

EAST ASIA & PACIFIC UPDATE

April 2007



10 Years After the Crisis

Special Focus: Sustainable Development in East Asia's Urban Fringe



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EAST ASIA AND PACIFIC REGIONAL UPDATE

Summary

Growth in Emerging East Asia accelerated to reach 8.1 percent in 2006¹ (Table 1). This was the strongest pace of economic expansion in the last ten years and a fitting commemoration of the decade that has passed since the start of the Asian financial crisis in 1997. The region's accomplishments in grappling with and overcoming the crisis and in returning to solid growth are varied and impressive – a doubling in the dollar value of regional output from pre-crisis levels, the emergence of China into the front rank of global economic powers, a halving in poverty rates, accumulation of over \$2 trillion in foreign reserves. But even as the region celebrates recovery, new challenges are arising, which could slow or even derail growth if not properly handled. The report looks at these issues in a section on “Ten years after the crisis.”

Another challenge of staggering proportions that lies ahead is East Asian urbanization: The region's population will rise by around 17 percent between 2000 and 2025 but its urban population will jump by 65 percent or 500 million. The Special Focus in this report on “Sustainable Development in East Asia's Urban Fringe” looks at the issues.

Table 1. East Asia Economic Growth

	2005	2006	2007	2008
Emerging East Asia	7.6	8.1	7.3	7.0
Develop. E. Asia	9.0	9.5	8.7	8.1
S.E. Asia	5.1	5.4	5.5	5.7
Indonesia	5.7	5.5	6.3	6.5
Malaysia	5.2	5.9	5.6	5.8
Philippines	5.0	5.4	5.6	6.0
Thailand	4.5	5.0	4.3	4.5
Transition Econ.				
China	10.2	10.7	9.6	8.7
Vietnam	8.5	8.2	8.0	8.0
Small Economies	7.6	7.2	5.9	4.9
Newly Ind. Econ.	4.8	5.4	4.5	4.9
Korea	4.0	5.0	4.4	4.9
3 other NIEs	5.5	5.8	4.6	4.9
Japan	2.6	2.2	2.3	2.4

World Bank East Asia Region; March 2007. Consensus Forecasts for NIEs..

This year is also likely to be memorable for another reason, as the turning point in the global cycle, after 5

¹ Emerging East Asia comprises Developing East Asia (China, Indonesia, Malaysia, Philippines, Thailand, Vietnam and some smaller economies) and four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan, China).

years of sustained and accelerating expansion, with the US economy slowing and a global tightening of monetary policies still underway. The base outlook remains for a ‘soft landing’ and continued expansion, but one that is weighted with more uncertainties and with greater volatility. The next two sections of the report explore the implications for East Asia.

East Asia Regional Outlook

- **Growth.** The strong overall regional outcome for 2006 was dominated by China, which now comprises over half of Emerging East Asian GDP and where growth reached 10.7 percent, a fourth year of over 10 percent growth, driven by buoyant exports and investment. Activity also expanded at energetic 8-10 percent rates in low income economies such as Cambodia, Lao PDR, Mongolia and Vietnam. In Vietnam, across-the-board strength in exports, consumption and investment was buttressed by a surge in foreign direct investment before the economy's accession to the WTO this January. The larger middle and high income economies of the region also continued to expand at more moderate but still healthy rates of 4-6 percent. Some slowing in regional activity became apparent in the latter part of the year, with growth easing to 7.6 percent (y-o-y) in the fourth quarter. In China this mainly reflected a moderation of investment spending following policy tightening by the authorities. Elsewhere, though, the slowing trend reflected lower export growth, especially to the US. And the emerging US downturn and slowing export growth are also the main factors behind the forecast easing in Emerging East Asian growth to 7.3 percent in 2007. The extent of the US slowdown is one important risk in the outlook, but continued growth in Japan and Europe should provide some balance, together with continued growth in China's imports of components and other inputs from the rest of Asia (although recent trends suggest growing competition in the China import market as the country deepens its domestic supply chain for export goods). Another area of uncertainty is the extent to which domestic demand in the East Asian economies outside China will be able to pick up slack from slowing exports.

- **Poverty.** We estimate that the number of poor people in East Asia at the \$2 a day level fell to some 552 million in 2006 (or 29 percent of the region's population). Looking back, it is likely that the last five years of economic recovery and expansion have been among the most productive for poverty reduction in the history of East Asia. Since 2001 the number of people living below the \$2 a day line has been reduced by some 228 million, an even bigger reduction in poverty than in the previous extended ‘boom’ of 1991-96. Those earlier

poverty reduction gains were also partially squandered during the subsequent 1997-98 financial crisis. If the region's policy reform efforts succeed in reducing macroeconomic and financial vulnerability while maintaining high growth, the payoffs for sustained poverty reduction would be large indeed. The Poverty section of the report also looks at new policy approaches that governments are taking to tackle poverty in a more comprehensive way. Thus China recently announced plans for a nationwide rural safety net or 'di bao' to tackle vulnerability to poverty (i.e. the fact that many more people are vulnerable to falling into poverty as a result of adverse shocks than are actually poor at a given time). Indonesia announced plans to scale up spending on poverty reduction through a National Community Empowerment Program that builds on the success of existing community development programs. These programs focus on improving local governance and service delivery through participatory planning, providing community block grants for productive assets such as rural infrastructure, education, and health.

The international and regional environment

- **Developed economies.** After reaching 4 percent in 2006 (5.3 percent in PPP terms), global growth is at something of a turning point, projected to fall to 3.4 percent in 2007, led by a more than one percentage point fall in US growth to 2.1 percent. Growth in Japan and Europe has tended to surprise to the upside over the past year, however, and is expected to continue at rates similar to 2006. The rotation in the balance of growth from the US to the rest of the world should help stabilize and begin a gradual adjustment in global macroeconomic imbalances. Another key aspect of the turn in the global cycle is the continued gradual tightening of monetary policies in the developed world, most recently in Europe and Japan, which is bringing to an end an extended period of negative real interest rates. Tighter monetary policies are helping curb an incipient upturn in inflation in developed economies, and are also providing a check to the danger of bubbles in financial and other asset markets, a healthy development. Higher developed country interest rates are also likely to slow or partially reverse the surge in 'yield seeking' private capital flows to emerging markets underway since 2003. This development may actually ease macroeconomic management in many East Asian economies, which have been grappling with the exchange rate and monetary consequences of not only large current account surpluses, but also of significant capital inflows.
- **China.** Growth in China decelerated mildly in the second half of 2006, easing from almost 11 percent in the first half of the year to around 10.5 percent in the second, the result mainly of policy tightening aimed at curbing excessive investment growth. Slower investment growth

in the latter part of 2006 was partly offset by a further increase in the contribution of net trade to growth – export growth accelerated (at a time when US demand and other East Asian exports were waning), while import growth decelerated. Rising net trade also contributed to a surge in China's current account surplus to an estimated \$230 billion in 2006, or a striking 8.7 percent of GDP, up from \$161 billion in 2005. The large external surplus is complicating the authorities' efforts to establish an appropriately tight monetary policy by tending to feed more rapid growth in domestic credit. These circumstances point towards a continued focus on the authorities' policy of rebalancing the pattern of economic growth, orienting growth more towards domestic demand and consumption, towards more even distribution of the benefits of growth, and towards less intensive use of energy and natural resources. They also point to a continued focus on the role of greater exchange rate flexibility and a stronger exchange rate as instruments to bring about desirable expenditure switching and laying the basis for a more independent and flexible monetary policy.

- **Commodity markets.** Oil prices remain extremely volatile and subject to political risks. Having fallen sharply from their peak of over \$70 last August, crude oil prices averaged around \$58 through much of the last six months, although they were moving sharply higher to the mid sixty dollar range by the end of March as a result of escalating political tensions in the Gulf. The report assumes a mild decline in oil prices from \$64 in 2006 to \$56 in 2007 as whole, which would provide a modest terms of trade based income gain for the region. Among fundamental factors favoring this stable to gradually declining price scenario is evidence that consumers in many places are adjusting to high prevailing prices by improving efficiency and cutting demand. Thus, even while demand from China continued strong in 2006, it fell in the OECD. On the supply side high prices are finally inducing significant increases in production capacity and output in non-OPEC suppliers. Given the significant fall in prices in the second half of 2006, OPEC has moved to stabilize prices by restricting output. That has also increased its margin of spare production capacity to the highest level in several years, which should be helpful in case of serious political disruptions to the market. Still, while it is hard to predict, a large politically driven spike in oil prices is well within the bounds of possibility. And that would constitute another significant risk in the East Asian outlook.
- **Balance of payments and financial market developments.** Emerging East Asian economies saw a record increase in their foreign exchange reserves (i.e. an overall balance of payments surplus) of \$357 billion – worth 7 percent of GDP - in 2006. This was the fourth year when the increase in regional reserves exceeded

\$200 billion. Foreign reserves for the region exceeded \$2 trillion by the end of 2006, of which \$1.06 trillion was held by China. Reserve accumulation was almost entirely driven by East Asia's current account surplus, an estimated \$362 billion in 2006, another record. Almost two thirds of the regional imbalance occurred in China, where the current account surplus rose to an estimated \$230 billion or 8.6 percent of GDP, both records by a significant margin. The other main economies in the region also ran current account surpluses in 2006, which in the majority of cases were also higher than in 2005. Wary of letting surpluses push up their exchange rates too far, for fear of hurting exports and employment, most governments have intervened, accumulated foreign reserves and then mopped up the resulting increases in domestic liquidity with fairly hefty bond issues. But the growing costliness and other inconveniences of this procedure have also led governments to consider other options. Thailand introduced controls on capital inflows in December, but rescinded a significant part of them following heightened uncertainty among investors. Overall though, the extraordinary scale of balance of payments inflows over the last 4-5 years is leading policy makers to put more emphasis on exchange rate flexibility. This is evidenced by China and Malaysia's adoption of a more flexible exchange rate framework in mid 2005, and an increased pace of appreciation among several other economies.

A sudden sell-off on the Shanghai stock market at the end of February set off a correction in stock markets around the world. While there was no single cause for the sell-off at the global level, the event does provide evidence for a heightened appreciation of risk among investors, more uncertainty about the outlook, for example about prospects for the US economy, as well as the impact of tightening global monetary policies. Asset markets in East Asia as elsewhere are likely to be more volatile in the coming period.

Ten years after the crisis

A decade after the financial crisis that devastated East Asia in 1997-98, the region is far wealthier, has fewer poor people and a larger global role than ever before. Led by continued strong growth in China, Emerging East Asia now has an aggregate output of over \$5 trillion, double the dollar value just before the crisis. In per-capita terms real incomes are some 75 percent higher. The poverty rate at the \$2 a day level has fallen from 50 percent of the population to 29 percent today. When Vietnam reaches middle income status (defined as annual per capita income of about \$900), which could happen as soon as 2010, more than 9 out of ten East Asians will live in a middle income economy.

But even as the region celebrates recovery, new challenges loom, which could slow or even derail growth

if not properly handled – economies could find themselves in a 'middle income trap' and struggle to climb onwards to higher income levels. History shows that while many economies can reach middle income status – often quite quickly – few pass through it because the policy and institutional changes needed are more complex and more challenging technically, politically and socially. Ten years after confronting the reforms needed to rebound from the financial crisis, East Asia is confronting reform challenges at least as complex. The fact that other economies in the region like Japan, Hong Kong (China), Korea, Singapore and Taiwan (China) have already escaped the 'middle income trap' shows that it is possible. But the task will not be simple. We look at three key challenges: facing East Asia 10 years after the crisis, and at some policy perspectives that can help address them.

- **Maintaining High Growth, Sustainably.** While overall East Asian per-capita income growth in the post crisis period 2002-06 has been as strong as pre-crisis trends, this conceals two distinct stories. In China per capita growth of near 9 percent is somewhat faster than pre-crisis. But many other middle (and high) income economies in the region are growing at about 2 percentage points less than pre-crisis. There are thus at least two middle income growth challenges in East Asia.

In China rapid growth has led to an accumulation of stresses and imbalances that could affect China's onward development if left unchecked. Environmental stresses are the most apparent. China today contains 20 of the world's 30 most polluted cities. Industry is large relative to services, which adds to environmental pressure. On the demand side, the share of investment is large relative to consumption, raising concerns about inefficient use of capital and a potential build up of overcapacity in specific sectors. Rural-urban income gaps have widened. To address these problems the government is developing policies aimed at 'rebalancing the economy' and 'striving for a harmonious society'. While maintaining fast growth, the aim is to achieve a shift in production from industry towards services, more reliance on domestic demand, and growth that is more equally shared and more environmentally sustainable.

Among other middle economies in the region, however, growth has been less than pre-crisis, with investment somewhat weak and erratic. Their overall shares in world trade have also been under pressure as they have adjusted to the rapid emergence of China on the world trade scene. China's emergence, while it is generating tremendous welfare gains for consumers around the world, is also creating intense competitive pressures for other East Asian economies in global markets (especially in the last 5 years). But China has also provided a fast growing market for components and

other inputs from other East Asian economies. The result is a new division of labor, with pan-Asian production networks centered on China as a final integrator of products for export to the outside world, and a rapid rise in intra-regional trade in production inputs. World Bank Investment Climate Surveys find East Asian firms rating *uncertainty* as the biggest constraint on their operations. That is hardly surprising, given the wrenching competitive challenges and structural adjustments they are undergoing. Global competition is not going away. Efforts to strengthen the investment climate are key to creating an environment in which firms are able to more effectively seek out efficient investments and areas of global comparative advantage.

- **Poverty and Inequality.** At the same time as East Asian poverty has been falling, inequality of income and consumption has increased in many economies of the region, in some cases sharply. This matters. Inequality can hamper growth, as poor people without access to credit may be unable to exploit investment opportunities. It can be a source of political and social unrest. Research suggests that many of the same forces that are contributing to rapid growth and more global integration are also the forces that are shaping unevenness in growth. Among other factors, increased globalization has increased relative demand for skilled labor, pushing up wage premiums for education and skills, one of the key factors behind the rise in inequality. Spatial disparities between urban and rural areas are exacerbated by location and agglomeration effects that reward coastal areas and cities with good transport links to global markets, and firms and workers in cities who benefit from their closeness to each other in various ways. How might inequality be mitigated without killing the golden goose of productivity growth and wealth creation?

- **Managing Vulnerability.** The financial crises of 1997-98 highlighted the potential costs of mismanaging vulnerability. Economies in the region have pursued two broad strategies to reduce the risk of crisis. First, they have run current account surpluses and built up large foreign exchange reserves as an insurance policy against crises. Research suggests that reserves now far exceed optimal levels for precautionary purposes. Instead they can create unwanted side-effects of their own, for example by fueling excessive expansion of credit, economic overheating, higher inflation or speculative bubbles in asset markets, potentially compromising the central bank's ability to pursue an independent monetary policy. Second, economies have sought to strengthen fundamentals, in particular the financial sector. Progress in this area has been significant. Banks in the previously crisis-affected East Asian countries have improved capital adequacy, asset quality and profitability. Financial systems have become more diversified as

equity and bond markets have grown. Prudential regulation and supervision to strengthen the stability of the banking system have improved, but this is a work in progress and several areas still need to converge to international standards. To strengthen securities markets the focus needs to be on factors that help increase market liquidity and efficiency. These include improving the availability of information to price securities accurately, reducing transactions costs, and fostering growth in the size and heterogeneity of the investor base.

- **Policy perspectives.** The report highlights a number of policy areas in which progress could have multiple benefits across the three highlighted areas of concern.

- ✓ *Investment climate reforms* that reduce policy uncertainty and needless and costly regulations can help strengthen the competitiveness of not only formal sector firms but also entrepreneurial activity among the poor.

- ✓ *Deeper, more diversified capital markets* lessen vulnerability and enhance growth by offering more specialized modes of resource mobilization and allocation, for example by supporting investment in new, more uncertain and innovative projects. Improving credit access for the poor removes a key impediment to their pursuing profitable investment opportunities.

- ✓ *Services trade liberalization*, where East Asia has lagged, would provide a boost to the productivity and competitiveness of services consuming sectors.

- ✓ *High quality infrastructure* is an increasingly important element of competitiveness. It is estimated that East Asia has infrastructure needs of approximately \$200 billion annually over the next five years,

- ✓ *Meeting skilled labor shortages*, which are an important constraint on firm operations in the region's middle income economies. Education and other forms of human capital development are a fundamental underpinning for both domestic innovation activity and the capacity of the economy to absorb knowledge from abroad. Strengthening quality and enrollment in secondary and tertiary education, improving labor force training capabilities and fostering development of national innovation systems are an increasingly important part of the region's policy agenda. Policies that improve access to higher education will also promote a more equitable distribution of the benefits of growth.

- ✓ The importance of *prudent macroeconomic policies* cannot be overestimated. Continued movements towards greater flexibility would improve the ability of economies to adjust to external shocks more smoothly and would also allow central banks greater independence in the conduct of monetary policy.

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East Asia Regional Outlook

Growth

Growth in Emerging East Asia reached 8.1 percent in 2006, which was, fittingly, the strongest pace in the ten years that have elapsed since the start of the Asian financial crisis in 1997 (Table 1). Among the developing economies of the region growth came in at 9.5 percent, also the highest in ten years. A moderate slowing in regional activity became apparent in the latter part of the year, however, with regional GDP growth easing to a year on year pace of 7.6 percent in the fourth quarter, close to the 7.3 percent pace we forecast for 2007 as a whole, primarily reflecting slower growth in the US economy and in East Asian exports.

