth rates in all East Asian economies except Malaysia and Hong-Kong SAR, China (Figure 4).

**Figure 4. Industrial production slowed in Q2 2010**  
 (In percent, quarter-on-quarter, seasonally adjusted)



Source: Haver Analytics.

**Figure 5. Capacity utilization continued to increase, and is close to pre-crisis levels, except in Thailand**  
 (In percent, and in percent of peak)

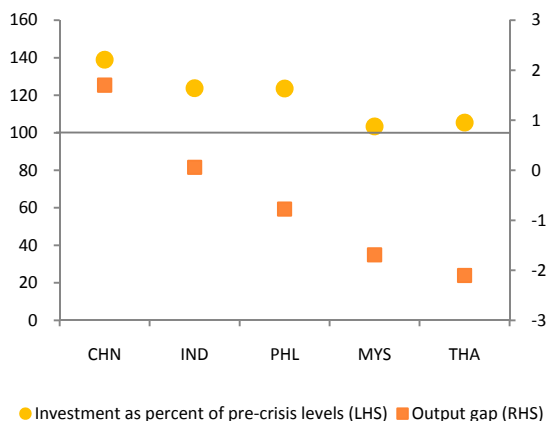


Source: Haver Analytics.

**Capacity utilization continued to increase and almost reached its peak pre-crisis levels in most countries (Figure 5), as private investments picked up (Figure 7).** Private domestic demand expanded and became the main driver of growth, offsetting a slowdown in government spending. The contribution from investment grew fast, especially in the Philippines and Malaysia. Countries where investment recovered to pre-crisis levels the fastest as a share of

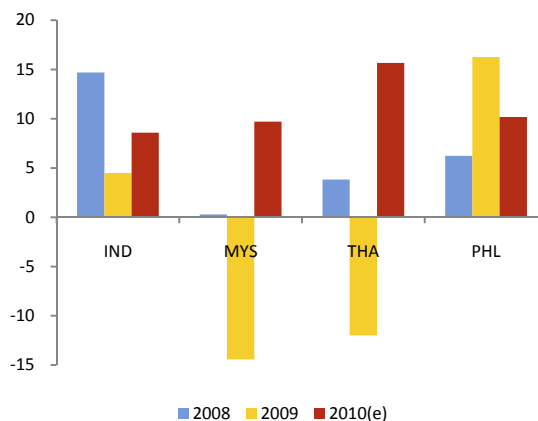
GDP also showed smaller output gaps in comparison to pre-crisis trends (Figure 6). As capacity utilization limits are gradually reached, more investment will be needed to drive growth in the medium-term (see Section III).

**Figure 6. Countries where investment recovered faster also had smaller output gaps**  
(Investment as an index, 2007=100; output gap in percent of GDP)



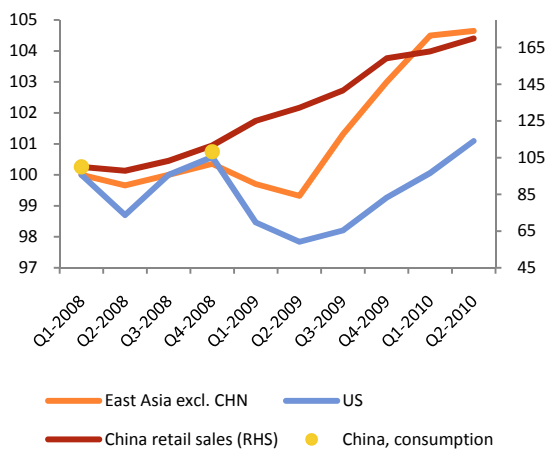
Source: Haver Analytics. Note: To obtain a measure of the “output gap”, we estimate the long-term trend in GDP, using an HP filter, and compare it to an average actual GDP during the crisis years 2008Q4-2010Q2.

**Figure 7. Private investment is projected to grow rapidly in 2010**  
(Percent change, year-on-year)



Source: Haver Analytics and World Bank staff estimates.

**Figure 8. Consumption and retail sales boomed**  
(Real consumption index, and retail sales index Q1-2008=100)



Source: Haver Analytics.

**Consumption growth in East Asia remains more than double the pace in the United States and other advanced economies.** Retail sales, an admittedly imperfect proxy for consumption, have climbed sharply in China is now two-thirds above pre-crisis levels; sales of flat screen TVs, automobiles and even Bordeaux wines in East Asia are now the largest for any region in the world (Figure 8). The contribution of private consumption to growth recovered to pre-crisis levels in most middle-income countries.

**EXPORT GROWTH IS SLOWING**

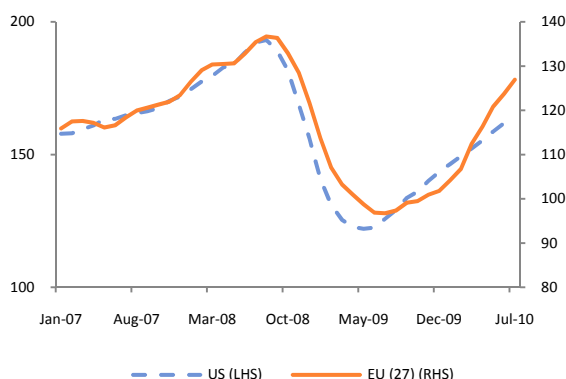
Exports recovered to their pre-crisis levels almost everywhere in the region, but their growth slowed recently. Half of China’s exports go to the U.S. and EU (some via Hong-Kong SAR, China), and even though G-3 imports have recovered to pre-crisis levels, further growth should decelerate (Figure 9). China’s export growth, earlier led by

steel and heavy machinery moderated since June (Figure 11). Driven by expectations of slowing consumer demand amid uncertain G-3 growth prospects, exports within the production networks stabilized and even fell in nominal terms for some products. In particular, electronics exports fell starting early in 2010 with the suppliers at the bottom of the production networks (the Philippines) and spreading to the final producers' (China) exports that fell in July (Figure 10).

**China's trade surplus nevertheless increased during the last six months, and there are pressures for its further strengthening (Figure 12).** China's imports growth has slowed as activities supported by the stimulus package waned and demand growth for imports of intermediates needed for export production followed suit (Figure 11). China's demand for energy moderated since the start of the year (Figure 11). Terms of trade are turning more favorable for China in the second half of the year though. Trade balances did not change significantly in other countries, but in Lao PDR and Cambodia trade deficits increased, driven by increased imports unmatched by export growth; in Lao PDR, these imports were for construction of roads, office buildings, and other infrastructure that has been fueled by high credit growth.

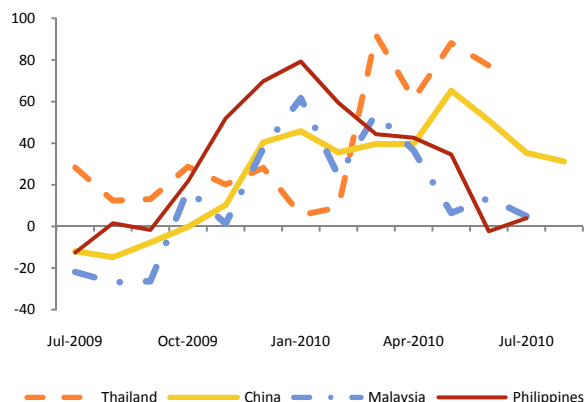
**Figure 9. EU and U.S. imports have almost recovered to pre-crisis levels**

(U.S. imports in billions of U.S. dollars; EU imports in billions of euros; seasonally adjusted, 3-month moving average)



Source: CEIC.

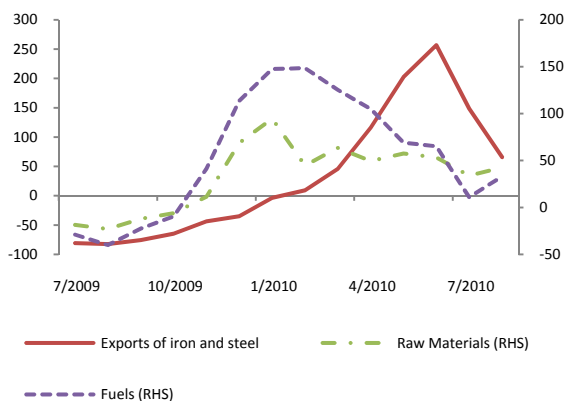
**Figure 10. Exports of office machines and computers slowed**  
(percent change year-on-year)



Source: CEIC.

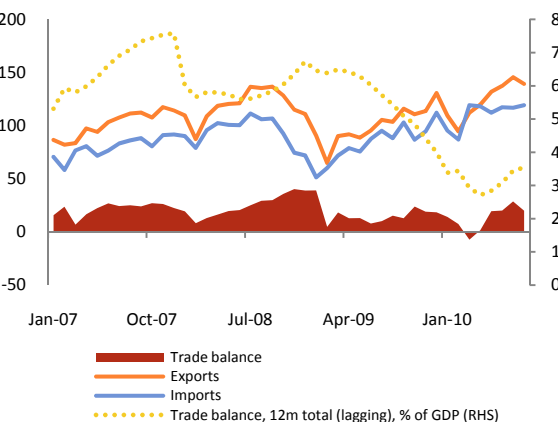
**Figure 11. Growth in China's steel exports slowed dramatically, as did imports of raw materials**

(Percent change year-on-year)



Source: CEIC.

**Figure 12. China's trade surplus increased**  
(In percent of GDP and in billions of U.S. dollars)



Source: CEIC.

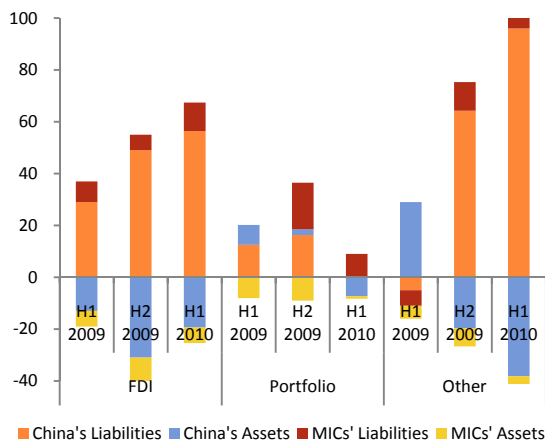
**CAPITAL INFLOWS OF ALL KINDS SURGED**

The region is experiencing a surge in capital inflows driven by improved East Asian growth prospects and strong investor sentiment, and large differentials between East Asia and the advanced economies for both growth and interest rates. While some of these drivers could be short-lived, others – notably the growth gap - are likely to continue into the medium-term.

The revival in capital inflows, from levels that were depressed early last year, is for both direct investment and portfolio flows (Figure 13). China posted higher net foreign direct investment (FDI) inflows of \$37 billion (of which \$56.4 billion inward flows) in the first half of the year compared to \$34 billion all of last year. The other middle-income countries of East Asia reported net FDI of \$5 billion (of which \$11 billion inward flows) in the same period, compared to negative \$900 million all last year. FDI inflows also increased into Mongolia: by 62 percent in the second quarter (on a four-quarter rolling basis), compared to the first quarter of 2010, mainly driven by the investments into the mining sector. Foreign portfolio investment has also surged recently, especially into Indonesia and Korea, driven by profitable carry trade in the equity and fixed income markets (Figure 14).

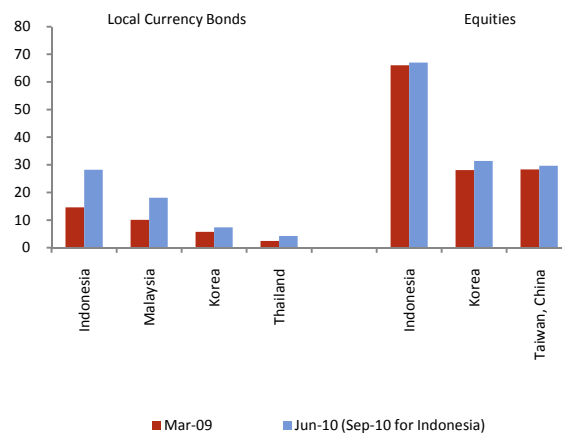
In part, the inflows were facilitated by increased opportunities for foreign investors through the successful introduction of new local currency instruments. China and Hong-Kong SAR, China have been the main issuers (led by central banks), followed by Korea, Thailand, and Indonesia. With \$2 trillion in new issues for the entire region, outstanding local currency bonds are now equivalent to 58 percent of the region’s GDP, up from 53 percent at the beginning of 2009. Of these, \$1.1 trillion was for developing East Asia, of which 68 percent -- for China. Foreign currency bonds outstanding remain at 5 percent of the region’s GDP, although some countries rely on such instruments more than others (such as the Philippines, where the stock of such bonds is equivalent to 20.3 percent of GDP). Emerging markets collectively raised \$42 billion in initial public offerings (IPOs) in the third quarter, topping IPOs by developed nations by \$31 billion. Chinese issuers accounted for the three largest sales, with the Agricultural Bank of China posting the world’s largest IPO to date at \$22.1 billion. Foreign ownership of the region’s bonds and stocks has increased gradually since the crisis trough (Figure 14); McDonalds was the first private company to issue a renminbi-denominated bond.

**Figure 13. Capital inflows have returned to the middle-income countries**  
(In billions of U.S. dollars)



Source: Haver Analytics and CEIC.  
Note: MICs are Indonesia, Malaysia, the Philippines, and Thailand.

**Figure 14. Foreign ownership of bonds and stocks also grew, for some countries -- dramatically**  
(Bonds: in percent of bonds outstanding; equities: in percent of market capitalization)

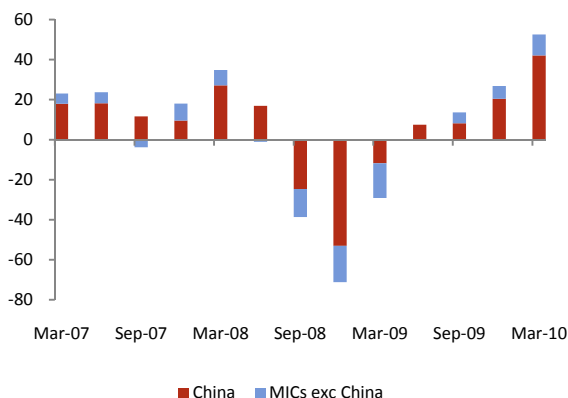


Source: CEIC, ADB, Korea Financial Supervisory Service.  
Note: For Indonesia, ownership of government only.

**Bank flows are still weak globally but have returned to the region.** Claims by foreign banks on East Asian borrowers have been growing anew since April 2009 (Figure 15). Other inflows, however, including repatriation of resident assets, have yet to return to their pre-crisis patterns, except in Thailand. Residents bringing home foreign assets were a substantial portion of capital inflows in the first half of 2010 (Figure 16).

**Figure 15. Bank flows returned to the region**

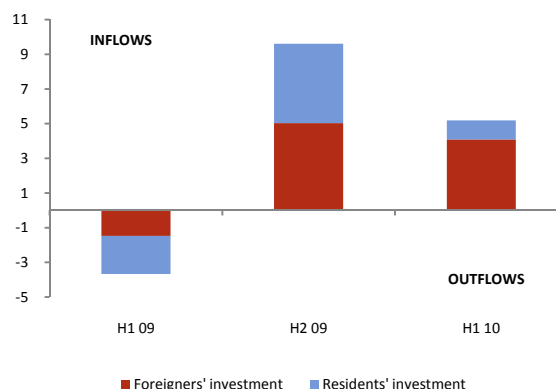
(Changes in claims of BIS-reporting banks on EAP, exchange rate-adjusted, in billions of U.S. dollars)



Source: Bank for International Settlements (BIS).

**Figure 16. Thailand's residents are bringing their assets back home**

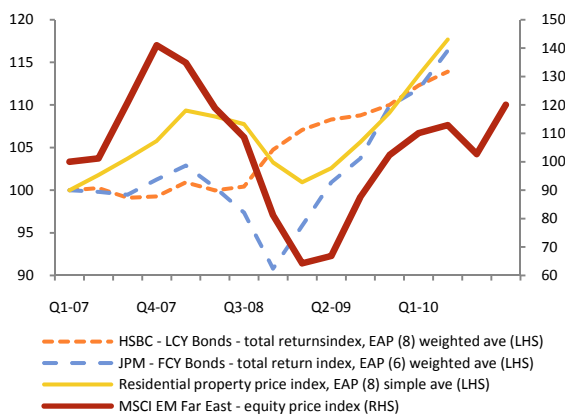
(Resident lending abroad, in billions of U.S. dollars; a positive amount indicates asset repatriation)



Source: CEIC.

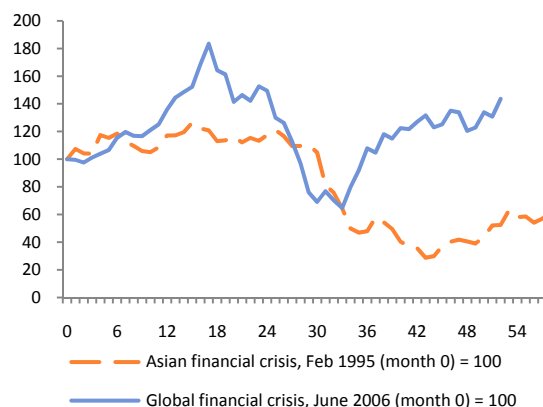
**Larger inflows combined with ample domestic liquidity and rising confidence have boosted stock markets, real estate prices and other asset valuations in some countries, precipitating fears of a new bubble.** Asset markets in the region have recovered from their lows in late 2008 and early 2009 and are now booming, also aided by relatively accommodative monetary conditions at home. Equity prices have more than recouped their losses during the crisis; bond values have raced significantly above their lows (Figure 17); and the average real estate property price index for eight East Asian countries is about 17 percent above its level in early 2007. Memories remain fresh of the Asian financial crisis that ended with unfortunate (and well-known) consequences; in equities, the run up in prices was just half of the current increase (Figure 18). The authorities in East Asia need to take adequate precautions to ensure that they do not repeat the same mistake twice in slightly over a decade.

**Figure 17. Are asset prices in East Asia growing too fast?**  
(Indices, Q1 2007 = 100)



Source: MSCI/Barra, Hong Kong Shanghai Banking Corp., JP Morgan, and World Bank staff estimates.

**Figure 18. Equity prices rose faster and higher after the global crisis than after the 1997-98 Asian financial crisis**  
(index)

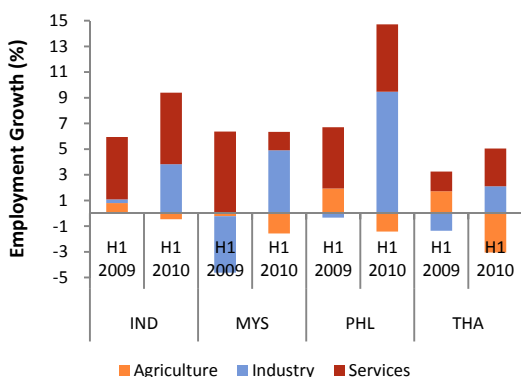


Source: MSCI/Barra.

**EMPLOYMENT IS RECOVERING, BUT MORE SLOWLY THAN OTHER KEY ECONOMIC INDICATORS**

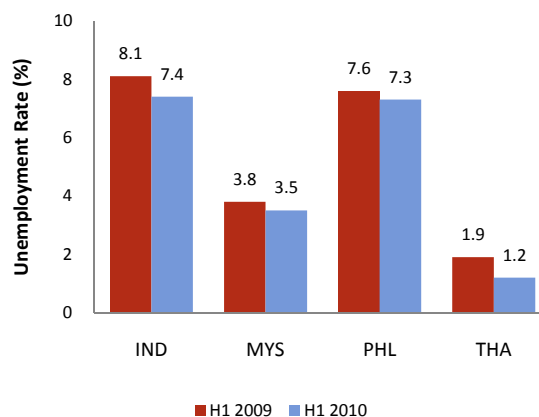
Employment has continued to grow in the aftermath of the crisis, with marked sectoral shifts from agriculture toward industry and services in 2010 (Figure 19). Unemployment remained relatively low in East Asia during the food and fuel crisis in 2008, and continued to edge downward in the aftermath of the global financial crisis (Figure 20). Workers laid off from manufacturing and other industrial jobs during the crisis often found alternative employment in the agriculture and service sectors, although commonly in lower paying, informal sector jobs. Sectoral patterns of employment have begun to revert to pre-crisis patterns in 2010. But the pace of recovery of manufacturing employment—often among the higher quality, better paying jobs—has varied across the region. In some countries it has not yet reached pre-crisis levels, even though production has resumed (Figure 21). While manufacturing sector employment has essentially recovered in the Philippines and is above pre-crisis levels in Indonesia, it remains below 2007 levels in Malaysia and Thailand.

**Figure 19. Employment increased, but services continued to drive it in most countries**  
(Percent change)



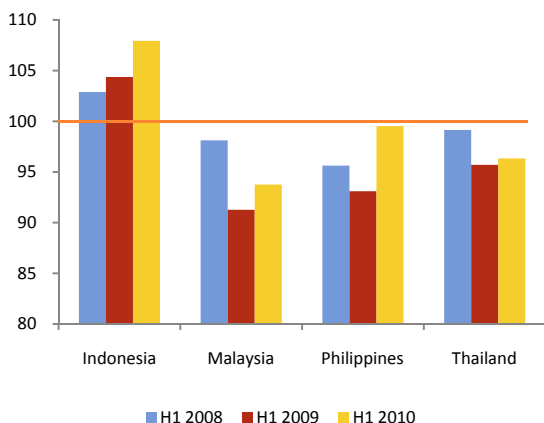
Source: CEIC.

**Figure 20. Unemployment has declined only slightly as the region's economies have rebounded**  
(In percent)



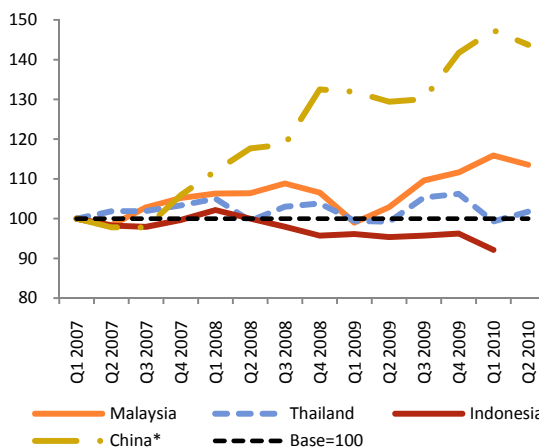
Source: CEIC.

**Figure 21. Despite recent gains, manufacturing employment has not yet recovered in some countries**  
(Index, 2007=100)



Source: CEIC.

**Figure 22. Real manufacturing wages are holding firm or rising in most countries**  
(Index, 2007=100)



Source: CEIC.

Note: China's wage is the average for all non-state owned units. All series are deflated by CPI.

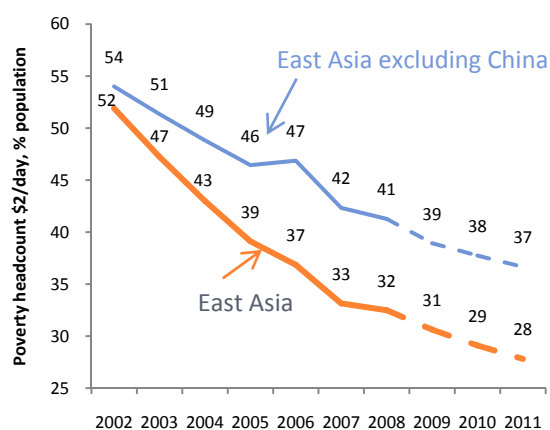
**Real manufacturing wages are holding firm or rising in most countries following downward pressure at the height of the crisis.** Data indicate that real manufacturing wages have been rising in China and more recently in Malaysia, once normal seasonal variations in wages are accounted for, while in Thailand manufacturing wages are holding firm (Figure 22). Real wages of the garment sector workers have stabilized in Cambodia, following significant declines during the crisis, and there are signs that the real daily earnings of garment workers have started to increase again. In Indonesia, however, the data suggest that real manufacturing wages have not yet rebounded in the aftermath of the crisis and, in fact, declined slightly in the first quarter of 2010 (Figure 22). Higher-than-expected inflation driven by rising food prices may have continued to put downward pressure on real wages in Indonesia as the year has progressed (see Box 2 in Section II), although these factors are expected to have a temporary effect.

**Within countries, workers' employment and earnings are recovering at different rates depending on how quickly labor demand in their specific sub-sectors is rebounding.** Interviews with groups of crisis-affected workers in Cambodia suggest, for example, that demand for labor in the garment sector has risen relatively quickly with the economic rebound. Garment workers whose hours had been cut during the crisis reported working full-time again or even working overtime. Interviews with rural families of garment workers employed in urban factories confirm these accounts, as rural family members report renewed receipt of remittance income. Labor demand has recovered more slowly—and unevenly—among workers in other crisis-affected sectors, however. While skilled construction workers report an increase in demand for their skills, unskilled construction workers along with providers of small-scale transport services, report continued difficulty in finding adequate work opportunities.

### POVERTY REDUCTION HAS RESUMED, BUT MORE SLOWLY THAN BEFORE THE CRISIS

**With economic recovery, the pace of poverty reduction is expected to pick up again in 2010 and 2011 – albeit more slowly than before the food, fuel, and global financial crises** (Figure 23). The pace of poverty reduction slowed considerably in 2008-2009. The share of the region's population living below \$2/day declined by about 4 percentage points a year between 2002 and 2007, but by less than 1 percentage point a year on average between 2007 and 2009. As the region's economies recover, poverty reduction is expected to accelerate to about 2 percentage points a year in 2010 and 2011. The same general conclusions regarding the pace of poverty reduction before and after the crisis hold true even if China, with its historic rates of poverty reduction, is excluded from the picture (Figure 23).

**Figure 23. Poverty reduction is expected to continue in developing East Asia, albeit at a slower pace (headcount index, percentage of total population)**



Source: PovcalNet and World Bank staff calculations.

affected agricultural production in the Philippines. This natural shock following quickly on the heels of the food, fuel, and financial crises, has created new challenges for the country in its efforts to reduce rural poverty.

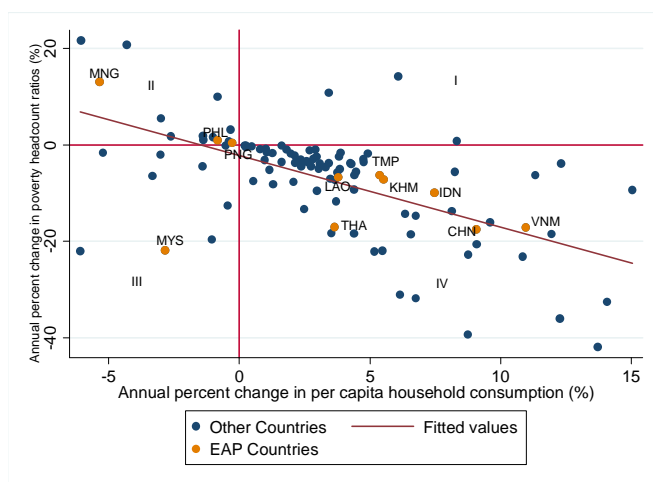
**The slower pace of poverty reduction is due to several factors, including a weakened effect of economic growth on poverty reduction in China.** The lag between recovery in key economic indicators and in employment opportunities is one key reason for a slower pace of poverty reduction in the aftermath of the crisis, at least in the short-term. Moreover, recent structural increases in income inequality in China have reduced the effect of any quantum of growth on poverty; in other words, any given amount of growth is less effective than before in reducing poverty in China. The global crisis also raised income inequality in Mongolia, similarly affecting the effectiveness of growth to reduce poverty. Other countries have faced different challenges on the crisis aftermath. For example, just as other sectors were rebounding from the global crisis, an El Nino phenomenon significantly

**INCLUSIVE GROWTH, QUICKER POVERTY REDUCTION**

Higher economic growth is generally associated with faster poverty reduction, and rapid growth has been at the center of East Asia’s success in reducing poverty over the last few decades. As the effects of rising income inequality in China suggest, some patterns of growth can be more effective in reducing poverty than others (Figure 24). Thailand, for example, was more successful in fighting poverty between 2006 and 2009 than other countries with similar levels of income growth because growth in household-level income has been significantly higher among poorer than richer households (Figure 25). Growth in Indonesia between 2008 and 2009 has been more evenly distributed across poor and non-poor households.

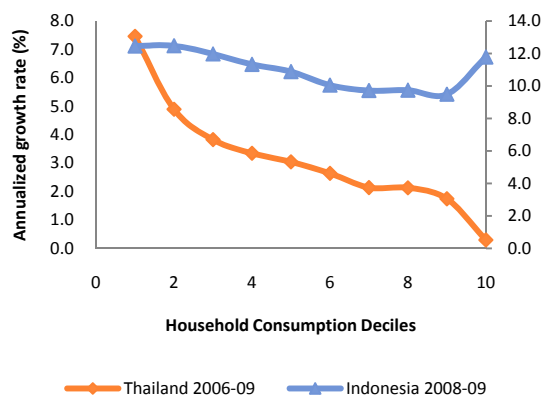
One way to foster more effective poverty reduction in the region, as the region’s economies rebound, is to promote greater equality of opportunities among poorer—and sometimes excluded—segments of the region’s populations. Addressing inequalities in opportunities therefore make growth more inclusive for the more than one-quarter of developing East Asia’s population that still lives below \$2 a day. Increased human capital investments that improve their skills and capabilities, for example, at the secondary school level and beyond, would enable poor and excluded groups to participate more effectively in the growth process and would simultaneously create new sources of growth. Similarly, infrastructure investments that connect poorer, more remote areas to key growth centers and that enable poor people to migrate and work in areas where jobs are growing would also help to foster more inclusive growth (see Box 1).

**Figure 24. Income growth has been a major driver of poverty (percent change)**



Source: World Bank staff calculations, using PovcalNet.

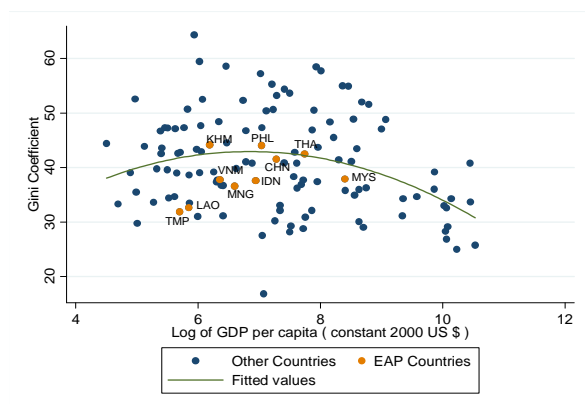
**Figure 25. In Thailand, incomes of poorer households have increased at a higher rate than those of richer households, unlike in Indonesia (In percent)**



Source: Thailand Socio-economic Survey 2006 and 2009, and World Bank staff calculations.

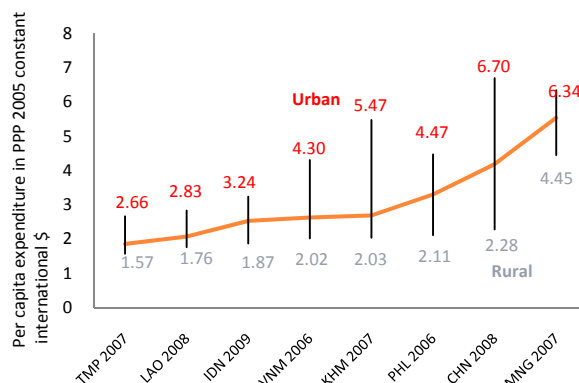
Overall inequality in East Asia is generally lower than in other countries with similar income levels (Figure 26); however, rising inequality in several countries in the region is threatening to dull the impact of growth on poverty reduction over time. Rising inequality may also have a negative effect on the social cohesion and stability needed to sustain economic growth. In this context, increasing income inequality between rural and urban populations is also an increasingly important issue in the region. Rural-urban income gaps have been widening, and are especially high in Cambodia (Figure 27) and in China (see Box 1). Concerted efforts to foster inclusive growth will thus be critical to sustaining effective poverty reduction in East Asia over time.

**Figure 26. East Asian countries are more equal on average (Index, 1-100)**



Source: World Bank staff calculations on World Development Indicators. Gini coefficients are expenditure-based.

**Figure 27. Consumption inequality between rural and urban population is the highest in China and Cambodia (In percent of adults)**



Source: World Bank staff calculations.

### Box 1. Addressing rural-urban inequality in China

The focus on more “harmonious” regional development within China’s overall investment-led growth policy is welcome as it aims to spread China’s social and economic achievements further in-land and among its relatively impoverished population.

Dramatic increases in agricultural productivity in the interior provinces and productivity increases that accompanied the expansion of town-village enterprises in the 1970s and 1980s were important enablers of the dramatic globalization-infused growth of coastal China in the 1990s and 2000s. Inland-coastal disparities have increased quite substantially since then precisely because the inland regions did not fully participate in China’s recent and phenomenal growth experience (Figure 28). Hence, reducing inland-coastal disparities will not only prevent potential political and social fallouts, but fuller economic integration of lagging regions is likely to enhance overall economic efficiency and productivity.

A new regional development strategy must derive important lessons from the tremendous progress made in the industrial clusters of the eastern coastland. But these lessons must be supplanted by fresh approaches to (1) identify regional resource endowments and comparative advantage nodes, (2) assess what types of infrastructural investments carry the highest payoffs wherein promoting connectivity and integration with key markets, and (3) find innovative ways of adapting institutions that promote and facilitate sustainable economic activities in environments that are significantly different from those in the coastal areas.

The twin advantages of geography and agglomeration will mean that even with an increased emphasis on the domestic economy, the coastal area will continue to remain a significant growth corridor. Hence spatial labor market policies, including reforms that improve migrants’ and their families’ access to good health and education and other basic services, will continue to be a major vehicle in reducing regional disparities, especially in remote areas where returns to infrastructure maybe too low to justify investment. In such environments, investments in human capital that upgrade skills and increase the ability to migrate would be more preferable. Current levels of per capita government expenditures in the coastal regions have been 1.5 times those of the inland regions (Huang and Luo 2009).

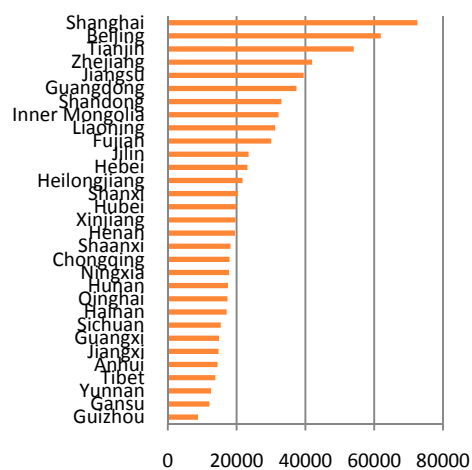
With the expected increase in domestic consumption in China, there is also growing scope for developing growth centers inland that have distinct cost and market advantages, especially when basic connectivity infrastructure is fully in place. Indeed a slight reduction in inland-coastal disparity is detectable after 2000 when the government significantly increased

infrastructure investments in the western regions (Figure 29). Studies show that the movement of production inland is preceded and driven in part by retailers and the networks they bring with them. The speed with which the retailer networks expanded inland shows that demand side for such expansion exists.