The strong overall regional outcome for 2006 was dominated by China, which now comprises over half of regional GDP and where growth reached 10.7 percent, a fourth year of over 10 percent growth, driven by buoyant exports and investment. The pace of activity in China slowed marginally from 11 percent in the first half of 2006 to around 10.5 percent in the second, following a range of policy tightening measures implemented from April onwards, although monthly data on industrial production and exports indicate that growth remained very strong in the first quarter of 2007. Growth also continued to run at energetic rates in several of the low income transition economies of the region like Vietnam, Cambodia, Lao PDR and Mongolia. Growth topped 8 percent in Vietnam, supported by across-the-board strength in exports, consumption and investment, the latter boosted by a surge in foreign direct investment before the economy's accession to the WTO this January. Cambodia grew by over 10 percent

for a third year running, fueled by garment exports, tourism, construction and agricultural expansion, and growth also ran at 7 ½ - 8 ½ percent in Lao PDR and Mongolia. Growth also came in at a relatively healthy 5 - 6 percent in the middle income economies of South East Asia, picking up from 2005 in Malaysia, Philippines and Thailand, while easing only modestly in Indonesia. Coming down one more notch,

Exhibit 1

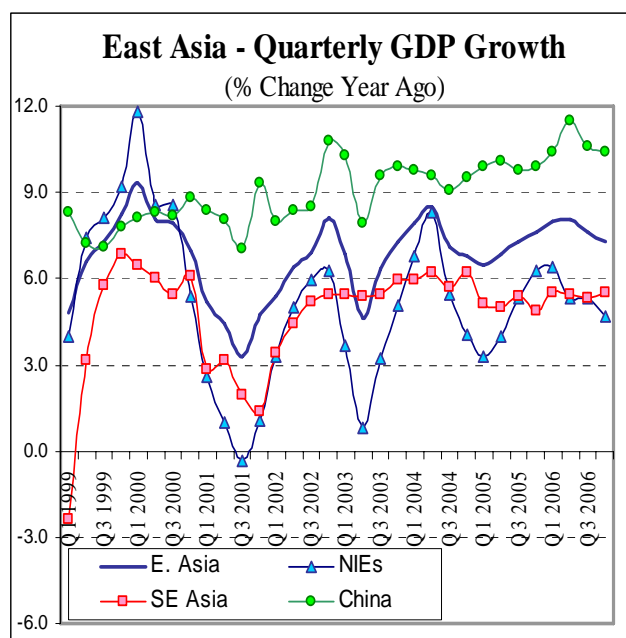


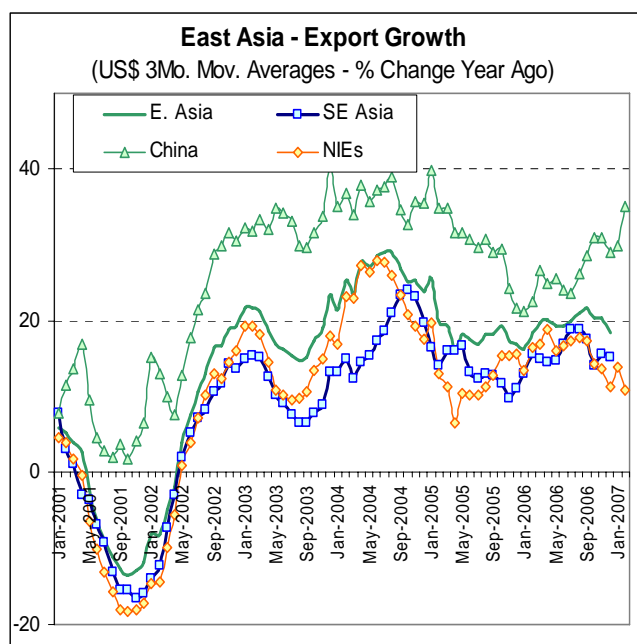
Table 2. Growth in Real GDP and Components of Aggregate Demand (% change year ago)

		Indonesia	Malaysia	Philippines	Thailand	Hong Kong	Korea	Singapore	Taiwan, China	S.E. Asia	NIEs
GDP	2005	5.7	5.2	5.0	4.5	7.5	4.0	6.6	4.0	5.1	4.8
	2006	5.5	5.9	5.4	5.0	6.8	5.0	7.9	4.6	5.4	5.4
	2006 H1	5.0	6.1	5.8	5.6	6.8	5.7	9.0	4.7	5.5	5.9
	2006 H2	6.0	5.7	5.0	4.4	6.9	4.4	6.8	4.5	5.3	5.0
Consumption	2005	4.0	9.2	4.9	4.3	3.3	3.2	3.1	2.7	5.2	3.1
	2006	3.2	7.0	5.5	3.2	5.1	4.2	2.5	1.5	4.3	3.4
	2006 H1	3.0	7.4	5.5	3.6	5.1	4.6	2.4	1.7	4.4	3.7
	2006 H2	3.4	6.7	5.4	2.7	5.1	3.8	2.6	1.3	4.5	3.2
Investment	2005	10.9	4.7	-3.9	11.1	4.6	2.3	-1.9	1.2	7.3	2.0
	2006	2.9	7.9	0.6	4.0	7.9	3.2	13.9	0.3	3.8	4.1
	2006 H1	1.1	9.4	0.0	5.3	5.9	2.2	8.9	-4.5	3.7	1.5
	2006 H2	4.6	6.5	1.1	2.8	9.9	4.2	13.8	4.7	3.9	6.1
Exports	2005	16.4	8.6	4.2	4.3	11.2	8.5	14.2	7.3	9.5	9.1
	2006	9.2	6.3	12.1	8.6	9.9	12.6	10.4	10.1	8.9	11.3
	2006 H1	11.4	5.4	16.6	11.7	9.9	13.7	23.4	13.0	11.1	13.8
	2006 H2	7.1	7.2	8.3	5.9	10.0	11.6	0.3	7.5	7.0	9.3

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

growth in the larger Newly Industrialized Economies (NIEs) like Korea and Taiwan, China continued to run in a 4-5 percent range. Smaller economies like Papua New Guinea and a number of the Pacific islands have also seen a pick up in growth over the last 2-3 years, in part due to higher commodity prices. However political instability and various social tensions continue to undermine the outlook in a number of cases.

Exhibit 2



Slowing exports by year end (for some)

As noted, year on year growth eased over the course of the year in much of the region, with second half growth lower than in the first in 7 of the 9 main economies of the region, and with only Indonesia and Hong Kong bucking the trend. One of the main common factors in moderating growth was a downturn in export growth in the second half of the year in the NIEs and in middle income South East Asia, especially in the fourth quarter. As Table 2 indicates, while real export growth in these economies averaged a solid 9-10 percent for 2006 as a whole, it fell from 11-15 percent year on year in the first half to around 7-9 percent in the second. On a seasonally adjusted basis, real exports actually contracted between the third and fourth quarters in several economies. Exhibit 2 displays the same slowing trend affecting South East Asia and NIE exports in dollar terms, while also showing that export growth in China was moving in precisely the opposite direction in the second half, accelerating strongly, and reaching a dizzying 42 percent year on year pace in the first two months of 2007.

There are several factors that may help explain these recent trends and also provide a window into the outlook for 2007. First, the long anticipated slowdown in US demand and imports does seem to be underway. Overall

US import growth slowed to 5.8 percent for 2006 as a whole and was negative 2.2 percent (quarter on quarter seasonally adjusted annual rate) in the fourth quarter of the year. US GDP growth is forecast to fall to just over 2 percent in 2007 and US import sluggishness may persist even in the consensus soft-landing scenario.

Second, there have been signs of some slowing in the global high tech cycle, although the picture remains mixed. Available monthly data indicated that East Asian high tech export growth among the NIEs and the South East Asian economies slowed sharply from a hefty seasonally adjusted quarter on quarter pace of 24 percent in the third quarter to almost zero in the fourth. While world semiconductor sales are continuing to grow at a healthy 9-10 percent rate in dollar terms, a drawdown of excess inventories that had built up in the global chip supply chain is a likely contributor to the recent slowing in East Asian tech exports. To that extent it should be a temporary event. How underlying global high tech demand fares with a slowing US and world economy remains to be seen.

Third, the contrast between accelerating export growth in China and decelerating export growth in the rest of the region suggests that competition for international market share among East Asian exporters may also be intensifying. For example, China's exports to the sluggish US market were still growing at 25-30 percent in year on year dollar terms in the latter part of 2006 and early 2007, a time when Korea, Taiwan (China) and Malaysia's exports to this market had slowed to around 5 percent.

Fourth, China's own import growth has been slowing over the course of 2006, which partly reflects some slowing in the pace of investment spending, but also as China deepens its domestic supply chain for export goods. In recent years China has been by far the most dynamic and fast growing market for exporters in the rest of East Asia. Producers in the rest of East Asia have rapidly expanded exports of parts, components and capital equipment to China, in particular for use in China's export industries. Thus these economies' loss of direct market share in third markets has been offset by their growing role as suppliers to China's own export sector. During 2006, though, growth in China's imports from the rest of East Asia has slowed in line with its overall import growth, falling from 25-30 percent at the start of the year to 10-15 percent at its end.

Domestic demand trends continue to diverge

Domestic demand trends around the region continue to diverge and are harder to classify as neatly as exports. Consumption and investment continue to grow at strong rates in China, Vietnam and some of the other small, low-income transition economies. In China urban fixed asset investment was growing at 19 percent in the fourth quarter, even after policy tightening measures had brought growth down from 31 percent in the first half of 2006.

The picture was much more mixed among the four middle income South East Asian economies. Taken in

aggregate, consumer spending in these economies slowed from 5.2 percent in 2005 to 4.3 percent in 2006, while investment slowed from 7.3 percent to 3.8 percent (Table 2). Consumption and investment in several of these economies was adversely affected by the impact of higher oil prices since 2004, the reduction of fuel subsidies in Indonesia and Thailand, and the general tightening of monetary policy in these economies through 2005 and into the first half of 2006. But there is a good deal of diversity at country level. In Thailand domestic demand was adversely affected by political uncertainty in addition to the factors mentioned above, leading to a loss of momentum over the course of the year, with both consumer and investment spending slowing from the first half of the year to the second. Indonesia saw precisely the opposite pattern, though. Domestic demand was weak in the first half of the year as consumers and businesses adjusted to the impact of the higher interest rates and the removal of fuel subsidies in 2005, but was then accelerating in the second half as lower inflation allowed the central bank to begin reducing interest rates. Domestic demand growth was also buoyant in Malaysia, with both consumption and investment growing at 7-8 percent. Consumers in the Philippines also increased real expenditures by 5-6 percent, supported in part by a 20 percent rise in remittances from abroad.

Table 3. Inflation (% change year ago)

	2004 Year	2005 Year	2006 Year	2006 Q3	2006 Q4	Latest Month
"Headline" Consumer Price Inflation						
China	3.9	1.8	1.5	1.7	1.9	2.7
Indonesia	6.1	10.5	13.1	14.9	6.1	6.3
Korea	3.6	2.8	2.2	2.5	2.1	2.2
Malaysia	1.5	3.1	3.6	3.6	3.0	3.1
Philippines	6	7.6	6.3	6.1	4.8	2.6
Thailand	2.8	4.5	4.6	3.6	3.3	2.3
"Core" Inflation						
China	0.4	0.9		1.0	0.8	0.9
Indonesia			8.7	9.6	6.3	6.0
Korea	2.9	2.4	1.8	2.1	2.1	2.3
Philippines	4.9	7	5.6	5.2	4.8	3.0
Thailand	0.4	1.6	2.3	2	1.7	1.4

Outlook for 2007

Growth in Emerging East Asia is expected to slow by close to one percentage point in 2007, from 8.1 percent in 2006 to 7.3 percent in 2007. With China comprising over half of Emerging East Asian GDP, much of the decline in regional growth is accounted for by the projected moderation in China's GDP growth from 10.7 percent in 2006 to 9.6 percent in 2007, the result principally of some easing in exports (which, however, would still continue to grow at close to 20 percent in real terms). Growth among the NIEs is also expected to ease by close to a percentage point. In middle income South East Asia growth is

expected to increase slightly to 5.5 percent in 2007, however, the result in part of the present buoyant domestic demand led recovery in Indonesia.

Whether these projections turn out to be over-optimistic or conservative will depend to a significant degree on the outcome for the world economy and on the performance of East Asian exports. As noted, exports had slowed significantly by late 2006 in most of the economies other than China. However the broad macro trends for the world economy in 2007 still look reasonably sound. While down from an exceptional pace close to 10 percent in 2006, overall world trade volume growth is still forecast at a solid 7.7 percent in 2007. And although US growth had slowed to only around 2 percent in the second half of 2006, growth in Japan and the EU surprised to the upside in the fourth quarter – and these two economies together take close to 30 percent of East Asian exports, more than the 20 percent currently going to the US. Intra-East Asian trade takes close to another one third of regional exports. The central engine in intra-East Asian trade is China's imports from the rest of the region, which are primarily driven by China's exports to the world outside East Asia, as well as, to a lesser extent, China's domestic demand. We currently see China's exports growing by around 19 percent in real terms in 2007, which while it may generate competitive pressures for other East Asian economies in third markets, will also continue to provide a robustly growing Chinese market for components and other inputs from these other economies. As noted above, there has been a worrying slowdown in the pace China's imports from East Asia in 2006, possibly related to competitive substitution from imports to local production. This is one of the risks in the forecast that will need to be monitored in coming months.

The other main area of uncertainty is the extent to which domestic demand in the East Asian economies outside China will be able to pick up slack from slowing exports. During the 2001 global slowdown and high tech recession, domestic demand in these other economies proved highly sensitive to exports, so that overall GDP growth fell to only 1-2 percent. However there are a number of factors that may provide greater resiliency now. Capacity utilization is at much higher levels now than it was in 2001 and profitability and balance sheets in the region's corporations are also much stronger, providing a more favorable footing for investment. A particularly uncertain factor impacting domestic demand is the outlook for oil prices. Our current central projection is for oil prices to average \$56.5 in 2007, down from \$64.3 in 2006, which would provide a nice income boost for consumers and businesses in the non-oil sectors of the region. But the surge in oil prices to well over \$60 in mid March due to political tensions in the Gulf is a reminder of just how volatile this aspect of the outlook is.

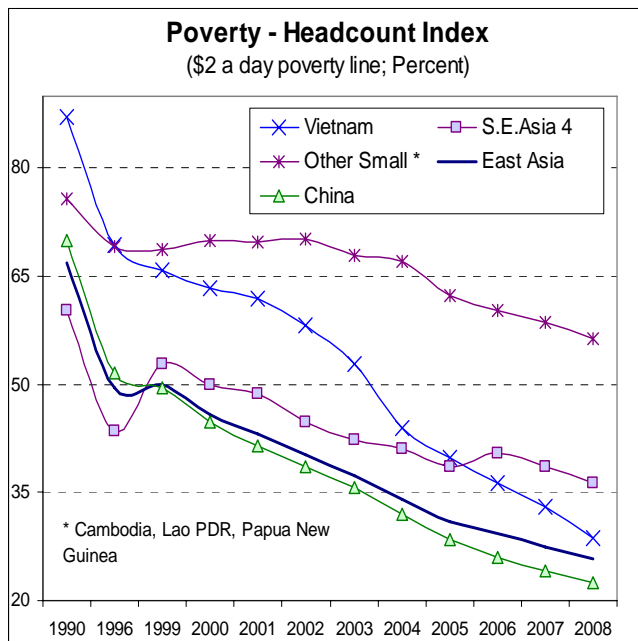
On the policy side, East Asian central banks have generally tightened monetary policies from mid 2004 to the early part of 2006 to curb potential acceleration of inflation. Inflation rates have indeed been stabilizing and turning

lower over the course of this year (Table 3), allowing central banks to keep policy rates stable, and in the case of Indonesia and Thailand, to begin easing. In the event of an unexpectedly severe export slowdown, central banks should have room to begin or continue easing monetary policy in 2007, to help bolster domestic demand. The move towards greater exchange rate flexibility in the region in the years since the financial crisis should also give central banks more freedom to use monetary policy in support of domestic policy targets rather than to maintain a given fixed exchange rate target. Fiscal balances have improved and government debt has generally declined over the course of the decade in most of the larger East Asian economies, thanks to fiscal consolidation efforts, relatively low interest rates and sustained economic growth since 2001. Except for the Philippines, central government debt levels are now generally less than 50 percent of GDP, leaving room for greater public spending, should circumstances require

Poverty reduction and human development

Aggregate economic growth of 9.5 percent in Developing East Asia – the most rapid since before the financial crisis a decade ago – contributed to a further significant reduction in poverty in 2006. Our current estimates suggest that the number of East Asian poor at the \$2 a day level fell to some 552 million (or 29.4 percent of the population) in 2006, a drop of some 24.5 million (or 1 ½ percentage points) from 2005. (Exhibit 3).

Exhibit 3



China, which contains the largest absolute number of poor, some 62 percent at the \$2 a day level, remains at the center of the region's poverty reduction performance.

Economic growth having reached close to 11 percent, poverty at the \$2 a day level is estimated to have fallen to a little over 340 million people or 26 percent of the population in 2006. Poverty reduction is also occurring at rapid rates in Vietnam, where poverty at the \$2 a day level is estimated to have fallen to around 36 percent in 2006, down from over 62 percent only five years ago. Poverty rates in Vietnam are estimated to have now fallen below those in Indonesia and Philippines. The November 2006 East Asia Update, discussed Vietnam's exceptional poverty reduction performance in more detail, pointing to the contribution of rapid productivity gains in agriculture, diversification to new crops and non-agricultural activities, income gains from higher international prices for key exported crops, more resources for targeted poverty reduction programs and a more pro-poor focus in public investment and other fiscal expenditure programs. Poverty reduction and economic growth have also accelerated in low income economies like Cambodia and Lao PDR in recent years, although poverty levels still remain high – over 50 percent of the population at the \$2 a day level.

The pace of poverty reduction in the region in the year was however a little below that in other recent years, in part because of an up tick in poverty in Indonesia. Much of the increase resulted from significant increases in domestic rice prices in both 2005 and 2006, in part due to climatic conditions as well as to a ban on rice imports introduced in January 2004, which has contributed to an environment of low domestic stocks of rice. In response the government's decision to import additional rice is helping to stabilize prices. Growth in Indonesia also picked up in the latter part of 2006 and is expected to reach 6.3 percent in 2007, up from 5.5 percent in 2006. Our current forecast suggests that higher growth in 2007 should help offset the adverse impact of higher rice prices, allowing some reduction in poverty rates for the year. But this projection is subject to much uncertainty, depending to a large degree on the future course of rice prices.