West-ward integration of markets also stands to gain from transferring the experience of industrial clustering from the coastal areas, especially in industries that are relatively more land- and labor-intensive, so that the regional comparative advantage associated with lower land and labor unit costs can be fully exploited.

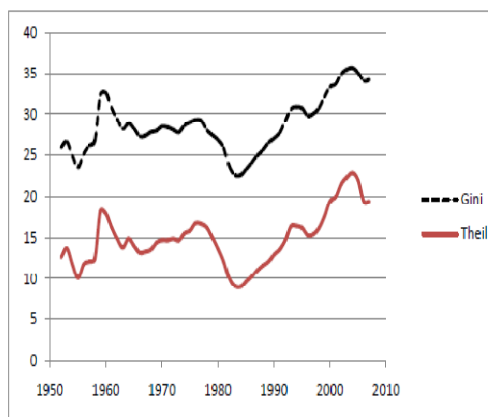
Finally, a more consistent application of policy incentives for investment and growth across space is called for, especially recognizing China’s unique combination of fiscal decentralization and centralized government structure. Extending preferential policies related to taxation and deregulation further inland, broadening the access to credit, and standardizing basic health and education services across provinces will greatly level the playing field in favor of the inland provinces, improving both equity and growth.

**Figure 28. GDP per capita varies between China’s provinces**  
(In renminbi, 2008)



Source: China Statistical Yearbook 2.

**Figure 29. Rising inequality in China accompanied the decoupling of coastal regions**  
(Index)



Source: Fan S. R. Kanbur and X. Zhang, 2010, China’s Regional disparities: Experience and Policy. Department of Applied Economics and Management. Cornell University, Ithaca, NY.

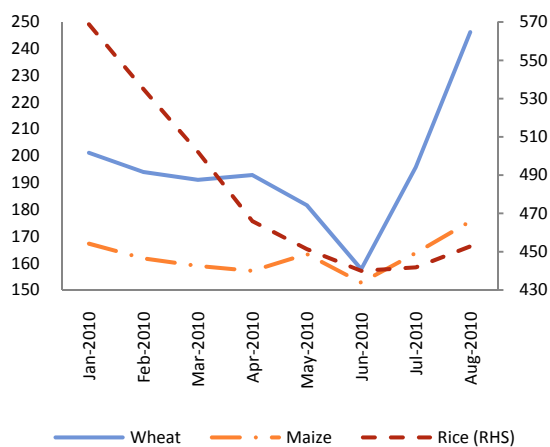
## II. EMERGING RISKS

This section examines three emerging risks that arise directly from the current global liquidity conditions and the accompanying surge in capital flows into many East Asian countries. The first is the risk of rising inflation expectations in goods and asset markets at a time when food prices are already rising and threaten to rise further, and monetary policies are already burdened with accommodating fiscal deficits that are winding down slowly. Governments will now need to rethink the most appropriate mix of fiscal and monetary policies to curb inflation while supporting the recovery in growth. The second is the risk that these inflows are intermediated through the financial system in ways that undermine stability, placing a premium on central bank supervision of banks and non-bank financial intermediaries to guard against imprudent borrowing or lending practices. The banking systems in East Asia entered the global financial crisis with sound financial structures thanks to the lessons learned during the Asian financial crisis; this prudence should not give way to temptation now that low-cost international capital is available in abundance. These first two risks raise early concerns about East Asia’s increasing vulnerability to sudden stops, and possibly even capital reversals, once the global liquidity taps are turned off. The third is the risk that export competitiveness may be eroded if countries in the region do not cooperate to tackle these common challenges.

### CURBING INFLATION, SUSTAINING GROWTH

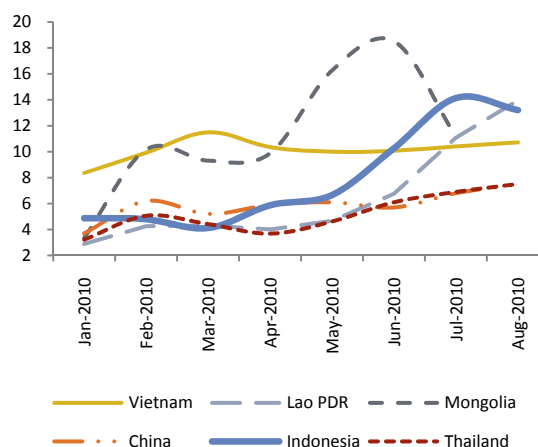
Strong domestic demand, accommodative monetary policy, and a large increase in international food and commodity prices have caused inflation to rise across the region. Inflation has exceeded the upper limit of the central bank’s inflation target band in some countries, including in Indonesia and China, and the monetary authorities in Thailand warned of a similar risk there in the near future. In Indonesia inflation has also been boosted by an increase in administered prices of electricity, and in Malaysia by cuts in household subsidies for food and energy.

**Figure 30. Rice prices increased by 10 percent in August, driven in part by a sharp increase in wheat prices... (U.S. dollars per metric ton)**



Source: Haver Analytics.

**Figure 31. ...this led to double-digit increases in domestic food prices (Percent change in food price index, year-on-year)**



Source: Haver Analytics.

Food prices are on the rise in most countries, notably in Indonesia, Vietnam, Lao and Mongolia (Figure 31). Apart from the spillover of the international wheat price panic to other grains, domestic reasons vary. Drought sent vegetable prices 38 percent higher than a year ago in July in Thailand, and is believed to have increased glutinous rice prices by nearly 50 percent in Lao PDR, compared to a year ago. Drought and floods, although expected to have only temporary impacts on prices, will likely cut rice production in other countries, raising food security fears across the region. Most importantly, high food prices affect populations below the poverty line (see

Box 2): the poorest people in the Philippines and Indonesia buy around 80 percent of their food. In Indonesia, the poverty basket inflation rate is around 5 percent higher than the headline inflation rate, the rice component of which, in turn, is now 70 percent higher than the international price. These developments are, however, against a more favorable background than during the last food crisis: rice supplies appear to be stable globally and in the region, with Thailand, Vietnam and Cambodia reporting large surpluses available for exports, the Philippines indicating plans for lower imports, and China having considerable reserves to deal with supply shocks. Prices are also well below the levels that prevailed during the 2008 food crisis, when they were roughly twice their current level.<sup>1</sup>

### Box 2. On the watch for food security as prices edge up

The first half of 2010 saw a decline in the price of the dominant staple, rice, in many countries in the region including China, Vietnam, and Cambodia. However, rice prices increased by about 10 percent in August due, in part, to the knock-on effects of the increase in wheat prices resulting from the poor harvests in Russia as well as to weather-related shocks that depressed rice production in Pakistan and China.

Although the food supply situation in the region remains robust with Thailand and Vietnam having large rice surpluses, staple-importing countries such as Indonesia, the Philippines, and Mongolia are likely to feel food price pressures, especially if the recent floods in China and the region end up exacerbating the overall supply-demand situation.

Global wheat prices increased by 56 percent between June and August 2010 and this has had a significant effect on food prices in Mongolia where wheat, the dominant staple, is imported. Even though international prices are still much below the 2008 crisis levels, some countries have started to issue warnings on stocks; for example, the U.S. Department of Agriculture warned that its stocks of corn were at 14-year low. Although most countries in developing East Asia reported healthy stocks and higher production than in 2008, prices may stay high for a while.

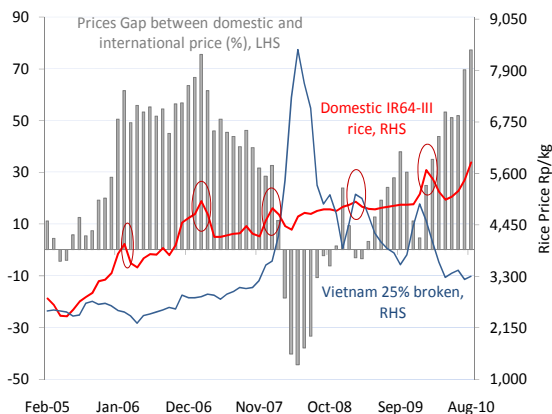
Even in the face of a robust global food supply situation, local food supply disruptions have the potential to cause price hikes when domestic markets are weakly linked to international markets. Indonesian domestic wholesale rice prices, for example, did not follow lower international prices in 2010. In January, wholesale rice prices in Indonesia were only 5 per cent higher than regional equivalents but by late August, domestic price increases, resulting from supply shortages due to unusually wet weather, combined with import restrictions pushed the gap out to 70 per cent (Figure 32). Such increases in basic food prices, mainly the result of rice imports restrictions, particularly affect poor households as food items make up 63 percent of poor households' consumption basket on average. They specially affect those households that are net buyers of food. The poverty basket inflation rate in Indonesia in August reached 11.3 per cent, around 5 percentage points higher than the headline rate – the largest gap between the two since the global food crisis in 2006.

Overall, food price volatility remains a key issue in the region as unexpected natural disasters and production shocks can easily upset the food situation. For example, the 2010 El Nino phenomenon in the Philippines reduced agricultural production by 2.6 percent in the first half of 2010, complicating the country's recovery from the global economic crisis. The crop sector was the hardest hit, with corn production in the

<sup>1</sup> During the 2008 food crisis, prices rose to \$900/mt for rice, \$400/mt for wheat, and \$300/mt for maize.

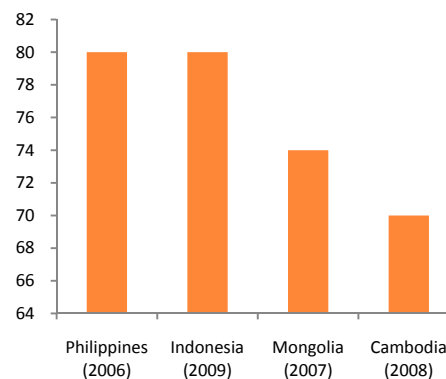
first half of the year down by 25 percent and rice production down by 10.2 percent. With the bulk of the poorest groups depending on food purchases, food price spikes can quickly translate into steep income losses and can have negative impacts on poverty and hunger, and can complicate achievement of other human development goals. In the case of the Philippines, the poverty headcount rate in 2010 is estimated to be higher by 0.4 percentage point due to the El Niño effect (Figure 33).

**Figure 32. Inadequate integration between domestic and international rice markets has prevented Indonesian consumers from benefiting from lower rice prices**



Source: Indonesia Economic Quarterly, September 2010.

**Figure 33. Poorest people in the Philippines and Indonesia purchase a large percentage of their food (Food purchased as percent of total food consumption for the bottom income quintile group, in percent)**



Source: Household surveys and World Bank staff calculations.

**Industrial commodity prices also soared recently to their highest levels since 2008 in dollar terms (Figure 35).** The expectations of the monetary easing in the United States, as well as high demand from China and other relatively fast-growing economies combined with some disruption on the supply side seem to be main reasons for this rally. The recent weakening of the U.S. dollar in which prices are denominated has been another factor, although the dollar is still 3.3 percent stronger in real terms than in the first half of 2008 when prices peaked most recently. Some concerns were raised that a significant and prolonged industrial commodity price increase might hamper growth in G-3, but even more so in countries where production is commodity- and energy-intensive (see Box 4). The commodity exporters in the region (Mongolia, Papua New Guinea, Timor Leste, and Lao PDR) stand to benefit, however. For example, Mongolia registered a near 250 percent increase in windfall profits tax receipts and more than a 100 percent increase in royalty payments in August, compared to a year ago, and Timor Leste recorded a \$1.4 billion current account surplus in 2009 and increased the assets of its Petroleum Fund to \$6.5 billion.

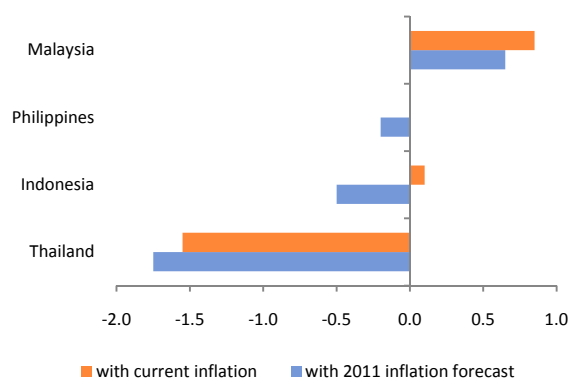
**The monetary authorities in the region have continued with increasingly restrictive monetary policies amid rising inflation.** The response also reflects concerns about rising asset prices in some countries. At the same time, central banks have limited policy rate increases, on the concerns that high interest rates may boost capital inflows and strengthen currencies further, however.

**Thanks to adjustments in the monetary stance earlier this year (reported in our April 2010 Update),<sup>2</sup> most central banks have by now partially withdrawn the exceptional policy support provided during the crisis, including by raising minimum reserve requirements and tightening prudential requirements.** In Vietnam, for example, the central bank abolished the interest rate subsidy that boosted lending during the crisis, capped bank

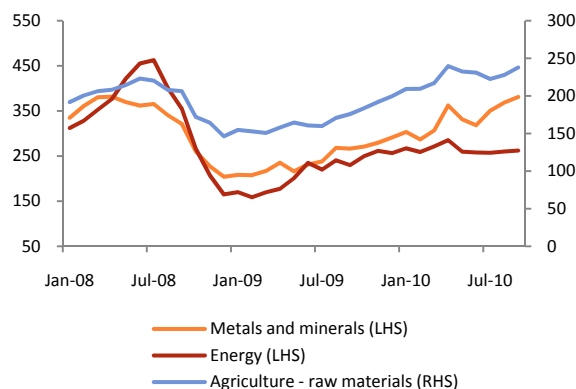
<sup>2</sup> World Bank. 2010. *East Asia and Pacific Economic Update: Emerging Stronger from the Crisis*, [www.worldbank.org/eapupdate](http://www.worldbank.org/eapupdate).

credit to 80 percent of deposits, and increased the regulatory capital adequacy ratio. The People's Bank of China increased reserve requirements, cut the lending target by 22 percent from last year, and tightened lending for heavy industry and to the housing sector. The authorities also introduced several important micro-prudential regulations: they increased downpayments for second mortgages and instructed banks not to grant loans to finance purchases of third homes. Policy rates were increased most substantially in Malaysia by a cumulative 75 basis points, reversing more than a third of the reductions during the crisis. Thailand and Vietnam have seen much more modest increases. However, there is still ample space for tightening to reach pre-crisis rates, and at present policy interest rates are below the projected end-2011 inflation only in Thailand (Figure 34).

**Figure 34. The key policy rate in Thailand is still lower than inflation**  
(Policy rate less 12-month inflation, in percent)



**Figure 35. Industrial commodity prices inflation accelerated, as they reached 2008 levels**  
(Index)

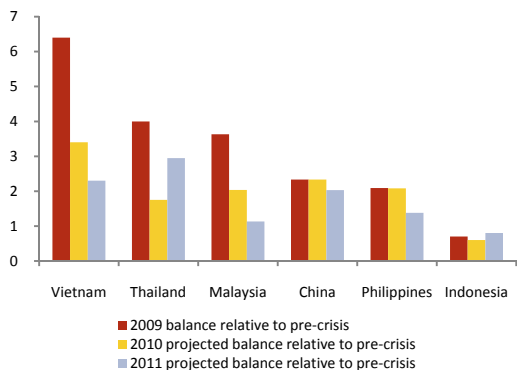


Source: Authorities and World Bank staff estimates. Source: World Development Indicators.  
Note: Inflation data as of August 2010.

**The ability to tighten monetary policy is also constrained by fiscal deficits that are winding down slowly following the implementation of the stimulus packages in 2009.** Fiscal deficits are on track to narrow this year and next, given a pickup in revenues and the unwinding of the fiscal stimulus measures. Nonetheless, deficits in most countries are projected to remain substantially larger than pre-crisis averages at least through 2011, as governments worry about the downside risks to growth despite the clear recovery in private investment and consumption. Moreover, in the region's middle-income countries some temporary stimulus measures are becoming permanent and governments are planning to boost infrastructure spending to address gaps accumulated since the 1997–98 Asian financial crisis. To the extent that expenditure levels are increased permanently, additional fiscal resources will be needed to ensure adequate fiscal space in time for the next shock. Except in a few countries, the fiscal effort to do so is unlikely to be too demanding and the impact on growth should be limited. But if these fiscal resources are not prudently managed, the public sector could potentially crowd out private investment at the margin through higher interest rates.

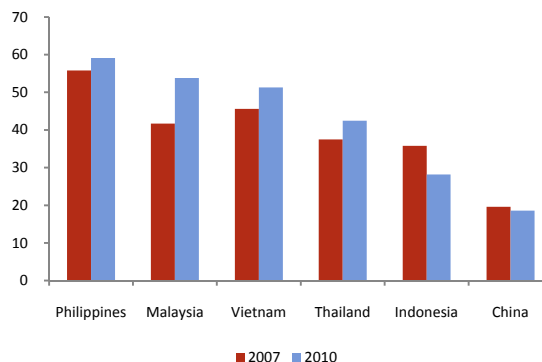
**On average, fiscal deficits in East Asia and the Pacific are projected to decline faster than in most other regions.** Through 2011, the average fiscal deficit is projected to narrow by 1.5 percent of GDP, reversing more than a third of the fiscal deterioration in 2009 (Figure 36). The average conceals large differences among the individual countries, however. The deficits in Indonesia and China—the countries with the lowest levels of debt in the region—are projected to remain broadly unchanged in 2010 and 2011. In Indonesia, the authorities' draft budget planned a deficit of 1.7 percent of GDP, incorporating an increase in infrastructure spending, with discussions ongoing regarding the treatment of energy subsidies. An increase in infrastructure spending also contributed to the projected increase in the deficit in Thailand in 2011, although it was mainly driven by increases in current expenditures on health care and agricultural support, as well as a 5 percent increase in civil servants' pay.

**Figure 36. Fiscal balances are set to improve, but remain well above pre-crisis levels**  
(difference between fiscal balance and 2005-07 average, in percent of GDP, a positive number indicates higher deficit than in 2005-07)



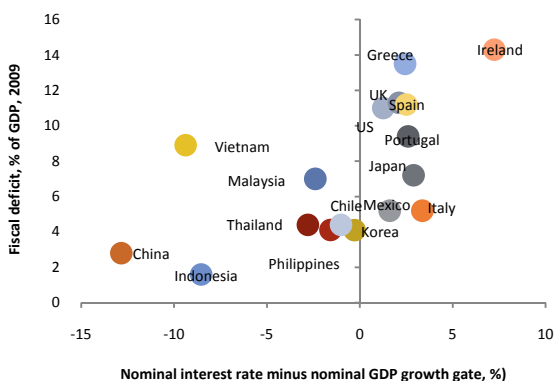
Source: National authorities and World Bank staff estimates.

**Figure 37. Levels of public debt in most countries rose only modestly during the crisis**  
(in percent of GDP)



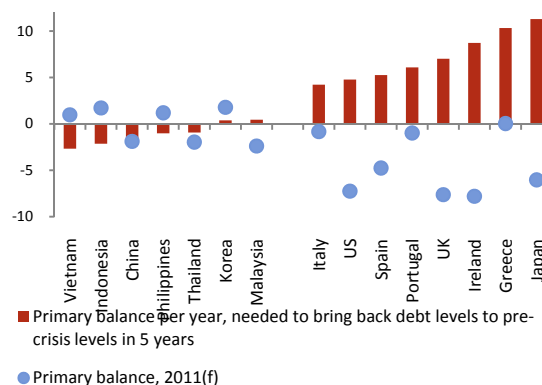
Source: National authorities and World Bank staff estimates.

**Figure 38. Fiscal adjustment in East Asia will be facilitated by favorable growth and interest rates**  
(Debt in percent of GDP; interest rate and growth in percent)



Source: National authorities, Organisation for Economic Co-operation and Development and Bloomberg.

**Figure 39. Fiscal efforts needed to reduce debt to pre-crisis levels are much smaller in EAP than in advanced economies**  
(In percent of GDP)



Source: National authorities, Organisation for Economic Co-operation and Development and World Bank staff calculations.

**The relatively moderate increases in government debt during the crisis and favorable interest rates should keep the debt-servicing costs of the larger deficits modest for most countries.** Government debt rose by less than 6 percent of GDP in 2010 compared with 2007 in the Philippines, Thailand and Vietnam, and by twice as much in Malaysia (Figure 37). Debt ratios in China and Indonesia, by contrast, are still below 2007 levels (although, in China debt figures do not include stocks related to local governments, extra-budgetary funds, or bank recapitalization). For the countries with debt increases, the additional interest costs amount to 0.2–0.6 percent of GDP a year at present market rates. These costs are not insignificant given relatively low revenues, but are a modest price to pay for helping to limit the impact of the global crisis on domestic demand. The increase in government debt in advanced economies, by contrast, is adding about 0.6 percent of GDP a year to expenditures in Japan and the United States.

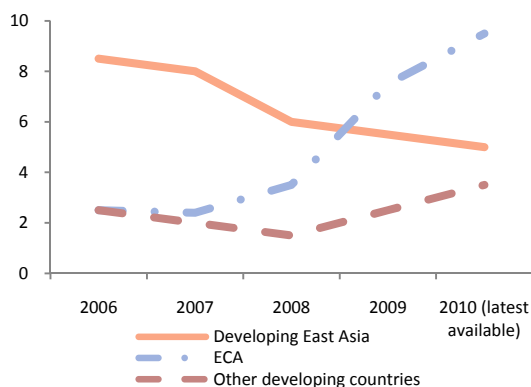
**Efforts to reduce government debt in East Asia are facilitated by favorable growth and interest rate dynamics.** The comparisons with advanced economies are particularly stark (Figure 38 and Figure 39). Except for Malaysia

and Thailand, primary balances projected for 2011 need to be changed little to help reduce debt ratios to their pre-crisis levels within a five-year period. The required fiscal effort in Malaysia is substantially larger, given the larger increase in government debt during the crisis.

**One important implication of the surging capital inflows is their impact on the future stability of the banking system.** The rise in asset prices (see previous section) and potential bursts of related bubbles, especially when the share of speculative inflows has been high, could result in sudden stops and capital reversals. The banking sector can also exacerbate the macroeconomic challenges related to large inflows, and become vulnerable. Bank flows have already increased dramatically in the region (see Section I), and there is a danger that banks having access to cheap liquidity abroad will extend it as credit to the private sector. If assets provided as collaterals are also inflated, credit could be extended to borrowers who would have otherwise been liquidity-constrained and thus may lead to an increase of non-performing loans and further harm the banking system. Banks can also gain risky exposure to the real estate or foreign exchange sectors and get troubled with foreign exchange or maturity mismatches, much like in Thailand during the Asian crisis. The situation with non-performing loans is better right now in EAP than before the Asian crisis, but their share in total bank lending is still higher than in other developing countries outside Europe and Central Asia (Figure 40). Credit growth, after decelerating in the immediate crisis aftermath has picked up again in some countries; it accelerated recently in Indonesia from 5.4 percent in March to 9.4 percent in May in year-on-year terms (Figure 41).

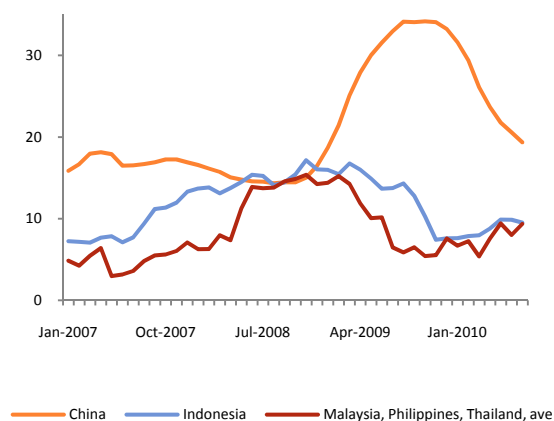
**To prevent the possible exacerbation of macroeconomic shocks through the banking system, a set of macro prudential measures are usually implemented.** Macro-prudential measures focus on the financial and banking system as a whole and in particular on pro-cyclical policies aimed at reducing risks amplified over the credit cycle. Simple rules could be introduced to prevent overheating, such as unremunerated reserve requirements, countercyclical provisioning, and minimum maturity restrictions on foreign borrowing by banks. Tightening lending standards (such as higher collateral requirements) may also be useful, such as those that have already been implemented in China (see above on page 20). Monitoring corporate borrowing abroad will also serve well, to avoid problems that Indonesia experienced in 1997 and Russia experienced in 2008. Several high-income countries are also considering such measures; for example, Spain and Portugal require higher provisions when credit is growing by more than the historical average and these can be accumulated in a fund during an upswing.<sup>3</sup>

**Figure 40. At this time, non-performing loans (NPLs) are less of an issue in East Asia**  
(In percent of total loans)



Source: National data sources and World Bank.

**Figure 41. ...credit growth however has been high**  
(Percent change, year-on-year)



Source: CEIC.

<sup>3</sup> Ghosh, S., 2010, Dealing with the Challenges of Capital Inflows in the Context of Macrofinancial Links, PREM Economic Premise 19, June.

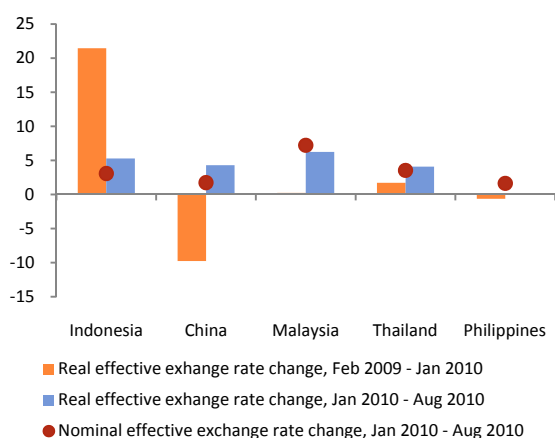
**EXCHANGE RATES HAVE APPRECIATED STRONGLY**

**The surge in capital inflows caused exchange rates to appreciate strongly.** Exchange market interventions by the monetary authorities in the region are helping to build foreign exchange reserves at a rapid pace, but appear to have had limited success in stemming appreciation thus far (Figure 43). And East Asia is not alone in this predicament. Developed and developing countries worldwide are bent on avoiding stronger exchange rates, as concerns about weak foreign demand—and a limited scope for exports to boost growth—intensify. While the United States and most countries in the EU have avoided exchange market interventions thus far after this crisis, Japan and Switzerland have joined countries from all developing regions in selling local currencies to keep them from strengthening. Other countries have also intervened; for example, Brazil also accumulated foreign exchange reserves. Without any coordination, these efforts are not bearing fruit and are only adding to already abundant global liquidity searching for high yields. The market consensus seems to be that these yields are to be found in developing countries, especially in East Asia.

**In real effective terms, exchange rates in the region are 10-15 percent stronger than their pre-crisis levels.** The Indonesian rupiah has appreciated most in real terms. China’s renminbi appreciated more modestly after the depreciation during the crisis (Figure 42). The authorities have allowed the nominal rate to US dollar to appreciate by 2.4 percent between June and mid-October 2010, after keeping it little changed since the beginning of 2009. Renminbi appreciated by over 4 percent in comparison to its trade partners in real terms since January 2010. The authorities have the option whether appreciation occurs through higher inflation—which has dominated the appreciation so far—or through a gradual rise in the nominal rate to help stem price pressures.

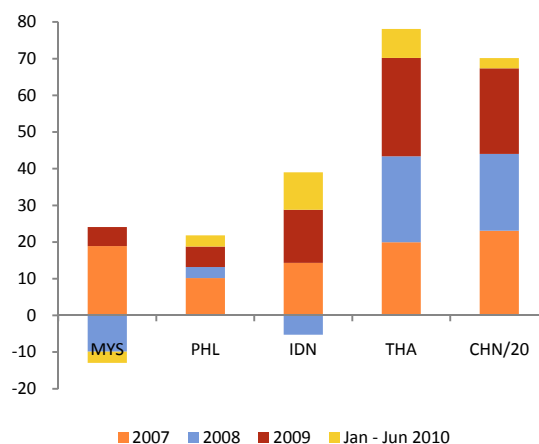
**Appreciating exchange rates so far have not crippled the recovery, but further appreciation will bear close watching.** So far, export growth has remained robust, but with continued real appreciation of East Asian currencies this growth could slow. Some countries have been intervening in foreign exchange markets to slow the pace of appreciation, but in the absence of appropriate sterilization this could add to inflationary pressures. Countries that are more successful in arresting real appreciation of their currencies may enjoy a temporary competitive advantage, provided this does not lead to other countries following the same path. These issues need to be discussed in the context of ASEAN and ASEAN+6, where member countries could fashion a common approach to these regional challenges.

**Figure 42. Most recently, the pressure was toward exchange rate appreciation (Percent change)**



Source: Bank for International Settlements (BIS).

**Figure 43. All countries accumulated foreign exchange reserves (Change in reserves, in billions of U.S. dollars)**



Source: Haver Analytics.  
 Note: China’s reserve accumulation is divided by 20.

## MANAGING THE LEVEL AND VOLATILITY OF CAPITAL FLOWS

**The surge in capital inflows poses challenges for policymakers as they strive to balance the need for long-term foreign capital with efforts to ensure that exchange rate appreciation does not adversely affect competitiveness.**

Thus far, most monetary authorities in the region have allowed substantial exchange rate appreciation in response to the renewed inflows (Figure 42). By contrast, efforts to control inflows or encourage outflows have been almost absent, unlike in the aftermath of the 1997-98 Asian financial crisis. And micro- and macro-prudential regulations have yet to be tightened in several countries.

**Indonesia and Thailand introduced measures to discourage capital inflows.** The Indonesian central bank has imposed a minimum holding period of 28 days on the ownership of one-month central bank bills (SBI bills) in the primary and secondary markets. Thailand eliminated an exemption to foreign investors from paying tax on interest and capital gains from new acquisitions of government bonds. The measures introduced by the Newly Industrialized Economies (NIEs) have also been modest. Korea began to cap banks' foreign currency forward positions and limit the use of foreign currency bank loans for overseas purposes. Taiwan, China now bars foreign investors from holding dollar-denominated time deposits for longer than a three month period and introduced a one-week deadline for funds from overseas to be used for their stated purpose or repatriated. Compare these measures with the 4 percent tax on inflows into debt securities introduced by Brazil.

**China, Thailand and Malaysia have moved to expand the range of allowed outflows and liberalize capital accounts.** Last year, China re-invigorated its "Go Global" outward investment strategy with a fresh mandate for its state-owned enterprises (SOEs) to increase foreign direct investment abroad. State agencies and the central bank also simplified the process of approval and funding of foreign investment projects. This year, China is supporting more private capital outflows and boosting other official outflows from its policy banks and sovereign wealth funds (see Box 3). Thailand has also introduced measures to facilitate outflows. These include lifting limits on vertical outward investments, increasing limits on outward FDI per company, raising ceilings on property investments, increasing the maximum for foreign currency deposits, and more than doubling the minimum amount of mandatory repatriation of export earnings. Malaysia in turn has allowed the settlement of international trade transactions in Malaysian ringgit, abolished all limits on cross-border foreign-currency inter-company borrowing, and lifted the limit on anticipatory hedging by residents of current account transactions with onshore banks.

**Governments have many instruments in their armory to maximize the benefits of capital inflows while minimizing their risks.** When policymakers are faced with excessive capital inflows that might be creating potential asset price bubbles or exchange rate overshooting, the standard instruments available to them include fiscal and monetary policy, foreign exchange market intervention and other exchange rate policy, and micro- and macro-prudential regulations. Capital controls are usually the last measure, implemented only when the inflows are deemed excessive, the economy is operating close to full capacity, further strengthening of the currency or reserve accumulation is undesirable, and macro prudential tools have been overused and thus are of limited effectiveness. Moreover, when capital controls have been introduced in the past, the results have been mixed. The controls introduced in Thailand in 1995-96 are considered to have succeeded, but it is unclear whether investor concerns about the viability of the exchange rate regime at the time played a more significant role. The capital controls introduced in Malaysia after 1997-98 were also credited with success in limiting short-term inflows, but that period coincided with much reduced investment and long-term inflows in Malaysia. Experience also suggests that controls are less effective in limiting the overall level of inflows, especially when the inflows are expected to last for a long time. But introduction of selected capital controls may be effective in increasing the maturity of the flows; they are also better suited in counteracting factors that are assessed as temporary. The current disparity in global policy rates and perceptions of sustained differences in growth potential between advanced economies and East Asia may not be of temporary duration, however. Closer coordination between fiscal and monetary policies will be needed to help limit the volatility of flows. Such volatility, after all, is one of the key driving forces of financial crises.

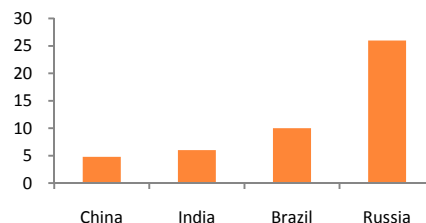
**Box 3. China’s private outflows are becoming more noticeable**

A part of the strategy to acquire assets and invest in projects abroad, by SOEs or private companies, FDI flows from China to other countries have shot up in the last quarter: outward FDI increased from an annual average of \$16 billion in 2005-07 to \$53 billion in 2008 and \$44 billion in 2009. Recent wage increases and the expected relocation by transnational corporations of manufacturing activities from China and Malaysia that has already benefitted latecomers in regional production networks, such as Vietnam, are expected to add to the trend. Still, the stock of outward FDI remains relatively modest (Figure 44). China’s share of the global outward FDI flows was 4 percent in 2009 while its share of the stock was 1.2 percent at the end of 2009. These are tiny for the second largest economy in the world: China’s overseas FDI assets are under 5 percent of GDP, compared to 6 percent for India, 10 percent for Brazil and 26 percent for Russia, suggesting further scope for expansion.

Last year, China granted new quotas worth \$8.1 billion to funds operating under its Qualified Domestic Institutional Investors (QDII) program, which stalled in 2008 as the global economic downturn intensified (Figure 45 and Figure 46). It added another \$5.3 billion in quota approvals through the mid-year and has announced plans to lower the capital threshold for a QDII license from RMB 200 to RMB 100 million, aiming to enlarge the program by allowing smaller fund houses to launch overseas investment products.

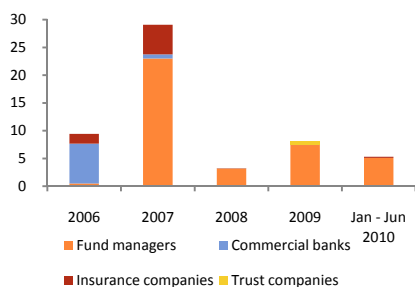
Cross-border lending by China’s banks and foreign investment by China’s sovereign wealth funds (SWFs) provide additional channels for outbound capital flows. Traditionally, most of China’s external lending has been undertaken by the policy banks, often to support outward FDI by the SOEs or to secure resource supplies through loan-for-commodity deals. Recently however, the policy banks have also turned toward broader spectrum of international lending. For example, China Eximbank signed a \$10.4 billion, and China Development Bank (CDB), a \$3 billion concessionary loan agreement with Ghana for energy, road and rail projects in the country. China Investment Corporation (CIC), better known for taking a \$5 billion 9.5 percent stake in Morgan Stanley and a \$3 billion 9.4 percent stake in the Blackstone Group during the global financial crisis, invested \$58 billion globally in 2009, taking its overseas holdings to about \$100 billion, by some estimates.

**Figure 44. China’s outward FDI is tiny compared to other BRICs (percent of GDP)**



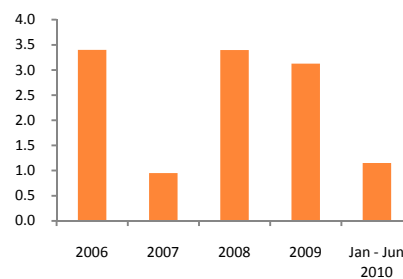
Source: CEIC.

**Figure 45. China has restarted its retail outward investment program ... (QDII quota approvals, in billions of U.S. dollars)**



Source: State Administration of Foreign Exchange (SAFE).

**Figure 46. ... while keeping retail inward investment in check (QFII approvals, in billions of U.S. dollars)**



Source: CEIC.

### III. ESCAPING THE MIDDLE-INCOME TRAP

The global economic crisis brought into sharper focus the need for East Asia’s middle-income countries to accelerate structural reforms needed to transition through the crowded middle of industrial development and emerge as high-income economies. This will not be easy. For decades, many economies in Latin America and the Middle East have been stuck in this middle-income trap, where countries are struggling to remain competitive as high-volume, low-cost producers in the face of rising wage costs, but are yet unable to move up the value chain and break into fast growing markets for knowledge and innovation-based products and services (Figure 47).

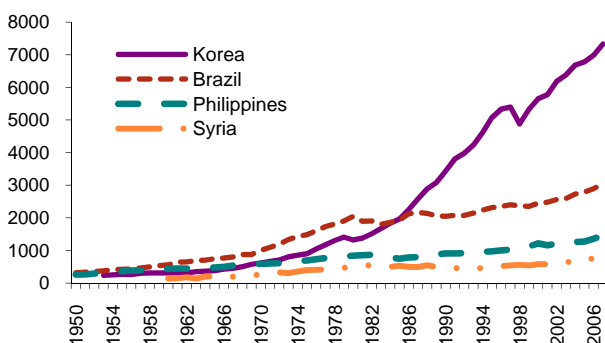
For the middle-income countries of East Asia, some key ingredients for a strategy of faster convergence to the advanced economies are in place. They are in the most vibrant region of the world that includes China and India, where macroeconomic stability and prudent fiscal, monetary and regulatory policies are well entrenched; global and regional integration are proceeding apace; and urbanization is rising rapidly.

Much more is needed for transition to high-income status. Rapid and sustainable growth requires high levels of investment which embody new technologies. These investments will be in physical and human capital, including in roads, information technology and other infrastructure. The business environment needs to enable entrepreneurs to create and develop businesses, and then exit from them—should they fail—without suffering a stigma that tends to discourage risk taking and economic growth. An enabling environment for creative destruction, as the process of entry of new and improved firms and exit of less efficient ones is called, also includes conditions for innovation supported by an education system that shifts from equipping workers with basic skills to providing them with abilities to create new products. Improved logistics and connectivity are vital for rapid growth to be sustained, as is the transformation of urban centers from mega-cities into incubators for new ideas; and so is access to adequate financing for innovative entrepreneurs.

These reforms are crucial for the region’s future. Indices of global competitiveness show stagnation for all of the region’s middle-income countries other than China (Figure 48). The lack of an innovation-conducive policy framework, weak technological readiness, persistent skill mismatches, and an inadequate quality of infrastructure were amongst the most important constraints to improving competitiveness. The rest of the Section addresses some of these challenges.

Figure 47. Some countries get stuck in middle-income, others escape

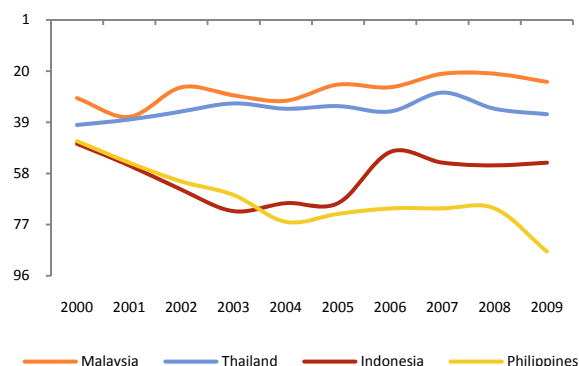
(GDP per capita in constant 2005 U.S. dollars)



Source: Penn World Table 6.3.

Figure 48. The competitiveness ranking of the region’s middle-income countries declined or stagnated

(GCI ranking, based on 10 categories)



Source: Global Competitiveness Indicators 2009.

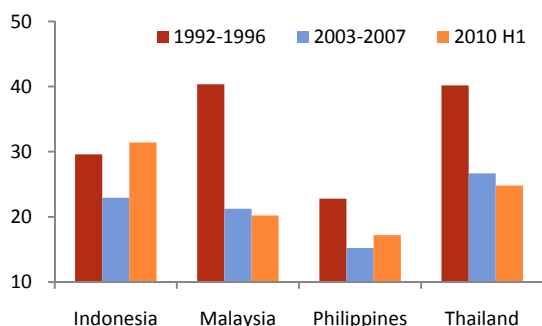
**THE NEED TO RAMP UP INVESTMENT**

**Fixed investment in developing East Asia (excluding China) is likely to reach pre-crisis levels this year, as will its direct contribution to growth.** Private investment has been the driver of the recovery of the overall investment, but fiscal stimulus packages supported the rebound in 2009 (see Section I).

**But are current investment levels adequate to support strong growth over the medium term?** Historical precedent suggests that sustained higher levels of investment are critically necessary, along with much improved efficiency of investment. Only in Indonesia among the middle-income countries of Asia (excluding China) is investment now above the levels reached before the 1997-98 Asian financial crisis (Figure 49). Investment rates in Thailand, Malaysia, and The Philippines have yet to recover, and in the case of the rates of Malaysia and the Philippines they are among the lowest in middle-income countries worldwide. Another reference point is provided by the Growth Commission, which concluded that for robust and high growth, investment rates of 25 percent of GDP or above are needed.<sup>4</sup> (Only Indonesia and Thailand have investment rates of 25 percent of GDP or higher.) Most important, however, investment rates in the middle-income countries of East Asia are below the 31 percent averaged by Korea and Japan during their economic take-offs (Figure 50). It is this reference point that is most relevant for East Asia; other comparisons invariably include countries that sustained rapid growth for a few decades but failed to escape the middle-income trap.

**Relatively low investment rates in the middle-income countries of East Asia (excluding China) do not appear to be due to insufficient saving.** Saving rates in these countries have not changed for more than a decade, but investment rates have declined in most of them. As a result, countries run current account surpluses. These countries are, in fact, exporting capital. Encouragingly, countries appear to be using capital more efficiently of late (Figure 51). This is a common phenomenon for periods after crises, including after the Great Depression during the 1930s, and across the world’s advanced countries following the recent economic crisis. It reflects improved capacity utilization and restructuring of business activity resulting in enhanced productivity (although capital to output ratio is an imperfect measure as it could also indicate a change towards less capital-intensive industries). The challenge is to build on the recovery from the crisis and boost investment in physical and human capital to help not only support stronger immediate growth, but create the appropriate structure to support vibrant and innovative companies within dynamic clusters and livable cities, and elevate the skills of the workforce that will support higher and sustainable economic expansion over the longer term.

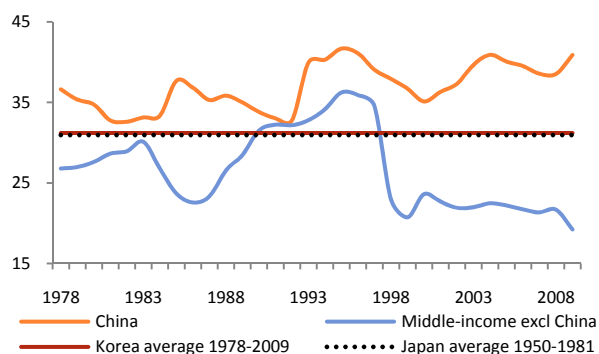
**Figure 49. In Malaysia, the Philippines and Thailand, investment is below the levels of the previous two decades...**  
(In percent of GDP)



Source: Haver Analytics.

**Figure 50. ...and is trailing levels in Korea and Japan during their take-offs**

(Investment, in percent of GDP, compared to Japan’s 1950 and Korea’s 1978 growth episodes)

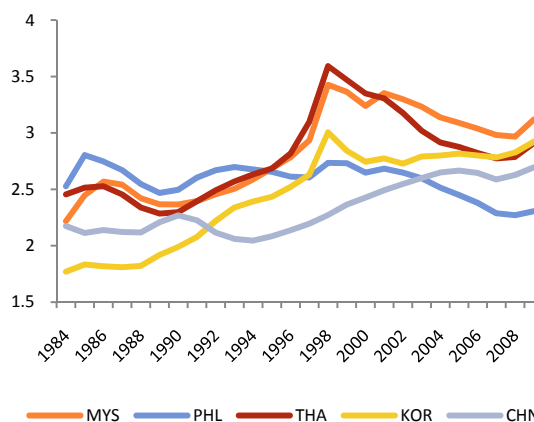


Source: Haver Analytics and Bank staff calculations.

<sup>4</sup> Growth Commission, 2008, *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, p. 34, [www.growthcommission.org](http://www.growthcommission.org).

Consider infrastructure that has not been upgraded to keep up with the demands of growth and connectivity, and it has become a binding constraint in many countries in the region. In the Philippines, a key shortcoming is the quality of urban infrastructure, roads, ports and airports. The high electricity costs and relatively high losses caused by blackouts are also a problem.<sup>5</sup> Similarly in a recent survey in Indonesia, firms identified a large infrastructure gap, including in roads, as one of the greatest obstacles to private investment.<sup>6</sup> In Thailand, in general, the quality of infrastructure is better than in most of its neighbors, but it could still be a lot better. Moreover, there is a large variance in the quality of infrastructure services across regions: logistics costs in the North and Northeast (the poorest parts of Thailand) are 50 percent higher than those in the Eastern region close to Bangkok.<sup>7</sup> Ensuring a high quality of information technology (IT) infrastructure, together with affordable access, should also be a priority.

**Figure 51. Most economies appear to be using capital more efficiently after the 1997-98 Asian financial crisis (ratio of capital stock to output)**



Source: Bosworth and Collins 2003 and Bank staff calculations.

**Innovative technologies can help not only increase returns to investment and improve productivity, but also transform threats into opportunities.** Given the region's large investment needs and the challenge posed by the climate change, it is feasible that investment in the green economy will not only be good for the environment, but also good for business, and help position East Asia near the top in a sector poised for sustained rapid growth (Box 4).

**Governments finance about three-fourths of the infrastructure around the world, and East Asia is no exception.** But ongoing and effective mobilization of private capital for infrastructure investment through public private partnerships (PPPs) will be critical for ensuring adequate resources, risk diversification by the public sector, and cost control.

#### **Box 4. Invest in the green economy, but beware of white elephants**

Climate change and energy security present both a challenge and an opportunity for the countries of East Asia. Energy consumption in the region is poised to double over the next two decades, following a similarly sharper increase since late last century. At the same time, rapid urbanization and industrialization, coupled with the surging energy use, has created some of the world's largest mega-cities, with challenges for livability. The opportunity is to help mitigate and adapt to the adverse consequences of climate change, while turning the challenge into growth. The much needed new investment could be used to adopt innovative technologies that increase productivity and efficiency of the capital stock. Some will be viable on their own, while others may need a certain level of public support to become profitable. In all cases, however, these should offer companies in the region the possibility to move

<sup>5</sup> World Bank, 2006, *Philippines Investment Climate Assessment*, World Bank, 2008, *Philippines Enterprise Survey*.

<sup>6</sup> World Bank, 2010, *Indonesia Rising: Policy Priorities for 2010 and Beyond*.

<sup>7</sup> World Bank, 2008, *Thailand Investment Climate Assessment*.

up the value chain in a sector experiencing rapid global growth and where there is international capital to be attracted home.

The fiscal stimulus packages introduced during the recent crisis boosted spending on green technologies in many countries. Globally, the share spent on green energy appears to have been the largest in the case of Korea, with over 80 percent of the total stimulus. China has been the leader in absolute terms, spending more than twice than the United States in 2009, with pledges of investments of about \$400 billion in public funds through 2013. Government spending helped finance the doubling of wind-power capacity—each year for five years in a row—and is now invested in an unprecedented expansion of high-speed rail.

Technologies that help improve energy efficiency have been identified as priority by several countries. Combined heat and power generation (or cogeneration) is one example. Currently, only 13 percent of China’s domestic electricity consumption is provided through cogeneration facilities. When such facilities are combined with district heating and cooling (DHC) systems, further synergies can be created. Depending on the construction and implementation of a DHC facility as well as the size and number of buildings, total capital and investment costs can be lower than more traditional options for heating and cooling individual buildings. Changes in building design to improve energy efficiency, such as through insulation, represent similar technologies for which demand currently exists. On top of these gains, these and other energy efficiency measures will significantly reduce carbon emissions.

Some green technologies have substantial poverty reduction or inequality mitigation benefits (see also Section I). For example, renewable energies such as solar power can facilitate rural electrification, which is known to help reduce poverty.<sup>8</sup> For example, 4 percent of Lao PDR’s population in remote areas have been provided with solar energy, with significant implications for poverty reduction. Wind and solar power technologies can provide off-grid power from non-fossil fuel sources. However, they must overcome financing challenges, and secure investment for further production and use. Vietnam’s legislation to facilitate such investment in renewable energy and rural electrification illustrates the recognition that these technologies can be important for achieving development objectives.<sup>9</sup>

As with every investment, ensuring the efficiency of outlays in green technologies is paramount. Too often public funds get misallocated or finance “white elephant” projects, with minimal contribution to the economy or potential waste, despite good intentions. For example, many of China’s green investments are in wind technology. However, some analysts report that a high proportion of China’s current wind assets might be either not in use, or not connected to the national power grid. In other cases, promoted new technologies can be far from the economy’s comparative advantage or their subsidization can harm competitiveness. In this sense, measures that let the market provide direction when subsidizing or investing in green economy are preferable.

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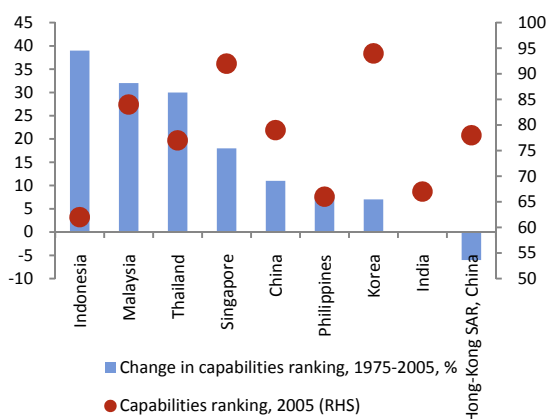
<sup>8</sup> World Bank, 2000, *Energy Services for the World’s Poor*. Energy and Development Report 2000. ESMAP, World Bank, Washington DC.

<sup>9</sup> World Bank, forthcoming, *Climate Change and Economic Policies in APEC Economies: Synthesis Report*, Report No. 56562-EAP, East Asia and the Pacific Region, World Bank, Washington DC.

## FACILITATING INNOVATION

The middle-income countries of East Asia have made remarkable progress exploiting a model of high volume, low value added assembly operations for exports. But this model is reaching its limits, and countries are facing the need to move up the value chains. This will require that companies become more innovative at introducing new or improved goods and services, developing or adopting innovative production processes and better modes of business operation (see Box 5).

**Figure 52. Change in the number of “capabilities” to produce new products, 1975 to 2005**  
(change and level of the capabilities ranking, 0-100, higher is more capabilities)



Source: Staff calculations based on Hidalgo, César A., 2009, *The Dynamics of Economic Complexity and the Product Space over a 42 year period*, CID Working Paper No. 189, December 2009.

Note: Capabilities refer to the level of sophistication of companies in a country to perform more tasks so as to produce a greater variety of products.

### Box 5. What is innovation?

Innovation includes activities that advance the technological frontier and adoption of existing knowledge and production processes—sometimes in a better way. Innovating at the frontier requires sophisticated education, continuous investments in research and development, and property rights, while benefits may accrue only after a substantial period of time. Most companies in developing countries – including in middle-income East Asia, by contrast, are innovating inside the frontier by absorbing knowledge, typically from abroad, through international transfers and spillovers. Even the simple use of existing knowledge can be innovation, from a perspective of a company (that adopts a new product line, for example) or a grass-roots entrepreneur (who starts using a phone for a financial transaction, for example). The most productive and inclusive kind of innovation seems to be in the middle when firms can be *piggybacking* through technological change: leapfrogging to wide use of new technologies by piggybacking on the existing knowledge and patent base.

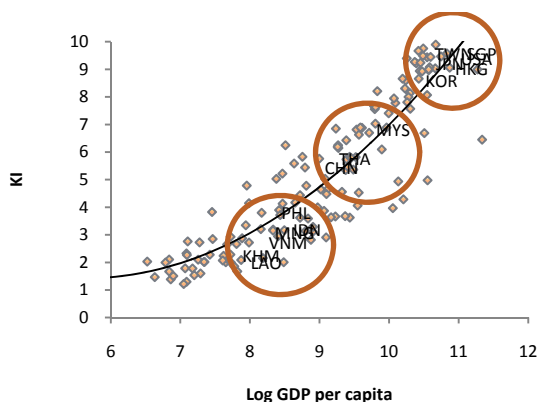
**Most of East Asia’s middle-income countries have absorbed foreign knowledge and improved their production capabilities in the process.** Production capabilities, or the level of sophistication of the country’s companies to produce diverse products, have grown rapidly in East Asia in large part through participation in global or regional production networks and the accompanying technology transfers.<sup>10</sup> Nonetheless, these countries innovate at par or below compared with middle-income countries in other regions (Figure 52 and Figure 53). But East Asia’s competitors, notably those in Latin America and the Middle East, are mostly countries that have been caught in the middle-income trap. Innovating more, rather than as much as others, will be crucial for East Asia’s middle-income countries to break out of the middle-income trap. It is the NIEs, Japan and the advanced economies that middle-income Asia has to look up to.

**There is steady progress by the authorities of East Asia’s middle-income countries on the agenda for facilitating innovation, but more is needed for the transition to high-income status.** The previous section discussed the need for improving infrastructure in middle-income countries, including roads, housing, energy and information technology. Along with larger government outlays, the need for stable and enhanced foreign capital inflows is crucial, as these bring along knowledge and management expertise. Components of good innovation policy are the following four agendas: creating incentives for productive entrepreneurship, providing adequate skills to the

<sup>10</sup> Brahmabhatt, M. and A. Hu, 2007, *Ideas and Innovation in East Asia*, Policy Research Working Paper 4403.

workforce, ensuring good transmission of information and ideas, and making sure financing is available for start-ups, upgrades and commercialization.<sup>11</sup> Based on the surveys of entrepreneurs, binding constraints to innovation differ by country (Figure 54), and we turn to each of these four facilitating or constraining factors below.

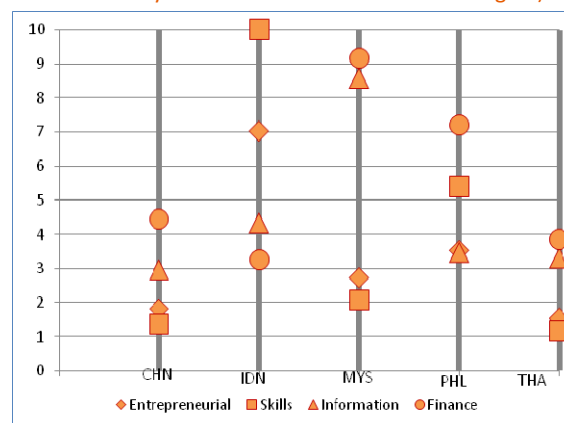
**Figure 53. East Asia’s middle-income countries are innovating at par with comparators with similar income levels (ranking)**



Source: World Bank Knowledge Assessment Methodology Innovation Index (KAM) 2009.

Note: KI on the vertical axis refers to the Knowledge Index that is a simple average between innovation, skills, and ICT indices.

**Figure 54. Firms in middle-income countries are constrained by different factors in their innovation efforts (percent of firms experiencing the constraint as most severe, scaled by maximum and minimum in the region)**



Source: World Bank Enterprise Surveys, where available.

## INVESTMENT CLIMATE FOR INNOVATION

**Creating incentives for entrepreneurs to experiment is a key challenge in creating an innovative economy.** Overall, an environment conducive to innovation is similar to the environment conducive to attracting foreign investment. The key components of such an environment include macroeconomic and regulatory stability, clearly defined property rights, well-articulated and not too onerous policies for competition, and business entry and exit.

**Countries in the region sustained progress on structural reforms during the economic and financial crisis.** As policy support for growth is gradually withdrawn, advancing reforms in East Asia’s middle-income countries becomes imperative if rapid growth is to be maintained. Two-thirds of all economies in the region enacted one or more reforms to improve the business environment over the last several years (Figure 55). Starting a business, paying taxes, getting credit, and trading across-borders were the main areas of reform in the region in 2009.

**Important entry and exit regulation reforms have made mixed progress.** One-stop shops for business registration and online filing were also introduced in some economies to streamline the registration of new firms. As a result, the time to start a business was reduced in 10 economies between 2007 and 2009, and the cost of business registration fell in almost as many. At the same time, there has been modest progress in simplifying the rules for closing a business. Since the mid-2000s, the average time for middle-income East Asia to close a business has declined from 4 years to 3.8 years, but still prevents assets from reallocating to more productive uses. By contrast, the time to close a business in Singapore is 0.8 year and in Korea, 1.5 years. This difference is even starker than

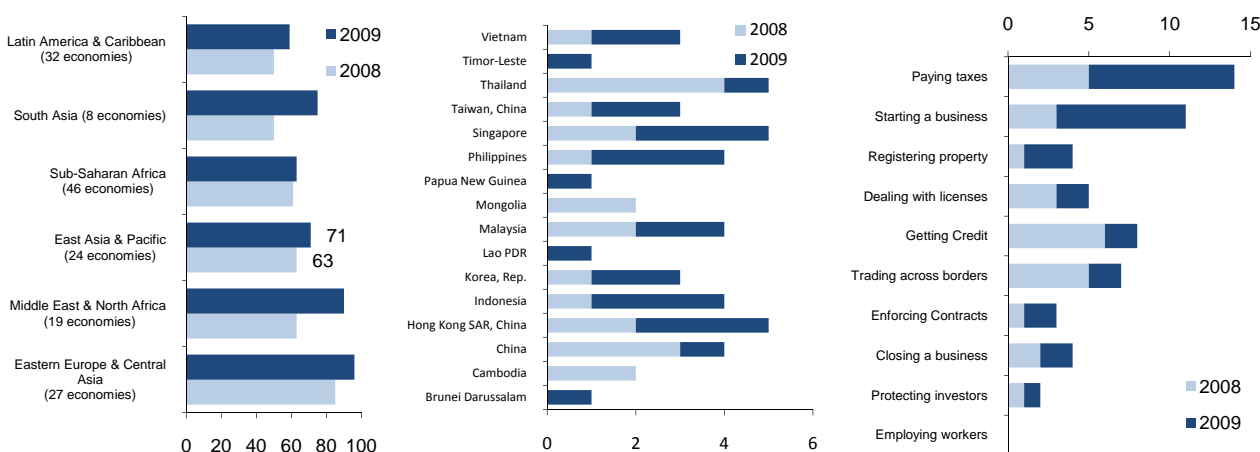
<sup>11</sup>Canuto, O., M. Dutz, and J. G. Reis, 2010, *Technological Learning and Innovation: Climbing a Tall Ladder*, Economic Premise 21, July.

the time to start a new business, and presents a challenge to authorities in the region as they strive to ensure a thriving and dynamic private sector.

**Improved tax administration also helped ease the administrative burden on firms.** Some of these efforts were part of the fiscal stimulus measures many countries implemented (Figure 57). Indonesia, China and Timor-Leste simplified their tax structure, introduced low flat corporate income tax rates and helped level the playing field for domestic and foreign firms. In Indonesia, the corporate income tax rate was further reduced of 25 percent in 2010. In China, a new law equalized the treatment of domestic and foreign firms in terms of income taxation for the first time since 1978, including through a flat corporate income tax rate at 25 percent, and unified criteria for tax deduction and exemption. In Timor-Leste, the corporate income tax was reduced from 30 to 10 percent, and both the alternative minimum tax and the withholding tax on interest were abolished.

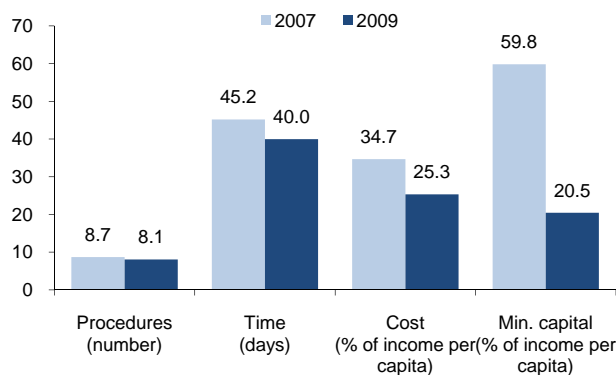
**Figure 55. Structural reforms proceeded at full speed during the crisis**

The share of economies with at least one reform in improving the business environment increased ... (In percent of the total) ... as did the number of reforms across economies ... although they varied across categories



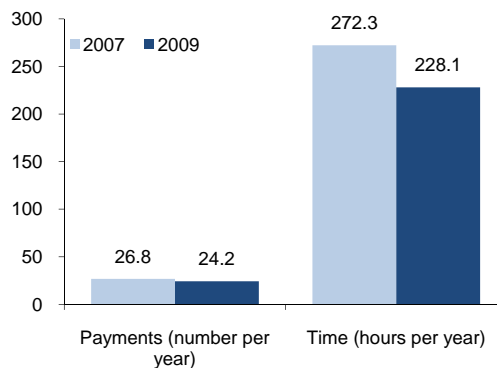
Source: Doing Business 2009.

**Figure 56. Starting a business in East Asia is now easier ...**  
(Regional averages in ranking)



Source: Doing Business 2009.

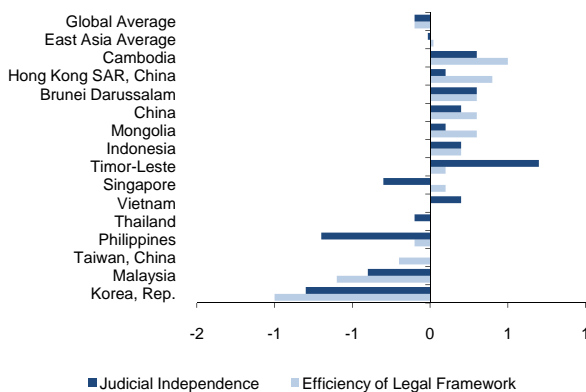
**Figure 57. ... and the administrative burden of paying taxes has been reduced**  
(Regional averages in ranking)



Source: Doing Business 2009.

**Figure 58. Progress improving the efficiency of the business-related legal framework was mixed ...**

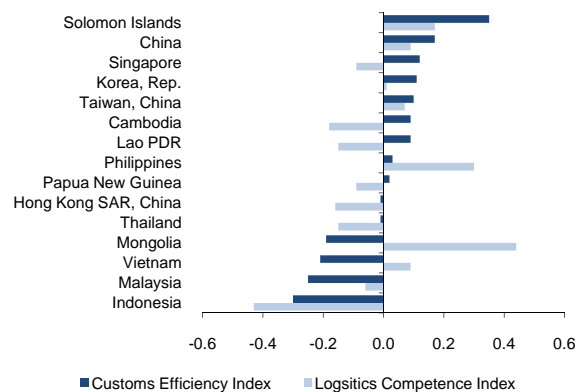
(Change in ranking between 2007 and 2009)



Source: Doing Business 2009

**Figure 59. ... as were advances in trade facilitation**

(Change in rating between 2007 and 2009)



Source: Logistics Performance Index 2007, 2010.

Note: Indices range from 1 to 5 (best performance).

**There has been progress on competition policy and protection of property rights.** Encouraging competition, notably through foreign entry, may depress innovative activity by domestic firms. At the same time, productivity spillovers encourage the more efficient allocation of resources and stimulate entry of other, more agile companies. Stronger patent rights in large middle-income countries, for example, are shown to have the most significant impact on foreign companies to export, given the threat of imitation and reverse engineering.<sup>12</sup> At the same time, such rights appear to have a limited impact on inflows of foreign direct investment to these countries, very likely because the inflows typically are for low cost assembly rather than knowledge intensive production.

**Despite incipient protectionist pressures worldwide, countries in the region have resisted introducing curbs on international trade in goods and services.** Some tariff increases introduced at the beginning of the crisis were subsequently reversed. And from the start of 2010, in line with the ASEAN-China Free Trade Agreement (FTA) that came into effect in 2005, six ASEAN countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) and China reduced tariffs on 90 percent of trade between them to zero over time. Other restrictions remained, however. For example, in Indonesia, the imports of food, textiles, footwear, toys and electronics can still be processed only through five ports. Progress on trade facilitation has similarly been mixed. Some progress was made in simplifying documents, automating customs functions, and introducing better risk management approaches. Progress was similarly made toward an ASEAN single window and in improving the timeliness, customs efficiency, and logistics competence in some countries, although there remains much room for improvement (Figure 58 and Figure 59).

**Economic integration within the region and with other countries proceeded apace.** Trade has been a key driver of the prosperity of ASEAN countries, and along with it the diffusion of knowledge. Their total trade volume of US\$1.5 trillion in 2009 was roughly the size of their combined GDP. About 25 percent of their trade is intra-ASEAN. Although this internal trade includes a large variety of goods, it is dominated by trade of raw materials and machinery and equipment, suggesting that there is considerable scope for further trade integration by increasing the share of final goods in trade flows. Intra-ASEAN trade is underpinned by the ASEAN Free Trade Agreement of 2003 under which member countries have cut the tariffs on ASEAN trade to 0–5 percent but without any common external tariffs. ASEAN has also boosted regional trade in recent years by signing free trade agreements with Australia, China, India, Japan, and Korea.

<sup>12</sup> Gill, I. and H. Kharas, 2007, *The East Asian Renaissance*, The World Bank, Washington DC.

**Future integration will be guided by ASEAN's goal to establish and ASEAN Economic Community by 2015.** The countries aim to develop a single market with a free flow of goods, services investment, skilled labor, and a more liberalized flow of capital. Three issues will need particular attention as the Economic Community is established. First, behind the border issues such as trade infrastructure and institutions will need to be addressed as a priority. In particular, improvements in ports and internet services have the potential of improving ASEAN trade by more than 10 percent. Second, greater harmonization of standards and removal of impediments to cross border trade in professional services, finance and investment, education and health is needed. Finally, facilitating the cross-border mobility of skilled labor is needed. To this end, countries need to establish protocols for mutual recognition of professional certificates among ASEAN member countries.

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## GETTING TOGETHER: INDUSTRIAL CLUSTERS AND CONNECTIVITY

**Innovative companies need tighter connectivity at home and abroad, knowledge-related infrastructure, and well defined policies to encourage the formation of clusters in urban centers.** Technological clusters have been proven to be the process by which innovation transmits in manufacturing. Information and communications technology (ICT) has been shown to be the main driver of transmission of innovative information generally, and in our region – in particular.<sup>13</sup> Box 6 shows how ICT technology can help connect the entrepreneur where physical infrastructure fails or is not viable. The section below delves into the role and prospects of cluster development.

**Globalization has resulted not just in a closer integration of economies but also a tightening of the linkages among East Asian major cities.** Advances in ICT and transport technologies together with the modernization of urban infrastructures, have facilitated interaction among cities at many different levels and contributed to the emergence of global urban regions. Cities like Shanghai, Seoul, and Bangkok lie at the core of urban regions and benefit from agglomeration economies arising from specialization, the scale of production, and from industrial diversity that promotes spillovers and the emergence of new activities. Research suggests that each doubling of city size can raise productivity by between 3 and 14 percent. Urban regions are characterized by a concentration of services, high tech and creative activities and nascent industries in the core city, with large scale manufacturing coalescing in nearby medium-size cities and more specialized cities. This arrangement optimizes the gains from urbanization economies in the core city and localization economies in the hierarchy of medium and small sized cities in the urban region.

**Globalization has created new channels for comparing experiences and sharing lessons.** At the same time, it has sharpened the competition for final goods and mobile human capital. This competition is multidimensional and it is forcing cities within urban regions to take a holistic approach to development and to compete on many different fronts, the business climate and the urban infrastructure being just two areas with others such as livability and urban amenities, acquiring more significance.

**To attract resources and sustain the momentum of development, cities need to demonstrate their ability to enhance growth potential by cultivating a number of vibrant and preferably interlaced leading sub-sectors.** Growth potential also depends on the demographics, whether population, is expanding or not and the quality of the workforce. Quality, more than the volume of human capital appears to be a more significant determinant of growth. Recent research also seems to suggest that in view of the importance of entrepreneurship, innovation, adaptation and invention for technological convergence among countries, the absolute quality of talent and skills might have a strong bearing on economic performance.

**The growth imparted by leading sectors can be magnified by the formation of specialized clusters of networked firms that compete, cooperate, deepen markets for labor, give rise to intangible capital, generate technological spillovers and promote start up activity.** A symbiotic relationship between manufacturing firms and services providers as is emerging in the Bangkok, Hong Kong SAR, China/Shenzhen/Guangzhou/Dongguan and Seoul urban

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<sup>13</sup> Gill, I. and H. Kharas, 2007, *The East Asian Renaissance*, The World Bank, Washington DC.

regions for example, can lead to an unbundling of activities and to greater specialization to the advantage of both parties. A significant share—close to 37 percent—of the employment generated by the export of manufactures by U.S. companies was in upstream and downstream services. In fact, manufacturing gives rise to employment multipliers of up to 5 and 6 that are far larger than the multipliers associated with services.

**Clusters generally form around nuclei.** Urban centers with a strong development orientation and leadership, such as Beijing and Shenzhen, are attractors and a preexisting industrial base can be a source of skills and intangible assets. These latter assets which include scientific and non-scientific research and development (R&D), software, worker training, brand equity, product design, and organizational capability, have accounted for 27 percent of the growth in the U.S. since 1995. Major research oriented firms or multinational corporations (MNCs) can provide a nucleus as well and there are plenty of examples from, Cambridge U.K., Silicon Valley, Medicon Valley, San Diego and elsewhere of firms such as CCL and Acorn, HP, Novo Nordisk, and Hybritech, spawning scores of daughter enterprises and helping to scale up the activities of a cluster. MNCs and local firms are also giving rise to spin-offs and new starts in Beijing, Shenzhen/Guangzhou, Seoul, and Taipei/Hsinchu.