Cambodia

In Cambodia, a variety of indicators suggest continued progress on poverty reduction and human development, but also a significant increase in inequality over recent years. The proportion of the population under the national poverty line fell from an estimated 47 percent in 1993/4 to 35 percent in 2004. Trends in housing and asset indicators also confirm rising living standards. Education participation rates have increased considerably (although they suffered a small reversal in 2006), with rates rising faster amongst girls than boys. Information from the 2005 Demographic and Health Survey suggests significant progress in expanding health service coverage and in improving health outcomes, notably a 30 percent decline in infant and under-five mortality rates since 2000, as well as a significant fall in HIV prevalence. The maternal mortality

rate, however, has remained effectively unchanged at 472 deaths per 100,000 live births.

Rising living standards and falling poverty rates have been made possible by strong rates of economic growth, which averaged 8.4 percent between 1994 and 2006. However, the benefits of growth have been spread rather unevenly. Average per capita consumption increased by 45 percent in the top quintile but only 8 percent in the bottom quintile between 1993/4 and 2004. The urban-rural divide also remains great, with 91 percent of the poor living in the countryside. Inequality is also rising *within* the rural population as more accessible villages get connected to urban-based growth and pull ahead of more remote villages, and as households with better endowments of assets and skills (and better access to capital) diversify into off-farm production and trading activities.

Achieving high and more widely distributed growth in agriculture and the off-farm rural economy requires investment in rural roads to better connect the poor with markets and reduce production risk, efforts to tackle complex land management challenges and improvements in the quality and coverage of basic services. Meeting these challenges in turn requires governance reforms on a number of fronts, including civil service reform, improved accountability and better delivery of justice.

China

The latest official estimate of rural poverty in China puts the number of rural poor—those with per-capita annual incomes less than the official poverty line of 693 yuan—at 21.5 million at the end of 2006, 2.2 million less than at the end of 2005. Because poverty in China is almost exclusively rural, these estimates suggest that less than 2 percent of China's population is currently poor, by official count. The official poverty line is however a particularly stringent one. First established in the mid-1980s, it is meant primarily to capture the minimum income needed to meet basic subsistence needs such as food and clothing. Using the World Bank's international poverty standard of a dollar-a-day per-capita consumption, we estimate that at the end of 2006 China still had about 105 million people—roughly 8 percent of the population—consuming less than a dollar a day. That is the second largest number of poor in the world after India and is one reason why poverty reduction remains an important priority for China.

Another reason is that vulnerability to poverty remains widespread. World Bank estimates indicate that nearly a third of China's rural population was consumption poor (by the dollar-a-day standard) at least once between 2001 and 2004. This vulnerability to poverty reflects the exposure of rural households to a variety of shocks—high profile aggregate shocks such as the SARS epidemic, as well as a myriad of more localized and idiosyncratic shocks, ranging from the ill health of the primary income-earner and job loss, to crop-yield variability, adverse commodity price movements and area-specific natural hazards. Health-related shocks and natural disasters such as floods, droughts,

landslides and earthquakes appear to be the most common causes of households falling into poverty. The National Bureau of Statistics reported that in the 592 poor counties in 2004, over forty percent of the households who fell into poverty suffered a severe loss of income associated with natural disasters while over a quarter of the households experienced a major health shock.

The government is responding by scaling up rural social protection programs. Apart from a longstanding disaster reduction and disaster relief effort, China has not had a national (centrally-funded) rural safety net. That, however, is changing. In his report to the National People's Congress in mid-March, Premier Wen Jiabao announced several new national social protection initiatives. Perhaps the most important is decision to set up a nationwide rural safety net—a di bao or minimum subsistence allowance scheme—financed at least in part by the central budget. A similar scheme has been in place in urban China since the late 1990s and in 2005 provided income support to over 22 million urban residents. In rural areas, however, only some provinces and counties had such a scheme, with generally very low and widely varying benefit levels. Under the new initiative, the aim will be to establish a uniform di bao system across all of China's rural areas, and to scale up coverage from the 8 million who were covered in 2005 to nearly 30 million within the next year. Importantly, the central government appears committed to providing the necessary financial assistance to poorer jurisdictions.

A related initiative is the decision to scale up the National Cooperative Medical Scheme in rural areas. The NCMS is a new voluntary rural health insurance scheme that was introduced on a pilot basis in 2003, operated by counties and subsidized by the local and central governments. Premiums paid by households are low, but reimbursement rates also appear to be low. Premier Wen indicated that in the coming year the NCMS pilot will be expanded to cover 80 percent of counties and that the allocation from the central government budget to subsidize the scheme will nearly double, from 5.8 billion yuan to 10.1 billion yuan.

Indonesia

As noted, recent poverty developments in Indonesia have been significantly affected by large recent increases in the price of rice. Poverty in Indonesia is quite sensitive to the price of rice, since it makes up about 25 percent of the consumption basket of the poor, and since three-fourths of the poor are net consumers of rice. Rice prices increased by over 40 percent over the course of 2005 and by over one third over the course of 2006, with further increases in January and February 2007. In part, this was because a moderate El Nino delayed the planting season by over a month, but the situation was exacerbated by the rice import ban introduced in January 2004, which contributed to an environment of low domestic stocks. The government's decision to import additional rice and BULOG's implementation of Operasi Pasar is helping to stabilize prices but prices are only likely to move towards

the level of a year ago when the delayed main harvest arrives in March/April. In addition, the unconditional cash transfer (UCT) put in place to compensate the poor for the fuel price increases in late-2005 ended in late-2006. On the other hand economic growth in Indonesia picked up to the 6 percent range and is projected to exceed 6 percent in 2007. Our current estimate is that higher growth will tend to offset other factors and start bringing poverty down in 2007. However this estimate is subject to much uncertainty.

The Government of Indonesia recently announced several major new poverty reduction initiatives. The government plans to scale up spending on poverty reduction through a National Community Empowerment Program (*PNPM*). In 2007, *PNPM* will be expanded to some 2,800 rural and urban sub-districts, with full national coverage of 5,360 sub-districts by 2009. The program builds upon Kecamatan Development Program (*KDP*) and Urban Poverty Program (*UPP*), which focus on improving local governance and service delivery to communities at the sub-district and village levels through participatory planning and community block grants. Funds are generally used for productive assets, such as rural infrastructure, education, and health. Previous evaluations of these community-driven development (*CDD*) programs reveal positive results. They have proven successful in the targeting of poor Kecamatan and have had a demonstrable impact on poverty. Investments produce high economic internal rates of return ranging from 39 to 68 percent, and the costs for infrastructure projects were estimated to be 20 to 25 percent less than other government-sponsored public works of the same quality. The programs also provide much needed employment to the poor, especially during the agricultural off-season, or when there is drought, flood, and other natural or economic catastrophes.

Indonesia's unconditional cash transfer (*UCT*) program, which was introduced in 2005 to mitigate the impact of the removal of fuel subsidies, is to be replaced by a conditional cash transfer (*CCT*) program. *CCT* approaches will be piloted in seven provinces in 2007 and are designed to address Indonesia's relatively high maternal and child mortality rates, and low progression to junior secondary school among children of poor families. Based on the experience of about 40 other countries with household *CCT* programs, cash transfers will be given to mothers of 500,000 very poor and poor households on the condition that the family fulfills the relevant health and education conditions. Impact evaluations of *CCTs* in other countries show impressive results in terms of reduced poverty, increased school enrolment and attendance, usage of preventive health services, and improved nutritional status. The *CCT* will be rigorously evaluated two years after implementation

Lao PDR

A recent Poverty Assessment for Lao PDR finds that poverty has fallen sharply since the early 1990s, from 46 percent in 1992/93 to 39 percent in 1997/98 and 33

percent in 2002/03 relative to a national poverty line. Thanks to robust growth and a reduction in income inequality in the more recent half decade, the share of poverty was reduced by almost a third, lifting one eighth of the population out of poverty. Projections suggest that the poverty headcount fell further to 31 percent in 2005.

There are important changes in the character of poverty reduction between the two five year periods. The focus of poverty reduction shifted from areas with low poverty in the first half of the decade to areas with high poverty in the second half of the decade, from valleys to hilltops, and from the just poor to the very poor. As a result, the Gini coefficient of inequality first increased from 30.5 to 34.9, and then decreased from 34.9 to 32.6 in the more recent period. However, poverty still retains strong geographic features: it is higher in rural areas, in priority districts and in ethnic minority areas.

There have also been significant improvements in non-monetary indicators of human development, although regional disparities persist. The proportion of persons 6 years or older with at least primary education increased from one in four in 1995 to around two in four by 2002/03. Birth deliveries at health care centers doubled from 12 percent in 1992/93 to 25 percent in 2002/03. The proportion was however much lower among ethnic minority women than among Lao-Tai women.

Mongolia

New survey data for 2006 show that poverty in Mongolia has continued to fall in recent years. The national poverty headcount fell from 36 percent in 2002 (the date of the previous comparable household income and expenditure survey) to 32.6 percent in the first 9 months of 2006. Urban poverty incidence fell from 30.3 percent to 27.7 percent while rural poverty incidence dropped from 43.4 percent to 38 percent during this period. Poverty incidence declined most markedly in the Western region and in Ulaanbaatar, falling from 51 percent to 40 percent, while it remained unchanged in the Highland, Central and Eastern regions. The poverty decline in recent years continues a longer term trend – the national poverty headcount is estimated to have fallen by 10 percentage points between 1998 and 2002.

Philippines

According to the most recent available Family Income and Expenditure Survey (*FIES*), poverty incidence in the Philippines (using a national poverty line) was 30 percent in 2003 compared to 33 percent in 2000. With stronger economic growth in the interim period (an average of 5.5 percent versus a historical trend of 3.5 percent), poverty incidence should have declined further and faster, but final official estimates using the 2006 *FIES* will not be available until 2008 at the earliest.

Increasing social spending could help accelerate the decline in poverty, and this is now more feasible, given

recent improvements in tax collection. In the recently concluded 2007 Philippine Development Forum (a meeting of government and development partners), the Philippine government declared its intention to implement a national social protection strategy, including a pilot conditional cash transfer program to address human capital shortfalls and protect the poor by supplementing their income. Its efficiency would, however, depend on the reliability of the targeting system in use. Currently, there is a multitude of national and local targeting systems and there is scope for a more comprehensive, national system of targeting. Further developing disaggregated poverty data down to the municipal level from the current regional level will also help. There is also a consensus among stakeholders that poverty statistics ought to be released in a more timely fashion if they are to be more useful.

The international and regional environment

After reaching 4 percent in 2006 (5.3 percent in PPP terms), global growth is at something of a turning point, projected to fall to 3.4 percent in 2007, led by a more than one percentage point fall in US growth (Table 4). Growth in Japan and Europe has tended to surprise to the upside over the past year, however, and is expected to continue at rates similar to 2006. The rotation in the balance of growth from the US to the rest of the world should help stabilize and begin a gradual adjustment in global macroeconomic imbalances, that is, in the US current account deficit, which showed a significant fall in the fourth quarter of 2006. For East Asia this means a weakening in its important US export market.

Another key aspect of the turn in the global cycle is the continued gradual tightening of monetary policies in the developed world, bringing to an end an extended period of negative real interest rates. Although tightening is most advanced in the US, where policy rates have been stable since early 2006, after increasing 425 basis points over the previous two years, it is still continuing in Europe and Japan. The Bank of Japan raised its policy rate by 25 basis points to 0.5 percent on February 21, followed by a 25 basis points increase in the ECB policy rate to 3.75 percent in early March. Tighter monetary policies appear to be succeeding in curbing the incipient upturn in inflation in developed economies, and also to be providing some check to the danger of excessive euphoria or bubbles in financial and other asset markets. Apart from the bursting of the bubble in the US housing market, higher rates also contributed to the correction in global stock markets in the spring of 2006 and to the declines in stock markets at the end of February and in March 2007, which may reflect a partial normalization in the pricing of risk.

Higher short term interest rates also have a bearing on two other aspects of the global economy. Capital flows to developing countries rose once again in 2006, but their rate of growth slowed as interest rates in developed

economies became more competitive with those in developing economies. These flows may remain somewhat flat in the coming year.² This development may actually ease macroeconomic management in many East Asian economies, which have been grappling with the exchange rate and monetary consequences of not only large current account surpluses, but also of significant capital inflows. Commodity prices also show signs of having reached a cyclical peak, with substantial declines in oil and some metals prices after the middle of 2006. Although oil prices are forecast to remain relatively stable in 2007-08, the forecast \$50-60 range would be less than the \$64 average in 2006, which would be a net boost for a region which is overall an oil importing one. The rapid surge in oil prices in mid to late March due to political tension in the Gulf nevertheless underlines the high volatility and uncertainty surrounding oil prices in the present climate.

Table 4. International Economic Environment

	2005	2006	2007	2008
% Change from previous year, except interest rates				
GDP Growth				
World	3.5	4.0	3.4	3.6
World (PPP Weights)	4.7	5.3	4.7	4.7
OECD	2.5	3.0	2.4	2.7
United States	3.2	3.4	2.1	3.0
Euro Area	1.3	2.7	2.5	2.2
Japan	2.6	2.2	2.3	2.4
Developing Econ.	6.6	7.2	6.5	6.1
World Trade (Volume)	7.6	10.2	7.7	8.1
CPI Inflation - G7 ^{a/}	2.5	2.6	1.6	1.7
Oil Price - \$/bbl	53.4	64.3	56.5	54.4
- % Change	41.5	20.4	-12.2	-3.6
Non-oil Commodity				
Prices	13.4	24.7	1.5	-8.2
LIBOR - US\$. 6 Mo.	3.6	5.2	5.4	4.8
-Euro 6 Mo.	2.2	3.1	3.8	4.3
Source: World Bank DEC Prospects Group March 2007. a/ In local currency aggregated using 2000 weight. ...				

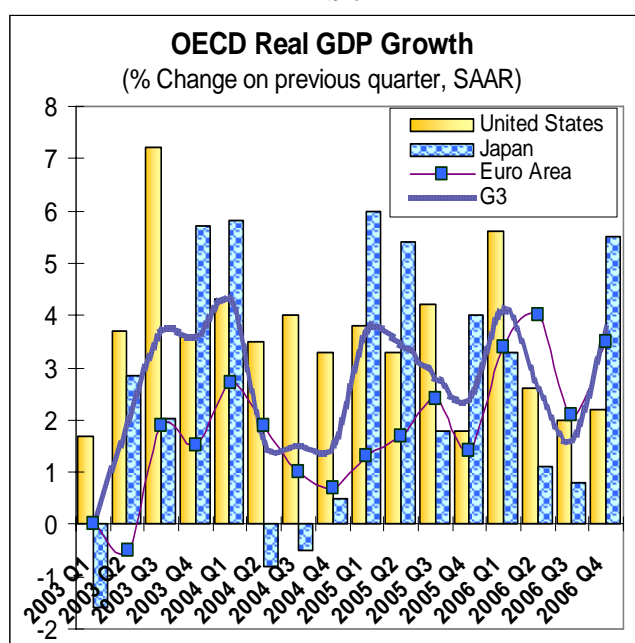
Developed country trends

The *United States* economy grew 3.4 percent in 2006, about the same as in 2005, although quarter on quarter (q-o-q) growth slowed sharply after the first quarter of the year. Output growth slowed from a strong 5.6 percent q-o-q seasonally adjusted annual rate in the first quarter to only 2 percent in the third quarter and 2.2 percent in the fourth. Reflecting the recession in the housing market, residential investment fell 12.6 percent over the four quarters of the year. While non-residential investment had grown at robust

² The Institute of International Finance forecasts private capital flows to emerging economies declining from \$502 billion in 2006 to \$469 billion in 2007, with nearly all of the fall in bank lending and portfolio debt flows. "Capital Flows to Emerging Markets", January 18, 2007.

rates during the first three quarters of the year, it too fell at a 2.4 percent annualized rate in the fourth, suggesting that reduced construction sector activity was beginning to have knock-on effects elsewhere in the economy. In the latter part of the year, growth had become increasingly dependent on private consumption growth, which was underpinned by healthy growth in employment and wages. In the last quarter overall growth was also boosted by a 1.5 percentage point contribution from net trade, as export volumes rose at a 10.5 percent annual rate, buoyed by strong growth in foreign markets and the decline in the dollar since 2002, while imports fell 2.2 percent, reflecting weaker domestic investment spending and de-stocking. For 2006 as a whole exports growth accelerated to 8.9 percent while import growth slowed to 5.8 percent in 2006. The turnaround in real trade flows, combined with lower oil prices, helped the US current account deficit drop from 6.9 percent of GDP in the third quarter to 5.8 percent in the fourth.

Exhibit 4



Monthly data for the first quarter of 2007 was mixed but showed continued weakness in many sectors. Housing starts tumbled 14.3 percent in January (month on month annual rate) to stand 28 percent below year earlier levels. New factory orders for durable goods fell 7.8 percent in January. Retail sales were stagnant for a second month in February 2007. This was partly due to unexpectedly cold weather, but was still a worrying development in an economy where demand growth has lately become increasingly dependent on the consumer. On a more positive note the unemployment rate fell to a near 5 year low of 4.5 percent in February. Consumer confidence in February also increased to its strongest reading in five years, on the back of good wage gains and ample job opportunities.

Overall, the consensus view continues to be for a 'soft landing' in the economy. The sharp decline in

housing-sector activity, which has already cut into investment in other sectors, is expected to gradually shallow out over the course of the year. As a result, even though knock-on effects in the construction and manufacturing sectors may continue to be felt, the overall negative impact of the adjustment in the sector on GDP should weaken. Overall, GDP in the United States is projected to increase 2.1 percent in 2007, picking up to 3 percent in 2008. Weaker domestic demand will continue to be reflected in slower import growth and a decline in the trade and current-account deficits of the United States, with the latter coming in around 4.5 percent of GDP by 2009, down from 6.5 percent in 2006.