**To thrive and grow, clusters require anchors.** The size and affluence of the urban market (as in Seoul, Shanghai, and Tokyo) are among the most important however; there are other anchors of consequence as well. Research universities have an increasing role if they can supply high quality skills, contribute to network formation—local and global—and enrich the local knowledge economy by way of tacit knowledge, workshops, patenting, publications, trouble shooting, and the dialogue on technology. Vocational training institutions, the physical and social infrastructure, affordable housing and recreational facilities are among some of the other anchors. How a city goes about developing these anchors determines its overall competitiveness in the global economy.

**Competitive clusters must be capable of upgrading, of diversifying, and of incubating new industries.** Silicon Valley, for example, has served as a breeding ground for several different kinds of clusters, and both Beijing and Shanghai are attempting to develop multiple high-tech activities. A dynamic cluster has a number of attributes. It has an entrepreneurial culture that leverages the resources of universities and firms; it benefits from the local presence of angel investors and venture capitalists who support and mentor local activities; it combines the advantages of specialization in key fields with an openness to new ideas; it has the capacity to learn from mistakes and to unlearn; and it has a "buzz" in national and global circles.

**History shows that many clusters have formed accidentally.** Examples include a decision to locate an important facility (such as the NASA space center in Houston), a university, or a firm that emerged as a major player in the industry (e.g. Dell in Austin, Texas, and arguably Huawei in Shenzhen). History further shows that these chance events might have floundered were it not for supporting initiatives taken by urban leaders and national governments.

**The supporting policies can take many forms.** Strategic foresight exercises can assist governments to map out a long-term cluster development strategy and undertake to provide the stable long term financing for R&D that research-intensive activities frequently require. Complementing these are policies to ensure the supply of quality skills.

**For cities, the incentive policies to attract industry—domestic and foreign—need to be supplemented by others that secure the city finances and ensure that services and housing meet the expectations of industry that is aware of and comparing opportunities in other cities throughout the world.** But providing services and infrastructure is not enough; cities must also market themselves aggressively by organizing events and seeking out business nationally and internationally. Such marketing is the most reliable way of infusing capital and ideas into existing clusters and sowing the seeds of new clusters.

#### **Box 6: Smart innovation in the Pacific: connecting people**

The Pacific Islands include some of the smallest and most remote countries in the world. The Islands are facing daunting challenges on each of the dimensions of economic geography—density, distance, and division. Limited density of economic activity limits the scope for

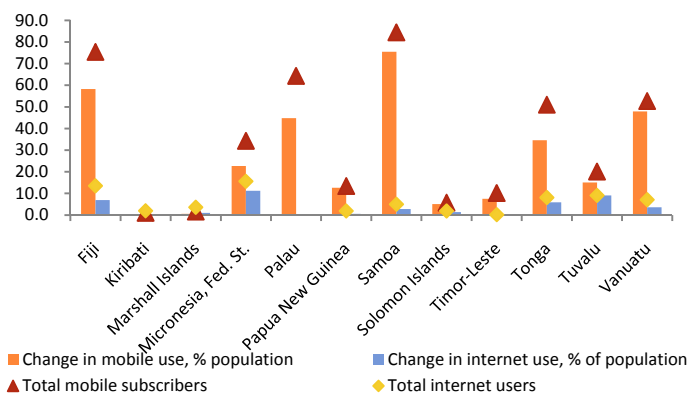
economies of scale and specialization. The countries' remoteness from the nearest large market results in higher costs of trade and limits the scope for participation in the production networks that are spreading rapidly throughout East Asia. And considerable divisions impede product and factor flows even within their own borders. Because of the constraints of economic geography, production costs even for the small variety of products produced or sold in the Pacific Islands—are substantially higher relative to the rest of the world. Such a wedge will likely remain permanent in general, but for some industries it could be moderated by economic policies or new technologies that help reduce economic distance, and efforts to reduce division.

A recent innovation in tourism marketing demonstrates the effectiveness of information and communication technology (ICT) in mitigating the disadvantages of economic geography in the Pacific. This innovation—of a link to several Pacific islands on the Worldhotel-link.com Limited (WHL) portal—provides information about local accommodation and tour providers available to independent travelers. Local tourism operators market their products globally online through a collective tool, at a fraction of the cost of doing so individually, and without needing the requisite skills, Internet connection, computer, or even electricity supply. A mobile phone enables them to link to the local franchise-holder to process the bookings coming through the portal. This innovation has been enabled by the sharp drop in the unit cost of mobile phone calls following the recent liberalization of telecommunications markets in the region (Figure 60).

The benefits to local tourism have been significant. For example, in Samoa, the turnaround time for a booking has declined from several days to a few minutes. Over the last three years, the growth of revenues attributed to the portal was about 80 percent for Samoa, 90 percent for Fiji, and 130 percent for Vanuatu. In Vanuatu, the benefits of the WHL portal have been particularly noticeable for small-scale operators in rural areas and on outlying islands. In the two years of operation of the Solomon Islands portal, revenue grew by 770 percent, while the number of businesses featured on the site rose 70 percent.

For small and medium enterprises (SMEs) in rural areas and on outlying islands that retail products from wholesalers in the capital, mobile phones have significantly shortened the ordering cycle and reduced information asymmetries—such as in Vanuatu.<sup>14</sup> This benefit has been most pronounced for retailers who previously had to travel to use public land lines. In the fisheries sector, entrepreneurs are now able to check and command supply, and inform in real time potential customers in hotels and restaurants of the status of their orders. In the agriculture sector, entrepreneurs can now simultaneously serve as vendors at the marketplace and manage customers' orders.

**Figure 60. Use of ICT mobile phones and internet grew dramatically between 2002 and 2009**  
(Percent of adults)



Source: World Development Indicators, ITU, and World Bank, 2007, *Telecommunications in the Pacific*.  
Note: For Tuvalu, refers to Internet subscriptions.

<sup>14</sup> Pacific Institute of Public Policy, 2009, *Social and Economic Impact of Introducing Telecommunications throughout Vanuatu*.

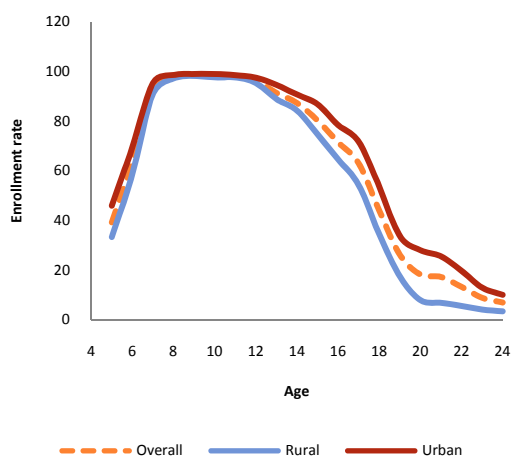
## EQUALIZING OPPORTUNITIES FOR A CREATIVE WORKFORCE

**Adequate skills of the workforce are important throughout the entire process of innovation, from the emergence of ideas to their implementation and commercialization.** When large parts of the population do not have basic education or skills, it will curb agricultural productivity or that of informal or low-skilled sectors. Lack of secondary or vocational education will harm further development of services sectors and manufacturing. For innovation, good quality tertiary education can result in an effective collaboration of industry with academic institutes and universities and facilitate creation of clusters and industry incubators allows to form clusters that are innovative and productive industry incubators.

**Developing East Asia is falling below international averages on education outcomes, hurting the scope for equipping the labor force with the skills needed to be innovators rather than simply users of new technology,** according to the latest data.<sup>15</sup> This is having a palpable impact on the ability of firms to move up the value chain. Manufacturing firms in Thailand, for example, cite the lack of skills as the foremost constraint to investment and innovation.<sup>16</sup> Companies across the middle-income countries in the region, meanwhile, refer to the absence of entrepreneurial abilities as another crucial constraint to growth.

**The quest to strengthen the quality of skills in the workforce needs to include equal opportunities for education to all.** In most countries in the region, school enrollment is near universal between ages 7 and 12, but drops off thereafter. Policies and incentives to retain children in secondary schools should receive priority in most countries in the region. Without a proper secondary education, children are on a path of life-long lower wages, and the pool from which universities recruit the best and brightest diminishes substantially.

**Figure 61. Enrollment rates differ between rural and urban areas, Indonesia 2009**  
(% of children enrolled in school)



Source: Indonesia Socioeconomic Survey (SUSENAS) 2009.

**In most countries in East Asia rural-urban differences in enrollment rates are larger than disparities by gender.**

This is the case in Indonesia, for example, where enrollment rates for boys and girls are similar in rural and, separately, in urban areas, but enrollment rates in urban areas are consistently higher than those in rural areas (Figure 61). Addressing constraints to schooling at the secondary and post-secondary levels may involve tackling challenges not only at the national but sub-national levels. Where demand-side constraints are important, the authorities can focus on demand-side policies such as conditional cash transfers. In cases where supply-side constraints are important, interventions that improve physical access to schools or school quality may be most effective. Government spending on education as a share of total outlays in the middle-income countries in the region seems to be converging to 15-20 percent of the total—with substantial declines in Malaysia and Thailand from levels that were almost twice as large as in the other

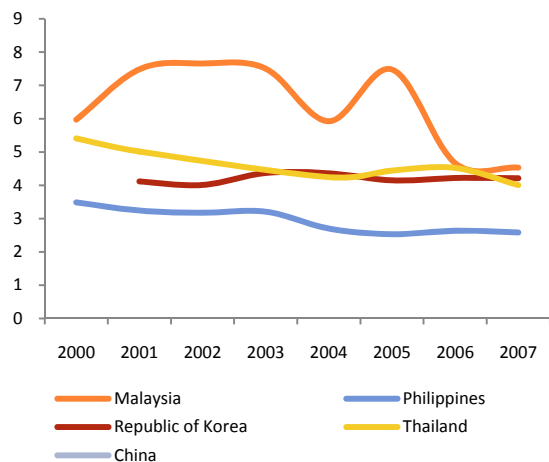
countries at the beginning of the decade (Figure 62). As Korea's example demonstrates, more money is not necessarily the key to better education outcomes. But the authorities in Malaysia and Thailand are reviewing education policies in the context of private sector concerns about lack of adequate skills and innovative workforce.

<sup>15</sup> World Bank. 2010. *East Asia and Pacific Economic Update: Emerging Stronger from the Crisis*, [www.worldbank.org/eapupdate](http://www.worldbank.org/eapupdate).

<sup>16</sup> World Bank. 2008., *Thailand Investment Climate Assessment*; World Bank. Forthcoming or 2010. *Industrial Development in the Bangkok Urban Region*.

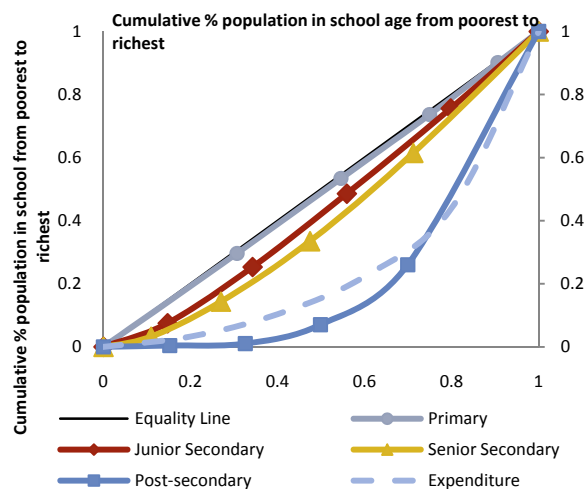
**In almost all East Asian countries, income equality has little impact on access to primary and senior secondary education** (Figure 63). However, this is different for the post-secondary education, however, where access to schooling is at least as unequal as income. Government support may be needed to ensure that access to post-secondary education is more equitable, so that more people have the opportunity to become entrepreneurs and innovators.

**Figure 62. Public expenditures on education declined or remained broadly unchanged in most countries**  
(% of total government expenditures)



Source: UNESCO Institute of Statistics.

**Figure 63. Post-secondary education is at least as equal as income in Thailand**  
(% of school aged children enrolled in school, 2009)



Source: Thailand Household Income and Expenditure Survey and staff calculations.

## FINANCE: FROM GRASS-ROOTS TO FRONTIER

**Even educated workforce cannot innovate without adequate finance.** Getting financing for innovative investment is difficult, because these are typically risky and unprofitable at the initial stages of the process. Still, large firms can finance their frontier innovations, technologies and upgrades by accessing venture capital, bond markets, or benefit directly from own or public resources. But middle-income countries innovate mostly behind the technological frontier. Those that do it better also have well developed financial systems and policies to support venture capital companies. Such venture companies, and to a lesser extent the capital market, tend to finance many of the innovation activities in developing countries, and contribute to alleviation of finance as the key constraint to innovation activities in the region (Figure 54). A robust corporate bond market in East Asia is emerging, but it will take time until firms that are not investment grade are able to raise funds. But these sources of financing are not available where risk is considered too high or mentoring is needed to achieve results, such as for most of grass-roots innovators.

**For grass-roots innovation, improving access of SMEs to financing is essential to ensure that small but powerful ideas can also be commercialized.** SMEs account for more than one-half of formal employment in the region, and in some countries they are collectively the largest employer. Yet SMEs contribute only about 20-30 percent of GDP, compared with 40-50 percent in advanced economies.<sup>17</sup> For small firms and innovative grass-roots entrepreneurs, access to finance for innovative projects is a severe constraint. High transaction costs of dealing with start-ups and micro, small and medium enterprises could make traditional financing unavailable to SMEs. One

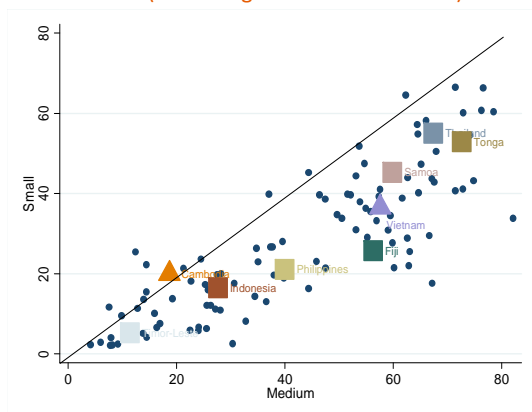
<sup>17</sup> Ayyagari, Demircuc-Kunt, and Maksimovic, 2008, *How Important Are Financing Constraints? The Role of Finance in the Business Environment*, World Bank Economic Review, November 2008, 22(3): 483-516.

way to reduce such transaction costs, which has already been implemented in several countries in East Asia, can significantly improve access to finance for small firms.

**HELPING SMALL FIRMS BY IMPROVING ACCESS TO FINANCE**

**Improving the access of SMEs to finance can contribute to productivity improvements and growth, and it will help to reduce inequality of opportunities** (see also Section I). On average, only about a third of small firms in

**Figure 64. Small firms are more disadvantaged in finance than medium-size firms**  
(Percentage of firms with credit)

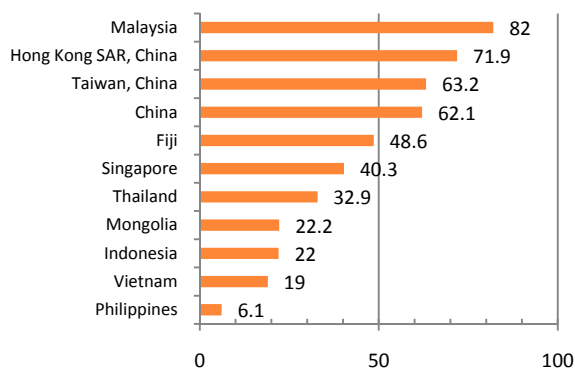


Source: World Bank Enterprise Surveys.

East Asia have a loan or a line of credit with a bank, compared to 50 percent of the medium-size firms and more than 60 percent of large companies (Figure 64). The financial crisis further reduced the availability of financing to SMEs, a development that has now been largely reversed.

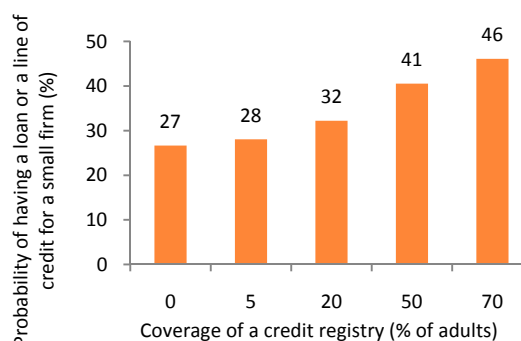
**Small firms in countries with more comprehensive credit information systems are more likely to have better access to finance.** Asymmetric information problems apply to all credit market segments, but are especially acute for the SME. Credit registries that collect data on loan repayments help reduce information asymmetries and enable lenders to lower the costs of processing loan applications (Figure 66).

**Figure 65. Credit information systems still have partial coverage in many economies**  
(Percentage of adults)



Source: Doing Business 2010. Note: The credit registry coverage is the maximum of the public and private credit registry coverage.

**Figure 66. Small firms are more likely to obtain a loan in a country with a comprehensive credit information system**  
(Percent)



Source: Staff estimates based on the World Bank Enterprise Surveys and the Doing Business database. Note: Estimate of a probability to have a loan or a credit line for a small, domestic, non-exporting firm with female ownership, under five years old, using internet, with reliable access to electricity. Based on enterprise surveys data for 27565 firms in 104 countries, controlling for country specific factors. Credit registry coverage is a maximum of public or private credit registry coverage.

**The coverage of credit information systems in East Asia increased from about 5.5 percent of adults in 2004 to about 15 percent in 2008.** China has led the way, with coverage rising from nearly nil to 62 percent of adults in the

last five years. In Indonesia, Mongolia and Vietnam, registries now include 20 percent of adults compared to nearly zero five years ago. And in Thailand coverage doubled from 15 to 33 percent in the past five years (Figure 65).

#### **Box 7. Some low hanging fruit in SME financing**

The establishment of an SME credit bureau in Malaysia is a recent example of a successful public-private partnership to improve access to finance. The SME credit bureau was formed as a joint venture between Credit Guarantee Corporation Malaysia, Dun and Bradstreet (D&B) Malaysia, and the Association of Banks, with the leadership of the central bank. The bureau provides a range of analytical tools to lenders by combining historical information from the credit registry operated by Bank Negara and the expertise of D&B. Thanks to SME credit scores that the bureau now calculates, banks have reduced processing times for loan applications, in some cases in half.

The establishment of an online registry for pledges of receivables by the People's Bank of China is another example of improvement of the financial infrastructure. Less than two years after it started operation, 75 thousand notices of security interests have been registered representing loans that total \$570 billion. More than 48 thousand SMEs are registered as secured debtors and are benefiting from increased access to credit.

**COUNTRY PAGES AND KEY INDICATORS****CAMBODIA**

Cambodia's economic recovery is underway. Real GDP growth is projected to reach 4.9 percent in 2010 and 6 percent in 2011, driven by a rebound in exports (particularly garments) and tourism, and the uninterrupted growth of agricultural production. Apparel exports rose by 15 percent over the first six months of 2010, reflecting a pickup of shipments to the U.S. This helped create 16,000 new jobs since January 2010 after a loss of 43,000 jobs in 2009. Garment exports are expected to post a 14 percent growth in 2010. Tourism picked by 12 percent in the first half and is projected to grow by 9 percent for 2010 as a whole. The recovery is also visible in credit to private sector (up 17 percent) and new firm registration (up 21 percent in the first half of the year). The recovery of foreign investment and construction remains at a much slower speed: construction and FDI permit approvals remained subdued despite a slight increase of imports of construction materials (up by 5 percent) suggesting that recovery took place in small construction activities only.

Growth prospects in 2010 and 2011 depend on the performance of the agriculture sector. The sector has weathered the global crisis well, but crop production might be negatively affected by the sporadic droughts in some parts of the country. Even if these developments were to materialize, they would be offset by a surge in exports of milled rice. These exports are up 3.5 times in the first half of 2010 year-on-year in value terms (the 6-month volume is already above the annual total volume exported in 2009). The sector benefited from the recent adoption of paddy production and rice export policy. Quick measures introduced to boost rice exports are to double the government-run Agriculture Development and Support Fund and to develop a Credit Guarantee Scheme to provide government guarantees of up to 50 percent to companies and paddy collectors.

The current account deficit is expected to worsen in 2010, as the economic recovery boosts aggregate demands. The current account deficit is expected to widen to 13.6 percent GDP from 11.6 percent in 2009. Foreign exchange reserves have also continued to rise even in the period of crisis. The inflation rate has slowed for the fifth consecutive month, declining from 5.3 percent in 2009 to 2.6 percent by June. Despite a hike in rice prices by 5 percent over the first half of 2010, overall food price inflation remained subdued at 1.8 percent and core inflation was 1.3 percent over this period. The 2010 yearly consumer price inflation is projected to be around 5 percent.

The exchange rate depreciated slightly against the US dollar by about 2 percent a month during the first six months of the year. This prompted the central bank to sell foreign exchange amounting to \$17 million in May and June. The depreciation of the riel may help Cambodian exporters, but it may have an adverse impact on poor consumers.

Lending by the banking sector is picking up, although banks remain liquid. Deposits in banks continued to grow, by 9 percent in mid 2009 and 32 percent by mid 2010, reflecting cautious lending by banks exercised since the crisis period. Lending nevertheless started to improve during the first half of 2010 but remained lower than the pre-crisis level. The lending-deposit-ratio stood at 71 percent in June 2010, compared to 81 percent in June 2009. Most lending over the past 12 months was directed at low risk sectors, mainly retail/wholesale trades, tourism related activities (hotel/restaurants) and some manufacturing. Credit to private sector is expected to accelerate during the second half of 2010.

Confidence in the banking sector continues to improve. In August, the National Bank of Cambodia issued a prakas allowing banks to outsource their payment transaction services to third-party processors. The service processor may provide service such as money remittance and other payment transaction services by mobile phone, clearing and settlement of credit card payment, inter-bank clearing facility, etc. This may help promote the use of the banking system, modernize the electronic payment system and mitigate the country's largely cash-based economy. To further build confidence in the sector, continued tight supervision of the banks and proper management of the new minimum capital requirements (to be enforced at the end of 2010) remain important priorities.

The government has started to unwind the fiscal stimulus introduced in 2009. The fiscal deficit reached 8.1 percent of GDP in 2009 and is expected to shrink to 5.5 percent of GDP in 2010. In the first half of the year, revenues rose by 17.5 percent year-on-year while expenditures fell 3 percent. The increase in revenues was led by VAT, excise and import duties collections. Revenues also benefit from a doubling of the road tax on vehicles and the introduction of a property tax. Anti-smuggling efforts have been stepped up in recent months especially in log/timber smuggling. The government is also planning to expand its automated customs declaration process from its current three main customs sites to more than 10 other sites. The automated system has helped improve customs processing time, management and the risk-based inspection. On the expenditure side, the government are curbing the growth of the wage bill by freezing new recruitment and promotion of civil service except in the education and health sectors, and limiting non-essential recurrent expenditures.

The government adopted the Updated National Strategic Development Plan (NSDP) in May to extend its development targets until 2013. The updated plan targets economic growth of 6 percent a year and per capita income of nearly \$1,000 by 2013. Under-five child mortality is targeted to decline to 55 per 1,000 live births from its current rate of 82. According to the Cambodia's MDG Monitoring Update Report prepared by the Ministry of Planning (September 2010), Cambodia has made substantial progress towards the achievement of its MDGs in many areas. However maintaining high, broad-based economic growth and pro-poor policy are crucial to realize the goals of reducing the poverty rate as targeted to 19.5 percent by 2015.

<b>Cambodia: Key Indicators</b>						
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010e</b>	<b>2011f</b>
	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>
<b>Output, Employment and Prices</b>						
Real GDP (% change y-y)	10.8	10.2	6.7	-2.0	4.9	6.0
Domestic demand (% change y-y)	8.3	7.6	6.5	1.8	5.2	6.5
Industrial production index (2000=100)	227	246	256	249	257	276
(% change y-y)	18.3	8.4	4.1	-2.5	3.1	7.5
Consumer price index (% change y-y)	4.2	14.0	12.5	5.3	5.0	5.0
<b>Public Sector</b>						
Government revenues (% GDP)	11.5	11.9	12.0	11.5	13.3	13.6
Government expenditures (% GDP)	14.2	14.8	14.8	19.6	18.8	19.0
Government balance (% GDP)	-2.7	-2.9	-2.9	-8.1	-5.5	-5.4
<b>Foreign Trade, BOP and External Debt</b>						
Trade balance (millions US\$)	-1,078	-1,343	-1,801	-1,574	-1,939	-2,299
Exports of goods (millions US\$)	3,693	4,089	4,708	4,302	4,947	5,689
(% change y-y)	26.9	10.7	15.2	-8.6	15.0	15.0
Key export (% change y-y) 1/	21.1	8.1	3.3	-19.0	14.0	8.0
Imports of goods (millions US\$)	4,771	5,432	6,509	5,876	6,886	7,988
(% change y-y)	21.5	13.8	19.8	-9.7	17.2	16.0
Current account balance (millions US\$) 2/	-522	-705	-1,280	-1,161	-1,520	-1,600
(% GDP)	-7.1	-8.1	-12.4	-11.6	-13.6	-12.9
Foreign direct investment (millions US\$)	475	866	795	511	639	799
External debt (millions US\$)	3,318	3,537	3,892	3,170	3,531	3,882
(% GDP)	45.1	40.4	37.8	31.8	31.6	31.2
Short-term debt (millions US\$)	209	218	218	218	218	218
Debt service ratio (% exports of g&s)	1.4	1.0	1.0	1.2	1.2	1.2
Foreign exchange reserves, gross (millions US\$)	1,097	1,616	2,164	2,367	2,651	2,890
(months of imports of g&s)	2.4	3.0	3.4	4.0	3.9	3.7
<b>Financial Markets</b>						
Domestic credit (% change y-y)	35.7	70.7	51.1	19.9	20.0	22.0
Short-term interest rate (% p.a.) 3/	16.4	16.0	15.8	15.0	14.5	14.0
Exchange rate (Riel/US\$, eop)	4,061	4,003	4,081	4,169	4,150	
Real effective exchange rate (2000=100)	94.3	99.2	112.8	111.5	112.5	
(% change y-y)	-1.7	5.2	13.7	-1.2	0.9	
Memo: Nominal GDP (millions US\$)	7,350	8,754	10,286	9,966	11,162	12,423
Source: National data sources and World Bank staff estimates						
e = estimate						
f = forecast						
1/ Garments						
2/ Excludes official transfers						
3/ One-year US\$ loans						

**CHINA**

China's economic growth remained strong during the global financial and economic crisis, reflecting a massive fiscal and monetary stimulus and strong underlying momentum related to the size of its domestic market and robust fundamentals. Since bottoming out in early 2009 amidst a collapse in exports, GDP growth has risen substantially. Initially this was predominantly because of the massive domestic policy stimulus. The monetary expansion was particularly large—credit expanded by 30 percent of GDP in 2009—but it reflected in part infrastructure-oriented quasi-fiscal activity.

The key drivers of growth have changed since the end of 2009. Investment slowed, as a pickup in real-estate investment offset only partly a substantial weakening of government-led investment. Meanwhile, the contribution of net external trade shifted from strongly negative in mid-2009 to strongly positive in mid-2010, reflecting in large part the rebound of exports as the global economy recovered. China's exports grew faster than world imports, however, reflecting the strong competitiveness of China's manufacturing industry. China's share of global trade continued to rise as a result.

The pace of economic expansion is moderating from a very rapid expansion in early 2010, reflecting the fading impact of the stimulus package and the normalization of monetary policy. Industrial value-added increased by 13.5 percent year-on-year in June-July, compared to almost 18 percent in March-April.

With exports so far remaining strong and imports weakening, the trade surplus is rising again. Exports continued to grow through July, due to a recovering world economy and continued increases in China's global market share. Imports had slowed after the stimulus-driven import surge earlier on. In August however a decline in exports was accompanied by an unexpected increase in imports. Overall though, the current account surplus has been rising again and may come out higher in 2010 than last year.

Consumer price inflation rose on the back of higher food prices, but remains modest. Prices rose 3.3 percent year-on-year in July, with two-thirds contributed by higher prices for food largely because of several domestic supply shocks. The international food price increases have added some pressure, but were limited because of standard government intervention. Meanwhile, core inflation has remained low.

However, property prices have hardly budged since the introduction in April of measures to contain them. Property prices rose very rapidly in much of 2009 and in the first part of 2010. The pace of real estate price increases was considered unsustainable and the government took measures in April that focused on tightening access to mortgage financing.

Looking ahead, China's outlook remains favorable, even though expansion in China's main export markets remains subdued. Growth in China is easing in the second half of 2010 because of continued normalization of the policy stance after the large stimulus, the lagged impact of the measures introduced in mid-April to contain property price rises, administrative measures to meet energy efficiency targets, and a moderating global growth. All in all, we project real GDP to grow 9.5 percent in China in 2010. In early 2011, activity should be supported at least modestly from the end of the administrative measures designed to meet energy efficiency targets. However, with weak global growth and fading impact of the stimulus package, we project growth to slow to 8.5 percent in 2011.

Inflation is likely to increase somewhat in the short term, but such increases will be contained. With domestic staple food prices largely shielded from international price movements in the short and medium term, key upward risks stem from international prices for industrial raw materials as well as from domestic supply conditions in agricultural markets. The domestic supply side factors that have been driving food prices up are not likely to persist. Moreover, core inflation is likely to remain subdued. Large wage increases in parts of the manufacturing sector earlier this year reflected a strong rebound in the labor market after a downturn last year, when wage growth slowed. Wage growth however is not far from historical averages. Given the track record of manufacturing to keep growth in labor costs under control and the flexibility of the labor market, a wage-inflation spiral remains unlikely.

China's favorable short-term growth outlook warrants further normalization of the policy stance. Against the backdrop of the large monetary expansion since end 2008, the key macroeconomic risks include further asset price increases, strained local government finances, and the increase in the banks' nonperforming loans. With the economy operating close to full capacity and the growth outlook favorable, further consolidation of the overall monetary stance is needed to contain these risks. However, downside risks to growth call for maintaining policy flexibility.

Rebalancing the pattern of growth remains important. The rebalancing should be towards more emphasis on services and consumption, away from industry and investment. There has been some progress, notably in increasing the role of the government in health, education, and social security. However, the momentum of the existing pattern is strong and substantially more rebalancing is needed. Very broadly, two types of structural reforms are needed: (i) reforms to ensure that new resources are channeled to sectors that should grow in the new setting, instead of to sectors that have traditionally been favored and done well; and (ii) reforms to support successful urbanization.

## China: Key Indicators

	2007	2008	2009	2010e	2011f	2009		2010	
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2
<b>Output, Employment and Prices</b>									
Real GDP (% change y-y)	13.0	9.6	8.7	9.5	8.5	9.1	10.7	11.9	10.3
<b>Industrial production index /1</b>									
(% change y-y)	14.9	9.3	10.3			12.3	17.9	19.6	16.0
Unemployment (%) 2/	4.0	4.2	4.3	4.5		4.3	4.3	4.2	4.2
Real wages (% change y-y)	13.3	10.7						10.7	9.9
Consumer price index (% change y-y)	4.8	5.9	-0.7	3.7		-7.7	-2.1	2.2	2.9
<b>Public Sector</b>									
Government revenues (% GDP)	19.3	19.5	20.1			21.1	15.5	24.0	26.0
Government expenditures (% GDP)	18.7	19.9	22.4			19.6	28.4	17.6	21.4
Government balance (% GDP)	0.6	-0.4	-2.2	-3.5		1.50	-12.89	6.49	4.65
Domestic public sector debt (% GDP) /3	19.6	17.0	18.0	19.1					
<b>Foreign Trade, BOP and External Debt</b>									
Trade balance (billions US\$)	262.0	297.3	198.2	210.2		39.3	61.5	14.5	41.2
Exports of goods (billions US\$)	1218.3	1429.2	1202.0	1378.7		325.1	355.1	316.1	389.1
(% change y-y) 4/	25.7	17.3	-15.9	14.7		-20.3	0.2	28.7	40.9
Key export (% change y-y) 5/	26.2	16.8	-15.7			-20.1	0.2	28.3	40.8
Imports of goods (billions US\$)	956.3	1131.8	1003.9	1168.5		285.8	293.6	301.6	347.8
(% change y-y) 4/	20.8	18.4	-11.3	16.4		-12.0	22.3	22.8	25.9
Current account balance (billions US\$)	371.8	426.1	284.1	304.0				53.7	70.5
(% GDP)	10.3	9.3	5.8	5.5				4.5	5.3
Foreign direct investment (billions US\$) /6	83.5	108.3	90.0			168.0	238.8	284.0	
External debt (billions US\$)	373.6	374.7	428.6			386.8	428.6	443.2	
(% GDP)	10.4	8.2	8.6			8.0	6.7	9.3	
Short-term debt (billions US\$)	220.1	210.8	259.3						
Debt service ratio (% exports of g&s)	2.0	1.8	1.10						
Foreign exchange reserves, gross (billions US\$)	1534.7	1952.5	2405.7	2818.0		2279.2	2405.8	2447.1	2454.3
(months of imports of g&s)	19.3	20.7	28.8	28.9		23.9	24.6	24.3	21.2
<b>Financial Markets</b>									
Domestic credit (% change y-y)	16.1	15.9	31.7			34.2	31.7	21.8	18.2
Short-term interest rate (% p.a.) 7/	3.3	2.8	2.8			2.8	2.8	2.8	2.8
Exchange rate (RMB/US\$, eop)	7.37	6.84	6.83			6.83	6.83	6.83	6.82
Real effective exchange rate (2000=100)	103.6	118.1	111.7			116.9	115.1	115.7	119.1
(% change y-y)	1.3	13.9	-5.4			-1.3	-5.0	-7.2	2.3
Stock market index (Dec. 19, 1990=100)/8	5262	1821	3277			2779	3277	3109	2398
Memo: Nominal GDP (billions US\$)	3,607.8	4,589.7	4,912.1	4,999.5				1,195.7	2,535.6

Source: National data sources

f = forecast

1/ Annual data are not comparable with the quarterly data. Annual data cover all industrial enterprises. Quarterly and monthly only refer to those enterprises with sales value above Rmb5 millions.