Growth in *Japan* was unexpectedly volatile over the course of 2006 (Exhibit 4). Solid growth rates of 3-4 percent (saar) in the last quarter of 2005 and first quarter of 2006 were followed by an unexpected downturn to rates of only 1.4 and 0.3 percent in the second and third quarters respectively, pulled down by lower public investment (reflecting longer term efforts at fiscal consolidation), destocking, a slowing in export growth and a weakening in consumer spending that occurred despite the best labor market conditions in more than a decade. In the fourth quarter the economy mounted an even more unexpected rebound, however, increasing 5.5 percent at annual rates, led by strong growth in business investment and consumer spending, which increased by 13.2 and 4.2 percent respectively. The robust growth in the quarter bolstered confidence that the economy could withstand monetary tightening, allowing the Bank of Japan to increase its policy interest rate by 25 basis points to 0.5 percent. Growth for 2006 as a whole came in at 2.2 percent and is expected to grow at almost the same pace, 2.3 percent, in 2007.

Growth in the *Euro Area* was also generally robust in 2006, growing at quarter on quarter rates of over 3 percent in three of the four quarters of the year. Fourth quarter GDP growth came in at 3.5 percent, led by healthy growth in exports, business investment and consumption, the latter boosted by a pick up in German consumer spending in advance of a 3 percentage point hike in the value-added-tax rate in Germany. Growth in the Euro Area in 2006 as a whole picked up to 2.7 percent from 1.3 percent in 2005. Euro Area growth is likely to moderate in the first quarter of 2007, in part as consumers in Germany adjust to the higher VAT - German retail spending fell an unexpectedly steep 5.1 percent month on month in January. The outlook for the year remains broadly positive however. Business and consumer sentiment were at unexpectedly high levels in February. Unemployment continued to fall, reaching 7.4 percent in January. Euro Area growth is projected to moderate only slightly in 2007, reaching 2.5 percent for the year.

China

Growth in China decelerated mildly in the second half of 2006, easing from almost 11 percent in the first half of the year, to 10.6 and 10.4 percent in the third and fourth

quarters respectively. Growth for the year as a whole amounted to 10.7 percent, the fourth year in succession of over 10 percent growth. The modest slowing in the second half of the year followed tightening measures that have been implemented from last April onwards, aimed at curbing excessive investment growth, which, together with exports, was one of the principal drivers of growth in the year. Recent monthly data on industrial production, exports and monetary aggregates however indicates that growth has remained strong in the first quarter of 2007. As in other countries, volatility in the stock market has increased substantially, with steep price declines in late January/early February and late February being followed by significant rebounds in equity prices.

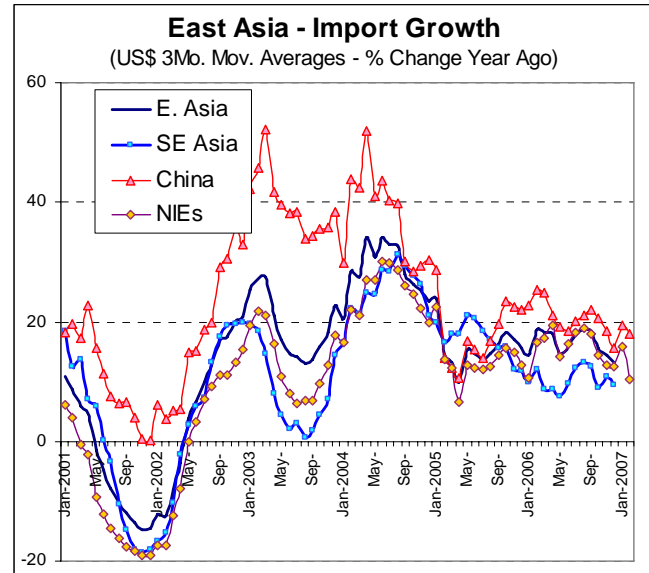
Growth in nominal urban fixed asset investment (FAI)³ did slow from about 31 percent in the first half of 2006 to 22 percent in the third quarter and 19 percent in the fourth. The slower pace of investment growth followed imposition of administrative controls to limit speculative investment in real estate, reinforcement of controls and regulations on investment projects, including a re-evaluation of all large investment projects under implementation; and loosening controls on capital outflows. For the year as a whole gross fixed investment (on the national account definition) increased 25 percent in nominal terms, a fourth year of annual increases in the 25-30 percent range. Investment is estimated to have reached over 42 percent of GDP in 2006, up from 36 percent in 2002.

The tightening measures also included a range of monetary policy measures to curb increases in liquidity, credit and monetary growth, which are linked to burgeoning balance of payments inflows and which raise concerns that accelerating monetary growth could fuel excessive investment as well as the emergence of speculative 'bubbles' in asset markets such as real estate and equities. These measures have included open market operations to mop up liquidity in the inter-bank markets through greater issuance of Central Bank bills, increases in interest rates and increases in reserve requirement ratios. Issues of Central Bank bills increased to 3.65 trillion yuan in 2005, up 860 billion yuan or 31 percent from 2004. In March 2007 the People's Bank of China raised one year lending rates and deposit rates by 27 basis points to 6.4 and 2.8 percent respectively, the third increase in a year. In February the PBC also raised the reserve requirement for depository financial institutions by 50 basis points to 10 percent, the fifth increase in a year. Despite these efforts, the year on year rate of bank lending picked up to 17-18 percent in January-February 2007 from 13-14 percent in the same period a year earlier, while M1 money growth accelerated to 20-21 percent from 12-13 percent between the same periods. While the recent interest rate increase is in large part a response to a pick up in inflation, it is also consistent with the authorities' concern that continued buoyancy in the

credit and monetary aggregates could stimulate a further resurgence of investment. Early 2007 data show that investment has remained strong, with FAI growth reaching 23 percent in January-February. Industrial production numbers were indicative of the continued strength in the real economy, accelerating to 18.5 percent in January-February 2007, up from 14-15 percent in the last quarter of 2006.

The slowdown in investment growth in the latter part of 2006 was partly offset by a further increase in the contribution of net trade to growth. Export growth has in fact been picking up over the course of the year, rising from around 22 percent in nominal US dollar terms in the last quarter of 2005 to 29 percent in the fourth quarter of 2006. Export growth further accelerated to 42 percent in January-February 2007. Export strength partly reflects new production capacity put in place by the heavy investment of recent years, as well as continued gains in productivity. Import growth, on the other hand, decelerated from a 25 percent year on year pace in the first quarter of 2006 to 15.5 percent in the last quarter of the year, before picking up to a little over 20 percent in January-February 2007. Slower import growth in recent years is partly related to the government's efforts to slow investment growth, but also to the expansion of industrial capacity and increasing technological sophistication, which is allowing producers to substitute towards local production and deepen their supply chains within the country. (Exhibit 5).

Exhibit 5

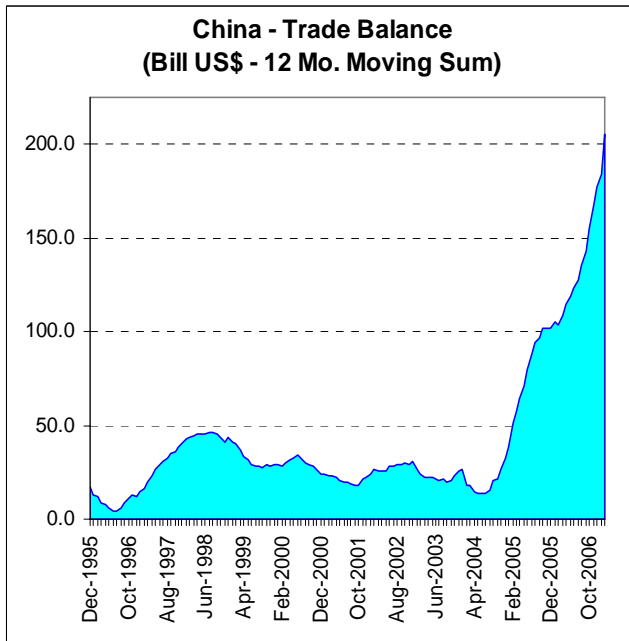


With rising export growth outpacing imports by a growing margin, the contribution of net trade to GDP growth increased to 3.3 percentage points in the second half of 2006, up from close to 2 percentage points in the first half. The trade surplus surged to \$177.5 billion in 2006 and to \$204.9 billion in the 12 months to February 2007, compared to \$102 billion in 2005 and a mere \$32 billion in 2004. (Exhibit 6). The current account surplus increased to

³ FAI is an imperfect measure of fixed investment and differs significantly from the national accounts measure. It is, however, available in a monthly data series.

an estimated \$230 billion in 2006, or a striking 8.7 percent of GDP, up from \$161 billion in 2005.

Exhibit 6



The surge in the trade and current account surpluses (discussed further in the later section on balance of payments issues) is one of the main short term macroeconomic imbalances of concern to the authorities.⁴ As noted, the authorities have aimed to cool the rapid growth in investment, so as to reduce the risk of overcapacity and resources being wasted in inefficient investment projects, which could also contribute to bad debt problems in the banking system. However there is a policy dilemma here, since lower investment growth is also likely to slow imports and aggravate the rise in the external imbalance, unless offset by stronger consumption growth and a greater switching of domestic demand growth towards imports. The large external surplus in turns tends to feed more rapid growth in domestic credit and money supply, complicating the authorities' efforts to establish an appropriately tight monetary policy.

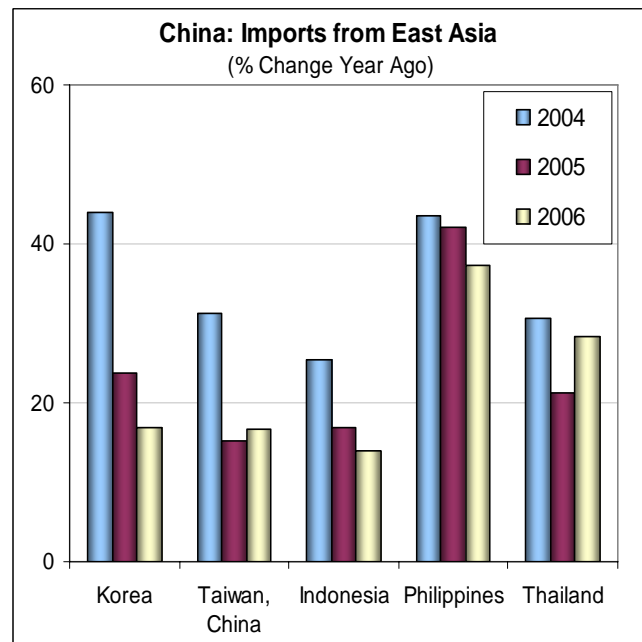
These circumstances therefore point towards a continued focus on rebalancing the pattern of economic growth, which entails orienting growth more towards domestic demand and consumption, towards more even distribution of the benefits of growth, and towards less intensive use of energy and natural resources. Such measures can include, among other, expansion of the social safety net, in particular expansion of rural health insurance and establishment of rural pensions, as well more public financing of education and health care, especially in rural

⁴ Minister of Commerce Bo Xilai noted in January that "China's excessive trade surplus is detrimental to both domestic economic development and foreign trade relations" and that reducing the trade surplus was the "top priority" of trade policy this year.

areas. The recently completed National People's Congress in March made important advances in several of these directions. Current circumstances also point to a continued focus on the role of greater exchange rate flexibility and a stronger exchange rate as a means of bringing about desirable expenditure switching and laying the basis for a more independent and flexible monetary policy.

In recent years China's rapid growth has provided an important locomotive for trade and growth in the region as a whole, although, more or less in line with overall imports, growth in imports from the rest of emerging East Asia slowed modestly in 2006, easing modestly from 20.5 percent in 2005 to 18 percent last year. (Exhibit 7). As with overall imports, there was a slowing in import growth from the rest of Emerging East Asia over the course of the year, falling from 24 percent in the first quarter to about 13 percent in the fourth. Exports to China (and Hong Kong) now make up over one fifth of the exports of other Emerging East Asian economies. If the slower pace of import growth in China persists through 2007, it could pose a concern for these other economies, which are generally highly export dependent and which are also likely to be facing a slowdown in exports to the slower growing US economy.

Exhibit 7



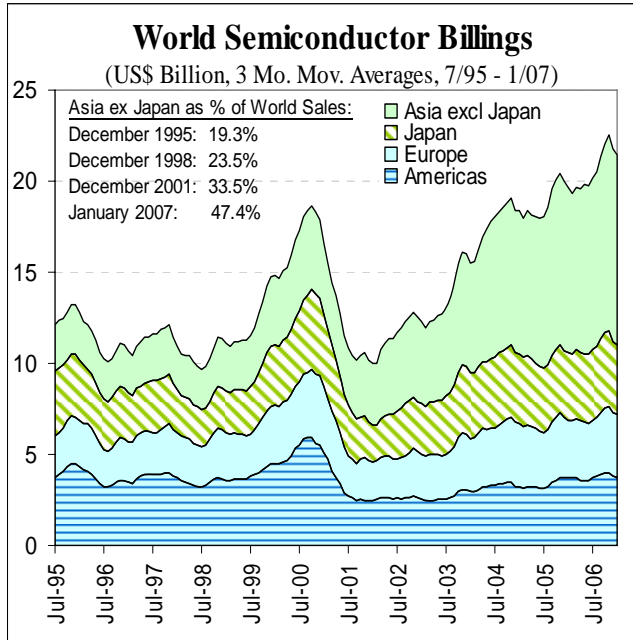
Commodity markets

High tech cycle

Recent indicators provide a mixed picture of demand trends in global high tech markets, a key export sector for most middle and high income East Asian economies. Growing inventories in some segments of the market appear to have already led to some slowdown in exports and high tech production and exports from several East Asian economies.

On the more positive side world semiconductor sales in January 2007 were up close to 10 percent from year earlier levels and were also growing at a similar rate on a seasonally adjusted month to month basis (Exhibit 8). For 2006 as a whole sales rose by 8.9 percent, up from 6.8 percent in 2005, and the Semiconductor Industry Association is looking forward to a 10 percent increase in global sales in 2007.

Exhibit 8

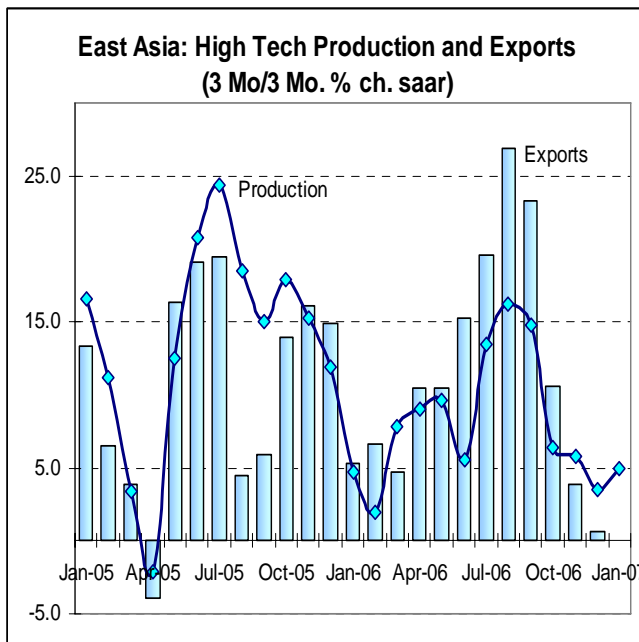


2006. Market researchers also reported increases in global semiconductor inventories in the global electronics supply chain in the second, third and fourth quarters of 2006.⁵ Producers and exporters in East Asia appear to have felt some of the impact as more of demand is met by drawing down of excess inventories. Exhibit 9 indicates that both high tech industrial production and exports in several East Asia middle and high income economies (excluding China) slowed quite sharply in the last quarter of 2006.⁶ However, so long as underlying final demand keeps growing at reasonably solid rates in line with a continuing global expansion, the inventory correction affecting East Asian exporters should be a temporary affair.

Non oil commodity markets

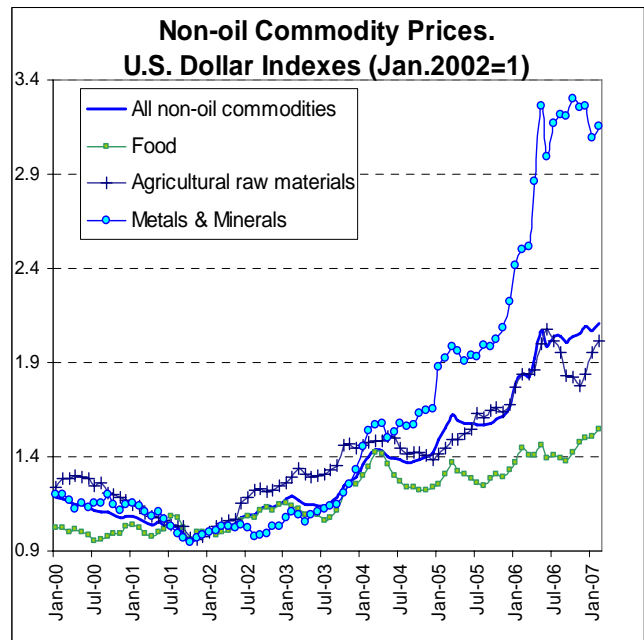
Taken as a group, non-oil commodity prices have been relatively stable over the past 6-9 months, remaining around the high levels reached after more than four years of strong price increases. The World Bank's index of non-oil commodity prices in nominal US dollar terms had increased about 85 percent between the beginning of 2002 – roughly the start of the current boom in commodity prices – and May 2006. However, between last May and February 2007 the non-oil index rose only another 2 percent, although, as will be seen, there was much divergence in the performance of individual commodities. (Exhibit 10). The more stable trend in prices recently is consistent with both moderately slowing world growth and tighter monetary policies around the world.