5/ Manufactured exports

2/ Official urban unemployment only, not including laid-off workers

6/ Gross FDI utilized

3/ Includes treasury bond, policy financial bond and the financial bond (end-period outstanding)

7/ Central Bank loans to financial institutions, less than 20 days

4/ Nominal growth rate

8/ Shanghai Stock Exchange A-Share Price Composite

**FIJI**

Fiji's economy is expected to grow by 0.5-1 percent in 2010, only partially recovering from the 3 percent contraction last year. The partial economic recovery in 2010 is being driven by the rebound of tourism, the stronger performance of some of Fiji's commodity exports, and growth in consumer spending supported by increased inflows of remittances. The main downside risks to growth stem from an even weaker than anticipated performance of the sugar sector and the impact that any further shock political developments may have on tourist arrivals in the remainder of the year. Inflation, which had risen sharply to 10.5 percent year-on-year by April following the removal of price controls on some basic consumer items, moderated to 5.4 percent by July.

The trade deficit is estimated to have narrowed by 13 percent in the first half of 2010, thanks to higher export earnings from gold, fish, timber, and mineral water. Over the rest of the year, however, the improvement in export earnings from these sectors is expected to be more than offset by lower earnings from sugar exports (crushing season began in May), owing to the announced EU preferential price cut and lower sugar production. In dollar terms, tourism earnings are projected to only increase slightly compared to 2009 because of heavy discounting by hotel operators and the impact of the currency devaluation, despite arrivals by over 20 percent in the first five months of 2010. Inflows of remittances continued to be strong in the first half of 2010, rising about 15 percent from a year earlier. Foreign exchange reserves remained relatively stable during 2010, at around 3.5 months' imports of goods and non-factor services.

Investment activity has not shown positive signs so far. In the first five months of 2010, imports of investment goods fell 1.7 percent year-on-year. Value-added in construction also declined. These developments follow declines in investment in 2009 to 13 percent of GDP from 15 percent in 2007 and 2008. Political uncertainties are likely to continue to constrain investment in the near term.

For 2010, the government targets a fiscal deficit of 3.5 percent of GDP compared with 2.7 percent in 2009. The outcome for 2010 will depend on several factors that are pulling in different directions. Firstly, both GDP and revenues are likely to be lower than assumed by the budget. Direct revenues as a percent of GDP are projected to continue to decline, reflecting a reduction in the corporate income tax rate, an increase in the tax-exempt minimum from personal income taxes, and the slower growth. Secondly, capital expenditures are likely to be lower than under the budget, due to insufficient implementation capacity to rollout the expanded capital works program. On balance, the deficit in 2010 may be lower than projected under the budget.

The fiscal space that the government has had in recent years to respond to the global economic crisis and local natural disasters has been constrained by the relatively high level of public debt. Fiji's public debt is estimated to have amounted to 52 percent of GDP at the end of 2009, with a further 15 percent of GDP in public guarantees of the debts of state-owned enterprises. In September 2011, Fiji faces the challenge of refinancing a 150 million U.S. dollar-denominated sovereign bond (about 5 percent of GDP).

At present, Fiji is confronting a complex and pressing structural reform agenda. A series of interrelated structural reforms are needed in order to increase the output and improve the productivity of the agricultural sector. The structure of Fiji's sugar industry – the backbone of the rural economy – requires an overhaul to realign incentives across the sector, encourage viable growers to remain in the industry, and improve the efficiency of both the intra-industry transport system and the sugar mills. Supply chain management and the marketing of non-sugar agricultural products also needs to be addressed, particularly with respect to forging backward linkages from the tourism industry, which is now the engine of Fiji's economy. The success of both sugar and non-sugar agricultural reforms will depend on the effective resolution of the long-standing and very complex problem of ensuring secure land tenure in Fiji. The government has acknowledged these interrelated structural reforms as priority issues, but gaining traction on these reforms has thus far remained elusive.

The government has also acknowledged the importance of public sector reforms, including of the civil service and public financial management, and the need to reduce the strain of state-owned enterprises on public finances. With regard to the civil service, the government has enacted a wage and hiring freeze to curb the public sector

wage bill. Going forward, the government will need to complement these measures with a well-sequenced reform strategy to address human resource management objectives in the public sector without jeopardizing fiscal sustainability.

<b>Fiji: Key Indicators</b>						
	2006	2007	2008	2009	2010e	2011f
	Year	Year	Year	Year	Year	Year
<b>Output, Employment and Prices</b>						
<b>GDP (% change y-y)</b>	1.9	-0.9	0.2	-3.0	1.0	1.4
<b>Domestic demand (% change y-y)</b>						
<b>Tourist arrivals (thousands)</b>	549	540	585	542	575	605
<b>(% change y-y)</b>	0.6	-1.6	8.4	-7.3	6.1	5.2
<b>Unemployment rate (%)</b>	8.3	8.6	7.7	9.4		
<b>Consumer price index (% change y-y)</b>	3.1	4.3	6.6	6.8	4.0	3.0
<b>Public Sector</b>						
<b>Government revenues (% GDP)</b>	26.1	25.4	24.9	25.0	24.5	24.5
<b>Government expenditures (% GDP)</b>	29.0	27.0	25.1	27.7	27.3	27.0
<b>Government balance (% GDP)</b>	-3.0	-1.6	-0.2	-2.7	-2.8	-2.4
<b>Domestic public sector debt (% GDP)</b>	45.4	42.6	42.9	43.9	44.0	44.4
<b>Foreign Trade, BOP and External Debt</b>						
<b>Trade balance (millions US\$)</b>	-897	-842	-1,108	-670	-764	-795
<b>Exports of goods (millions US\$)</b>	729	787	944	625	640	660
<b>(% change y-y)</b>	-1.8	8.0	19.9	-33.8	2.4	3.0
<b>Key export (% change y-y) 1/</b>	-6.1	-7.5	35.5	-38.7	-34.4	0.0
<b>Imports of goods (millions US\$)</b>	1,626	1,629	2,052	1,295	1,405	1,455
<b>(% change y-y)</b>	11.2	0.2	26.0	-36.9	8.5	3.6
<b>Current account balance (millions US\$)</b>	-582	-462	-634	-285	-362	-376
<b>(% GDP)</b>	-18.8	-13.6	-17.8	-10.1	-12.0	-12.2
<b>Foreign direct investment (millions US\$)</b>	415	329	313	54	276	271
<b>Total external debt (millions US\$)</b>	445	461	449	394	383	444
<b>(% GDP)</b>	14.3	13.5	12.6	13.9	12.7	14.3
<b>Short-term debt (millions US\$)</b>	111	210	210	210		
<b>Debt service ratio (% exports of g&amp;s)</b>	2.7	3.3	2.5	4.1	3.1	13.3
<b>Foreign exchange reserves, gross (millions US\$) 2/</b>	460	551	381	568	544	563
<b>(months of imports g&amp;s)</b>	2.6	3.1	1.7	3.9	3.5	3.5
<b>Financial Markets</b>						
<b>Domestic credit (% change y-y) 3/</b>	23.7	2.8	11.2	4.0		
<b>Short-term interest rate % p.a.)</b>	7.5	4.5	0.3	7.1		
<b>Exchange rate (FJ\$/US\$, eop)</b>	1.7	1.6	1.8	1.9		
<b>Real effective exchange rate (2000=100)</b>	97.9	100.6	103.6	91.6		
<b>(% change y-y)</b>	-2.1	2.8	3.0	-11.6		
<b>Memo: Nominal GDP (millions US\$)</b>	3,103	3,405	3,565	2,825	3,008	3,091
Source: National data sources						
e = estimate						
f = forecast						
1/ Sugar.						
2/ Includes foreign assets of non-bank financial institutions.						
3/ Domestic credit to the private sector.						

**INDONESIA**

Indonesia was less affected by the global economic downturn of 2008-09 than most countries, and by the first half of 2010 the economy's growth patterns had normalized. Growth in the first half of 2010 reached 6.2 percent year-on-year. Private consumption was supported by high consumer confidence and relatively low and stable inflation for most of the period. Private investment has also recovered. Meanwhile, net exports subtracted from growth as the domestic economy grew more strongly than economies abroad. Government consumption also subtracted from growth as a result of slow disbursements and the unwinding of Indonesia's modest fiscal stimulus. On the production side, much of the strength has come from service producing sectors, including wholesale and retail trade, transport and communications, and finance and business services. Growth in goods producing sectors was still solid, but slower than that of services.

Trade volumes continued to grow in the first half of 2010, although at a slower pace than in late 2009. Commodity prices also rose. However, the trade balance narrowed as imports outpaced exports. This reflected the relative strength of domestic demand, and the expenditure switching effect due to the stronger Rupiah, as well as some restocking of intermediate goods for export processing industries. The current account surplus also narrowed in line with the trade surplus, as the income deficit remained flat.

After weakening sharply during the global financial turmoil of late 2008, Indonesia's financial markets recovered well and have exceeded their pre-crisis levels. In August 2010, the currency appreciated to a 3 year-high against the U.S. dollar, with the real exchange rate up 22 percent from a year earlier and 16 percent higher than the pre-crisis levels in July 2008. Thanks in large part to large nonresident purchases, prices for government bonds have also risen strongly. Net foreign inflows have amounted to \$11 billion year-to-date, despite a momentary weakening during May's global turbulence which saw \$5.7 billion of net capital outflows. Bank Indonesia (BI) continues to eschew explicit capital controls, instead changing regulations in a way that is not explicitly discriminatory against non-residents. For example, the central bank implemented measures from June to make investments in the shortest term central bank instruments less attractive and to encourage banks to use the interbank market rather than the central bank for intermediation.

Foreign reserves have more-than recovered from the crisis. In contrast with the rapid turn-around in portfolio flows, FDI was very weak through 2009, although it also shows a significant recovery in the first half of 2010, in part to finance infrastructure investments. BI has used the issuance of short-term money market instruments (SBIs) to manage the impact of the rapid growth in reserves on the domestic money supply.

Consumer prices accelerated in mid-2010, largely due to the food prices. This year's extended rainy season affected the domestic harvest and disrupted distribution networks leading to sharp increases in some food prices. For the most part these appear to be temporary and have started to reverse. Seasonal demand pressures associated with Ramadan coupled with administered price increases in recent months, including electricity tariffs and vehicle registration, have contributed to a sharp increase in overall consumer prices. The 12-month inflation rate was 6.4 per cent in August – the highest in 16 months. Core inflation, generally unaffected by this volatility, has however continued to gradually pick up and by August 2010 was 4.2 per cent year-on-year.

Policy interest rates have remained unchanged this year at 6.5 percent. BI has not increased interest rates in response to higher than expected inflation, but it has absorbed excess liquidity from the market and announced a rise in reserve requirements from November 2010. With a limited pass-through to lending rates from the cuts in policy rates during the crisis, credit growth was anemic in 2009. But it picked up in 2010, rising 19 percent year-on-year in June, led first by consumer lending and then by a recovery in working capital and investment loans. To promote banking intermediation, Bank Indonesia also revised its loan-to-deposit ratio (LDR) policy, effective from March 2011. Under the policy, banks with LDR outside the range of 75-105 percent will have to increase their required reserves (except for those banks with higher LDR but with adequate capital). The health of the banking sector overall remains robust and has been little affected by the crisis.

Parliament approved a revised 2010 budget deficit of 2.1 percent of GDP, up from an initial 1.6 percent, and the government is proposing a 2011 deficit of 1.7 percent of GDP. The 2010 budget includes a small stimulus package of 0.6 percent of GDP, like 2009 mainly as tax cuts (including a corporate tax rate cut from 28 to 25 percent). Due to slow disbursement of core capital and material budgets and stronger-than-expected revenues, the Finance Minister announced in July that the 2010 deficit may be 1.5 percent of GDP. The government has enjoyed improved access to commercial debt markets in 2010, filling three quarters of its initial 2010 bond issuance target by September, at yields sharply lower and longer maturities than a year earlier. Actual financing needs are likely to be smaller given the likelihood of a deficit below target. The government announced its 2011 budget proposal in mid August, projecting a 1.7 percent of GDP deficit. This includes significant increases in infrastructure capital spending, signaling the government's efforts to address long-standing bottlenecks affecting the country, with funds allocated away from subsidies in particular.

Indonesia's relatively high and rising investment ratios, robust domestic demand and improvements in the investment climate including through infrastructure projects are projected to support faster growth in the face of the uncertain and possibly weaker external outlook. Growth of 6.0 percent is expected in 2010, increasing to 6.2 percent in 2011. Trade growth is expected to remain broad-based. Imports are expected to continue to recover somewhat faster than exports, as the domestic economy grows more quickly than Indonesia's export destinations, and production to meet the ongoing recovery in non-commodity exports requires more imported inputs, leading to a narrowing of the trade surplus. The balance of payments surplus is also expected to narrow through H2 2010 and 2011, as the current account surplus narrows and weaker projected portfolio investment inflows more than offset recovery in foreign direct investment and banking inflows. The annual inflation rate for 2010 is likely to be around 5.1 percent following the acceleration in prices mid-year. Into 2011 while some of the short-term supply disruptions are likely to unwind, inflation rates are likely to remain at the top of or just above BI's 4-6 percent target band further as the recovery in new lending and acceleration in the money base experienced since late 2009 support domestic demand, adjustment in energy prices towards their economic price continues, and the exchange rate stabilizes. The longer-term inflationary outlook is highly dependent on the conduct of policy by Bank Indonesia and its commitment to limit inflation to around 5 percent, which is challenged by the need to stabilize the domestic economy while managing capital inflows, although it is committed and ensuring that adjustments in key regulated prices (notably energy) do not translate into persistently higher inflation.

Looking to the medium-term achieving the pace of reform required to lift average growth rates above 7 percent remains the key challenge. Developments in Q2 2010 highlighted the risks posed by volatile capital flows and uncertain trading partner growth. Over a longer horizon, the government has set a demanding policy reform agenda in its medium-term development plan unveiled in February 2010 (RPJMN 2010-2014). The plan, intended to achieve stronger and more inclusive growth, lays out national development priorities in 11 areas. Most programs under poverty reduction, education and health are a continuation or expansion of existing development programs. Many of the new program priorities reflect a focus on Indonesia's infrastructure and connectivity challenges, for example, construction of highways, electricity generation, or developing a national logistics system, for example.

Indonesia: Key Indicators									
	2007	2008	2009	2010e	2011f	2009		2010	
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2
<b>Output, Employment and Prices</b>									
Real GDP (% change y-y) 1/	6.3	6.0	4.6	6.0	6.2	6.4	5.2	5.7	6.2
Industrial production index (2000=100)	123.4	127.2	128.8	132.7	135.4	131.0	132.9	129.9	133.0
(% change y-y)	5.6	3.0	1.5	3.0	2.0	0.1	4.9	4.3	4.3
Unemployment (%)	9.1	8.4	8.1						
Real wages (% change y-y)	1.7	-3.3							
Consumer price index (% change y-y) 2/	5.4	11.1	2.8	6.4	6.1	2.8	2.8	3.4	5.0
<b>Public Sector 3/</b>									
Government revenues (% GDP)	17.9	19.8	15.5	15.9	15.5				
Government expenditures (% GDP)	19.2	19.9	17.0	17.4	17.2				
Government balance (% GDP)	-1.3	-0.1	-1.6	-1.5	-1.7				
Domestic public sector debt (% GDP)	35.2	33.0	29.5	28.3	26.4				
<b>Foreign Trade, BOP and External Debt 4/</b>									
Trade balance (billions US\$)	20.9	9.9	21.0	13.9	10.5	5.0	6.8	4.8	5.3
Exports of goods (billions US\$)	118.0	139.6	119.5	154.9	180.3	31.3	35.9	35.0	37.8
(% change y-y)	14.0	18.3	-14.4	29.6	16.4	-17.9	20.6	44.7	34.4
Key export (% change y-y) 2/	14.5	23.1	-31.0			-33.9	74.8	94.3	54.2
Imports of goods (billions US\$)	85.3	116.7	84.3	116.9	136.6	-22.8	-24.5	-26.6	-28.8
(% change y-y)	15.4	36.9	-27.7	38.7	16.8	-29.5	-4.3	53.7	45.800
Current account balance (billions US\$)	10.5	0.1	10.6	1.8	-1.2	2.2	3.6	2.1	1.8
(% GDP)	2.4	0.0	1.9	2.5	-1.4	1.5	2.4	1.3	1.1
Foreign direct investment (billions US\$)	6.9	9.3	4.9	5.4	4.6	1.0	0.5	2.6	
External debt (billions US\$)	135.9	148.5	166.2						
(% GDP)	31.5	29.1	30						
Foreign exchange reserves, gross (billions US\$)	56.9	51.6	66.1	81.3		62.3	66.1	71.8	76.3
(months of imports of g&s)	8.0	5.3	9.4	7.8		8.2	8.1	8.1	7.9
<b>Financial Markets</b>									
Domestic credit (% change y-y)	26.5	30.5	9.9	19.0	22.0	12.5	7.2	10.1	16.9
Short-term interest rate (% p.a.) 6/	8.6	9.2	7.3	6.8		6.6	6.5	6.5	6.5
Exchange rate (Rupiah/US\$, ave)	9,163	9,756	10,35	9,091	9,000	9,887	9,475	9,271	9,091
Real effective exchange rate (2000=100)	136.8	148.8	148.9	149.8		153.7	159.0	167.4	174.2
(% change y-y)	5.6	8.8	0.1	0.6		-5.2	17.4	24.2	14.5
Stock market index (Aug. 1988=100) 7/	2210	2087	2014			2467	2534	2777	2913
Memo: Nominal GDP (billions US\$)	431.1	507.5	544.0	712.2	857.4	146.0	153.2	161.5	173.0

Source: National data sources and World Bank staff  
f = forecast

1/ Based on GDP 2000 base.  
2/ Crude oil exports.  
3/ Revenues, expenditures and balance figures are Ministry of Finance projections for 2010 with 2011 figures from proposed budget.  
4/ Monthly trade figures are from BPS, whereas quarterly figures are BOP figures from Bank Indonesia.  
5/ Crude oil exports.  
6/ Policy rate: one-month Bank Indonesia Certificates.  
7/ Jakarta Composite.

**LAO PDR**

Lao PDR's economic performance has been strong. Real GDP is projected to grow at about 8.5 percent in 2010 up from 7.5 percent in 2009. This projection has been revised upwards from the 7.8 percent forecast in April 2010 because major sectors, such as natural resources (especially with commercial operation of NT2, and a higher than anticipated mining extraction), manufacturing (agro-processing, food and beverages, cement and metal) and construction have performed better than earlier anticipated this year while garments and tourism started to rebound. However, growth in agriculture (especially rice production) is expected to slow in 2010 due to early draught and recent flood in some provinces fueling food prices in the country. FDI in resource and non-resource sectors has rebounded, supported by the recent recovery in regional demand and the rise in prices of commodities the country exports. Slower growth in the global economy is likely to have a relatively modest impact on Lao, with growth projected to settle at about 7.8 percent over the medium term.

Headline inflation rose notably in past months because of a faster increase in food prices and stood at nearly 8 percent year-on-year in August 2010. Core inflation excluding prices for food and energy is up modestly to 3.4 percent year-on-year in August. Food prices rose 14 percent in August, contributing 5.7 percentage points to total inflation. The rapid increase in food prices was due seasonal factors and fear of shortage in food supply during the rainy season. Nevertheless, food prices are likely to decline during the harvest season in November-December and the average inflation is likely to stay at about 6 percent this year and 5-6 percent in 2011.

The budget deficit is expected to drop to 4.8 percent of GDP in FY2010 from 6.6 percent in FY2009. Revenues during the first three quarters of this fiscal year reached 85 percent of the annual target, and for the year as a whole should increase to 14.6 percent from 13.7 percent in FY2009. Overall public spending is expected to increase to 23.7 percent of GDP in FY2010 from 22.3 percent in FY2009 mainly due to the new inclusion of non-project grants (about 2.5 percent of GDP) into the budget from this fiscal year. Wage spending and domestically financed capital expenditure is expected to decline. The FY2011 budget envelope has recently been approved by the National Assembly in June and targets a budget deficit of 3.5 percent. While Lao PDR has made progress in reducing its external and public debt burden, it still faces a high risk of debt distress because of its large debt stock. Nevertheless, public debt service remains manageable as much of the debt is contracted on concessional terms.

Lao exports have performed well due to increased commodity prices and regional demand. Exports are projected to surge by about 37 percent this year to \$2 billion, with resource exports growing at 54 percent (electricity produced by NT2 up by 150 percent and mining up 40 percent). Imports are expected to grow by 9 percent this year driven by consumer and to a lesser extent by investment-related goods as inflows of foreign direct investment are still to fully rebound. The current account deficit is expected to narrow to 9.6 percent of GDP in 2010 from 13.8 percent in 2009. Net capital inflows are projected to decline, mostly driven by a pause in hydropower investment, while investments in mining and non resource are resuming. Foreign exchange reserves have declined to \$558 million or about 3.2 months of non-resource imports by mid-2010. As appreciation pressures subside due to lower capital inflows in the second half of the year, the reserves are projected to remain at this level for a while.

The Government is pursuing an exchange rate policy of managed float. The kip has appreciated by 4.4 percent against the US dollar and depreciated by 4.4 percent against Thai baht during the first nine months of 2010.

After growing rapidly in 2008-2009, credit expansion is slowing in 2010 after the government terminated off-budget spending activities in September 2009 and as a result of a marked slowdown in private credit expansion. The credit share in GDP is projected to increase to 26.3 percent by end-2010 from 21.3 percent at end-2009.

Laos continued to make good progress on structural reforms. This has included advances in public finance management with the successful introduction of the VAT (improvement in tax collection in FY10) and substantial progress in treasury reform (issue of Treasury Decree by the PM and further achievement in implementing a Treasury Single Account system – completed stocktaking and started the transfer of spending accounts into treasury). The investment climate has also been improved through the approval of the new Unified Investment Promotion Law, a revised Decree on Rules of Origin and its implementing guidelines, a new Decree on the

Notification and Enquiry of Trade Related Information, the completion of draft Trade Facilitation Master Plan, and the establishment of a Trade Facilitation Secretariat. There is steady progress in advancing financial reforms, including with the approval of the Financial Sector Strategy Action Plan for 2010–2020, the separation of the functions of banking and financial supervision within the central bank, and the development of the regulatory and supervisory framework for the upcoming stock exchange.

<b>Lao PDR: Key Indicators</b>						
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010e</b>	<b>2011f</b>
	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>
<b>Output, Employment and Prices</b>						
<b>Real GDP (% change y-y)</b>	8.5	7.4	7.5	7.6	8.5	8.4
<b>Consumer price index (% change y-y)</b>	6.8	4.5	7.6	0.1	5.0	5.0
<b>Public Sector 1/</b>						
<b>Government revenues (% GDP)</b>						
<b>Government expenditures (% GDP)</b>						
<b>Government balance (% GDP) 2/</b>	-3.8	-2.7	-2.6	-6.6	-4.8	-3.0
<b>Foreign Trade, BOP and External Debt</b>						
<b>Trade balance (millions US\$)</b>	-406	-817	-1,033	-988	-675	-724
<b>Exports of goods (millions US\$)</b>	1,080	1,215	1,451	1,431	1,973	2,361
<b>(% change y-y)</b>	49.0	12.5	19.4	-1.3	37.8	19.7
<b>Key export (% change y-y)</b>	49.2	2.6	16.6	4.9	38.8	21.1
<b>Imports of goods (millions US\$)</b>	1,486	2,032	2,484	2,419	2,647	3,084
<b>(% change y-y)</b>	19.9	36.7	22.2	-2.6	9.4	16.5
<b>Current account balance (millions US\$)</b>	-329	-812	-1,019	-848	-715	-939
<b>(% GDP)</b>	-9.3	-19.0	-18.2	-13.8	-9.6	-11.1
<b>Foreign direct investment (millions US\$)</b>	502	838	976	769	724	1,027
<b>External debt (millions US\$)</b>	3,424	4,386	5,360	6,028	6,227	6,721
<b>(% GDP)</b>	97	101	96	101	91	92
<b>Debt service ratio (% exports of g&amp;s)</b>	5.7	12.5	10.4	15.6	16.2	14.0
<b>Foreign exchange reserves, gross (millions US\$) 3/</b>	336	531	636	633	558	620
<b>(months of imports of g&amp;s)</b>	2.5	3.1	3.2	2.9	2.4	2.3
<b>Financial Markets</b>						
<b>Domestic credit (% change y-y)</b>	-6.0	16.0	77.4	101.2	43.9	17.7
<b>Short-term interest rate (% p.a.) 4/</b>	14.5	13.0	10.5	7.0	7.0	..
<b>Exchange rate (Kip/US\$, ave)</b>	10060.6	9603	8635	8516	8235	..
<b>Real effective exchange rate (2000=100)</b>	106.2	105.3	124.7	116.6	..	..
<b>(% change y-y)</b>	2.9	-0.8	18.4	-6.5	..	..
<b>Memo: Nominal GDP (millions US\$)</b>	3,495	4,275	5,601	6,145	7,412	8,445
Source: National data sources						
f = forecast						
1/ Fiscal year basis			3/ Excluding gold			
2/ After grants			4/ Treasury bill rate			

**MALAYSIA**

Malaysia's economy completed its rebound from the sharp downturn in 2009, and moved to more sustainable, moderating growth rates through the first half of 2010. The economy expanded by a stronger than expected 8.9 percent year-on-year in the second quarter, following 10.1 percent growth in the first quarter. These high growth rates reflect in large part the depth and speed of the downturn a year earlier. The rebound and recovery have taken capacity utilization back to the pre-crisis long-term average. Nevertheless, Malaysia's output level appears to be 5 percentage points lower than in a scenario without the global downturn.

The fiscal stimulus and the revival in external demand were initially driving the recovery, but now private consumption and investment are taking the lead. By the second quarter, growth in private fixed investment was outpacing that in public investment. Both foreign and domestic private investors responded to the recovery in activity and the tightening of capacity constraints in many sectors by investing in both manufacturing and other sectors. The main exceptions were in sectors where Malaysia's productive capacity is constrained by absence of key endowments, such as suitable land for the crude palm oil producers and low-cost labor for textiles production. FDI inflows and corporate credit have returned to pre-crisis levels. Household spending also recovered strongly, as evidenced by resurgent car sales, retail turnover and spending on consumer services. It was supported by the recovery in employment, stabilization and growth in incomes especially in commodity producing areas, and further strength in consumer lending.

The fragility of global recovery is impacting Malaysia's important electronics & electrical device (E&E) sector and, through that, general sentiment across the larger economy. The weakness in external demand mid-year appears to have surprised firms. On the one hand they continued to rebuild their inventories, although these are still below pre-crisis levels. At the same time, exports started to fall mid-year, especially for electronics items. With this, by midyear industrial production across the externally-oriented sectors started to ease – contrasting with the domestically-focused sectors where the recovery in output broadened.

Largely due to moves to make regulated prices better reflect economic costs, Malaysia's consumer price inflation trended moderately higher through the first half of 2010. Twelve-month inflation rose to 2.1 percent by August from 1.3 percent in March. As such, most of this increase has been in non-durable goods inflation (subsidized goods are generally fuels and foods), with core inflation near-flat at 1.0 percent in the year to August. The small rise in inflation was largely due to faster growth in food prices, with only limited impact from the reform in non-food subsidies. Food and non-alcoholic beverage inflation has increased from 1.7 to 3.1 percent between the year to March and the year to August. Fresh meat prices drove much of this increase, rising by 4.4 percent in the year to August, and the government responded in August by issuing licenses to import chicken to supplement domestic supply. Adjustments in subsidies in mid-July lifted sugar prices by 14.1 percent from June to August, and confectionary prices also rose though less markedly. Weather-related increases in grains prices elsewhere in the world have had little impact on Malaysian food prices by Q3, and the adjustments to regulated fuel prices had only a small impact (e.g., household gas prices rose by a modest 5.9 percent from June to August, still their largest movement in over 4 years).

Bank Negara Malaysia (BNM) preemptively responded to the recovery in activity and inflation by raising its policy interest rate by 75 basis points between February and July. It held rates at 2.75 percent through to October. At the same time, BNM allowed a marked if relatively smooth appreciation of the Ringgit against the U.S. dollar to RM3.15 by late September 2010, or 9.4 percent increase from December 2009, limiting inflationary pressures. Against this background, interest rates on deposits and loans rose by less and actual financing flows accelerated. BNM also continued its gradual liberalization of the exchange rate regime, with three significant policy changes made in August, designed to reduce the transaction costs associated with organizing real trade flows. Malaysian residents can now use Ringgit to settle trade with non-residents, where previously only foreign currencies could be used. The second reform improves flexibility in the management of the financing of integrated transnational corporations by allowing them to borrow any amount in foreign currency from non-bank related companies. The third allows firms to hedge current account (mostly trade-related) foreign currency needs on an anticipatory basis,

whereas the earlier rule limited hedges to the previous 12 months' flows, which had been suppressed by the collapse in trade flows in early 2009.

Fiscal policy has also started to normalize. The revised budget for 2010 projects a deficit of 5.4 percent of GDP, compared with a deficit of 7 percent in 2009 (in line with earlier projections) and a shortfall of 4.8 percent in 2008. The deficit in the first half of 2010 was 4.7 percent of GDP, but spending in the first half tends to be somewhat smaller than the second half. The final stages of the Ninth Malaysia Plan and the second stimulus package absorb much of the additional spending, with gross development spending totaling RM19.4 billion in the first half, more than a third higher than in 2008 but 4.4 percent lower than the stimulus-boosted first half of 2009. Education and transportation received most of the development spending. The more substantial increase in spending was from operating spending, particularly subsidies, reflecting the recovery in global commodity and particularly energy prices. In light of this, the government embarked on a well-publicized first step to systematically reforming subsidies in mid-July. The government raised energy prices, including gasoline, natural gas for households, and sugar. The authorities also announced plans to adjust regulated fuel prices monthly, as a step towards indexation, although with global oil prices relatively stable and the Ringgit's appreciation, there had been no further adjustments by October. Savings from the July round of subsidy reform alone are expected to amount to RM0.75 billion during July-December.

Meanwhile, Malaysia's financial markets continued to strengthen, though less markedly than elsewhere in the region. By August the capitalization of the main stock market had risen a quarter from a year earlier, with financial and the largest listed companies showing the strongest increases. Part of this strength reflected offshore portfolio investment. The overall balance of payments returned to near-balance by the second quarter, with a small deficit of RM1.9 billion, compared with ten times this amount in the first quarter. Both inward and outward investment rose.

Looking ahead, growth is expected to be strong over 2010 as a whole, at 7.4 percent, but softening in H2 and into early 2011, with annual growth that year of 4.8 percent expected. Towards the turn of 2011 growth is expected to remain driven by domestic private demand on the back of fiscal consolidation and uncertain external conditions. Inventory restocking is likely to moderate, while private consumption and, to a lesser extent, private fixed investment may fill that slack. While fiscal consolidation is expected to lead to slower public consumption growth, public investment should remain relatively strong if stimulus disbursement picks up. With impressive nominal GDP growth, the fiscal deficit is projected at 5.4 percent of GDP in 2010, relative to government's target of 5.6 percent. Net exports may subtract from growth, but by less than the first half as firms cut their intermediate and capital goods imports following weaker external demand. Modest export growth coupled with more rapid import growth in 2011 is likely to reduce the current account surplus further. The key downside risk is weaker-than-expected export performance, which would reduce private consumption growth with a lag. Subsidy cuts and rising commodity prices could also hold back consumer spending. On the upside, exports may in fact be stronger than projected, if progress on the Economic Transformation Program is faster-than-expected—which would raise investor confidence and private investment.

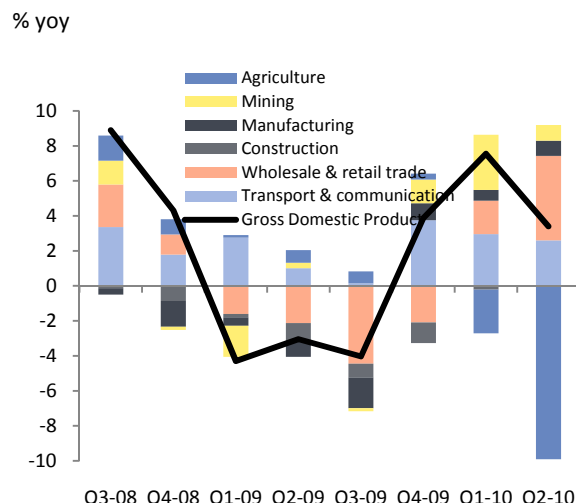
Malaysia: Key Indicators									
	2007	2008	2009	2010e	2011f	2009		2010	
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2
<b>Output, Employment and Prices</b>									
Real GDP (% change y-y)	6.3	4.6	-1.7	7.4	4.8	-1.2	4.4	10.1	8.9
Industrial production index (2000=100)	107.2	107.8	99.8			103.1	104.0	105.1	107.8
(% change y-y)	2.3	0.6	-7.5			-7.0	2.5	11.0	10.8
Unemployment (%)	3.2	3.3	3.7			3.5	3.4	3.6	
Consumer price index (% change y-y)	2.0	5.4	0.6	2.0	2.4	-2.3	-0.2	1.3	1.6
<b>Public Sector</b>									
Government balance (% GDP) /1	-3.2	-4.8	-7.0	-5.4	-4.5	-4.5	-11.4	-5.6	-3.8
Domestic public sector debt (% GDP) 1/	38.5	39.6	53.4			51.6	53.4	51.6	52.2
<b>Foreign Trade, BOP and External Debt</b>									
Trade balance (billions US\$)	29.2	45.3	31.4			7.6	9.5	11.6	7.2
Exports of goods (billions US\$)	176.0	209.7	154.5			40.9	46.8	47.1	48.5
(% change y-y)	9.6	19.1	-26.3			-26.4	10.1	40.8	33.2
Key export (% change y-y) 2/	-4.2	-3.8	-13.9			-20.4	24.2	46.9	27.1
Imports of goods (billions US\$)	146.8	164.4	115.1			33.3	37.2	35.6	41.2
(% change y-y)	12.0	12.0	-30.0			-22.6	11.4	45.4	42.7
Current account balance (billions US\$)	29.2	38.8	31.4			7.2	8.0	4.8	9.4
(% GDP)	15.7	17.5	16.7	15.3	14.5	14.6	14.8	8.9	16.4
Foreign direct investment (billions US\$)	8.5	7.2	1.6			1.0	-0.6	1.5	1.8
External debt (billions US\$)	55.8	66.4	62.4			69.2	68.5	65	68.4
(% GDP)	29.9	29.9	33.2			34.8	31.4	29.9	29.8
Short-term debt (billions US\$)	16.2	22.4	22.8			22.9	22.9	21.4	22.3
Debt service ratio (% exports of g&s)	2.6	3.1	6.8			3.4	6.9	8.0	7.3
Foreign exchange reserves, gross (billions US\$)	101.3	91.4	96.7			93.3	98.1	96.4	96.2
(months of imports of g&s) 3/	8.4	7.4	9.8			8.4	7.9	8.1	7.0
<b>Financial Markets</b>									
Domestic credit (% change y-y)	7.5	4.1	4.8			2.5	4.8	6.5	8.8
Short-term interest rate (% p.a.) 4/	3.5	3.5	2.1			2.1	2.1	2.2	2.5
Exchange rate (Ringgit/US\$, eop)	3.31	3.46	3.42			3.48	3.43	3.27	3.26
Real effective exchange rate (2000=100) 5/	102.4	103.3	99.9			98.6	100.0	101.9	107.4
(% change y-y)	3.4	0.8	-3.3			-5.6	-1.4	1.5	6.7
Stock market index (Apr. 4, 1986=100) 6/	1445	877	1273			1202	1273	1321	1314
Memo: Nominal GDP (billions US\$)	186.7	222.2	194.7			50.3	54.2	56.0	57.1
Source: National data sources, World Bank staff estimates f = forecast 1/ Federal government only. 2/ Electronics. 3/ Excludes services imports. 4/ One-month interbank rate. 5/ World Bank's staff estimate. 6/ KLSE Composite.									