Exhibit 9



Of more concern, US business investment spending on high tech tailed off during 2006 (although US consumers kept spending), and tech orders from the G-3 countries also showed month to month declines in the latter months of

Exhibit 10



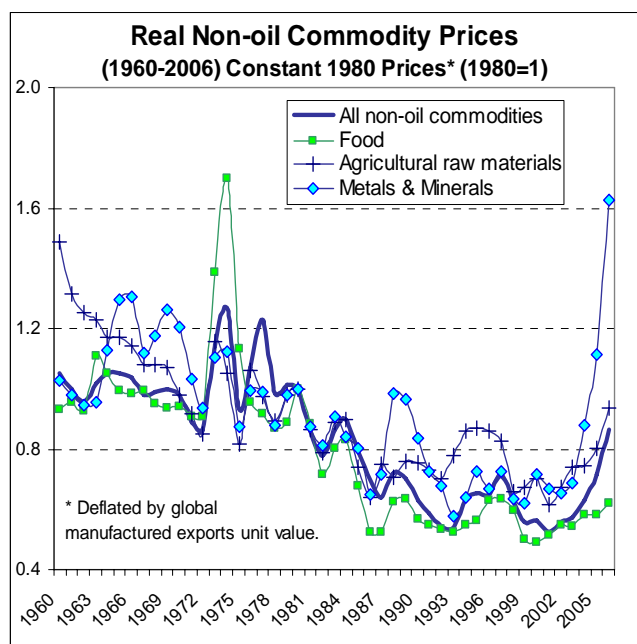
⁵ Ann Steffora Mutschler. "Chip Inventories Still on Rise, but won't derail market growth." Electronic News, 1/10/2007

⁶ Exports include Hong Kong, Korea, Malaysia, Philippines, Singapore, Taiwan (China) and Thailand. Production includes the same economies, except Hong Kong and Philippines.

Taking a longer view, the current boom in non-oil commodity prices has been both longer lasting and bigger than most cyclical commodity price upturns over the last 50 years. (Exhibit 11). In real terms (relative to world manufactured export unit values) non-oil commodity prices have reversed their declines over two decades and have now returned to their levels of the early 1980s. Metals and minerals prices in particular have reached levels in real terms that are higher than at any time since 1960 (the start of this data series).

Demand for commodities has been bolstered by the sustained period of strong global growth since 2002, including robust growth in developing economies, in particular fast growing large economies like China, with a voracious demand for industrial raw materials. Another factor supporting high commodity prices has been the low or negative level of real interest rates from 2001 through 2005. (Exhibit 12). Low interest rates could boost the demand for primary commodities or reduce their supply through several channels. On the demand side, low interest rates reduce the cost to firms of carrying larger inventories. On the supply side, low interest rates reduce the incentive for extracting primary commodities today rather than tomorrow (for example the rate at which minerals are mined or forests cut down and the proceeds put on deposit to earn interest). Frankel (2006) finds significant empirical evidence for the positive impact of low real interest rates on commodity prices and inventory levels.⁷

Exhibit 11



The tightening of monetary policies around the world over the past two years is one reason to expect that commodity prices may now be reaching their peaks in the

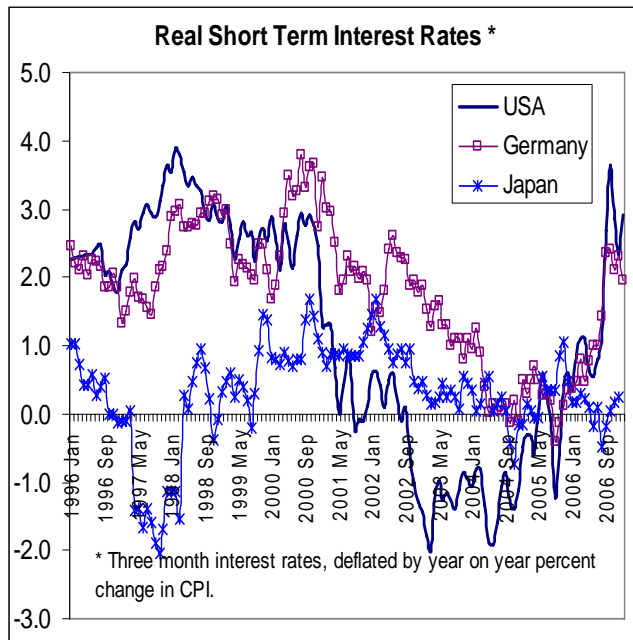
current cycle. As Exhibit 12 indicates, real short term interest rates in the U.S. and Europe have now risen to a 2-3 percent range, about the same range as in the mid-late 1990s, when real non-oil commodity prices were on average 35-40 percent lower than today. Slowing global growth in 2007 will also tend to dampen demand growth, although with China expected to continue strong growth in the 8-10 percent range, the slowing should be moderate rather than dramatic. In line with these trends the Bank's commodity projections look for non-oil prices in nominal US dollar terms to dip 1 percent in 2007 and perhaps 7.5 percent in 2008.

Among commodities of interest to East Asian economies as exporters or as industrial importers, metals and minerals prices have on average remained near the exceptionally high levels reached by early last year, dipping by only around 3 percent between May 2006 and February 2007. Copper prices, in particular, have fallen about 30 percent since May 2006, sapped by the steep downturn in the US housing construction sector and by a period of destocking in China, induced by the previous exceptionally high price levels. However other base metals such as nickel, lead and tin have seen further large gains of 45-95 percent over the last 6-9 months, boosted by continued healthy industrial demand, very low stocks and occasional supply difficulties. Looking forward, base metal prices are expected to be on a modestly declining trend in 2007-08. Apart from the broad growth and interest rate factors noted above, supplies are also likely to be increasing in response to prevailing high price levels. Mineral sector analysts note that it generally takes around four years for a significant supply response to higher prices to come through in this sector. With prices having started to pick up from their previous trough in 2002, past experience suggests new supplies will start to enter the market in 2007 and 2008. These considerations sound a note of caution for some of the smaller, low-income mineral exporting economies in East Asia such as Mongolia and Papua New Guinea, which have enjoyed huge windfall income gains from high export prices in recent years.

Agricultural exporters in South East Asia have continued to enjoy further gains across a wide range of commodities in recent months though. Rubber prices had fallen sharply in the middle part of 2006, reflecting the fall in world oil prices, and hence in the cost of synthetic rubber, but rebounded in recent months due to supply problems (drought in Thailand, floods in Indonesia). In real terms prices remain at 25 year highs. Prices for fats and oils such as coconut oil and palm oil also remain buoyant, at 10 year highs in real terms, due to continued strong world wide demand.

⁷ Jeffrey Frankel: (2006). "The Effect of Monetary Policy on Real Commodity Prices". In John Campbell. (Ed.) *Asset Prices and Monetary Policy*. Chicago. (Forthcoming).

Exhibit 12



Oil markets

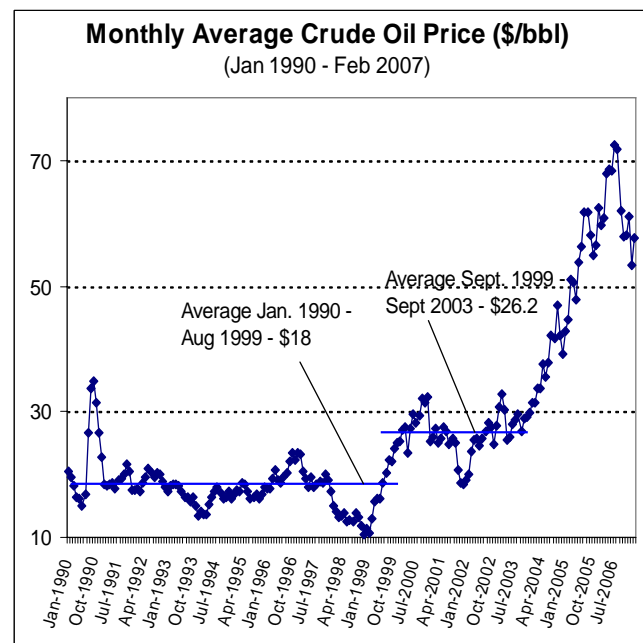
Having fallen sharply from their peak of over \$70 last August, crude oil prices in the last quarter of 2006 and the first quarter of 2007 have averaged around \$58 per barrel, falling to a little over \$50 in January 2007 but rebounding to over \$60 by early March, and then, with escalating political tension in the Gulf, towards the mid sixty dollar range by the end of the month⁸ (Exhibit 13). In nominal terms prices in the \$50-\$60 range remain well above anything seen before the beginning of the current run-up in oil prices in early 2003. In real terms (relative to US consumer price inflation), crude oil prices over the last six months were comparable to those in the mid 1980s. (Exhibit 14). Overall, developments over the last six months continue to provide evidence for the consensus view that - barring major political shocks that lead to large supply disruptions or an unexpectedly severe recession in the world economy - oil prices have seen their peak in the current cycle, but are unlikely to see dramatic declines in the near term, trading instead in a more stable range, with only modest declines over the next 2-3 years.

Among the factors contributing to the decline in oil prices from their August 2006 peaks, growth in world oil demand slowed to its lowest rate in several years in 2006 (an estimated increase of 0.8 million barrels per day according to IEA statistics), as firms and other consumers around the world began responding to the prevailing high prices by improving efficiency of oil energy use and by switching to other energy sources. Unusually warm weather in major markets also contributed to the slowing in demand growth by reducing demand for heating. (Exhibit 15). Oil

⁸ This reference price is an average of Brent, Dubai and West Texas Intermediate (WTI) crudes.

demand in OECD, in particular, actually contracted in 2006, falling to an estimated 49.2 million barrels per day from 49.6 mbd in 2005. Demand contracted in all major OECD regions, including North America, Europe and the Pacific. Adjustment to higher prices also curbed demand growth in developing Asia (other than China). Demand growth was more robust in China, however, driven by strong overall output and income growth and reflected, in particular, in surging demand for transport fuels. Oil consumption increased by a healthy 6.4 percent to reach an estimated 7.12 mbd in 2006. Strikingly, the increase in demand in China was over 50 percent of the overall increase in world demand in 2006. Over 2002-06, China contributed just over one third of world oil demand growth. Developing Asia as a whole contributed about half of world demand growth over this period.

Exhibit 13



On the supply side the high prices of recent years are also finally inducing significant increases in production capacity and output. Non-OPEC supply (excluding Angola, which recently joined OPEC) increased by an estimated 0.5 mbd in 2006, with gains in Russia and other FSU economies, North America and Africa. Given the significant fall in prices in the second half of 2006, OPEC has moved to stabilize prices by restricting output, with OPEC production (excluding Angola, which is not subject to production restrictions this year) falling by more than 1.5 mb/d in the last six months. Reflecting the somewhat easier conditions in the market, the level of spare production capacity in OPEC has risen to around 3.9 mb/d. Granted, about 1.5 mb/d of that is in Iraq, Venezuela and some other economies where there are significant impediments to converting capacity into actual production. Nevertheless, the effective spare capacity in OPEC of about 2.5 mb/d, while still low by historical standards, is at its highest level since December 2002.

Exhibit 14

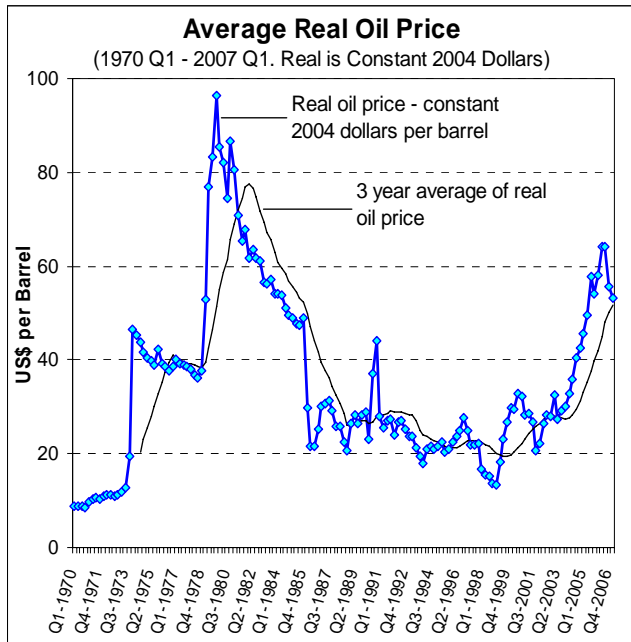
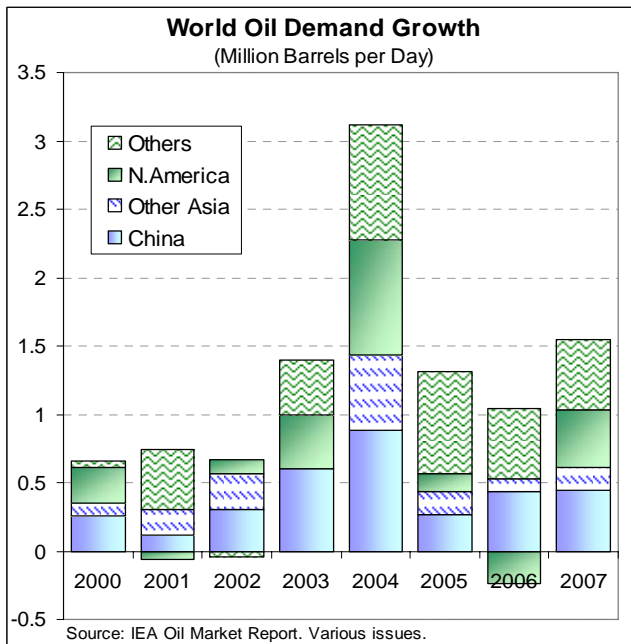


Exhibit 15



Looking forward, oil prices are currently projected to ease from \$64 in 2006 to \$56 in 2007 and \$54 in 2008, contributing to modest terms of trade based income gains in East Asia, a net oil importing region overall. On the supply side, the relatively still high level of oil prices should continue to contribute to new investments in capacity and further gains in non-OPEC production, which is projected by the IEA to increase by 1 mb/d in 2007. On the other hand, continued world economic growth at relatively robust rates over 3 percent is expected to induce stronger demand gains than in 2005 or 2006. Thus the margin of spare production capacity is expected to widen only gradually,

leaving prices vulnerable to unexpected supply disruptions and fears of disruptions.

Trade Policy Developments

Doha Round – Another Try

Following a six month suspension, WTO Members agreed to formally resume negotiations on the Doha Round of multilateral trade negotiations in February 2007. The key to reaching a deal remains greater cuts by the US on trade-distorting agricultural support, greater agricultural market access by the EU and further market opening in manufactures and services by developing countries such as Brazil and India. EU and US trade negotiators have been meeting intensively, and there have also been a number of high level meetings with other influential WTO members such as India and Brazil. Many of the proposals reportedly under discussion, when combined with progress already made (such as offers to eliminate agricultural export subsidies by 2013 and to provide duty- and quota-free market access for at least 97 percent of exports from least developed countries), are sufficiently substantive to make a deal worthwhile. Significant gains for developing countries would also flow from services liberalization and trade facilitation, and from aid for trade accompanying the Doha Round. According to a study by the WTO Secretariat, a successful Doha round would compare favorably with the Uruguay Round. Studies of the impact of the Round have generally suggested that East Asian economies would be among the more significant beneficiaries from a new agreement.

The alternative to concluding a Doha deal at this stage is likely to be - at best - several years of drift, with an accompanying cost in terms of a potential weakening of the rules-based multilateral system, a possible surge in protectionist sentiment in developed and developing countries, increased stress on the WTO’s dispute settlement system and increased scope for trade diversion from proliferation of preferential trade agreements (PTAs). According to WTO Director-General Pascal Lamy, it would “not be a major political shock that would precipitate any particular market crisis ... but rather a slowly developing disease that would progressively sap the strength of the multilateral trading system built up over the last 50 years, damaging its economic lungs, its political heart and its systemic bone structure.” As one of the principal beneficiaries of the multilateral trading system over the last 50 years, and as one of regions most deeply integrated into world trade – the region now generates over 20 percent of world trade, with exports averaging over 50 percent of GDP - East Asia would also be among the significant losers from a weakening of the rules-based system.

Vietnam Joins the WTO

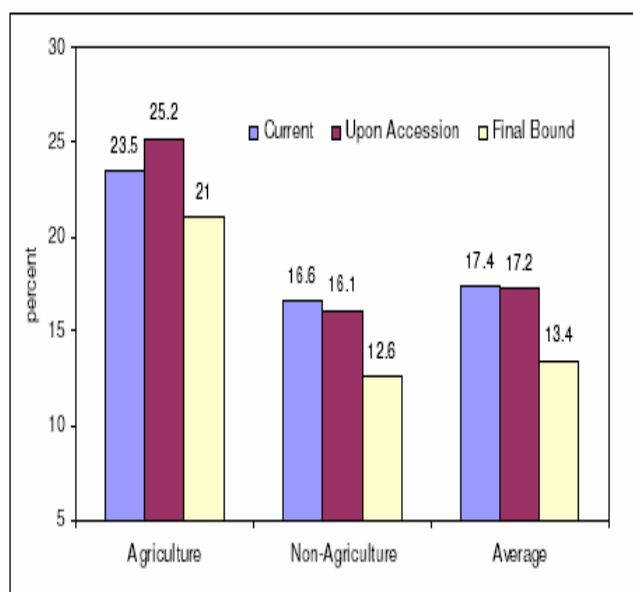
Vietnam’s National Assembly ratified its accession to the WTO in November, 2006 and the country was admitted in January 2007. Apart from reduction of border trade barriers, the accession agreement intersects with many

aspects of Vietnam's development agenda, including legal development, private sector development, the regulation of utilities, public financial management and public administration reform. Unlike other developing countries that have become WTO members in recent years, Vietnam is to comply with the bulk of its commitments upon accession

The average tariff will decline from a current level of about 17.4 percent to an average final bound of about 13.4 percent, with most cuts occurring within five years. (Exhibit 16). Going forward, Vietnam will have to rely on WTO-consistent instruments as regards subsidies and industrial incentives. Compliance with the Agreement on Subsidies and Countervailing Measures and the Agreement on Trade-related Investment Measures mean that Vietnam will no longer be able to offer investment incentives that are contingent upon exporting or localization ratios. With some exceptions special treatment for state owned enterprises will be phased out. All foreign firms and individuals will be permitted to import and export, except some items that remain subject to state trading. Vietnam has passed a WTO-compatible law on Intellectual Property, and focus will now shift to its implementing guidelines. Vietnam has further made commitments on a range of services, including in distribution, telecommunication, and financial services. Further, liberalization commitments have been made in several other services with varying degrees of foreign participation.

Exhibit 16

Vietnam: Average tariff cut under WTO commitment



Source: MOF, MOT

The most direct consequence of accession will be greater competition of domestic production with imports, resulting, in some decline in internationally less competitive sectors, offset by growth in more competitive ones. The government already has a number of effective instruments to assist workers in adversely affected sectors, which can be

adapted for post WTO conditions. The most vulnerable sectors are those where SOEs have been dominant players. A social safety net for redundant SOE workers has been in operation for more than three years and has assisted more than 120,000 people who lost their jobs in the process of SOE transformation. Another option is to focus assistance on provinces, if they suffer disproportionately from adverse shocks, for example due to a concentration of certain crops. Vietnam already has in place an effective mechanism to transfer budget resources from richer provinces to poorer ones.

Regional Arrangements and Rules of Origin

Interest in regional trade agreements (RTAs) has continued to grow over the past year in developing and developed countries alike. While East Asian economies remain committed to a successful Doha deal, many of them also consider RTAs to be a useful complement, and a means of maintaining trade-liberalizing momentum.

At their latest annual summit in Vietnam in November 2006, the leaders of the 21 members of the Asia Pacific Economic Cooperation (APEC) forum agreed to "seriously consider" negotiating a Free Trade Area of the Asia Pacific (FTAAP) and instructed officials to "undertake further studies on ways and means to promote" the initiative so that they could address it at their next summit in Australia in September 2007. Since becoming a WTO member in 2001, China has also launched a flurry of regional trade negotiations with more than 30 economies around the world, counting both those completed or under negotiation. The EU is also seeking new bilateral free-trade agreements negotiations with countries such as India, South Korea and the ten ASEAN states. While some have expressed concern that such initiatives could be detrimental to the Doha negotiations, the European Commission has stressed that these new generation of bilateral trade agreements "will ultimately drive forward the multilateral trade agenda", as they are designed to complement the WTO system by tackling areas such as investment, intellectual property and public procurement, not currently covered by WTO rules.

Properly designed RTAs can benefit their members, especially if combined with a nondiscriminatory reduction in external barriers. But if designed badly, the cost of such agreements in terms of trade diversion, high information costs and demands on limited administrative capacity may well exceed the benefits. For example, as many as half of all RTAs may divert more trade than they create.⁹ It is notable that, despite the rise of regional agreements, the majority of trade in East Asia continues to take place on a Most Favored Nation (MFN) basis. One reason for this may be the costliness of rules of origin. Such rules are a necessary feature of any form of RTA since they are required to ensure trade preferences are available only to

⁹ Global Economic Prospects "Trade, Regionalism, and Development", World Bank, 2006

the signatories to the agreement. The sheer number of RTAs has resulted in a complex web of multiple preferential tariff rates being applied to various trading partners, frequently with varying timelines for reducing tariffs. Complex and inconsistent rules of origin—which often govern eligibility criteria of RTAs—have the potential to restrict effective market access and can prevent many of the RTA benefits from being realized.

Domestic trends and policy challenges

Balance of payments and financial markets

Hefty BOP Inflows and Reserve Accumulation

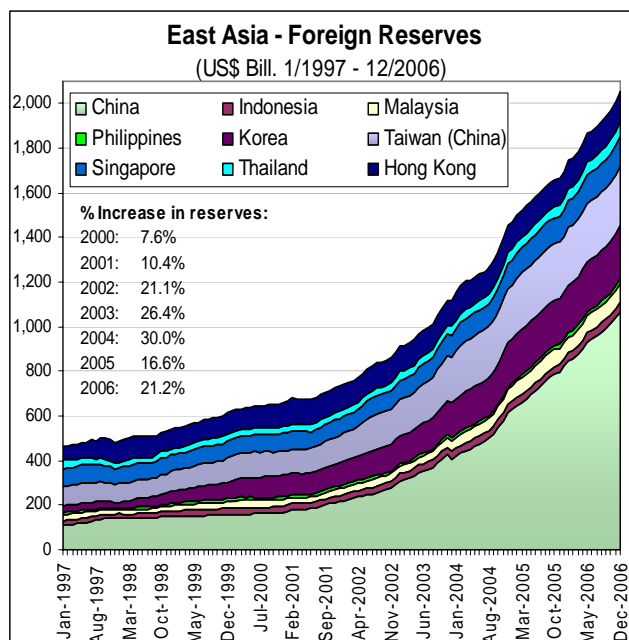
Emerging East Asian economies recorded an aggregate increase in foreign exchange reserves (an overall balance of payments surplus) of \$357 billion in 2006, up from \$241 billion in 2005. Foreign reserves for the region exceeded \$2.05 trillion by the end of 2006, of which \$1.06 trillion was held by China. (Exhibit 17). Reserve levels increased in all the main economies of the region, and did so, moreover, at a more rapid pace than in 2005. As Table 5 indicates the increase in reserves or overall balance of payments surplus amounted to 7 percent of regional GDP, much of that concentrated in China, the region's largest economy, where overall net balance of payments inflows were over 9 percent of GDP. Although overall inflows were not so large in most other economies, the median for these 9 largest economies still amounted to a hefty 4.7 percent of GDP, ranging from a little over 2 percent in Indonesia to near 16 percent in Singapore. Overall inflows to the region have been running at over 5 percent of GDP since 2002. As the discussion of longer run trends in the later section on "10 Years after the Financial Crisis" suggests, sustained overall inflows of this magnitude are unprecedented in the economic history of East Asia, posing new challenges for macroeconomic management.

As in 2005, Emerging East Asia's reserve accumulation was almost entirely driven by its current account surplus, which reached another record in nominal dollar terms in 2006, an estimated \$362 billion, up from \$255 billion in 2005. The regional current account reached 7.1 percent of GDP in 2006, also a record. Almost two thirds of the regional imbalance occurred in China, where the current account surplus rose to an estimated \$230 billion or 8.6 percent of GDP, both records by a significant margin. All the other main economies in the region also ran current account surpluses in 2006, which in the majority of cases were also higher than in 2005.

There are two distinct stories here. In China the exceptionally large surpluses are relatively recent, emerging only in 2005-06 (having run at less than 2 percent of GDP in the 1990s and 2-4 percent in 2000-04). Here it is a case of an extraordinary recent increase in domestic savings (especially in the business enterprise sector) outpacing

exceptionally strong domestic investment. Elsewhere, especially among the economies affected by the 1997-98 financial crisis, the current account swung into large surpluses as investment fell steeply after the crisis. In some of these economies (for example Indonesia, Korea and Thailand), surpluses have generally trended lower since the immediate aftermath of the crisis, partly as savings rates have trended lower and as investment rates have gradually (if somewhat erratically) picked up. In other economies (Hong Kong, Malaysia, Taiwan (China) and Singapore), surpluses remain substantial and without much of a trend, largely because of persistent weakness in investment.

Exhibit 17



Net capital inflows (inclusive of errors and omissions) made little contribution to the region's overall balance of payments in either 2005 or 2006, although they were significant in individual economies, for example Korea and Thailand. (Table 5). This does not mean such flows were economically unimportant. On the contrary, both capital inflows to and outflows from East Asia remain buoyant, reflecting the growing integration of capital markets within the region, as well as growing integration of the region into global financial markets. It is just that, while both growing, they are balancing each other out.

Among the major classes of capital flows, Emerging East Asia continues to receive strong net inflows of foreign direct investment, an estimated \$95 billion in 2006, about the same as \$98 billion in 2005. The equivalent figures for China were an estimated \$67 billion and \$68 billion respectively. Exhibit 18 shows that gross FDI inflows to the main South East Asian economies, Korea and Taiwan (China) revived strongly from 2004 to reach around \$30 billion on an annualized basis by the latter part of 2005, before leveling out in 2006. FDI gross inflows to Indonesia and the Philippines have seen particularly fast growth, more than tripling between 2004 and 2006, while gross inflows to

Table 5 - East Asia - Balance of Payments 2003-06 - Percent of GDP *

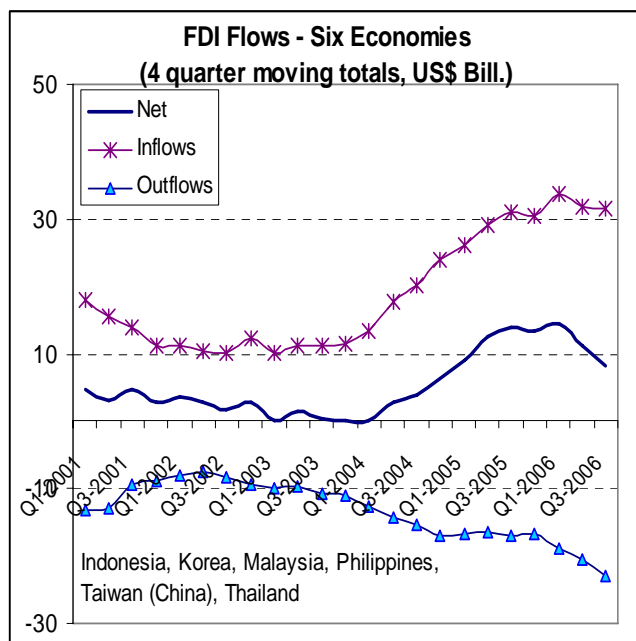
	Overall Balance**				Current Account				Capital Account***			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
East Asia	7.0	8.8	5.5	7.0	4.6	4.5	5.8	7.1	2.4	4.2	-0.3	-0.1
China	7.1	10.7	9.1	9.2	2.8	3.5	7.1	8.6	4.3	7.1	2.0	0.6
S.E. Asia	3.2	4.7	1.0	4.6	4.9	3.4	2.1	5.3	-1.7	1.2	-1.1	-0.7
Indonesia	1.8	0.0	-0.6	2.2	3.4	0.6	0.1	2.6	-1.6	-0.6	-0.7	-0.5
Malaysia	10.0	18.4	2.9	8.0	12.8	12.6	15.3	17.3	-2.8	5.9	-12.4	-9.3
Philippines	0.4	-0.6	2.9	3.5	1.6	2.4	2.0	4.7	-1.2	-3.0	0.9	-1.2
Thailand	2.1	4.7	1.2	7.1	3.3	1.7	-4.5	1.6	-1.2	3.0	5.6	5.5
NIEs	8.5	7.9	1.9	4.5	6.9	6.6	5.6	5.6	1.6	1.3	-3.7	-1.1
Hong Kong	4.1	3.1	0.4	4.7	10.4	9.5	11.4	10.7	-6.3	-6.4	-11.0	-6.0
Korea	5.6	6.4	1.4	3.2	1.8	4.1	1.9	0.6	3.8	2.3	-0.5	2.6
Singapore	14.9	15.3	3.1	15.8	24.2	20.1	24.5	27.5	-9.3	-4.7	-21.4	-11.7
Taiwan, China	15.0	10.9	3.3	3.6	9.7	5.8	4.6	7.0	5.2	5.1	-1.3	-3.4

* 2006 includes estimates for some economies.** Equals change in foreign reserves..***Includes errors and omissions.

Thailand almost doubled. These trends should alleviate previous concerns that the large volumes of FDI flowing to China in recent years would preclude significant flows to other parts of East Asia. At the same time gross FDI outflows from the region have also been growing quickly in the last 2-3 years, as East Asian corporations implement their own cross-border investment and production strategies. Such outflows are now running at \$6-8 billion a year in Korea and Taiwan (China), and have also picked up to \$3-5 billion in Indonesia and Malaysia.

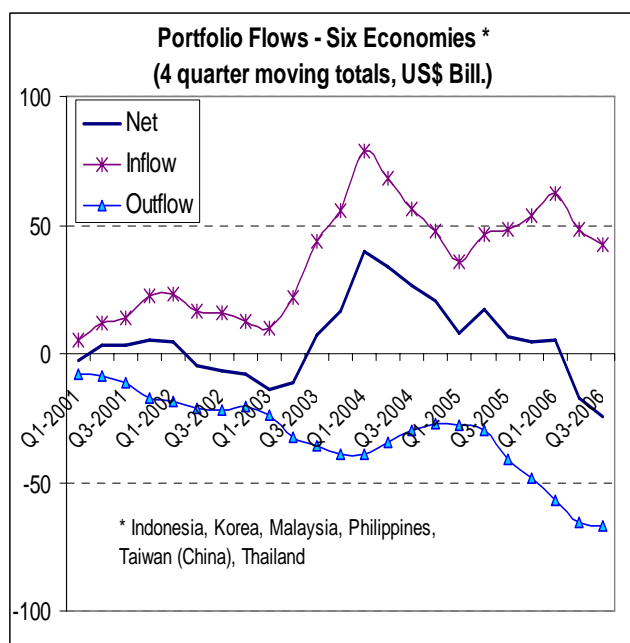
inflows of such capital of about \$100 billion. Again, net flows of these kinds of capital are the result of the balance between gross inflows and outflows, both of which are rising. Exhibit 19 shows that gross portfolio inflows to the four main South East Asian economies, Korea and Taiwan (China) rose substantially to reach near \$80 billion in 2003, in line with the global upturn in flows to emerging markets by investors which began at that time. Since then gross portfolio inflows to these six economies have run at a somewhat lower level averaging around \$50 billion per year while gross portfolio outflows have accelerated to a \$60-70 billion annual rate.

Exhibit 18



Net FDI inflows to East Asian in the \$90-100 billion range in 2005 and 2006 have been largely offset by net outflows of portfolio and other capital (chiefly bank lending), a sharp swing from 2004, when there were net

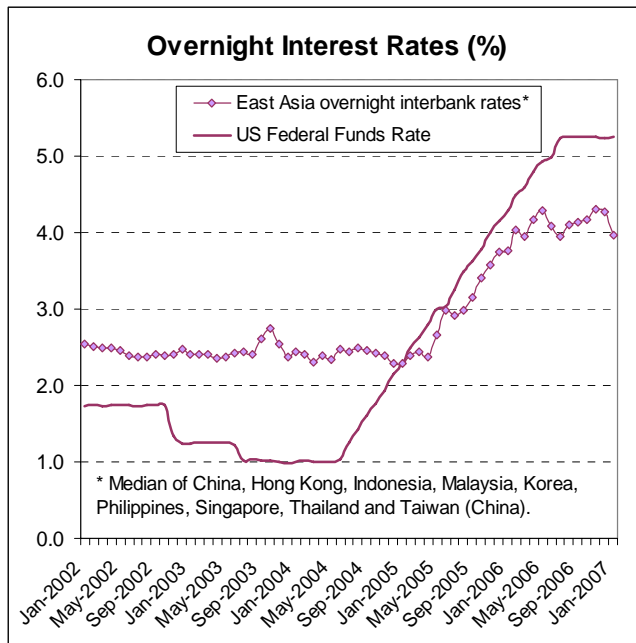
Exhibit 19



Among the factors that are likely to have contributed to this turnaround is the reversal of interest rate

margins: as a result of monetary policy tightening, interest rates in the United States now exceed the average level of rates in East Asia. (Exhibit 20). Policy changes in the direction of greater exchange rate flexibility and capital account openness are also likely to have contributed. A large volume of speculative short term capital flows were attracted to East Asia in 2004 by the prospect of capital gains to be made from exchange rate revaluation in countries with pegged exchange rates, such as China and Malaysia. However both China and Malaysia undertook small revaluations of their currencies in mid 2005, followed by a gradual or ‘crawling’ appreciation at variable rates. This has introduced a modicum of uncertainty about the future course of these exchange rates, tending to dissipate earlier speculative pressures.

.Exhibit 20



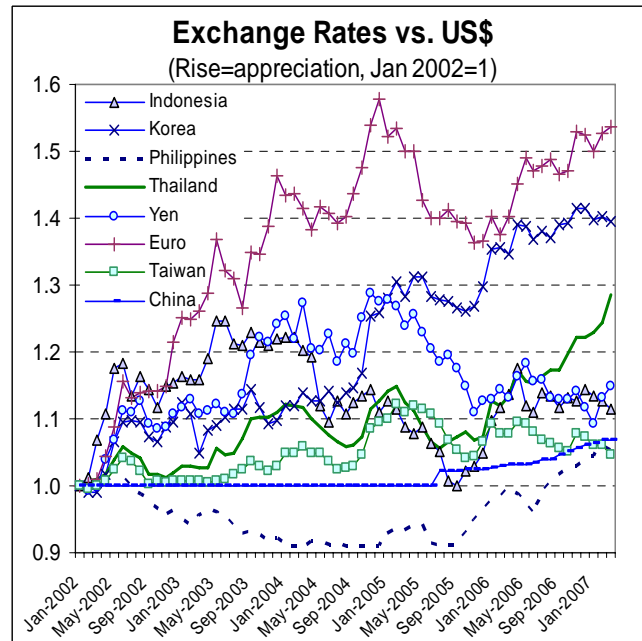
Managing Balance of Payments Inflows

Large balance of payments inflows are having a variety of macroeconomic effects, and are posing policy challenges for governments that are seeking the most effective means of adjustment. There is no single right answer here, but instead a variety of mechanisms through which adjustment can occur, with different costs and benefits that make them more or less appropriate according to the different characteristics of the economies in question.

In the first instance large balance of payments inflows have increased demand for local currencies and created pressure for exchange rate appreciation. To varying degrees most economies have attempted to offset this demand by intervening to buy foreign currency, resulting in the rapid build up of foreign reserves in recent years. On the one hand, governments have been concerned about the adverse impact of a rising currency on exports, and hence on employment and growth. These concerns have particular bite as many economies have become more export

dependent in recent years. The large build up of reserves in the decade since the 1997-98 crisis has also provided an insurance policy against future capital market crises and large unexpected outflows of capital, or other external shocks.