**MONGOLIA**

Mongolia has staged an impressive recovery from the steep recession of late 2008 and early 2009. Moreover, the economic recovery is becoming more broad-based. Strong demand for copper and coal from China are fuelling the recovery, and are also helping to substantially improve the external balance. By contrast, agriculture has performed the worst, due to the devastating impact of the winter dzud which wiped out substantial numbers of livestock.

Mongolia’s public finances are also improving. On a 12 month rolling basis, the fiscal deficit fell to just 0.4 percent of GDP, down from 10.6 percent in August last year. Excluding net lending, the budget balance swung into a small surplus of 0.8 percent of GDP, its first since October 2008. In large part this recovery reflects the support to government revenues from buoyant commodity prices. The bulk of the increase in revenues was accounted for by the windfall profit tax and domestic corporate and indirect tax revenues, reflecting the underlying improvement in the economy and the recovery in commodity prices.

**Figure 1. The economic recovery is becoming more broad-based**

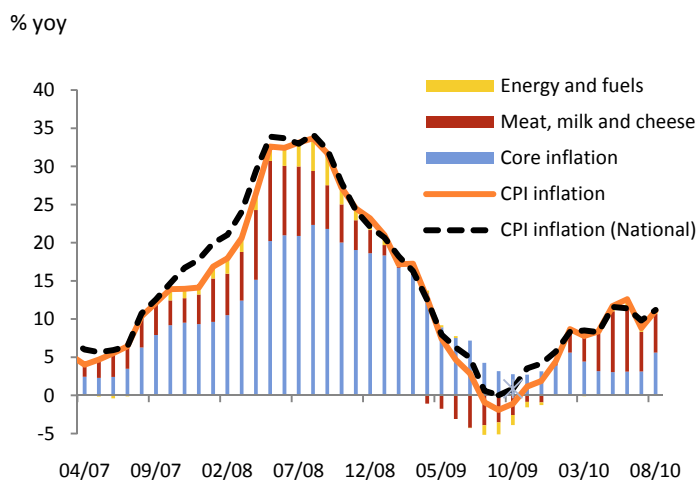


Source: NSO, NSO, WB staff estimates.

Consumer prices rose 11.1 percent year-on-year in August following a dip to 8.8 percent the previous month (Figure 2). Rising core prices (which exclude volatile food and energy prices) contributed to half the increase in the headline number, with the remainder accounted for mainly by rising food prices.

Price pressures are unlikely to abate in the coming months. First, the recent export ban in Russia and weather disasters elsewhere have led to resurgence in international grains prices. These rose by 7.6 percent on the month in August. Second, the 30 percent wage and pension increase for public sector employees planned for October and the cash transfers of MNT50,000 per person currently taking place between August and December will help to keep demand side inflation pressures strong.

**Figure 2. Inflation remains high, reflecting both demand and supply side pressures**



Source: NSO, NSO, WB staff estimates.

The improvement in public finances compared to last year and the rise in revenues in line with commodity prices have led to growing pressures for increased government spending. One round of cash transfers has already taken place in February with MNT 70,000 distributed per person. This is to be followed by another round of MNT 50,000 per person to be distributed in the remaining five months of the year, alongside a 30

percent increase in government sector wages and pensions which will take effect from October 1st. Meanwhile, in July, the parliament approved government proposed amendments to the original 2010 budget which envisaged a substantial increase in government expenditures.

In addition, as the elections of 2012 draw closer, spending pressures will continue to mount. Fortunately, Parliament recently passed a Fiscal Stability Law, which forces 2011 revenues to be based on a long-term copper and coal price trend, and starts setting the resulting savings aside in a stabilization fund. The law targets a structural budget deficit (along the lines of Chile's structural balance rule) of 4 percent of GDP in 2011, falling to 2 percent by 2013. It also puts a ceiling to debt (at no more than 40 percent of GDP) and restrains expenditure growth to not more than the rate at which the economy is growing.

The IMF Board concluded its final review of the Stand-by Arrangement on September 9th. The final review (a combined 5th and 6th) would have allowed the disbursement of US\$46.4 million (two tranches). But the Mongolian authorities will not draw on the last two tranches, as the international reserves of the Central Bank are at an all time high, while the exchange rate has appreciated by 11 percent since the start of the year.

In the banking sector, NPLs and loans with principal in arrears as a share of total outstanding loans fell to 17% in Augustus from a peak of 25% in Nov 2009. But current levels are still very high. The recent increase in inflation is rapidly bringing real interest rates down, and may lead to a return to negative real interest rates, particularly on deposits.

In the fall session, the Mongolia Parliament is expected to debate and enact a number of important reform laws. This includes a banking sector capacity strengthening and capital support program which contains, as a last resort tool, a stand-by bank recapitalization facility with proper covenants to protect the public funds. The Parliament will also debate a social welfare reform law which would set the stage for the introduction of a targeted means-tested poverty benefit, replacing the formerly universal transfers. Passage of the law is linked to the last tranches of the budget support operations of the ADB and Japan. Finally, the Parliament is also expected to adopt Organic Budget Law which will lay out a new process of budget management, including improvements in public investment planning and fiscal decentralization.

<b>Mongolia: Key Economic Indicators</b>						
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010e</b>	<b>2011f</b>
	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>
<b>Output, Employment and Prices</b>						
Real GDP (% change y-y)	8.6	10.2	8.9	-1.6	8.5	7.0
Industrial production index	100.0	110.4	113.4	109.7	..	..
(% change y-y)	..	10.4	2.7	-3.3	..	..
Unemployment (%)	3.2	2.8	2.8	3.3	..	..
Consumer price index (% change y-y)	5.9	14.1	23.2	1.9	12.0	7.4
<b>Public Sector</b>						
Government revenues (% GDP)	36.6	40.9	36.1	32.9	34.9	31.1
Government expenditures (% GDP)	28.4	38.0	41.0	38.3	37.1	35.9
Government balance (% GDP)	3.3	2.8	-5.0	-5.4	-2.2	-4.8
Non-mineral government balance (% GDP)	-7.3	-13.4	-15.5	-12.9	-11.2	-8.2
Domestic public sector debt (% GDP)	1.0	0.5	0.0	3.7	19.3	25.8
<b>Foreign Trade, BOP and External Debt</b>						
Trade balance (millions US\$)	136	-52	-613	-195	-639	-1680
Exports of goods (millions US\$)	1,544	1,951	2,535	1,875	2446	2567
(% change y-y)	44.8	26.3	29.9	-26.0	30.4	4.9
Key export (% change y-y) 1/	94.8	27.7	3.0	-39.9	40.4	8.36
Imports of goods (millions US\$)	1,408	2,117	3,147	2,070	3085	4247
(% change y-y)	20.8	50.4	48.6	-34.2	49	37.7
Current account balance (millions US\$)	222	265	-722	-411	-805	-1651
(% GDP)	7.0	6.7	-14.0	-9.8	-13.9	-22.9
Foreign direct investment (millions US\$)	290	360	836	496	422	849
External debt (millions US\$)	1,414	1,529	1,601	1,977	2141	2231
(% GDP)	44.3	38.9	33.7	47.1	39.0	35
Debt service ratio (% exports of g&s) 2/	2.3	2.0	2.0	3.7	..	..
Foreign exchange reserves, gross (millions US\$)	718	1,001	658	1,328	1599	1631
(month of imports of g&s)	4.6	5.0	3.0	4.3	3.9	4
<b>Financial Markets</b>				102.3812		
Domestic credit (% change y-y)	-3.1	78.4	52.5	-7.6	47.1	24.5
Short-term interest rate (% p.a.) 3/	5.1	8.4	9.8	10.0	..	..
Exchange rate (Tugrik/US\$, eop)	1165.0	1170.0	1267.5	1443.6	..	..
Real effective exchange rate (2000=100)	102.8	104.8	124.4	102.4	..	..
(% change y-y)	3.2	1.9	18.7	-17.7	..	..
Stock market index (2000=100) 4/	382	2048	1182	..	..	..
Memo: Nominal GDP (millions US\$)	3,156	3,930	5,150	4,203	..	..
Sources: National data sources						
e = estimate						
f = forecast						
1/ Copper concentrate.			3/ Yield of 14-day bills until 2006 and of 7-day bills for 2007.			
2/ On PPG debt.			4/ Top-20 index, eop, index=100 in Dec-2000.			

**PAPUA NEW GUINEA**

Higher commodity prices, principally for minerals, have boosted government revenues and export receipts at mid-year, allowing the government to only slightly downgrade its growth forecast for the year to 7.5 percent despite a delay in the completion of the \$1.4 billion Ramu NiCo (nickel-cobalt mine) project in Madang province.

Formal private sector employment growth picked up to 1.6 percent year-on-year (yoy) in the second quarter compared with 1.4 percent in the first quarter, helped in part by the resumption of LNG, a large project under construction, as well as the seasonal harvesting of coffee and palm oil. Construction activities at the LNG Project, including at the southern port of Kopi, at the bridge on the Kikori River and at the logistics base in Lae, lifted the labor market. Still, overall employment growth has been weaker than initially forecasted by the authorities, also contributing to a milder official growth outlook for the year.

The rise in export prices, paced by mineral prices but also including prices for forest and marine products --- 48 percent yoy overall in the second quarter and 40 percent yoy in the first quarter --- significantly boosted export receipts in the first half of 2010. Exports topped \$1.7 billion in the second quarter, a 48 percent yoy increase, in addition to \$1.1 billion in the first quarter. Imports only rose marginally in the second quarter and declined in the first, resulting in a trade surplus of \$1.0 billion in the first half of the year. The current account posted a small deficit of \$139 million in the first half, with deficits in the income and services accounts more than offsetting the trade surplus in the first quarter.

The capital account recorded a small surplus of \$102 million in the first half of the year. In the second quarter, positive net FDI, donor contributions for projects, and net inflows from other investments by mining companies helped offset large portfolio outflows related to money market investments by residents, a buildup in net foreign assets by the banking system, and higher net loan repayments by the government. Gross foreign exchange reserves reached \$2.7 billion at the end of June, providing eleven months of import cover, and are estimated to total some \$2.8 billion in mid-September.

The surge in commodity prices helped not only the country's export performance through mid-year but also boosted government revenue performance and its overall fiscal outlook for the year. The government has revised its forecast for total revenue by 9 percent to Kina 8.2 billion. While a balanced budget was initially targeted for the year, it is likely to be in surplus on the revenue uptick. The government has indicated that the additional revenues may be used to finance several priority projects.

However, due to the development of the massive LNG project that costs twice the country's nominal dollar GDP, more spending on infrastructure might affect further inflation, imports, capital flows, and the exchange rate over the next four years. In particular, the Bank of Papua New Guinea has expressed concern that the high demand for goods and services related to the project will have an inflationary impact on the economy. The central bank recommended that the government, instead, focus spending on priorities in education, health, environmental conservation, and law and order.

It is expected that monetary policy will continue to focus squarely on emerging inflationary pressures in the economy throughout the rest of the year. A recent decline in central bank bill rates suggests that excess liquidity may be forming in the financial system. The government itself has recently expressed concern that the National Statistical Office data may be understating inflationary pressures. Headline inflation may reach 7.1 percent this year and rise to 8 percent next year. The central bank has kept the policy interest rate, the kina facility rate, at 7 percent since December last year, but announced a hike in the CRR from 3 to 4 percent in its September Monetary Policy Statement.

The near-term challenge to policymakers at this time is to maintain macroeconomic stability in the face of an expected substantial demand shock from the construction of the LNG Project coupled the recent run-up in commodity prices globally. A strong commitment to the thresholds of Medium Term Fiscal Stability Framework should help the government contain the pressure for public spending when private spending is strong.

At the same time, the recent problems encountered in the implementation of both the Ramu NiCo and the LNG projects should alert the government to the challenges it faces in ensuring that the benefits of these natural resource projects should more materially and broadly accrue to the larger population and that the risks that these projects pose to the environment, to habitats, and to the means of livelihood of the affected populations should be seriously addressed.

<b>Papua New Guinea: Key Indicators</b>						
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010e</b>	<b>2011f</b>
	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>
<b>Output, Employment and Prices</b>						
<b>Real GDP (% change y-y)</b>	2.3	7.2	6.7	4.5	7.5	5.5
<b>Tourist arrivals (thousands)</b>	77.7	104.1	115.0	123.0	..	..
<b>(% change y-y)</b>	12.2	34.0	10.4	7.0	..	..
<b>Consumer price index (% change y-y)</b>	2.4	0.9	10.7	6.9	7.1	8.0
<b>Public Sector</b>						
<b>Government revenues (% GDP)</b>	37.2	37.3	32.6	28.3	30.4	29.8
<b>Government expenditures (% GDP)</b>	30.7	28.4	30.0	35.7	30.1	28.8
<b>Government balance (% GDP)</b>	6.5	8.9	2.5	-7.4	0.3	0.9
<b>Domestic public sector debt (% GDP)</b>	18.0	18.4	18.9	19.6	17.2	14.5
<b>Foreign Trade, BOP and External Debt</b>						
<b>Trade balance (millions US\$)</b>	2,333	2,193	2,675	1,187	318	79
<b>Exports of goods (millions US\$)</b>	4,324	4,822	5,823	4,617	5,742	6,391
<b>(% change y-y)</b>	28.2	11.5	20.8	-20.7	24.4	11.3
<b>Key export (% change y-y) 1/</b>	9.3	4.8	16.0	-17.5	30.4	13.5
<b>Imports of goods (millions US\$)</b>	1,991	2,629	3,148	3,430	5,424	6,312
<b>(% change y-y)</b>	13.9	32.0	19.7	9.0	58.1	16.4
<b>Current account balance (millions US\$)</b>	442	208	805	-541	-1,422	-1,653
<b>(% GDP)</b>	8.0	3.3	10.0	-6.8	-16.1	-18.5
<b>Foreign direct investment (millions US\$)</b>	196.2	462.7	-31.0	764.0	1137.0	1322.0
<b>External debt (millions US\$)</b>	2,192	1,978	2,042	2,127	2,273	2,382
<b>(% GDP)</b>	39.1	31.2	25.5	26.9	25.8	26.7
<b>Short-term debt (millions of US\$) 2/</b>	33	48	44	72	75	..
<b>Debt service ratio (% exports of g&amp;s)</b>	8.0	8.3	5.1	7.0	5.7	5.2
<b>Foreign exchange reserves, gross (millions US\$)</b>	1,449	2,087	1,988	2,571	2,432	2,299
<b>(months of imports of g&amp;s)</b>	3.8	4.2	4.4	5.6	3.8	3.2
<b>Financial Markets</b>						
<b>Domestic credit (% change y-y)</b>	19.4	5.5	31.3	30.2	25.2	..
<b>Short-term interest rate (% p.a.)</b>	3.7	4.4	5.9	7.2	..	..
<b>Exchange rate (Kina/US\$, eop)</b>	3.0	2.8	2.7	2.7	..	..
<b>Real effective exchange rate (2000=100)</b>	100.9	96.5	109.4	118.0	..	..
<b>(% change y-y)</b>	0.3	-4.4	13.4	7.8	..	..
<b>Memo: Nominal GDP (millions US\$)</b>	5,605	6,339	8,009	7,907	8,809	8,922
Source: National data sources, IMF, and World Bank staff estimates						
e = estimate						
f = forecast						
1/ Gold						
2/ Banking system short-term external debt only						

**PHILIPPINES**

The Philippine economy grew by a robust 7.9 percent in the first half of 2010 following the rebound in global trade and the recovery in investor confidence. Growth was driven mainly by strong increases in investment and exports. Private consumption continued to accelerate as consumer confidence improved and as inflows of remittances remains strong. Government spending was also supportive, thanks to pre-elections outlays and the fiscal stimulus measures.

The labor market has also recovered after the impact from the global recession. The unemployment rate fell to 6.9 percent in July from 7.6 percent a year before, helped by the creation of 800,000 new jobs mostly in the agriculture sector. Underemployment declined in July with the termination of temporary jobs created during the election campaign period. Structural weaknesses in the labor market remain, nonetheless, reflecting a large informal sector and self-employment which continue to account for about half of all workers. The self-rated hunger incidence remains at record high levels at over a fifth of the country's population in the last three quarters. Moreover, self-rated poverty increased anew in June despite the high growth.

Headline inflation averaged 4.1 percent year-on-year in January-September and there are signs of incipient inflation pressures. Minimum wages were raised from July in several regions of the country and a number of price increases have been proposed. The new government has moved to implement a VAT on toll roads (now pending before the Supreme Court) and major utility providers and highways operators have petitioned the government for price increases. Moreover, increasing prices for food, including flour, and a fall in rice production due to weather-related shocks pose upside risks to inflation. These pressures have been moderated to an extent by the strengthening peso. The monetary authorities decided to keep the policy interest rates unchanged at their August meeting.

The country's external position remains favorable with strong growth in exports and remittances. In the first half of 2010, exports grew at double digits, partially recovering the declines in 2009. Remittances also grew strongly following extensive deployment of overseas Filipino workers. On the financial side, while portfolio investment recovered and fueled the strong growth in equity prices, foreign direct investment remained subdued ahead of the elections. Foreign exchange reserves rose to a record high \$53.5 billion at the end of September.

Fiscal policy remained expansionary through the first half of 2010, with government spending up 0.2 percent of GDP from a year earlier. The economic resiliency program introduced during the crisis helped buoy economic growth through a combination of spending increases and tax cuts. Primary spending grew by more than 20 percent, reflecting increases of one-fourth in investment spending. Government-wide salary increases also contributed to higher spending. Revenues increased by 9 percent year-on-year in the first half, thanks to the economic recovery. Tax cuts that came into effect in 2009, notably the reduction in the corporate income tax rate and the increase in personal income tax exemptions, continue to pose serious challenges to the tax administration in raising adequate tax revenues. Consequently, the government increased its borrowing requirements by over 0.5 percentage points of GDP as of July 2010. With higher borrowings, the national government debt is projected to reach 56.2 percent of GDP by the end of 2010.

In its first two months in office, the Aquino government began to rationalize spending and focused on increasing tax efforts to control the deficit. However, without policy changes, notably the rationalization of tax incentives and increasing excise tax rates, raising the tax effort will remain challenging and could undermine the government's expenditure program. Given this, the deficit is likely to remain at 4.2 percent of GDP in 2010 (GFS basis). A quicker withdrawal of the fiscal stimulus program would help limit the deficit, but structural reforms are needed for a durable further reduction.

In August, the president submitted the proposed 2011 "reform budget" to Congress. At P1.6 trillion (18.2 percent of GDP), spending is proposed to increase 6.8 percent from the amount targeted for 2010. Under the proposed budget, spending on social services, notably basic education will increase significantly. Infrastructure spending is proposed to be cut by 0.5 percent of GDP, mostly from the removal of congressional insertions. The government

expects PPP projects help to fill the gap in public infrastructure. A list of priority PPP projects has been drawn up for 2011. Funding the 2011 expenditure program would solely rely on greater revenue efficiency and a moratorium on revenue-eroding measures. The budget does not propose any tax policy measures.

Growth prospects in the near term are favorable. Strong growth in the first half of 2010 is expected to ease with the gradual withdrawal of monetary and fiscal stimulus measures and the moderation of global growth. Assuming no material downward revisions on first-half GDP, growth is projected to slow from 6.2 percent in 2010 to 5 percent in both 2011 and 2012. Sustained structural reforms will be needed, however, to increase the medium-term potential growth rate to more than 4-5 percent.

The inauguration of the Aquino government in July 2010 and the global economic recovery offer Philippines a window of opportunity to embark on structural reforms to improve its development outcomes. The new government has initiated reforms to improve public finances and to strengthen the investment climate for more inclusive growth. These are commendable and should be pursued steadfastly and vigorously.

On public finances, the government has moved to improve the efficiency of spending. The proposed budget for 2011 limits special purpose funds by eliminating some items and incorporating others into the agency budget. Some inefficient programs, such as the food for school program and several agricultural input subsidies, have been cut. In their place, the government scaled-up the conditional cash transfer program from 1 million to 2.3 million households (nearly half of poor households in the country). While improving the efficiency of public spending is a welcome move, increasing the level of public spending is also needed to improve the stock of human and physical capital. This would entail some tax policy reforms to ensure a higher and sustained revenue base that would enable the government to embark on more ambitious reforms.

Strengthening the investment climate would be supported by the improved macroeconomic environment and progress in advancing governance reforms. Addressing longstanding constraints in doing business, ensuring a level playing field, and reducing corruption would all help to improve the investment climate and contribute to the new government's aim to attract more investment, including through partnerships with the private sector.

Philippines: Key Indicators									
	2007	2008	2009	2010	2011	2009			2010
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2
<b>Output, Employment and Prices</b>									
Real GDP (% change y-y) 1/	7.1	3.8	1.1	6.2	5.0	0.2	2.1	7.8	7.9
Industrial production index (1994 = 100)	84.6	84.8	74.7			77.9	87.7	80.9	90.3
(% change y-y)	-2.7	0.3	-11.9			-11.9	3.6	31.0	26.5
Unemployment (%) 2/	7.3	7.4	7.5			7.6	7.1	7.3	8.0
Nominal wages (% change y-y) 3/	4.5	5.3	0.0			0.0	0.0	0.0	1.9
Real wages (% change y-y) 3/	2.0	-1.6	-3.8			0.8	-2.2	-4.0	-0.8
Consumer price index (% change y-y)	2.8	9.3	3.2	4.2	4.5	0.3	3.0	4.2	4.1
<b>Public Sector</b>									
Government balance (% GDP) 4/	-1.7	-1.5	-4.1			-4.7	-2.9	-7.1	-3.2
Domestic public sector debt (% GDP) 5/	33.1	31.5				33.4			
<b>Foreign Trade, BOP and External Debt</b>									
Trade balance (billions US\$) 6/	-8.4	-12.9	-8.9	-9.4	-10.8	-1.9	-2.0	-2.3	-1.1
Exports of goods (billions US\$) 6/	49.5	48.3	37.5	45.8	49.0	10.2	10.5	11.1	12.4
(% change y-y)	6.4	-2.5	-22.3	22.0	7.0	-22.0	4.9	43.5	33.3
Key export (% change y-y) 7/	5.3	-7.2	-21.2			-17.7	9.7	51.3	..
Imports of goods (billions US\$) 6/	57.9	61.1	46.4	55.2	59.8	12.1	12.5	13.4	13.5
(% change y-y)	8.7	5.6	-24.1	19.0	8.3	-29.8	2.6	34.0	0.0
Current account balance (billions US\$) 8/	7.1	3.6	8.6	7.2	6.3	2.0	2.7	1.8	2.6
(% GDP)	4.9	2.2	5.3	3.8	3.0	5.2	5.8	4.4	5.6
Foreign direct investment (billions US\$)	-0.6	1.1	1.6	2.0	3.0	0.2	0.3	0.3	0.1
External debt (billions US\$) 9/	54.9	53.9	53.3			53.1	53.3	55.4	
(% GDP)	38.1	32.3	33.1			33.0	33.1	29.3	
Short-term debt (billions US\$) 9/	7.1	7.0	4.0			5.1	4.0	5.2	
Debt service ratio (% exports of g&s)	10.1	9.7	10.4			10.7	10.4	10.3	
Foreign exchange reserves, gross (billions US\$) 9/	33.8	37.6	44.2	51.5	53.3	42.5	44.2	45.6	48.7
(months of imports of g&s) 10/	6.0	9.0	9.0	8.2	8.2	8.6	8.7	8.5	9.0
<b>Financial Markets</b>									
Domestic credit (% change y-y) 11/	5.2	16.8	7.4			8.8	7.4	8.6	8.5
Short-term interest rate (% p.a.) 12/	6.9	5.4	4.5			4.1	4.3	4.2	4.2
Exchange rate (Peso/US\$, ave)	46.1	44.5	47.7	45.0	45.0	48.1	46.8	46.0	45.5
Real effective exchange rate (2000=100)	121.	128.	125.			122.	125.	129.	133.
(% change y-y) 13/	7	6	2			5	3	4	1
Stock market index (Jan. 2, 1985=100) 14/	3443	2587	2468			2729	2986	3035	3266
Memo: Nominal GDP (billions US\$)	144.	166.	161.	188.8	207.	38.8	47.2	42.1	45.9
	0	9	1		3				
<b>Source: National data sources</b>									
f = forecast									
1/ The GDP series has a break in 2000.									
2/ New methodology. Figures are based on the 2000 census.									
3/ Non-agriculture minimum wage, National Capital Region.									
4/ IMF GFS basis.									
5/ Total public sector domestic debt.									
6/ Balance-of-payments basis.									
7/ Electronics.									
8/ Estimate.									
9/ Central bank figures. For the quarterly figures, % of annual GDP.									
10/ Based on end-of-period gross international reserves.									
11/ Based on Depository Corporations Survey									
12/ Interbank call rate.									
13/ World Bank staff estimate.									
14/ PSEi Composite, period average for annual figures.									

## SMALL PACIFIC ISLANDS

The small states of Vanuatu, Samoa, Tonga, Kiribati and Tuvalu (the “Pacific Islands”) each have very small economies and are located far from their nearest large markets. But they vary sufficiently for the global economic crisis to have affected them in different ways and been met with different responses.

Among the Pacific Islands, **Vanuatu** has been the most resilient in the face of the global economic crisis. Its economy grew by 4 percent in 2009, sharply lower than the 6.6 percent average growth for the previous five years, but a result that stands out in the region nonetheless. Growth of about 4 percent is also expected for 2010. This solid performance in the face of the global downturn has been underpinned by activity in two key sectors: tourism and construction.

The tourism industry boomed in 2009, with visitor arrivals up 14.6 percent on the previous year. Earlier reforms to liberalize air transport and telecommunications had positioned the industry well for expansion, which was assisted in 2009 by the diversion of tourists from flood-stricken Fiji and the substitution of short-haul holidays for long-haul holidays by Australians and New Zealanders, induced by the global downturn. While these record numbers will probably not be matched in 2010, the industry is still expected to retain some of the gains made the previous year.

The construction sector also expanded in 2009, due to the continued implementation of infrastructure projects funded primarily by the Millennium Challenge Account (MCA) for Vanuatu. The MCA-funded projects are scheduled for completion at the end of the first quarter 2011, at which point Vanuatu will be looking to its tourism industry and its goods exports – supported by anticipated higher commodity prices – to underpin steady economic growth after the removal of this construction-based stimulus.

Vanuatu’s solid economic performance was facilitated by appropriate macroeconomic policy settings, with both monetary and fiscal policy eased in late 2008. The government is currently implementing a budget formulated to be exactly balanced. With public debt levels at just over 17 percent of GDP, the government has the room for manoeuvre to maintain budgeted expenditures if economic activity is slower than expected in 2010 and revenues consequently fall short of budget forecasts.

**Samoa** had the best growth record in the Pacific in the decade and a half before the global downturn, but was hit hard by the global crisis and then by the tsunami of September 2009. Its economy contracted by almost 5 percent in the 2008/09 fiscal year as a result of the global recession, and is estimated to have contracted by a further nearly 3 percent in 2009/10, largely due to the tsunami which caused significant loss of life and unprecedented economic damage. Boosted by post-tsunami reconstruction activity, the economy is expected to expand again in 2010/11.

Four factors combined to limit the size of the economic contraction in 2009/10 in Samoa. First, the government implemented a significant fiscal stimulus via increased capital expenditure (budgeting for a deficit of around 10 percent of GDP), which was then integrated with reconstruction and recovery spending following the tsunami. Secondly, remittances – which are the equivalent of around 25 percent of GDP – held up well, declining only 5.3 percent on the previous year despite significant economic slowdowns in key remittance-sending countries. Thirdly, the tourism industry managed a solid performance under very difficult circumstances, given considerable tsunami-induced damage to tourist facilities. Tourism receipts were only 6 percent below the previous year, with visitor arrivals actually recording a 4 percent increase, testimony to efforts to rapidly reconstruct tourist facilities and expand tourism marketing in the wake of the tsunami. Fourthly, a major auto parts manufacturing plant – whose downsizing was a significant contributor to the economic contraction the previous year – expanded its output substantially in the first quarter of 2010.

Appropriate macroeconomic policy settings assisted the response of Samoa’s economy to the global downturn and subsequent tsunami. In mid 2008, both monetary and fiscal policies were eased. Budgets designed to stimulate the economy through increased capital expenditure were implemented in both 2008/09 and 2009/10. Samoa has been

successful in securing grants and concessional loans to finance the resultant large budget deficits, a success it will need to repeat in 2010/11.

Tonga was affected by the global economic crisis primarily through remittance flows, which play an extremely important role in its economy. Prior to the global downturn, remittances provided some 60–70 percent of current account receipts and were equivalent to nearly 30 percent of GDP. Recessions in the US and New Zealand translated into substantial decline in these remittance flows of 12.8 percent in the 2008/09 fiscal year and a further 18.2 percent in 2009/10. The global downturn also affected tourism receipts, down 5.5 percent in 2008/09 and an estimated further 15 percent in 2009/10.

As a result, the economy contracted by about 0.4 percent of GDP in 2008/09 and the government estimates a further contraction of 1.2 percent in 2009/10 (when the impact of the global downturn was compounded by two natural disasters). These contractions would have been worse but for the boost to economic activity provided by increased public sector capital expenditure in 2008/09 and 2009/10; the latter was largely due to reconstruction activity in Nuku'alofa financed by a loan from China's EXIM Bank. Further increases in capital expenditure funded by China's EXIM Bank are planned over the medium term, supporting economic expansion, but could put Tonga at high risk of debt distress. The detrimental impact of the global downturn on public finances in Tonga is discussed in Box 1.

#### **Box 1: The Global Downturn and Public Finances in Tonga**

In the last two years, the global downturn has pushed government finances in Tonga into deficit. The deficit was 3.3 percent of GDP in the 2008/09 fiscal year, and is estimated to have risen to 3.9 percent in 2009/10 (or 5.3 percent without budget support grants). In both years, tax revenues were significantly lower than they were in the years leading up to the global downturn – by some 20–25 percent in nominal terms.

This fall-off in tax revenues was led by import tariffs, excise tax and consumption tax. Given the high import-component of consumption in Tonga, the tax bases for each of these revenue streams – not only tariffs – is determined primarily by imports. With imports, in turn, dependent on remittances, the sharp decline in remittances caused by the global downturn translated into sharp declines in tax revenues. The contribution of Tonga's newly liberalized tariff regime to stable aggregate tax revenues, however, had been calibrated on the basis of continued increases in imports, which the global downturn has impeded.

As the government recognized the extent of the impact of the global economic crisis on its tax revenues, it took steps to rationalize its expenditures in 2009/10. Substantially lower ceilings were successfully imposed on the expenditures of most ministries – with exceptions granted for health and education. For 2010/11, the government has sought to prioritize the core activities of each ministry in their programs and budgets, while it works with donors to undertake a public expenditure review.

In the medium term, Tonga needs to ensure that its macroeconomic policy framework is sustainable, through adjustments to current expenditure and revenue effort, and careful debt management.

**Kiribati** currently faces a number of economic challenges, several of which have been accentuated by the global economic crisis. Critically, the global financial crisis caused a significant fall in the asset value of the Revenue

Equalization Reserve Fund (RERF), which in recent years had provided nearly 40 percent of Kiribati's foreign exchange earnings. Kiribati also obtains substantial foreign exchange earnings from the remittances of its seafarers – typically some two-to-three times the value of its exports – which were negatively affected by the contraction in the global shipping industry during the global downturn. Kiribati will be looking to the rebound in global trade to restore their employment opportunities and remittances, and support economic recovery after a 0.7 percent contraction in GDP in 2009.

With government expenditure at around 115 percent of GDP, the economy is substantially dependent on the public sector (public sector wages and salaries alone are some 27 percent of GDP). Tax revenues – the bulk of which come from import duties – and non-tax revenues – primarily fishing licence fees – typically cover only about 34–38 percent of expenditure. Much of the remaining expenditure is funded by grants from donors, but substantial deficits have remained in recent years, of around 15 percent of GDP. These have been financed by drawdowns of the RERF, which is not sustainable.

**The Pacific Islands** are confronting a number of common reform challenges in the medium term, on which they have each made different degrees of progress. These include efforts to broaden the tax base, enhance the effectiveness of state service provision, improve the performance of public enterprises, and ensure that macroeconomic policy settings are sustainable. They also include efforts to increase the economic utilization of customary land, and facilitate the use of assets for collateral to improve access to finance. Measures to increase the flows and diversify the sources of remittances will also be important, particularly for Kiribati, with the same being true for other key sources of foreign exchange earnings.

#### **Box 2: The World Bank's Newest and Smallest Member – Tuvalu**

With a population of around 12,000 people, Tuvalu is one of the smallest countries in the world. The nine coral atolls that make up this island group in the South Pacific have a land area of just 26 square kilometres, but the area of its exclusive economic zone (EEZ) is equivalent to the size of Zambia, providing Tuvalu with access to substantial pelagic tuna fisheries. With a maximum elevation of 4.5 metres, the low lying islands of Tuvalu are particularly susceptible to the effects of climate change.

The estimated GDP per capita of Tuvalu is US\$1,600. Economic activity is highly dependent on the public sector, which typically contributes over one-quarter of GDP directly. The next most important area of economic activity is agriculture and fishing (at around one-sixth of GDP), which makes a vital contribution to the livelihoods of the poor and vulnerable, especially in the outer islands.

Like most very small economies, Tuvalu is reliant on a very limited number of sources of foreign exchange. It earns substantial revenue from the Tuvalu Trust Fund, which was established by a small group of donors in the late 1980s to provide Tuvalu with a reliable annual flow of income. Its other main sources of foreign exchange are fishing license fees, revenues from the licensing of its '.tv' internet domain, and remittances from its remaining seafarers working in the global shipping industry.

The government faces considerable fiscal challenges in the medium term. Its tax revenue potential is relatively limited, making earnings from its fishing and internet licenses as well as distributions from the TTF absolutely critical. However, the global financial crisis has severely affected the asset value of the TTF, preventing distributions from being made until its asset value recovers. Tuvalu relies on grants from donors to fund a substantial proportion of public expenditure. These grants, however, are unlikely to be sufficient to prevent significant fiscal deficits in the coming years, raising concerns about fiscal sustainability.