Exhibit 21



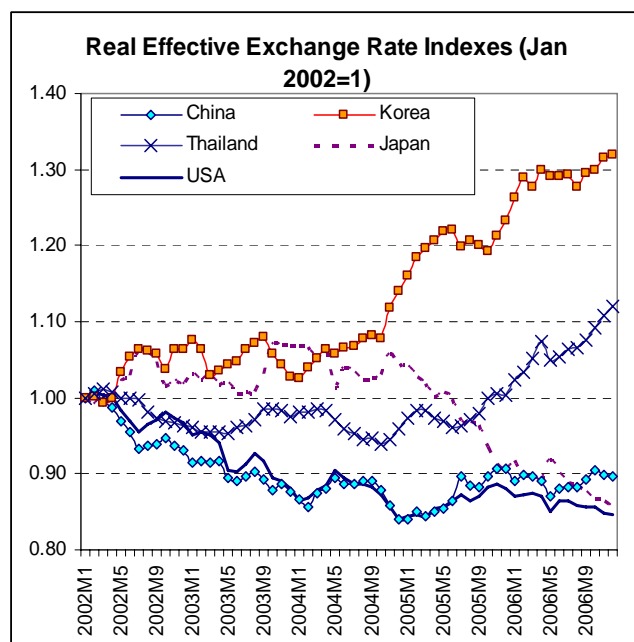
On the other hand efforts to temper the extent of currency appreciation can also create unwanted side-effects, including a diminution in the central bank’s ability to pursue an independent monetary policy. In the context of large balance of payments inflows, such efforts can contribute to an expansion in the domestic monetary base and a broader expansion of credit and aggregate demand. If the economy is near full capacity this can contribute to economic overheating, higher inflation and unwarranted euphoria or bubbles in asset markets. Governments have then attempted to address these side-effects with one or other from a tool box of other offsetting policies, for example bond issues to mop up excessive liquidity (‘sterilization’), increases in bank reserve requirements, controls on balance of payments capital inflows and relaxation of controls on capital outflows.

More exchange rate flexibility

While many governments in Emerging East Asia remain cautious about the excessive exchange rate flexibility, the extraordinary size of balance of payments inflows over the last five years is clearly bringing them to place more weight on the exchange rate as a means of adjustment. Thus China and Malaysia adopted a more flexible exchange rate framework in mid 2005, which has been followed by appreciations of around 7-8 percent against the US dollar. As Exhibit 21 indicates, this is more than in Taiwan (China) or Indonesia over the same period. As Exhibit 22 below indicates, appreciation against the US dollar has not led to a significant appreciation in the real

trade-weighted exchange rate of the Chinese yuan. However it has stabilized the real exchange rate of the yuan, even as the dollar has continued to gradually depreciate in trade weighted terms, instead of depreciating alongside the dollar, as occurred in 2002-2004. The pace of appreciation since mid/late 2005 has also accelerated in the Philippines and Thailand. Thailand's bilateral rate with the dollar surged over 20 percent between mid 2005 and March 2007. Korea has perhaps placed the greatest reliance on the exchange rate for adjustment, with the won appreciating some 27 percent against the dollar between the end of 2001 and mid 2005, with further gains of 8 percent since then.

Exhibit 22



Mopping up liquidity

Central banks have also increased efforts to mop up or sterilize the potential expansionary impact on rising reserves on domestic money and credit, mainly through sales of central bank securities (open market operations) or increases in commercial bank reserve requirements. In effect central banks have tried to get “the best of both worlds”, to manage exchange rates while also retaining control of monetary policy. Such *sterilized intervention* was also the most widely used policy response during the emerging markets capital inflows of the early/mid 1990s.

Table 6 provides a broad indicator of sterilization, measured as the change in foreign reserves less the change in base money (as a percentage of GDP). By this indicator several economies have relied on sterilization quite heavily in recent years, including China, Malaysia, Thailand and, to a lesser extent, Korea. In China the concern that excessive balance-of-payments induced growth in domestic liquidity could spur overheating has been particularly acute, given the prevailing high levels of economic growth and the investment boom in the economy.

Studies indicate that while there is some evidence that sterilization policies in developing countries can be effective in the short term, their effectiveness tends to erode over time and they can also have unwanted side effects.¹⁰ Sterilization tends to keep domestic rates (and spreads with international rates) higher than otherwise, attracting yet more capital inflows.¹¹ It can also entail quasi-fiscal costs for the central bank, because assets held as foreign reserves can earn less than the interest on liabilities issued to sterilize inflows. The central bank balance sheet is also subject to increased exchange rate risk on its foreign reserve holdings. (Central bank income did move into loss in 2004 and 2005 in Korea, and in 2005 in Thailand). Sterilization through higher bank reserve requirements can also have unpredictable consequences, acting as a tax on the banking system, which banks pass on through higher lending rates and lower deposit rates. This can, among other things, contribute to disintermediation from the banking system and a shift of deposits into the non-bank financial sector, which is harder to supervise and regulate.

Table 6. Reserves and Sterilization

	Foreign Reserves Growth (%)		Base Money Growth (%)		Sterilization Indicator (% of GDP)	
	2004	2006	2004	2006	2004	2006
China	42.9	35.2	10.4	20.8	6.0	4.2
Indonesia	5.1	12.1	16.3	28.5	-0.5	-1.0
Korea	9.0	8.9	3.3	19.9	2.1	1.4
Malaysia	26.9	9.1	7.5	10.6	9.8	3.4
Philippines	2.5	14.8	9.5	61.0	-0.4	-2.3
Thailand	20.0	6.7	8.7	2.2	4.5	1.9

(1) Sterilization measured as change in foreign reserves less change in base money (as % of GDP). * Annual average in 2004-05.

Some economies have also modified *capital account regulations*—either imposing controls on some inflows or further liberalizing outflows. On December 19, 2006, Thailand announced an Unremunerated Reserve Requirement (URR) scheme which required that 30 percent of inflows into the stock market, bond market, mutual funds, property funds and warrants, and foreign loans be held on deposit at the central bank interest-free for a year. Inflows held for less than one year would, in effect, be taxed at 10 percent. However the stock market was then quickly excluded from the scheme, which has also been relaxed in various other ways since then.

Although it is difficult to draw firm conclusions from empirical work on the efficacy of capital controls, some lessons can be drawn. If they are to be effective, such

¹⁰ Carmen M. Reinhart and Vincent R. Reinhart. (1998). *Some Lessons for Policy Makers Dealing with the Mixed Blessing of Capital Inflows*.

¹¹ Peter Montiel and Carmen M. Reinhart. (1999). “The Dynamics of Capital Movements to Emerging Economies During the 1990s.”

controls need to be comprehensive and forcefully implemented, and may need to be often strengthened and extended, as markets find loopholes and ways around them. The effectiveness of controls also seems to be limited in sophisticated financial markets since these markets can offer instruments that reduce the cost of circumvention relative to the incentives.¹²

Some economies are also looking to ease problems arising from balance of payments inflows by promoting or relaxing regulations on capital outflows. In January 2007, Korea exempted investors for three years from capital gains tax on earnings from equity funds abroad. Pension funds will be allowed to invest in overseas securities, and local investors can now buy unlisted or unregistered stocks. The ceiling on property investments abroad was also raised. Given adequate supervisory, regulatory and market infrastructure institutions, an approach of liberalizing capital outflows would have the additional structural benefit of fostering greater regional and international financial integration.

Renewed stock market volatility

Sharp 9 percent falls on China's Shanghai A and Shenzhen A stock markets on February 27 set off corrections around the world, in both developed and emerging stock markets. The sell off in China was not triggered by any specific economic or other news, beyond rumors about possible government actions to stem the boom in stock prices, which had surged by almost 150 percent between the end of 2005 and February 2007. Indeed, after a week, the Chinese market began climbing again, to end March close to 5 percent higher than just before the sell off (Exhibit 23).

The February 27 event in China provoked sell offs of varying size in other East Asian markets, as around the world. Within the next several days markets were down by 7-13 percent in Malaysia, Philippines and Taiwan (China) and by 1-4 percent in Indonesia, Korea and Thailand. As in China, markets made up some ground in the rest of March, although had not recovered pre-sell off levels by month end. As in China, most other East Asian markets had also seen substantial increases over the previous year, rising 30-50 percent since the end of 2005 in Indonesia, Malaysia, Philippines, Hong Kong and Singapore (Exhibits 23 and 24). And stock markets had also risen quite well in most parts of the world since the middle of 2006. Thus there was likely a large element of simple profit taking in the world wide decline that began in China.

At the broader global level, however, other background factors are also likely to have contributed to the recent volatility, and to continue playing a role going forward. In the US, for example, a reference to the risk of a US recession by former Fed chief Alan Greenspan added to investor concerns. The beginning of interest rate tightening

in Japan may have been a factor by providing a reminder that on average monetary policies globally are still being tightened and that the period of negative real interest rates and easy liquidity of recent years is drawing to an end. Oil prices also became much volatile during March than during the previous six months. Overall, then, perceptions of risk are on the rise and this suggests that financial markets may remain in a more volatile mode for some time to come. Such volatility may have a beneficial effect in so far as realistic risk perceptions reduce speculative fervor and induce a more prudent, long term mindset among investors.

Exhibit 23

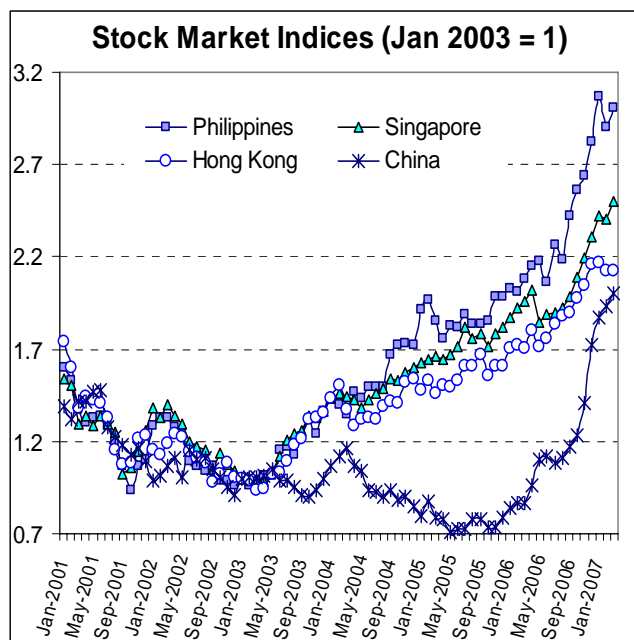
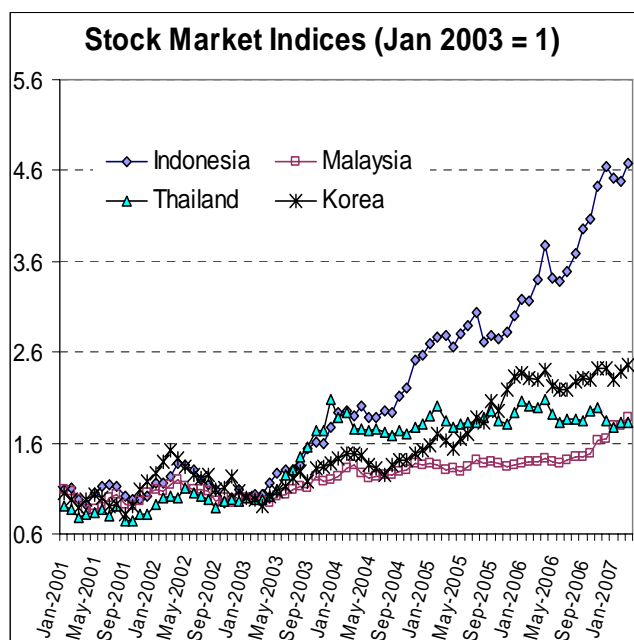


Exhibit 24



¹² IMF. "Capital Controls: Country Experiences with their Use and Liberalization" (IMF Occasional Paper 190 (2000)).

Financial sector trends and issues

Commercial banks in the larger economies of the region generally closed 2006 with further improvements in asset quality, including lower non performing loan ratios and rising or stable capital adequacy ratios (Exhibit 25). Economies continue to implement significant financial sector reforms, as the following country notes indicate.

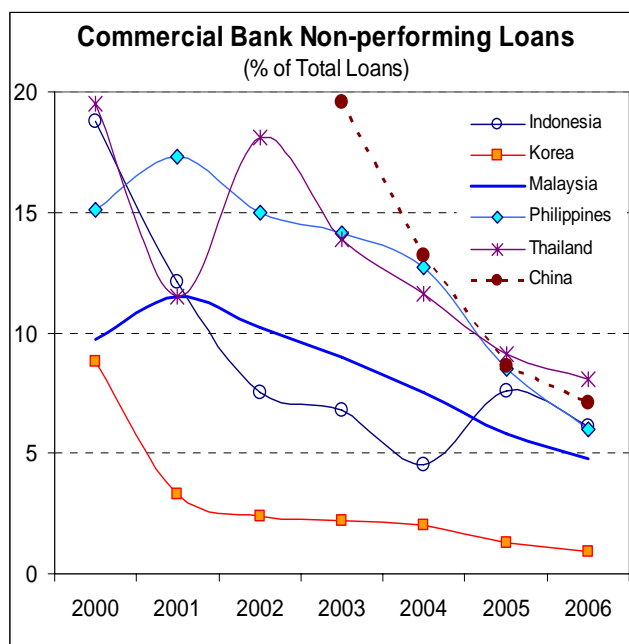
In **China** the third national financial work conference held in January set out directions for major financial sector reform. Key reforms discussed were in rural finance, foreign exchange management, and policy banks. On rural finance, it was decided to reduce the access thresholds for financial institutions to attract a more diverse set of providers and to continue the reforms of the Agricultural Bank of China. Looking ahead, rural finance would also benefit from interest rate liberalization and further reforms in existing providers. On foreign exchange reserve management, the meeting decided to explore ways to more actively manage the country's foreign exchange reserves.

Banking indicators for **Indonesia** generally improved in 2006. The capital adequacy ratio rose to over 20 percent with net interest margins remaining close to 6 percent. However, the return on equity (ROE) fell to a little over 17 percent from 18 percent in 2005, reflecting charges to cover an increase in non-performing loans in the earlier part of the year (due in part to a change in rules for loan classification). However the NPL ratio fell sharply in late 2006 due to a pick up in intermediation and total loans outstanding, as well as a regulatory change by which state-owned banks could write-down NPLs according to the same procedures as private banks. The government's financial sector reform package issued in early July 2006 however strengthened regulatory powers to resolve problem debts at state banks more speedily. More broadly, the July reform package covers key areas such as financial stability, the banking sector, non bank financial institutions (NBFI), capital market development, export financing and privatization of SOEs. Implementation of the package is continuing. Bank Indonesia announced eight initiatives in January 2007 with a focus on improving banking intermediation, not only for large firms but also for SMEs and micro enterprises.

In **Korea** the average non-performing loan ratio of the commercial banks fell to a record low of 0.8 percent at the end of 2006. In the non-bank sector, the six credit card companies have continued to improve financial health, with asset quality and capital ratios improving significantly. The companies have recorded positive net income for six consecutive quarters since the second quarter of 2005. A continuous drop in bad loans drove up their net income in the first three quarter of 2006 by 12.5 percent over the previous three quarters. Average credit card delinquency ratios have continued to fall, reaching 7.1 percent at end-September 2006, down from 10.1 percent at the end of

2005. The capital adequacy ratio rose of the credit card companies rose to 24.5 percent at end-September.

Exhibit 25



In the **Philippines** the banking sector has continued to reduce balance sheet vulnerabilities. The NPL ratio for Universal and Commercial banks fell from 8.2 percent at end 2006 to 6 percent at end 2006. Improvements in asset quality are due in part to enactment of the Special Purpose Vehicle (SPV) Act, which was an important catalyst in reducing banking sector vulnerabilities via the take out of non-performing loans and assets from commercial bank balance sheets. About P97 billion worth of non performing assets (NPAs) were sold through transactions under the SPV Act by end 2005, reducing by about 19 percent the stock of NPAs in the banking system. In early 2006, the SPV Act was extended by a period of another two years. This enabled (mainly) universal and commercial banks to reduce their stock of NPAs by another 18 percent in 2006.

East Asia: Ten years after the crisis

A decade after the financial crisis that devastated East Asia in 1997-98, the region is far wealthier, has fewer poor people and a larger global role than ever before. Led by continued strong growth in China, Emerging East Asia now has an aggregate output of over \$5 trillion, double the dollar value just before the crisis. Real per capita incomes in the previously crisis affected economies¹³ have significantly exceeded pre-crisis levels. For Emerging East Asia as a whole they are some 75 percent higher. The poverty rate at the \$2 a day level has fallen from 50 percent

¹³ Indonesia, Korea, Malaysia, Philippines and Thailand.

of the population to 29 percent today. When Vietnam reaches middle income status (defined as annual per capita income of about \$900), which could happen as soon as 2010, more than 9 out of ten East Asians will live in a middle income economy.

But even as the region celebrates recovery, new challenges loom, which could slow or even derail growth if not properly handled – economies could find themselves in a ‘middle income trap’ and struggle to climb onwards to higher income levels. A recent World Bank report notes the strategies that economies need to make the transition from low income to middle income are different from those needed to transition from middle income to high income status.¹⁴ Among other things, countries that are successfully making a transition towards high income status begin to specialize in selected areas where they are able to achieve economies of scale and technological leadership. Accompanying this change are a whole host of complex transitions, for example, substantial increases in the proportion of people with tertiary education and specialized skills, the transition from economies that largely absorb knowledge from abroad to ones that are also a source of innovation, the development of deep financial systems that provide a diverse range of services, the movement of much of the population into livable cities, among many others. At the socio-political level, successfully transitioning countries are able to maintain a certain level of social cohesion, avoiding the emergence of deep inequities of the kind that fuel social conflict and political instability and stall growth. Clean government and rule of law become the norm, while corruption becomes the exception.

Economic history has many examples of economies that succeeded in getting to middle income status – often quite quickly – but have then stalled, unable to manage all of the complex economic, social cohesion and political challenges needed to make the high income transition. Many economies in Latin America and the Middle East have remained at middle income level for decades, for example. Ten years after confronting the reforms needed to rebound from the financial crisis, East Asia is confronting reform challenges at least as complex. The fact that other economies in the region like Japan, Hong Kong (China), Korea, Singapore and Taiwan (China) have already escaped the ‘middle income trap’ shows that it is possible. But the task will not be simple.