**SOLOMON ISLANDS**

GDP growth in the Solomon Islands averaged 7 percent per annum during 2003-2008, a period which also coincided with an improved security environment in the country. However, this growth had been based in good measure on an unsustainable exploitation of forest resources, and thus of a questionable quality. The economy, however, contracted by 2.3 percent during 2009 as Solomon Islands was negatively affected by: weakened demand for export commodities – particularly logs – in the context of the global crisis, the impact of floods on agricultural production, and constrained government expenditure in the face of lower revenues. In 2010, logging activity picked-up again, and growth for the year is expected to be in the 3-4 percent range. Logging export volumes increased by 28% on year-to-July driven by slight price increases as demand from East-Asia strengthened, and exporters' attempts to reduce stockpiles prior to a forthcoming increase in the regulated taxable price in April. Strong increases in cocoa and palm oil export volumes and a strengthening of prices for fish and copra have also helped growth. Formal sector employment grew strongly during the first quarter, with job advertisements more than doubling from the fourth quarter of 2009.

Improved growth performance, however, has not benefited all areas and industries. The full potential benefits of increasing commodity prices have not been realized in some areas due to continued bad weather which hampered both agricultural production and transport networks. According to a recent survey, most businesses continue to report flat or declining sales compared with the same quarter the previous year, although most businesses also expect sales to improve over the next three months.

The unexpected rebound in log exports and growth, combined with expenditure control measures, has resulted in a narrowing of the fiscal deficit, but serious challenges nevertheless remain in the management of public finances. The cash deficit was around 1.5 percent of GDP at end- July, and is expected to move to a small surplus by year-end, compared with a surplus of 2.2 percent in 2009. Increased export duties from logging, combined with higher income tax receipts from stronger-than-expected growth, have been almost sufficient to compensate for poor revenue collections from other sources. During the first quarter, expenditure had to be reined in by reservations and cuts to non-payroll expenditure in all areas except health and education, while additional expenditure was approved through contingency warrants in the lead-up to elections. Overall expenditure remains around 1.5 percent above year-to-date budget projections, but payroll expenditure has exceeded projections by more than 13 percent, while other operating charges and development allocations are significantly under-spent. Growth in payroll expenditure reflects both the outcome of negotiations with public sector unions subsequent to the finalization of the 2010 budget, and more accurate allocation of expenditure between payroll and other charges through ongoing improvements to the Government payroll system.

Public debt has increased slightly during 2010 as a result of foreign exchange movements and currently stands at 30 percent of GDP. The IMF and World Bank recently moved Solomon Islands from “red light” to “yellow light” status, indicating a reduction in the risk of debt distress. Having taken on no new debt since 2003, the Solomon Islands is expected to resume limited concessional borrowing from multilateral donors over coming years. Both domestic and imported inflation has reduced significantly from a peak in September 2008, and overall inflation has remained below 2% throughout 2010. Foreign reserves have continued to increase through the year, due to donor and investment inflows and revaluation gains, and are now equal to 6.7 months of goods and services imports.

With import growth continuing to outstrip recovery in exports, the current account deficit for the second quarter was 48 percent higher than in the same period in 2009 (21 percent of GDP on an annualized basis). Over the medium-term, the exhaustion of natural forest stocks – expected from 2014 – will put greater pressure on the current account, foreign reserves and government revenue.

Despite recovery in growth, the need for structural reforms remains pressing. The Government is working with donors to respond to these challenges. In June, the Government and the IMF reached agreement on a US\$18 million dollar Standby Credit Facility. During 2010, the Government also received donor budget support linked to the implementation of a number of reforms to improve management of public expenditure. Ongoing reforms within the electricity and water utilities have already delivered some improvements in reliability, and have the

potential to substantially improve the business environment. Progress is being made towards the development of a major hydroelectric project, but implementation by a private operator is reliant on the achievement of financial sustainability within the water authority – the country’s largest electricity user. Recent analysis has identified the need for Solomon Islands to work further with donors in improving access to international labor markets, maximizing local economic benefits of aid-flows, revising policy and legislation around natural resource industries, and improving economic infrastructure in centers of production.

During peaceful elections in early August, the Solomon Islands elected a new Government. The Prime Minister has already announced the new Government’s intention to pursue reforms in land, public services, and local government administration.

<b>Solomon Islands: Key Indicators</b>						
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010e</b>	<b>2011f</b>
	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Year</b>
<b>Output, Employment and Prices</b>						
<b>GDP (% change y-y)</b>	6.9	10.7	7.3	-2.2	3.4	5.2
<b>Tourist arrivals (thousands)</b>	9,273	15,169	18,321	18,050	..	..
<b>(% change y-y)</b>	-12.9	63.6	20.8	-1.5	..	..
<b>Consumer price index (% change y-y)</b>	9.9	10.9	18.1	1.8	6.5	6.0
<b>Public Sector</b>						
<b>Government revenues (% GDP)</b>	41.5	42.1	45.2	45.3	51.8	51.2
<b>Government expenditures (% GDP)</b>	42.8	40.8	45.5	43.1	49.4	49.0
<b>Government balance (% GDP)</b>	-1.4	1.3	-0.3	2.2	2.4	2.2
<b>Domestic public sector debt (% GDP)</b>	13.8	10.1	9.1	8.0	6.7	5.2
<b>Foreign Trade, BOP and External Debt</b>						
<b>Trade balance (millions US\$)</b>	-63	-75	-69	-62	-178	-169
<b>Exports of goods (millions US\$)</b>	113	160	193	157	145	145
<b>(% change y-y)</b>	10.0	41.6	21.1	-18.8	-7.8	-0.1
<b>Key export (% change y-y) 1/</b>	16.4	27.0	10.1	-20.0	-19.0	-14.3
<b>Imports of goods (millions US\$)</b>	176	235	262	219	323	314
<b>(% change y-y)</b>	22.0	33.7	11.7	-16.5	47.4	-2.8
<b>Current account balance (millions US\$)</b>	-8	-48	-106	-139	-203	-194
<b>(% GDP)</b>	-1.6	-8.2	-16.4	-21.1	-30.1	-27.6
<b>Net Foreign direct investment (millions US\$)</b>	6	11	13	10	16	18
<b>Total external debt (millions US\$)</b>	152	173	164.0	145.9	..	..
<b>(% GDP)</b>	45.4	32.1	25.4	22.2	19.4	18.0
<b>Debt service ratio (% exports of g&amp;s)</b>	2.7	5.8	9.7	8.9	9.1	9.1
<b>Foreign exchange reserves, gross (millions US\$) 2/</b>	104	121	90	146	168	187
<b>(months of imports g&amp;s)</b>	3.8	3.9	3.5	4.2	4.8	5.2
<b>Financial Markets</b>						
<b>Domestic credit (% change y-y) 3/</b>	58.6	53.3	26.5	-4.2	12.2	18.8
<b>Exchange rate (SBD\$/US\$, eop)</b>	7.6	7.7	8.0	8.1	..	..
<b>Real effective exchange rate (2005=100)</b>	107.5	106.5	114.2	119.9	..	..
<b>(% change y-y)</b>	7.5	-0.9	7.2	5.0	..	..
<b>Stock market index (Aug 1988=100)</b>						
<b>Memo: Nominal GDP (millions US\$)</b>	457	586	646	657	..	..
Source: National data sources and IMF						
e = estimate			1/ Logs.			
f = forecast			2/ Includes foreign assets of non-bank financial institutions.			
n.i. = no issues			3/ Domestic credit to the private sector.			

**THAILAND**

Thanks to the manufacturing sector, the Thai economy consolidated its rebound from the global financial crisis despite the escalation of the political conflict and concerns about European sovereign debt. Thailand's economy grew by 10.6 percent year-on-year in the first half of 2010, with GDP rising above pre-crisis levels.

Following a vigorous expansion by over 15 percent (SAAR) in the last quarter of 2009 and first quarter of 2010, growth came to a halt in the second quarter of 2010, with GDP expanding only 0.6 percent. However, even this modest expansion was remarkable given the beginning of a slowdown in external demand and, most importantly, the domestic political turmoil in April and May. Tourist arrivals plummeted and service exports (which have substantial linkages with the domestic economy and employ about 25 percent of the workforce) contracted by 18 percent from the previous quarter (seasonally adjusted, not annualized). The manufacturing sector suffered little from the crisis, however, expanding by more than 10 percent in the quarter.

Growth in the manufacturing sector was partly driven by still-buoyant export demand (see Figure), as had been the case since the onset of the recovery. Merchandise exports grew by 42 percent year-on-year in nominal terms in Q2, an acceleration compared to the previous quarter. Although goods exports grew from the previous quarter, the severe contraction in tourism as well as the fact that some orders had to be filled out of inventories caused the growth in the value added of exports of goods and services to be practically flat in the second quarter.

Supporting the GDP expansion and marking a change from previous quarters, a higher proportion of manufacturing output (in this case, vehicles) went to domestic rather than foreign consumption. Private consumption, net of imports of consumer goods, grew by 7.6 percent mostly due to an almost 50 percent year-on-year increase in vehicle purchases. Investment was also robust, though it consisted mostly of imported equipment, which meant investment represented a net drag on quarterly growth (growth in real imports of capital goods was higher than investment growth itself). Overall, thanks to robust household and government consumption, domestic value added consumed or invested in Thailand increased 1.1 percent from the previous quarter.

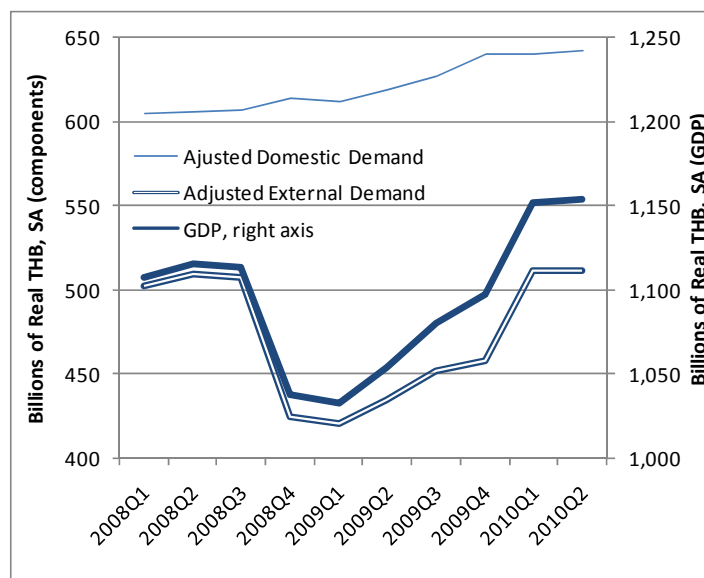
Despite slower growth in the second half of 2010, real GDP should grow 7.5 percent in 2010 as a whole before slowing to 3.2 percent in 2011. The "new normal" global environment will be characterized by slower growth in external demand than observed before the crisis, as advanced economies gradually deleverage and as labor markets normalize. In addition, it is unlikely that domestic demand can maintain the momentum of the second quarter. Consumption growth in the first half of 2010 was due to a combination of improved consumer sentiment, higher agricultural prices and low interest rates. Many automobile deliveries in the second quarter originated from sales made before the escalation of the political turmoil. Continued improvement in consumer sentiment (which nonetheless is still well below the 2000-2006 average) would be required to support high consumption growth rates, but concerns about the global economy and domestic politics are likely to dampen further increases in confidence. Finally, although interest rates are likely to remain low by historical standards, the Bank of Thailand is expected to continue raising policy rates over the coming months. Most importantly, there is no evidence of a structural change removing constraints to growth in sectors producing non-tradables (mostly services), which continued to underperform: services now account for 41.7 percent of real GDP compared to 44.1 percent three years ago and 45.7 percent ten years ago. One of the key obstacles still in place is the small size of the middle-class in Thailand: currently less than 35 percent of Thais live in a household making more than 14,000 baht (\$450) per month.

With inflation subdued at 3 percent and declining, the key challenge for monetary policy relates to the management of capital flows. Capital flows have been increasing, so far mostly from residents repatriating assets. However, given the decrease in political tensions and increased growth and interest rate differentials, there is a concern that portfolio flows will pick up further, putting additional upward pressure on the currency. In response, the Bank of Thailand has allowed some currency appreciation (the real effective exchange rate has appreciated by about 4 percent in 2010, in line with other countries in the region), managed exchange rate volatility through sterilized interventions (reserves have reached over \$155 billion at end-August) and announced two rounds of

measures to liberalize capital outflows. The Thai government eliminated an exemption to foreign investors from paying withholding tax on interest and capital gains from new acquisitions of government bonds. Although there is a heated debate as to whether additional measures – such as some form of capital controls – will be necessary, the central bank has so far resisted the calls for more forceful intervention, mindful of the negative market reactions to the (brief) imposition of capital controls in December 2006.

On the fiscal policy front, the challenge is to restore the strength of public balance sheets while boosting social and public investment spending. Some new social policy initiatives originally introduced as part of the stimulus package have now become permanent and additional ones have been introduced. These include a new agricultural price insurance scheme, a pension to the elderly not covered by social security, education subsidies and a debt refinancing scheme. These programs have now been integrated in the THB 2.07 trillion (20.4 percent of projected GDP) budget for fiscal year 2011 (October 2010 – September 2011). In addition, the government is trying to boost public investments, which have been depressed since the 1997-98 Asian financial crisis. Accordingly, the capital budget was increased, and implementation of the off-budget stimulus plan will continue, although the off-budget portion is winding down. The fiscal deficit is projected at 3.2 percent of GDP in FY 2011, up from 1.9 percent of GDP in FY 2010, when the deficit was constrained by the low on-budget expenditures dictated by Thailand’s fiscal rule in the context of more pessimistic revenue projections. The government plans to balance the budget within five years and is debating revenue measures to afford permanently higher levels of social and infrastructure spending.

Figure 1. Growth in manufacturing was driven by domestic demand



Source: World Bank staff calculations based on official data

Thailand: Key Indicators									
	2007	2008	2009	2010e	2011f	2009	2010		
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2
<b>Output, Employment and Prices</b>									
Real GDP (% change y-y)	4.9	2.5	-2.2	7.5	3.2	-2.7	5.9	12.0	9.1
Domestic demand (% change y-y)	2.3	4.1	-6.6	9.8	4.2	-1.4	19.1	7.5	
Industrial production index (2000=100)	172.2	178.9	166.1			174.6	185.2	191.8	186.4
(% change y-y)	8.1	3.9	-7.2			-5.5	11.6	31.2	17.6
Unemployment (%)	1.4	1.4	1.5	1.3	1.3	1.2	1.0	1.1	1.3
Real wages (% change y-y) 1/	0.7	4.8	-1.6			1.3	-2.1	-0.6	
Consumer price index (% change y-y)	2.2	5.5	-0.8	3.5	3.0	-2.2	1.9	3.72	3.21
<b>Public Sector</b>									
Government revenues (% GDP)		16.5	16.4	16.6	16.8	17.3	14.6	12.9	22.8
Government expenditures (% GDP)		17.6	21.4	19.0	20.2	22.5	18.6	18.8	16.2
Government balance (% GDP) 2/	-2.5	-1.9	-4.3	-2.1	-3.2	0.0	-7.2	-5.7	6.4
Domestic public sector debt (% GDP) 3/	32.7	33.7	39.7	38.8	39.4	40.9	39.7	39.8	39.4
<b>Foreign Trade, BOP and External Debt</b>									
Trade balance (billions US\$)	12.8	-0.4	19.4	5.2	0.3	5.2	2.6	2.1	4.6
Exports of goods (billions US\$)	151.3	175.2	150.7	175.3	192.2	40.7	42.8	44.0	48.1
(% change y-y)	18.2	15.9	-14.0	16.3	9.7	-17.6	12.0	32.1	41.8
Key export (% change y-y) 4/	16.4	7.6	-15.2			-13.6	12.8	57.5	27.2
Imports of goods (billions US\$)	138.5	175.6	131.4	170.0	191.9	35.5	40.2	41.8	43.5
(% change y-y)	9.1	26.8	-25.2	29.4	12.9	-28.4	1.5	63.6	44.8
Current account balance (billions US\$)	15.7	1.2	20.3	7.0	1.4	3.8	4.2	5.3	1.3
(% GDP)	6.3	0.4	7.7	2.3	0.4	5.7	5.8	6.7	1.7
Foreign direct investment (billions US\$) 5/	10.3	7.5	4.5	6.4	7.8	1.0	1.5	1.5	0.7
External debt (billions US\$) 6/	61.9	65.2	69.5			67.4	69.5	73.7	81.1
(% GDP)	24.8	24.0	26.4			25.6	23.9	23.6	26.3
Short-term debt (billions US\$) 6/	21.6	24.2	27.4			24.1	27.4	30.0	37.2
Debt service ratio (% exports of g&s)	11.8	7.1	6.7			6.0	6.1	5.2	5.5
Foreign exchange reserves, gross (billions US\$)	87.5	111.0	138.4	143.1	141.0	131.8	138.4	144.1	146.8
(months of imports of g&s)	7.9	7.9	13.2	10.1	8.8	9.5	8.9	9.0	8.8
<b>Financial Markets</b>									
Domestic credit (% change y-y) 7/	4.9	9.3	3.1			0.4	3.1	6.0	8.5
Short-term interest rate (% p.a.) 8/	3.7	3.4	1.4			1.3	1.3	1.3	1.3
Exchange rate (Baht/US\$, ave)	34.2	33.4	34.3	32.5	30.0	34.0	33.3	32.9	32.4
Real effective exchange rate (2000=100) 9/	112.2	112.8	108.8			108.4	107.8	111.1	115.0
(% change y-y)	6.6	0.5	-3.6			-2.6	-1.9	1.6	4.9
Stock market index (Dec. 1996=100) 10/	858	450	735			717	735	788	797
Memo: Nominal GDP (billions)	249.0	272.0	263.7	309.8	356.9	65.8	72.6	78.0	77.0

**US\$)**

Source: National data sources, World Bank staff estimates. f = forecast

1/ Average wage of employed person, using the National Statistical Office Labor Force Survey, deflated by CPI inflation

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2/ Cash balance of central government.

3/ Includes domestic central government (CG) debt, domestic debt of non-financial state enterprises, and the Financial institutions Development Fund (FIDF) debt. Series was revised by adding the Village Fund (VF) and the Energy Fund Public Organization (EFPO).

4/ Machinery and mechanical appliances.

5/ Non-bank FDI.

6/ Bank of Thailand figures.

7/ Private credits from domestically registered commercial banks, branches of foreign banks, international banking facilities, finance companies, specialized banks, thrift and credit cooperatives, and money market mutual funds.

8/ One-day repurchase rate, average.

9/ World Bank staff estimates.

10/ Bangkok SET

**TIMOR-LESTE**

Economic activity has remained strong on the back of government spending, though inflation has started to pick up largely due to higher food prices. There are also signs of increased costs in the construction sector, which are likely associated with the rise in infrastructure spending. Aggregate demand has remained strong, although it may have slowed a little in the first half of 2010. Recent estimates point to a drop in poverty incidence in 2009 compared to 2007, when poverty had spiked following economic contraction in 2006. Petroleum Fund balances are robust and continue to provide a good buffer against potential shocks. Fiscal policy continues to be expansionary in response to development needs. This will need to be managed carefully to avoid risks to fiscal sustainability.

The government estimates non-oil GDP growth in 2009 amounted to 12.7 percent. Government expenditures increased by about 20 percent, with capital expenditures up 38 percent. An important part of the latter reflected outlays on small scale infrastructure projects across the country. Spending eased in the first half of 2010 compared to the previous six months, particularly on capital projects. An extended rainy season is likely to have impacted adversely agriculture production after a strong performance in 2009. Although some indicators (e.g. electricity consumption) suggest continued strong demand, a combination of the former factors may have resulted in a slowdown in growth in the first half of 2010.

There are signs that in 2009 private consumption increased, including among poorer households. A recent estimate by the World Bank shows poverty incidence for 2009 at 41 percent. This suggests a drop of around nine percentage points compared to 2007, when poverty incidence had risen very sharply following the crisis and subsequent economic shock. The rebound is likely associated with strong economic recovery, including increased private consumption linked to rapidly rising government spending, particularly on social protection programs and labor-intensive infrastructure works. Final confirmation on poverty developments will need to be based on updated household surveys, which are planned over the course of 2011.

Prices have started to pick up in 2010, with headline inflation in Dili at 6.6 percent in the year to June, and food price inflation at 8.5 percent over the same period. Prices of cereals in particular rose rapidly in the first half of 2010 (14 percent in the year to June), in line with international price movements. The government at the same time increased provisions for rice subsidies in its 2010 budget revision. Non-food prices have remained relatively stable, although official statistics show a very sharp increase in house building costs, which are most likely related to the supply pressures associated with the rapid increase in public investment in 2009. The rise in inflation has led to an appreciation of the Real Effective Exchange Rate in the first half of 2010. This will not have had a major impact on non-oil exports, which are small and constrained by other factors.

Credit to the private sector has dropped slightly in the first half of 2010, after a 40 percent increase in lending to the construction sector in the latter half of 2009. Total loans and advances fell from \$111 million in December 2009 to \$107 million in June 2010. Non-performing loans have increased from around \$30 million in the first half of 2009 to around \$45 million at June 2010. This may be associated with the rapid increase in lending to the construction sector. This does not pose systemic risk, nor has it impacted significantly on the spread between lending and deposit rates, which remains high at around 10 percent.

The trade deficit in the first half of 2010 was 15 percent lower from a year earlier due to a fall in imports of consumer goods. The volume of coffee exports however also fell in half in January-June 2010 because of an extended rainy season. The volume of coffee exports picked up in the second quarter of 2010, as did coffee prices in line with international prices. This led to a recovery in non-oil export earnings in the second quarter, which should continue over the course of 2010.

The overall balance of payments remains strong thanks to petroleum receipts. Official statistics show the current account recorded a surplus of nearly \$1.4 billion in 2009. Taxes and royalty receipts were slightly higher in the first half of 2010 (\$971 million) compared to the same period last year (\$934 million). Receipts related to the investment performance of the Petroleum Fund improved compared to the same period last year. Petroleum Fund

assets were close to US\$6.5 billion at the end of August 2010. The government is exploring options to diversify the Petroleum Fund assets to secure higher returns over the longer-term.

Spending appropriations for 2010 were increased from US\$660 million to US\$838 million under the revised budget. The increase includes \$31 million for a new program of small scale infrastructure works (Decentralized Development Package) following up last year's Referendum Package. Other major increases include additional \$26 million for veterans, \$37 million for the power sector, and about US\$18 million for rice imports. The increase in planned expenditure for 2010 also means higher planned withdrawals from the Petroleum Fund of about \$811 million or \$309 million above the Estimated Sustainable Income. Less than 10 percent of the capital and development budget had been executed in the first half of 2010, which could be due to a combination of supply constraints following the scale up last year, and possible delays in procurement after some institutional changes introduced earlier in the year. Over the medium term, the role of fiscal policy remains critical, especially given the absence of monetary policy because of the official dollarization. The challenge for fiscal policy remains to ensure adequate resources for economic development are provided in a transparent and fiscally sustainable manner.

The government is finalizing its Strategic Development Plan, which envisages further scaling up of public investment in both physical and human capital. The government is looking at ways to address weaknesses in designing and implementing projects, whilst ensuring speedy delivery. To this end, the government is establishing an Economic Policy and Investment Agency. It is also exploring different financing options including borrowing, and the potential for public private partnerships.

**VIETNAM**

Vietnam's recovery from the global economic crisis has been rapid but uneven. The growth rates of key economic indicators, including real GDP, industrial production, investment and exports are expected to recover to near their pre-crisis trend growth rates. But the current account deficit remains high and households and firms appear to continue to stockpile foreign currency and gold, putting persistent pressure on the local currency. There are concerns that the rapid expansion of domestic credit to stimulate the economy led to weakening of the balance-sheet of some of the banks. The stock market, after staging a smart recovery in 2009, has slumped again and continues to underperform the broader economy. Vietnam's sovereign bond spreads remain high at around 400 basis points and are higher than most regional comparators. So while the real economy has managed to restore the pre-crisis growth momentum, investors remain concerned about the country's ability to manage a "soft landing."

More than the economy, the dominant discourse will be affected by the approaching election year. The Eleventh Party Congress is scheduled for January 2011, and a new administration will take office in the early-2011. With its one party system, the impact of a new Congress and a new administration on the economy may manifest itself differently than in countries with multi-party systems. Efforts to give a new impetus to structural reforms appear to be under consideration. Two important documents prepared for the Party Congress –the Socio-Economic Development Strategy for 2011-2020 and the Socio-Economic Development Plan for 2011-2015 – have an overriding theme of restructuring the economy towards "quality-based, sustainable growth." They emphasize achieving rapid growth through higher efficiency in investment (as opposed to higher capital accumulation), greater value-added and environmentally sustainable growth path.

The last three years have witnessed sudden changes in the global economic environment, forcing the authorities in Vietnam to recalibrate their policy response. Vietnam's economy started to overheat as a result of large capital inflows in the aftermath of the country's accession to the World Trade Organization. By the time the government took steps to stabilize the economy, the global economic crisis was on its borders. The government therefore had to switch gears in late-2008 to revive economic activity by adopting a large fiscal and monetary stimulus package. The stimulus, together with the relative resiliency of the country's financial section and exports, helped limit the slowdown of activity in 2009. With the recovery under way in 2010, the government switched gear again. It is now trying to phase out the stimulus package without disrupting the economy while striving to preserve good economic performance during the period leading up to the Party Congress.

The real economy has bounced back quite rapidly. Real GDP is estimated to have grown by 5.3 percent in 2009 and is on track to achieve the 2010 target of 6.5 percent. Industrial production is expected to grow 12.5 percent in 2010 after its growth slumped to 7.6 percent in 2009. Exports have also recovered back to the 20 percent annual growth rate observed before the crisis. Growth of fixed capital formation and private consumption continue to be the dominant source of overall growth, with their cumulative contribution to real GDP growth increasing from 5.7 percentage points in 2009 to 6.9 percentage points in 2010. The revival of investment has been associated with the recovery of foreign direct investment, which rose from \$6.9 billion in 2009 to \$7.6 billion in 2010 (see Annex-1). Anecdotal evidence indicates that the ongoing relocation by manufacturing firms from higher wage countries in East Asia is beginning to benefit Vietnam, which with its relatively low wages and easy access to coast is well positioned to absorb such investments.

A calibrated phasing out of the stimulus package is underway. The part of the stimulus package directly financed through the budget has been withdrawn, with the overall fiscal deficit expected to decline from 8.9 percent of GDP in 2009 to 5.9 percent in 2010. Stronger revenues could help cut the deficit to as little as 5.5 percent. Some of the monetary stimulus has also been withdrawn, although attempts to raise the minimum capital for the banks continue to face strong opposition from the banking sector. In the first eight months of 2010, credit is estimated to have risen by 16 percent compared to 27 percent growth during the same period last year. It appears that credit growth for 2010 as a whole will be slower than the 25 percent targeted by the central bank.

Vietnam's state-owned enterprises have played an important role in the country's progress, but have also become a source of long-term vulnerabilities. Despite the government's ambition to complete the transition to a market-economy with a socialist orientation and to develop the private sector, Vietnam's economy is still dominated by state-owned enterprises (SOEs). In 2007, Vietnam adopted a strategy to exploit 'economies of scale in production and technology' by transforming large SOEs to "Economic Groups (EGs)" and gave them first mover advantage in sectors with increasing returns to scale. While some of the EGs have served the cause of their existence (e.g., VNPT, EVN, Petro Vietnam, etc.), many have also contributed to magnify the economic instability. During the overheating in late-2007 and early-2008, the EGs invested heavily in the financial sector and real estate, exacerbating the asset price bubbles. In late-2009 and early-2010, some of them speculated against the Vietnamese Dong. Recently, it was revealed that Vinashin (an EG involved in ship-building) has used resources obtained through government guarantees to invest in its non-core activities, falsified financial reports, and is on the verge of default.

Finding a way to balance the economic contribution of EGs and improve their accountability and transparency remains a key imperative for the new Party Congress. While important policy decisions on EGs are unlikely before the new Party Congress, vigorous debates are taking place within the Party and the Government on how to balance the benefits of EGs with their shortcomings. The new development strategy is unlikely to remain silent on this issue. Strengthening institutions and making them more accountable and transparent is emerging as a key theme. Improved governance of the EGs, along with a new law on public investment and a new framework for public private partnership – if they are approved by the Government and supported by the new Party Congress – will boost structural reforms in Vietnam and set the foundation for a strong and sustainable growth.

## Vietnam: Key Economic Indicators

	2006	2007	2008	2009	2010e	2011f
	Year	Year	Year	Year	Year	Year
<b>Output, Employment and Prices</b>						
Real GDP (% change y-y)	8.2	8.5	6.2	5.3	6.5	7.0
<b>Industrial production index</b>						
(% change y-y)	16.8	16.7	13.9	7.6	12.5	14.5
Unemployment (%) 1/	4.8	4.6	4.7	4.6	4.0	4.0
Consumer price index (% change y-y)	6.7	12.6	19.9	6.5	8.0	7.0
<b>Public Sector</b>						
Government balance, official (% GDP) 2/	1.1	-0.7	1.3	-5.1	-1.7	-0.7
Government balance, general (% GDP) 3/	-0.4	-1.9	-0.9	-8.9	-5.9	-4.5
Public sector debt (% GDP) 4/	42.9	45.6	43.9	49.0	51.3	50.6
<b>Foreign Trade, BOP and External Debt</b>						
Trade balance (billions US\$)	-2.8	-10.4	-12.8	-8.3	-10.8	-11.4
Exports of goods (billions US\$)	39.8	48.6	62.7	57.1	68.0	81.0
(% change y-y)	22.7	21.9	29.1	-8.9	19.2	19
Key export (% change y-y) 5/	12.1	2.7	23.1	-40.2	-11.2	4.7
Imports of goods (billions US\$)	42.6	58.9	75.5	65.4	78.9	92.3
(% change y-y)	22.1	38.3	28.1	-13.3	20.6	17
Current account balance (billions US\$)	-0.2	-7.0	-10.8	-7.4	-9.3	-9.3
(% GDP)	-0.3	-9.8	-11.9	-8.0	-9.0	-8.0
Foreign direct investment (billions US\$)	2.3	6.6	9.3	6.9	7.6	7.9
External debt (billions US\$)	19.1	23.2	29.4	36.6	41.7	47.7
(% GDP)	31.4	32.6	32.5	39.2	40.3	41.3
Debt service ratio (% exports of g&s)	6.8	6.2	16.4	12.7	12.5	12.8
Foreign exchange reserves, gross (billions US\$)	11.5	21.0	23.0	15.2	17.5	
(months of imports of g&s)	12.5	16.6	14.4	10.9	11.4	
<b>Financial Markets</b>						
Domestic credit (% change y-y)	25.4	53.9	25.4	37.7	25.0	25.0
Short-term interest rate (% p.a.) 6/	7.9	7.8	8.1	10.7	11.0	
Exchange rate (Dong/US\$, eop)	16,068	16,003	17,486	18,479		
Real effective exchange rate (2000=100)	96.8	100.2	119.1	106.8		
(% change y-y)	-2.7	3.5	18.9	-10.3		
Stock market index (Jul. 2000=100) 7/	752	927	316	494.8		
Memo: Nominal GDP (billions US\$)	60.9	71.1	90.3	93.2	103.6	115.4

Sources: Vietnam Government Statistics Office, State Bank of Vietnam, IMF, and World Bank staff estimates.

e = estimate

f = forecast

1/ Urban areas.

2/ Excludes off-budgetary items.

3/ Includes off-budgetary items.

4/ Public and publicly-guaranteed debt.

5/ Crude oil.

6/ Three-month deposit, end-of-period.

7/ Ho Chi Minh Stock Index.

## APPENDIX TABLES

Appendix Table 1. Real GDP Growth											
(percent change from a year earlier)											
	China	Indonesia	Malaysia	Philippines	Thailand	Vietnam	Hong Kong SAR, China	Korea	Singapore	Taiwan, China	East Asia
Q1-2002	8.9	3.5	2.7	4.2	4.5		-1.0	6.6	-0.8	1.6	5.9
Q2-2002	8.0	4.2	4.7	4.6	5.0		0.5	7.0	4.6	6.5	6.6
Q3-2002	8.1	5.6	7.1	3.3	5.8		2.8	6.8	6.8	6.8	6.9
Q4-2002	8.1	4.7	6.9	5.5	6.0		4.8	8.1	6.5	6.0	7.2
Q1-2003	10.8	4.9	6.3	4.8	6.9		4.1	3.5	4.3	4.7	7.4
Q2-2003	7.9	5.0	5.9	4.3	6.6		-0.9	1.8	-0.6	-1.3	4.6
Q3-2003	9.6	4.6	4.6	5.4	6.7		3.8	2.0	5.4	4.6	6.4
Q4-2003	9.9	4.6	6.5	5.1	8.3		4.7	3.9	9.2	6.4	7.4
Q1-2004	10.4	4.1	8.2	7.2	6.7		7.7	5.2	10.0	6.1	8.1
Q2-2004	9.6	4.4	7.9	7.1	6.6		12.0	5.9	12.9	9.7	8.6
Q3-2004	9.1	4.5	6.4	5.6	6.3		6.6	4.8	7.7	6.7	7.3
Q4-2004	9.5	7.2	4.9	5.8	5.9		7.9	2.7	6.7	2.9	6.9
Q1-2005	10.5	6.0	5.6	4.5	3.6	7.4	6.2	2.7	4.7	2.7	7.1
Q2-2005	10.1	5.9	4.3	5.1	4.7	7.8	7.1	3.4	6.2	4.0	7.2
Q3-2005	9.8	5.8	5.6	4.7	5.5	8.3	8.1	4.5	8.6	4.8	7.6
Q4-2005	9.9	5.1	5.9	5.4	4.7	8.4	6.9	5.1	9.8	7.0	7.9
Q1-2006	12.4	5.1	6.0	5.5	6.2	7.3	9.0	6.1	10.8	5.8	9.4
Q2-2006	11.5	4.9	6.1	5.3	5.2	7.4	6.1	5.1	8.8	5.8	8.5
Q3-2006	10.6	5.9	5.8	5.2	4.8	7.9	6.4	5.0	7.8	6.5	8.1
Q4-2006	10.4	6.1	5.4	5.4	4.5	8.2	6.7	4.6	7.5	3.8	7.7
Q1-2007	14.0	6.1	5.7	6.8	4.6	7.7	5.6	4.5	7.6	4.5	9.6
Q2-2007	13.8	6.7	5.9	8.3	4.5	7.8	6.1	5.3	9.5	5.7	9.9
Q3-2007	13.4	6.7	6.8	6.8	5.3	8.2	6.8	4.9	10.9	7.1	9.9
Q4-2007	12.1	5.8	7.5	6.5	5.3	8.5	6.9	5.7	6.3	6.5	9.2
Q1-2008	11.3	6.2	7.6	3.9	6.4	7.5	7.0	5.5	7.4	6.9	8.9
Q2-2008	10.1	6.3	6.5	3.7	5.2	6.5	4.0	4.4	2.7	5.4	7.6
Q3-2008	9.0	6.2	4.9	4.6	2.9	6.3	1.1	3.3	0.0	-0.8	5.9
Q4-2008	6.8	5.3	0.1	2.8	-4.2	6.2	-2.7	-3.3	-2.5	-7.1	2.4
Q1-2009	6.5	4.5	-6.2	0.5	-7.1	3.2	-7.7	-4.3	-8.9	-9.1	1.2
Q2-2009	7.9	4.1	-3.9	1.2	-4.9	4.5	-3.8	-2.2	-1.7	-6.9	3.1
Q3-2009	9.1	4.2	-1.2	0.2	-2.7	6.0	-2.4	1.0	1.8	-1.0	5.0
Q4-2009	10.7	5.4	4.4	2.1	5.9	5.3	2.5	6.0	3.8	9.1	8.4
Q1-2010	11.9	5.7	10.1	7.8	12.0	5.8	8.0	8.1	16.9	13.7	10.9
Q2-2010	10.3	6.2	8.9	7.9	9.1	5.5	6.5	7.2	18.8	12.5	9.7

Source: Haver Analytics and national sources. Quarterly data for China uses annual production side GDP.

<b>Appendix Table 2. Real GDP and Components of Aggregate Demand</b>											
<b>(percent change from a year earlier)</b>											
		<b>Indonesia</b>	<b>Malaysia</b>	<b>Philippines</b>	<b>Thailand</b>	<b>Hong Kong SAR, China</b>	<b>Korea</b>	<b>Singapore</b>	<b>Taiwan, China</b>	<b>S.E. Asia</b>	<b>NIEs</b>
<b>GDP</b>	2005	5.7	5.3	5.0	4.6	7.1	4.0	7.4	4.7	5.2	4.9
	2006	5.5	5.8	5.3	5.1	7.0	5.2	8.6	5.4	5.4	5.8
	2007	6.3	6.5	7.1	4.9	6.4	5.1	8.5	6.0	6.1	5.8
	2008	6.0	4.7	3.7	2.5	2.2	2.3	1.8	0.7	4.4	1.8
	2009	4.5	-1.7	1.1	-2.2	-2.8	0.2	-1.3	-1.9	1.0	-1.0
	Q1 2010	5.7	10.1	7.8	12.0	8.0	8.1	16.9	13.7	8.5	10.4
	Q2 2010	6.2	8.9	7.9	9.1	6.5	7.2	18.8	12.5	7.8	9.6
<b>Private Consumption</b>	2005	4.0	9.1	4.8	4.6	3.0	4.6	3.6	2.9	5.3	3.8
	2006	3.2	6.8	5.5	3.2	5.9	4.7	3.1	1.5	4.3	3.9
	2007	5.0	10.5	5.8	1.7	8.5	5.1	6.5	2.1	5.4	4.9
	2008	5.3	8.5	4.7	2.7	2.4	1.3	2.7	-0.6	5.2	1.1
	2009	4.9	0.7	4.1	-1.1	-0.4	0.2	0.4	1.4	2.4	0.5
	Q1 2010	3.9	5.1	5.4	4.0	7.1	6.3	5.9	3.1	4.4	5.5
	Q2 2010	5.0	7.9	4.9	6.5	4.6	3.7	6.7	4.4	6.0	4.3
<b>Fixed Investment</b>	2005	10.9	5.0	-6.6	10.5	4.1	1.9	-1.6	2.7	6.7	2.1
	2006	2.6	7.5	3.9	3.9	7.1	3.4	16.9	0.1	4.2	4.2
	2007	9.3	9.4	10.9	1.5	3.4	4.2	19.9	0.6	7.5	4.5
	2008	11.9	0.7	2.7	1.2	0.8	-1.9	13.6	-11.2	5.3	-2.7
	2009	3.3	-5.6	-0.4	-9.0	-1.8	-0.2	-3.3	-11.1	-2.2	-3.6
	Q1 2010	7.8	5.4	16.0	12.9	8.2	11.4	10.6	29.3	10.0	15.7
	Q2 2010	8.0	12.9	25.5	12.2	15.2	6.4	-1.2	30.8	13.0	13.6
<b>Exports of Goods &amp; Services</b>	2005	16.6	8.3	4.8	4.2	10.6	7.8	20.7	7.8	9.6	9.3
	2006	9.4	6.6	13.4	9.1	9.4	11.4	11.7	11.4	9.4	11.1
	2007	8.5	4.1	5.5	7.8	8.3	12.6	15.7	9.6	6.9	11.4
	2008	9.5	1.6	-2.0	5.1	2.5	6.6	-28.1	0.6	4.8	1.3
	2009	-9.7	-10.4	-13.4	-12.7	-10.1	-0.8	10.0	-9.1	-11.2	-3.5
	Q1 2010	20.0	19.3	22.4	16.2	20.7	16.6	51.7	41.4	19.2	27.2
	Q2 2010	14.6	13.8	27.4	22.3	19.5	14.1	40.5	34.3	18.5	22.8

Source: Haver Analytics, national data sources, and World Bank staff estimates. Regional averages are 2000 US\$ GDP weighted.

**Appendix Table 3. East Asia - Merchandise Export Growth****(in U.S. dollars, percent change from a year earlier)**

	2007	2008	2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	May-10	Jun-10	Jul-10	Aug-10
<b>East Asia (10)</b>	17.0	13.6	-16.2	-19.8	5.4	33.4	37.0	41.7	36.6	31.5	32.5
<b>China</b>	25.7	17.4	-15.9	-20.5	0.2	28.7	40.9	48.5	43.9	38.1	34.4
<b>S.E. Asia</b>	13.6	15.0	-16.6	-20.7	3.4	31.4	39.4	36.4	34.0	25.6	29.5
<b>Indonesia</b>	13.2	20.1	-15.0	-19.3	23.9	54.7	36.9	37.4	31.4	28.9	30.0
<b>Malaysia</b>	9.5	13.5	-21.1	-26.3	9.8	40.9	33.2	32.0	26.3	25.6	23.5
<b>Philippines</b>	7.1	-2.7	-21.9	-21.5	5.1	43.0	33.3	37.3	33.7	35.9	36.6
<b>Thailand</b>	17.8	14.3	-13.6	-16.7	13.3	34.2	39.3	37.5	44.5	20.3	25.9
<b>Vietnam</b>	25.0	29.2	-10.1	-22.2	-3.7	2.8	33.7	43.0	33.4	25.4	51.6
<b>NIEs</b>	10.9	9.3	-16.2	-18.3	8.5	36.6	33.5	37.4	30.5	27.2	31.8
<b>Hong Kong SAR, China</b>	8.8	5.3	-12.2	-13.8	-2.0	25.8	23.9	23.8	26.1	22.9	35.7
<b>Korea</b>	14.1	13.6	-13.9	-17.6	11.7	35.8	33.1	40.1	30.2	28.3	29.6
<b>Singapore</b>	10.1	12.9	-20.2	-22.3	11.9	38.4	36.5	35.2	33.2	22.9	33.8
<b>Taiwan, China</b>	10.3	3.7	-20.5	-20.8	17.3	53.4	47.0	58.6	34.5	38.2	26.9
Source: Haver Analytics											

**Appendix Table 4. East Asia and the Pacific: GDP Growth Projections**

(percent change from a year earlier)

	2002	2003	2004	2005	2006	2007	2008	2009	Forecast 2010	Forecast 2011
<b>East Asia</b>	7.0	6.7	7.9	8.0	9.1	10.1	6.3	4.7	8.4	6.8
<b>Developing East Asia</b>	7.9	8.8	9.0	9.8	10.9	12.3	8.4	7.3	8.9	7.8
<b>China</b>	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.1	9.5	8.5
<b>Indonesia</b>	4.5	4.8	5.0	5.7	5.5	6.3	6.0	4.5	6.0	6.2
<b>Malaysia</b>	5.4	5.8	6.8	5.3	5.8	6.5	4.7	-1.7	7.4	4.8
<b>Philippines</b>	4.3	5.0	6.4	5.0	5.3	7.1	3.7	1.1	6.2	5.0
<b>Thailand</b>	5.3	7.1	6.3	4.6	5.1	4.9	2.5	-2.2	7.5	3.2
<b>Vietnam</b>	7.1	7.3	7.8	8.4	8.2	8.5	6.3	5.3	6.5	7.0
<b>Cambodia</b>	6.5	8.5	10.3	13.3	10.8	10.2	6.7	-2.0	4.9	6.0
<b>Fiji</b>	3.2	1.0	5.3	0.7	1.9	-0.9	0.2	-3.0	1.0	1.4
<b>Lao PDR</b>	5.9	6.1	6.4	7.1	8.5	7.5	7.5	6.7	7.7	7.8
<b>Mongolia</b>	4.2	6.1	10.8	7.3	8.6	10.2	8.9	-1.6	8.5	7.0
<b>Papua New Guinea</b>	-0.2	2.2	2.7	3.4	2.6	7.2	6.7	4.5	7.5	5.5
<b>Timor-Leste</b>	2.4	0.1	4.2	6.2	-5.8	8.4	12.8	7.4		
<b>East Asia NIEs</b>	5.6	3.2	6.0	4.9	5.8	5.8	1.8	-1.0	7.3	4.3

Source: World Bank data and staff estimates.

Appendix Table 5. Regional Aggregates for Poverty Measures in East Asia

	Mean Consumption (2005 PPP\$/month)	\$1.25 –a-day		\$2-a-day		Population (million)
		Headcount Index (%)	Number of Poor (million)	Headcount Index (%)	Number of Poor (million)	
<b>EAP</b>						
1990	49.16	54.7	873.3	79.8	1,273.7	1,595.9
1993	54.55	50.8	845.3	75.8	1,262.1	1,664.9
1996	67.01	36.0	622.3	64.1	1,108.1	1,728.7
1999	70.76	35.5	635.1	61.8	1,104.9	1,788.4
2002	85.65	27.6	506.8	51.9	954.1	1,837.0
2005	106.85	16.8	316.2	38.7	728.7	1,884.4
<b>EAP excluding China</b>						
1990	72.98	39.2	180.5	66.0	304.4	460.8
1993	73.84	42.6	207.3	68.0	330.9	486.4
1996	85.81	35.0	178.8	61.5	314.2	511.2
1999	82.96	35.2	188.1	62.7	335.2	534.7
2002	89.76	25.5	142.1	54.0	300.8	556.6
2005	100.98	19.0	110.2	44.8	259.5	579.9
<b>South East Asia (Indonesia, Malaysia, Philippines, Thailand)</b>						
1990	77.05	38.6	120.3	65.1	202.9	311.8
1993	82.24	37.8	124.2	63.8	209.8	328.7
1996	96.46	29.5	101.6	56.2	193.9	344.9
1999	91.12	31.8	114.8	59.2	213.6	361.1
2002	97.84	21.3	80.3	49.9	188.4	377.3
2005	107.30	17.0	66.8	42.2	166.0	393.8
<b>Lower-Income East Asia (Cambodia, Laos, PNG, Vietnam)</b>						
1990	58.57	41.2	34.6	69.5	58.4	84.1
1993	43.53	60.5	54.4	83.6	75.2	90.0
1996	47.82	55.1	52.7	80.6	77.1	95.7
1999	54.43	47.3	47.4	75.3	75.6	100.3
2002	60.87	41.0	42.6	69.1	71.9	104.1
2005	79.14	26.1	28.4	53.8	58.6	108.8
Source: World Bank PovcalNet						

**Appendix Table 6. Primary Commodity Prices**

(in U.S. dollars, percent change from a year earlier)

Commodity	Actual											Projections		
	1980-90	1991-98	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>Crude oil average</b>	0.0	-5.7	56.2	-13.7	2.4	15.9	30.6	41.5	20.4	10.6	36.4	-36.3	23.6	-4.2
<b>Non-Energy Commodities</b>	-0.8	0.4	-1.4	-9.1	5.3	10.2	17.5	12.0	29.0	17.1	21.0	-21.6	17.8	-4.5
<b>Agriculture</b>	-1.9	0.8	-5.7	-9.1	8.6	9.6	10.5	2.8	12.6	20.1	27.2	-13.8	8.4	-7.9
<b>Cocoa</b>	-7.3	4.0	-20.2	18.0	66.4	-1.5	-11.5	-0.8	3.5	22.6	32.0	12.1	10.8	-18.8
<b>Coffee, arabica</b>	-3.6	12.6	-16.2	-28.5	-1.2	4.3	25.3	42.7	-0.4	8.0	13.1	2.9	23.0	-23.1
<b>Coconut oil</b>	-1.4	10.6	-38.9	-29.4	32.4	11.0	41.4	-6.6	-1.6	51.4	33.2	-40.7	28.2	-19.4
<b>Palm oil</b>	-3.0	12.3	-28.8	-7.9	36.6	13.6	6.3	-10.4	13.3	63.1	21.6	-28.0	17.2	-5.0
<b>Rice, Thai, 5%</b>	0.8	2.1	-18.5	-14.6	11.0	3.0	20.3	20.4	6.5	7.1	99.2	-14.6	-14.4	1.1
<b>Sugar, world</b>	16.4	-2.8	30.6	5.6	-20.3	3.0	1.1	37.9	49.5	-31.8	27.0	41.8	5.0	-9.0
<b>Logs, Malaysia</b>	1.9	3.4	1.5	-16.3	2.7	14.5	5.4	3.0	17.9	11.9	9.1	-1.7	-7.7	3.8
<b>Sawn wood, Malaysia</b>	4.1	-0.1	-1.0	-19.1	9.4	4.6	5.5	13.4	13.6	7.6	10.3	-9.4	4.9	0.6
<b>Rubber, RSS1, Singapore</b>	-1.7	0.5	9.6	-13.8	33.0	41.6	20.4	15.2	40.3	8.7	14.3	-26.6	71.8	-24.2
<b>Metals and minerals</b>	2.9	-2.6	12.6	-9.6	-3.1	12.7	37.1	28.9	56.9	12.0	3.7	-27.7	38.3	1.4
<b>Tin</b>	-6.7	-0.7	0.6	-17.5	-9.5	20.5	73.9	-13.3	19.0	65.6	27.3	-26.7	36.3	2.7
<b>Copper</b>	4.3	-4.1	15.3	-13.0	-1.2	14.1	61.1	28.4	82.7	5.9	-2.3	-26.0	39.8	4.2

Source: World Bank DEC Prospects Group. Projections as of 8/17/2010.

## Appendix Table 7. East Asia: Exchange Rates

(local currency per U.S. dollar, end-of-period)

	China	Indonesia	Malaysia	Philippines	Thailand	Vietnam	Hong Kong SAR, China	Korea	Singapore	Taiwan, China	Japan
Jan-2008	7.19	9,291	3.24	40.65	33.03	15,971	7.80	943.9	1.42	32.20	106.36
Feb-2008	7.11	9,051	3.19	40.36	31.87	15,931	7.78	937.3	1.39	30.95	104.73
Mar-2008	7.02	9,217	3.19	41.87	31.51	16,105	7.79	991.7	1.38	30.41	100.10
Apr-2008	7.00	9,234	3.16	42.19	31.74	16,116	7.80	999.7	1.36	30.45	104.08
May-2008	6.95	9,318	3.24	43.88	32.46	16,246	7.80	1031.4	1.37	30.41	105.66
Jun-2008	6.86	9,225	3.27	44.76	33.52	16,842	7.80	1043.4	1.36	30.35	106.40
Jul-2008	6.86	9,118	3.26	44.14	33.54	16,755	7.80	1008.5	1.37	30.59	107.99
Aug-2008	6.85	9,157	3.39	45.69	34.17	16,525	7.80	1081.8	1.42	31.52	109.10
Sep-2008	6.85	9,378	3.46	46.92	34.02	16,575	7.77	1187.7	1.43	32.13	104.30
Oct-2008	6.86	10,995	3.56	48.75	34.99	16,813	7.75	1291.4	1.48	33.00	98.30
Nov-2008	6.87	12,151	3.62	48.88	35.47	16,974	7.75	1482.7	1.51	33.30	95.25
Dec-2008	6.86	10,950	3.46	47.49	34.93	17,433	7.75	1257.5	1.44	32.86	90.75
Jan-2009	6.86	11,355	3.61	47.08	34.93	17,475	7.75	1368.5	1.51	33.80	89.60
Feb-2009	6.84	11,980	3.69	48.24	36.05	17,475	7.75	1516.4	1.54	34.95	97.55
Mar-2009	6.84	11,575	3.65	48.42	35.52	17,756	7.75	1377.1	1.52	33.92	98.10
Apr-2009	6.85	10,713	3.56	48.70	35.30	17,784	7.75	1348.0	1.48	33.23	97.60
May-2009	6.82	10,340	3.51	47.55	34.38	17,784	7.75	1272.9	1.45	32.65	96.50
Jun-2009	6.81	10,225	3.52	48.31	34.02	17,801	7.75	1284.7	1.45	32.82	95.95
Jul-2009	6.82	9,920	3.52	48.12	34.04	17,815	7.75	1240.5	1.44	32.82	95.33
Aug-2009	6.82	10,060	3.52	48.91	34.01	17,823	7.75	1244.9	1.44	32.92	92.70
Sep-2009	6.83	9,681	3.47	47.59	33.55	17,841	7.75	1188.7	1.41	32.20	89.77
Oct-2009	6.82	9,545	3.41	47.73	33.43	17,862	7.75	1200.6	1.40	32.54	91.38
Nov-2009	6.83	9,480	3.39	46.75	33.21	18,485	7.75	1167.4	1.38	32.19	86.75
Dec-2009	6.83	9,400	3.42	46.36	33.36	18,472	7.76	1167.6	1.40	32.03	92.06
Jan-2010	6.82	9,365	3.41	46.74	33.15	18,472	7.77	1156.5	1.40	31.99	89.85
Feb-2010	6.84	9,335	3.41	46.26	33.09	18,925	7.76	1158.4	1.41	32.09	89.25
Mar-2010	6.83	9,115	3.26	45.22	32.37	19,080	7.77	1130.8	1.40	31.82	93.25
Apr-2010	6.83	9,012	3.19	44.64	32.32	18,960	7.77	1115.5	1.37	31.42	94.06
May-2010	6.83	9,180	3.25	46.21	32.53	18,980	7.79	1200.2	1.40	32.23	91.30
Jun-2010	6.84	9,083	3.26	46.42	32.44	19,065	7.79	1210.3	1.40	32.28	88.60
Jul-2010	6.85	8,952	3.19	45.81	32.28	19,095	7.77	1187.2	1.36	32.05	86.50
Aug-2010	6.86	9,041	3.14	45.18	31.30	19,485	7.78	1189.1	1.36	32.10	84.25
Sep-2010	6.85	8,924	3.09	43.90	30.40	19,485	7.76	1142.0	1.32	31.33	83.47

Sources: Haver Analytics, Datastream.

Appendix Table 8. East Asia: Foreign Reserves Minus Gold

(in billions of U.S. dollars)

	China	Indonesia	Malaysia	Philippines	Thailand	Hong Kong SAR, China	Korea	Singapore	Taiwan, China	Total
<b>Dec-1997</b>	107.0	19.3	27.0	10.1	37.8	63.8	33.2	76.8	88.0	463.1
<b>Dec-1998</b>	142.8	17.4	20.8	7.3	26.3	92.8	20.4	71.3	83.5	482.5
<b>Dec-1999</b>	149.2	23.5	25.6	9.3	28.8	89.7	52.0	75.1	90.3	543.4
<b>Dec-2000</b>	157.7	27.3	30.6	13.3	34.1	96.2	74.0	77.0	106.2	616.4
<b>Dec-2001</b>	168.3	29.4	29.5	13.1	32.0	107.5	96.1	80.2	106.7	662.9
<b>Dec-2002</b>	215.6	28.0	30.5	13.5	32.4	111.2	102.8	75.7	122.2	731.7
<b>Dec-2003</b>	291.1	32.0	34.2	13.3	38.1	111.9	121.3	82.2	161.7	885.9
<b>Dec-2004</b>	408.2	36.3	44.6	13.7	41.1	118.4	155.3	96.2	206.6	1,120.3
<b>Dec-2005</b>	614.5	36.3	66.4	13.1	48.7	123.5	199.0	112.6	241.7	1,455.9
<b>Dec-2006</b>	821.5	34.7	70.2	15.9	50.7	124.2	210.3	116.2	253.3	1,697.1
<b>Dec-2007</b>	1,068.5	42.6	82.2	20.0	65.3	133.2	238.9	136.3	266.1	2,053.0
<b>Dec-2008</b>	1,949.3	51.6	91.2	33.2	108.7	182.5	201.1	174.2	291.7	3,083.4
<b>Jan-2009</b>	1,916.6	50.9	91.0	34.7	108.2	181.7	201.7	167.1	292.7	3,044.4
<b>Feb-2009</b>	1,915.1	50.6	90.7	34.2	110.7	177.0	201.5	163.5	294.2	3,037.6
<b>Mar-2009</b>	1,956.8	54.8	87.4	34.5	113.7	186.2	206.3	166.3	300.1	3,106.2
<b>Apr-2009</b>	2,012.0	56.6	87.8	34.9	114.4	193.4	212.4	170.1	304.7	3,186.2
<b>May-2009</b>	2,093.1	57.9	87.9	34.7	118.9	205.1	226.7	171.8	312.6	3,308.6
<b>Jun-2009</b>	2,135.2	57.6	91.3	34.8	118.3	206.9	231.7	173.2	317.6	3,366.5
<b>Jul-2009</b>	2,178.2	57.4	90.8	35.3	120.9	218.0	237.4	174.1	321.1	3,433.3
<b>Aug-2009</b>	2,223.9	57.9	93.3	36.7	124.8	223.2	245.4	176.3	325.4	3,506.8
<b>Sep-2009</b>	2,288.5	62.3	94.8	37.5	129.1	226.8	254.2	182.0	332.2	3,607.4
<b>Oct-2009</b>	2,344.3	64.5	94.9	37.9	132.5	240.0	264.1	184.3	341.2	3,703.7
<b>Nov-2009</b>	2,405.3	65.8	95.0	38.5	136.7	256.2	270.8	188.9	347.2	3,804.4
<b>Dec-2009</b>	2,399.2	66.1	96.4	38.8	135.5	255.8	269.9	187.8	348.2	3,797.6
<b>Jan-2010</b>	2,415.2	69.6	95.7	40.2	139.5	257.0	273.6	189.6	350.7	3,831.1
<b>Feb-2010</b>	2,424.6	69.7	95.6	40.2	138.8	258.2	270.6	187.6	352.7	3,838.0
<b>Mar-2010</b>	2,447.1	71.8	94.0	39.6	141.1	258.8	272.3	196.9	355.0	3,876.6
<b>Apr-2010</b>	2,490.5	78.6	94.7	40.6	144.4	259.2	278.8	203.2	357.6	3,947.5
<b>May-2010</b>	2,439.5	74.6	96.2	41.0	140.2	256.1	270.1	198.1	360.1	3,876.1
<b>Jun-2010</b>	2,454.3	76.3	93.3	41.8	143.4	256.7	274.1	199.7	362.4	3,902.1
<b>Jul-2010</b>	2,538.9	78.8	93.6	42.4	147.7	260.6	285.9	206.7	370.1	4,024.7
<b>Aug-2010</b>	2,547.8	81.3	93.8	42.8	151.2	261.4	285.3	206.2	372.1	4,041.9
<b>Sep-2010</b>	2,648.3	86.6	99.2	46.1	159.0	266.1	289.7	212.4	380.5	4,187.9

Sources: Haver Analytics, Thomson Datastream, and IMF International Financial Statistics.

**Table 9a. East Asia: Balance of Payments**

(in percent of GDP)															
	Overall Balance 1/					Current Account					Capital Account 2/				
	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
<b>East Asia</b>	5.3	6.7	9.5	5.9	9.5	5.7	7.3	8.7	7.7	6.6	-0.3	-0.6	0.8	-0.7	2.1
<b>China</b>	9.0	8.9	13.4	9.5	9.5	7.0	9.1	10.8	9.9	6.1	2.0	-0.2	2.6	3.4	1.3
<b>S.E. Asia</b>	1.0	4.6	6.3	1.0	4.5	2.2	5.3	6.2	3.7	6.1	-1.2	-0.7	0.0	-5.2	-0.4
<b>Indonesia</b>	-0.6	2.2	3.3	-1.0	2.7	0.1	3.0	2.4	0.1	2.0	-0.6	-0.8	0.9	-3.0	1.8
<b>Malaysia</b>	2.7	7.6	10.1	-4.4	2.7	15.0	16.7	15.9	17.5	16.5	-12.3	-9.1	-5.8	-	-15.9
<b>Philippines</b>	2.8	3.5	7.0	1.8	3.5	1.9	4.4	5.0	2.1	5.3	0.9	-1.0	2.1	-3.5	-0.1
<b>Thailand</b>	1.1	7.0	8.1	8.6	10.2	-4.3	1.1	6.3	0.4	7.7	5.5	5.9	1.7	0.9	7.0
<b>NIEs</b>	1.8	4.2	4.0	0.1	13.2	5.2	5.4	6.2	5.0	8.5	-3.5	-1.2	-2.2	-8.4	6.4
<b>Hong Kong SAR, China</b>	0.4	4.7	9.4	13.9	34.8	11.4	12.1	12.3	13.6	8.7	-11.0	-7.4	-2.9	5.2	19.9
<b>Korea</b>	1.3	3.0	2.2	-6.4	8.2	1.8	0.5	0.5	-0.3	5.1	-0.4	2.5	1.7	-	5.6
<b>Singapore</b>	2.9	13.8	15.1	5.8	7.4	21.3	24.2	26.6	18.6	17.8	-18.4	-	-	-	-5.1
<b>Taiwan, China</b>	3.2	3.4	1.1	5.3	14.9	4.8	6.9	8.4	6.2	11.2	-1.6	-3.5	-7.3	-5.9	6.2
<b>Median</b>	2.7	4.7	8.1	5.3	8.2	4.8	6.9	8.4	6.2	7.7	-0.6	-1.0	0.9	-3.5	1.8

Sources: Haver Analytics, national sources.

1/ Equals change in foreign reserves.

2/ Includes errors and omissions.

**Table 9b. East Asia: Capital Account Components**

(in percent of GDP)															
	Net FDI					Net Portfolio					Net Other Capital 3/				
	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
<b>East Asia</b>	2.0	1.4	1.8	1.4	0.4	-0.7	-2.3	-0.9	-1.1	0.1	-0.6	0.2	-1.2	-1.3	2.0
<b>China</b>	2.9	2.0	3.5	2.1	0.7	-0.2	-2.4	0.5	1.0	0.8	-0.2	0.5	-2.0	-2.7	-0.5
<b>S.E. Asia</b>	2.2	1.6	0.7	0.2	-0.1	1.4	1.8	0.9	-2.5	0.2	-3.1	-3.7	-2.4	0.1	-2.1
<b>Indonesia</b>	1.8	0.6	0.5	0.7	0.4	1.5	1.2	1.3	0.3	1.9	-3.3	-1.0	-1.1	-1.4	-1.5
<b>Malaysia</b>	0.7	0.0	-1.5	-3.5	-3.4	-2.7	2.2	2.9	-	0.1	-5.1	-9.8	-7.5	-1.1	-5.7
<b>Philippines</b>	1.7	2.4	-0.4	0.8	1.0	3.5	2.6	3.2	-2.3	0.9	-3.0	-5.1	-0.3	0.4	-1.6
<b>Thailand</b>	4.3	4.1	3.4	2.2	0.8	3.1	2.1	-2.7	-0.7	-3.5	-1.1	-2.9	-1.9	3.8	-1.1
<b>NIEs</b>	0.5	0.3	-0.9	0.5	-0.3	-2.4	-4.2	-4.7	-5.3	-2.1	0.0	1.8	0.9	1.4	6.6
<b>Hong Kong SAR, China</b>	3.6	0.0	-3.3	4.2	-1.8	-	-	-1.3	-	-	2.0	3.2	-5.0	14.4	6.6
<b>Korea</b>	0.2	-0.5	-1.3	-1.7	-1.1	-0.4	-2.4	-2.5	-0.3	6.0	0.8	5.1	4.2	-1.8	1.5
<b>Singapore</b>	3.4	7.1	4.6	10.0	5.9	0.7	-0.3	-	-	-	-	-	-	-1.6	-
<b>Taiwan, China</b>	-1.2	0.0	-0.8	-1.2	-0.8	-0.8	-5.0	-	-3.1	-2.7	2.9	0.1	1.2	3.4	2.6
<b>Median</b>	1.8	0.6	-0.4	0.8	0.4	-0.2	-0.3	-1.3	-2.3	0.1	-1.1	-1.0	-1.9	-1.1	-1.1

Sources: Haver Analytics, national sources.

3/ Net Other Investment + Financial Derivatives

<b>Appendix Table 10. East Asia: Nonperforming Loans</b>															
(in percent of total loans)															
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2009	2010		
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Sep	Dec	Mar	
<b>China</b>						23.1	17.9	13.2	8.6	7.1	6.2	1.7	1.6	1.4	1.3
<b>Indonesia 1/</b>	7.2	48.6	32.9	18.8	12.1	7.5	7.2	6.0	6.5	8.0	5.6	3.9	3.7		
<b>Malaysia 2/</b>	..	10.6	11.0	9.7	11.5	10.2	9.0	7.5	5.8	4.8	3.2	2.1	1.8		
<b>Philippines 3/</b>	..	11.0	12.7	14.9	16.9	14.6	13.8	12.5	8.6	6.1	4.9	4.0	3.7	4.0	
<b>Thailand 4/</b>	..	45.0	38.9	17.7	10.4	15.7	12.7	10.7	8.2	7.5	7.3	5.3	4.9	4.6	4.5
<b>Korea 5/</b>	6.0	7.3	13.6	8.8	3.3	2.4	2.2	2.0	1.3	0.9	0.7	1.5	1.2	1.5	1.0
Source: National data sources															
1/ Excludes IBRA's AMC. Data from 1997 to 2002 excludes state banks. Data from 2003 covers all commercial banks including state banks.															
2/ Excludes Danaharta. This series, used by Bank Negara Malaysia, is net of provisions and excludes interest in suspense.															
3/ Includes interbank loans.															
4/ Excludes transfers to AMCs. The jump in headline NPLs in December 2002 was a one-off increase, reflecting a change in definition and did not affect provisioning.															
5/ Excludes KAMCO/KDIC.															

**Appendix Table 11. East Asia: Financial Market Indicators**

<b>Stock Market Index, end-of-period, Dec. 31, 2007 = 100</b>											
	Jun07	Dec07	Jun08	Dec08	Mar09	Jun09	Sep09	Dec09	Mar10	Jun10	Sep10
<b>China</b>	72.6	100.0	52.0	34.6	45.1	56.3	52.8	62.3	60.0	45.5	50.4
<b>Indonesia</b>	77.9	100.0	85.6	49.4	52.2	73.8	89.9	92.3	105.1	106.1	127.5
<b>Malaysia</b>	93.7	100.0	82.1	60.7	60.4	74.4	83.2	88.1	92.4	90.9	101.3
<b>Philippines</b>	101.1	100.0	67.9	51.7	54.8	67.3	77.3	84.3	91.1	93.1	113.2
<b>Thailand</b>	90.5	100.0	89.6	52.4	50.3	69.6	83.6	85.6	88.7	92.9	113.7
<b>Vietnam</b>	110.5	100.0	43.1	34.0	30.3	48.4	62.7	53.4	55.9	54.7	49.0
<b>Hong Kong, SAR China</b>	78.3	100.0	79.5	51.7	48.8	66.1	75.3	78.6	79.5	72.4	80.4
<b>Korea</b>	91.9	100.0	88.3	59.3	63.6	73.3	88.2	88.7	90.2	89.5	98.7
<b>Singapore</b>	100.3	100.0	85.1	50.8	49.1	67.3	77.1	83.6	85.7	81.8	89.4
<b>Taiwan, China</b>	104.4	100.0	88.4	54.0	61.3	75.6	88.3	96.3	94.4	86.2	96.8
Source: Thomson Datastream											
<b>Yields, 10-year local-currency government bonds, end-of-period, in percent</b>											
	Jun07	Dec07	Jun08	Dec08	Mar09	Jun09	Sep09	Dec09	Mar10	Jun10	Sep10
<b>China</b>	4.4	4.5	4.5	2.8	3.2	3.2	3.5	3.6	3.4	3.3	3.3
<b>Indonesia</b>	9.0	10.0	13.4	11.9	12.7	11.1	10.0	10.1	9.1	8.4	7.6
<b>Malaysia</b>	5.0	4.1	4.9	3.2	3.8	4.4	4.2	4.3	4.2	4.0	3.6
<b>Philippines</b>	7.4	6.6	9.4	7.4	8.2	8.1	8.0	8.1	8.1	7.9	6.2
<b>Thailand</b>	4.5	5.0	5.9	2.7	3.3	3.7	4.0	4.2	4.0	3.1	3.1
<b>Vietnam</b>	7.8	9.1	16.0	10.2	9.5	9.7	10.3	11.5	12.3	11.5	11.2
<b>Hong Kong, SAR China</b>	4.8	3.4	3.5	1.9	1.9	2.6	2.4	2.6	2.6	2.3	2.0
<b>Korea</b>	5.5	5.7	6.0	4.2	5.2	5.2	5.3	5.4	4.7	5.0	4.1
<b>Singapore</b>	2.9	2.7	3.6	2.1	2.0	2.6	2.5	2.7	2.7	2.4	2.0
<b>Taiwan, China</b>	2.5	2.6	2.7	1.4	1.5	1.6	1.4	1.5	1.4	1.4	1.2
Source: Bloomberg											
<b>Foreign-Currency Government Bond Spreads (EMBIG), end-of-period, in basis points over U.S. Treasuries</b>											
	Jun07	Dec07	Jun08	Dec08	Mar09	Jun09	Sep09	Dec09	Mar10	Jun10	Sep10
<b>China</b>	54	120	137	228	210	122	87	104	87	86	81
<b>Indonesia</b>	165	275	381	762	742	433	295	230	212	274	192
<b>Malaysia</b>	75	119	153	119	344	167	175	136	138	171	137
<b>Philippines</b>	155	172	303	546	432	324	265	206	219	266	184
<b>Vietnam</b>	122	203	368	747	574	379	290	314	293	338	305
Source: JP Morgan, Bloomberg											
<b>Credit Default Swap (CDS) Spreads on Foreign-Currency Government Bonds, 5-year, end-of-period, in basis points</b>											
	Jun07	Dec07	Jun08	Dec08	Mar09	Jun09	Sep09	Dec09	Mar10	Jun10	Sep10
<b>China</b>	13	29	75	188	156	75	69	73	63	91	67
<b>Indonesia</b>	110	154	286	638	575	317	187	188	156	186	140
<b>Malaysia</b>	16	44	116	225	238	105	83	90	70	102	80
<b>Philippines</b>	111	153	266	384	360	217	176	168	156	174	139
<b>Thailand</b>	39	55	135	256	233	110	87	96	104	134	102
<b>Hong Kong, SAR China</b>	5	18	42	104	145	68	56	48	39	57	48
<b>Korea</b>	17	47	107	319	328	182	101	85	75	131	101
Source: Thomson Datastream											