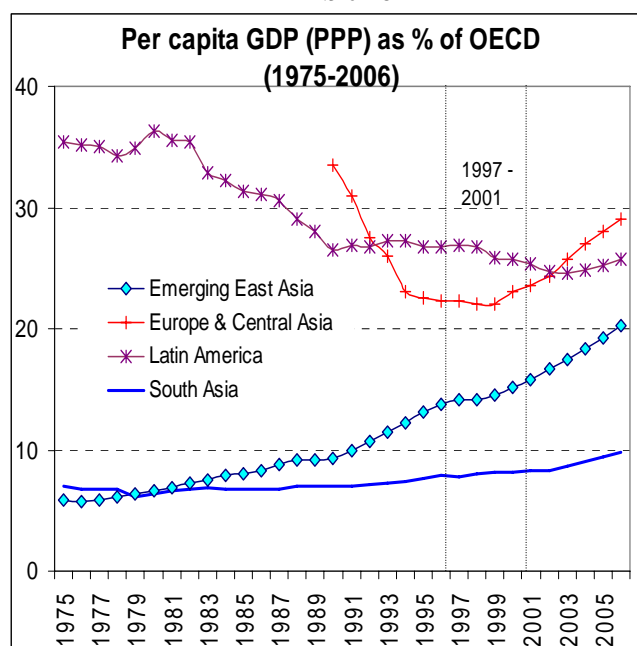
This section does not attempt to survey all of the challenges facing East Asia in transitioning from middle income towards high income status. Instead it looks at the region’s experience and some lessons learnt over the decade since the crisis in three key areas: maintaining high growth in a sustainable way, addressing the problem of growing inequality and managing economic and financial vulnerability, to reduce the risk of future crises.

¹⁴ Indermit Gill and Homi Kharas. “An East Asian Renaissance: Ideas for Economic Growth”, The World Bank, 2007 forthcoming.

Growth – facing a middle income challenge?

Emerging East Asia has come a long way since the financial crises of 1997-98. By 2006 real per capita income for the region as a whole had increased by over 75 percent compared to 1996, the last pre-crisis year. As Exhibit 26 indicates, the region’s real per capita income (measured in purchasing power parity terms) continued to increase relative to incomes in high income OECD economies, rising from a little under 14 percent in 1996 to over 19 percent in 2005. Further, this increase in relative per-capita income levels was the same as in the previous decade, 1986-96, showing no diminution in the pace of ‘catch-up’ to high income country levels.

Exhibit 26



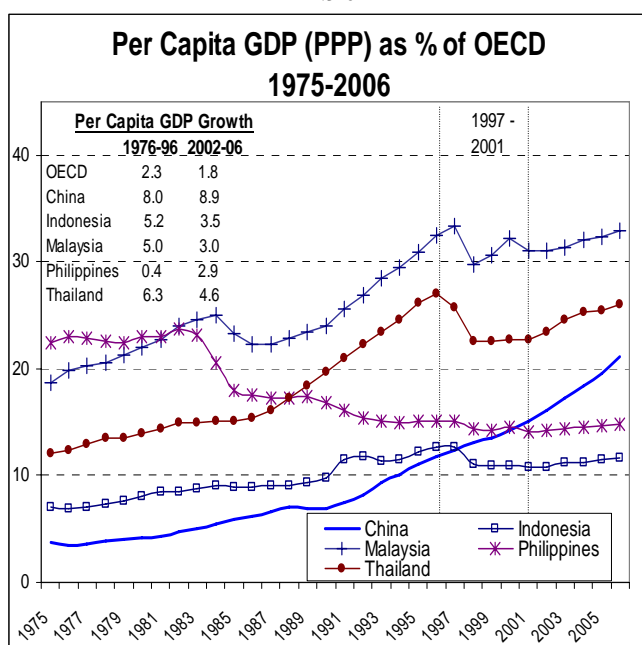
It of course true that a large part of the region’s strong performance over the last decade is due to China, where real per capita income growth averaged 8.1 percent. Growth in several low income economies like Vietnam, Cambodia and Lao PDR has also accelerated to rates above pre-crisis performance. Nevertheless the crisis affected economies have also displayed a robust performance in many respects. For one thing, all returned to positive growth quite quickly after the severe recessions of late 1997 and 1998. Korea, Malaysia and Philippines promptly regained or exceeded their pre-crisis level of per-capita income in 1999, while this took longer, till 2003, in Indonesia and Thailand. Taking 2002-06 as the period of sustained post-crisis expansion¹⁵, economies such as

¹⁵ It is not straightforward to assess the underlying growth performance of the crisis affected countries in the period after the crisis, because, for one thing, these economies were also soon hit by a second shock, the severe recession in the global high tech industry in 2001, which led sharp downturns in exports and output growth in much of East Asia. Thus for the purpose of this

Indonesia, Malaysia and Philippines have achieved real per capita income growth of 3-3.5 percent, with per-capita growth in Korea and Thailand averaging 4-4.5 percent.

Per-capita growth rates in the 3-4.5 percent range are certainly healthy enough compared to the per capita growth rate of the world as a whole over (say) the last quarter century, which was 1.8 percent. But there are also less flattering comparisons. First, recent growth in most of the post-crisis economies is running at around 2 percentage points less than in the two decades before the crisis. (The only exception is the Philippines, whose recent per capita growth of 2.9 percent is much higher than its negligible 0.5 percent performance in 1976-96.) Second, other emerging regions are growing substantially faster in recent years, so that the bar for comparison is now higher than in the past. For example the Europe and Central Asia region and the South Asia region experienced aggregate per-capita growth of 5-6 percent in 2002-06. Third, at their current growth rates it will take longer for the East Asian post-crisis economies to close the gap with the developed world. Exhibit 27 shows how the previous rise in East Asian per-capita incomes relative to the developed economies has tended to flatten out among post-crisis economies in recent years compared to previous decades.

Exhibit 27



Evidently there is not one but at least two sets of “middle income country challenges” facing economies in the region today. In China this means new strategies to tackle the severe environmental and other stresses and imbalances that have arisen during the last 20 years of very rapid growth. Elsewhere, among the formerly crisis affected economies, the challenge is different, to build on

their recovery from the crisis and boost growth to higher rates. In the rest of this section we first look briefly at the challenges facing China. We next consider the dramatic changes in international trade patterns that have affected the region over the last decade, in particular the rapid increase in economic integration between China and the rest of the region. Lastly we look at growth challenges in middle income East Asia outside of China, focusing in particular on investment.

Economic Rebalancing in China

China’s rapid growth over the last 20 years has reduced poverty and improved living standards on a scale and at a pace unequalled in history. Inevitably growth at such a rate has also led to an accumulation of interlinked stresses and imbalances that could affect China’s onward development if left unchecked. Environmental stresses are the most apparent. China today contains 20 of the world’s 30 most polluted cities, due largely to high use of coal and cars. Serious erosion, acid rain and polluted waterways also affect the lives of millions.¹⁶ On the supply side, the growth rate and share of industry is unusually high relative to services, which also contributes to pollution and high energy and natural resources consumption. On the demand side, investment (and saving) is high and rising relative to consumption, raising concerns about inefficient use of capital and a potential build up of overcapacity in specific sectors, which could also contribute to bad debts in the banking system. A rising rural-urban income gap, in part driven by the capital intensive, manufacturing-led pattern of growth, has contributed to a sharp rise in overall income inequality.

The broad long-term challenge of improving the quality of economic growth, rebalancing the pattern of growth and striving for a harmonious society was put firmly on the government’s agenda with the approval of the 11th five year plan in March last year and reconfirmed during the sixth plenum of the Communist Party of China (CPC) central committee in October 2006. It means a relative shift in production from industry towards services, more reliance on domestic demand, more equally shared growth and more environmentally sustainable growth. Besides being desirable in their own right, measures that support rebalancing are

¹⁶ A forthcoming multi-year multi-sector study estimates the physical and economic cost of air and water pollution in China as reflected in the pollution-related disease burden, pollution-exacerbated water scarcity, wastewater irrigation, fisheries loss, crop loss, and material damage. Building upon willingness-to-pay surveys for reducing health risks from pollution among households in Shanghai and Chongqing municipalities, the study finds that the health costs of air and water pollution amount to about 4.3 percent of GDP in China. By adding the non-health impacts of pollution, which are estimated to be about 1.5 percent of GDP, the study indicates that the total cost of air and water pollution in China is about 5.8 percent of GDP. (“[Call for a Green China](#)”).

discussion we take the 2002-2006 as the representing the period of sustained post-crisis expansion.

also likely to address the surging trade surplus, China's main short term macro challenge.

A shift towards services relative to industry and, on the demand side, a larger role for consumption relative to investment and exports would address many concerns. It would make growth less intensive in energy, raw materials, and resources and less tough on the environment. It would also make growth less capital intensive, allowing China to grow with lower saving. Moreover, it would mean more labor intensive growth, with more urban employment creation. Urban job creation is the key to reducing excess labor in agriculture and the related poverty and urban-rural inequality. Finally, it would ameliorate the pressures for overproduction of goods and current account surpluses.

The World Bank's November 2006 China Quarterly discusses policies that will help economic rebalancing, many of which are already in the pipeline.¹⁷ Several macroeconomic measures can help stimulate consumption, reduce saving and encourage services growth. These include shifting public spending from investment to education, health and social security, speeding up financial sector opening and reform to improve the efficiency of the allocation of capital, and establishing a dividend policy for State Owned Enterprises (SOEs) and improving corporate governance, to remove an over-investment bias.

Several price and tax based measures would help adjust the attractiveness of manufacturing (tradables) production relative to services (non tradables). These include allowing the exchange rate to move more closely in response to underlying pressures, which at moment imply an appreciation and an increase in the profitability of non tradables. They also include adjusting the price of inputs into manufacturing—including land, energy, water, utilities, natural resources, and the environment—to better reflect relative scarcities and social preferences. In the area of energy, China has in recent decades had major success with using price increases to improve energy efficiency. Looking ahead, the resolution of the October plenum notes that "industrial policies, fiscal and taxation policies and pricing policies shall be amended to encourage environmental protection." The 11th Five Year Plan (2006-11) also sets a target of reducing energy consumption per unit of GDP by 20 percent and the total discharge of major pollutants by 10 percent.

Dramatic Changes in International Trade Patterns

Integration with international trade – exploiting the opportunities offered by global markets - has for decades been a key element of the 'East Asian miracle'. The last decade has seen further expansion and striking structural changes in the pattern of East Asian integration, associated in particular with the dramatic emergence of China as both a major competitor and a source of opportunities for the other economies of the region.

¹⁷ [World Bank China Quarterly, November 2006.](#)

Exhibit 28

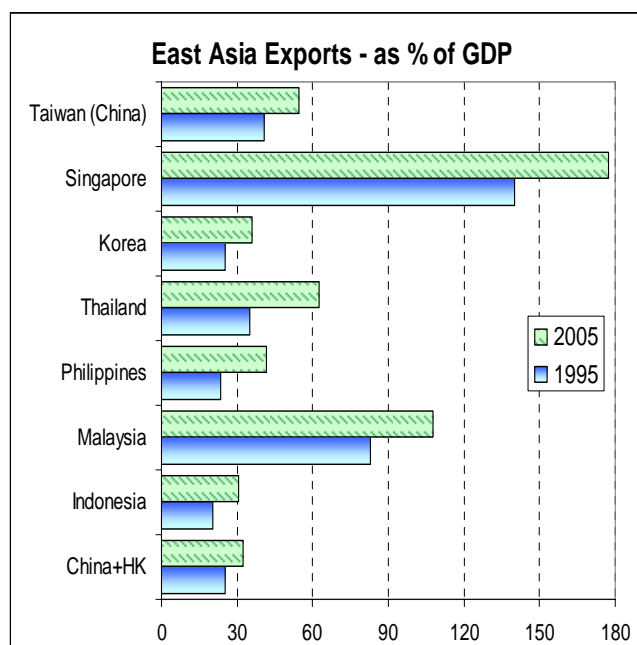
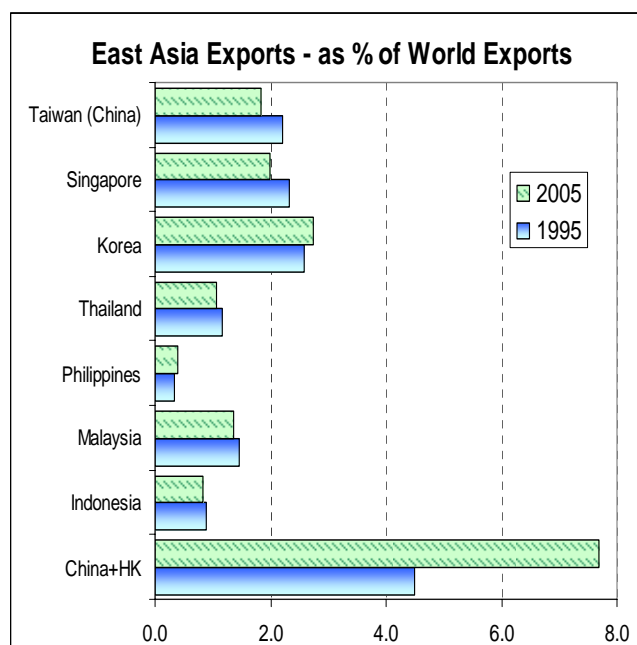


Exhibit 29



Emerging East Asian economies have continued to become more exposed to international trade over the last decade, with merchandise exports increasing from 34 percent of GDP in 1995 to 42 percent in 2005. As Exhibit 28 shows, trade to GDP ratios have risen in all of the major economies of the region. Emerging East Asia's overall share of world exports also continued to rise, picking up from 15.5 percent in 1995 to 17.9 percent in 2005. Here, though, we see more of the new trends that have emerged in the last 10 years. All of the increase in East Asia's world trade share came from China (taken together with Hong Kong because of the intense trade links between the two

economies), which increased from 4.5 to 7.7 percent of world trade. Exhibit 29 shows that world trade shares among the other main economies in the region either fell or increased only slightly over the last decade. This leveling out or decline in world trade shares among other East Asian economies represents a significant change from previous decades when these economies' trade shares also experienced steady increases.

There is little doubt that the emergence of China as an international trading power has had a major impact on the trade opportunities of other economies in the region, both as a competitor in world markets and as itself a new and dynamic market for these economies. Studies of the long run general equilibrium impact of the rapid growth of China on the rest of East Asia and the world stress the welfare gains that most economies are likely to derive from a growing China.¹⁸ But to exploit the new comparative advantages and secure the welfare gains created by the emergence of China is not an automatic process but will require significant restructuring and adaptation by firms in the other East Asian economies.

Ahearne, Fernald et al (2006) study the impact of China on trading patterns in the US market across 47 industry sectors between 1989 and 2005. China increased its market share in 41 of these sectors over this period, while, on the other hand, the market share of the East Asian NIEs fell in most sectors.¹⁹ Importantly, the pace of increase in China's market share in the US market increased dramatically in the most recent period 2001-05. Of particular note, the four middle income economies in South East Asia ("ASEAN 4") had also been increasing their market shares in many sectors through 2001. But in 2001-05 the ASEAN 4 economies also lost markets shares. Thus the post-crisis period 2001-05 appears to be the period when competitive pressure from China has increased most sharply. Exhibit 30 below illustrates how these trends played out in the largest sector of US-East Asian trade, computers, peripherals and semiconductors. More formally, Freund (2006) reports on an econometric investigation using bilateral trade data at the 4-digit SITC level from 1985 to 2004 to test how China's exports to a particular third country in a given product category affect East Asian exports, controlling for overall exporter supply growth. The study finds that on average other East Asian export growth to third markets in industrial products tends to be lower when Chinese exports in these same products are large and growing, with this effect being strongest in the most recent period, 2000-2004. The competitive impact has been strongest in North America, Japan and many developing

country markets. Viewed by the impact on exporters, the most significant impacts have been in Korea, Taiwan (China) and Singapore.²⁰

Exhibit 30

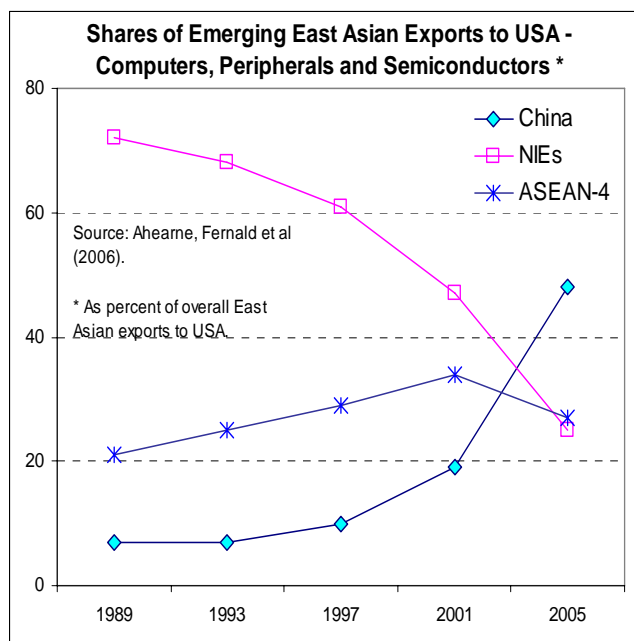


Table 7. Export Markets
(As % of Own Total Export)

To	China & Hong Kong		Other 7 EA Economies	
	1995	2005	1995	2005
USA	27.4	26.3	19.8	14.7
Japan	17.1	12.5	13.1	9.9
EU 25	20.5	23.3	14.1	13.4
China & HK			13.3	22.5
Other 7 EA	16.3	16.0	22.5	21.3
Rest of World	18.7	21.9	17.1	18.1

Not coincidentally, the increase in competitive pressures in third markets in recent years has also been associated with rapid growth in other East Asian exports to China, frequently in the very industry sectors that have felt the most competitive pressure in the US and other markets, for example in the computer, other office machinery and electronics sectors. However the character of this trade has changed – instead of exports of finished goods, exports from the other East Asian economies to China have been increasingly driven by exports of parts, components, capital equipment and other kinds of industrial inputs which are assembled or manufactured into finished goods in China for

¹⁸ See for example World Bank. (2006) "Dancing with Giants. China, India and the Global Economy". (Eds. L. Alan Winters and Shahid Yusuf).

¹⁹ Alan Ahearne, John Fernald, Prakash Loungani and John Schindler. (2006). "Flying Geese or Sitting Ducks: China's Impact on the Trading Fortunes of other Asian Economies." Board of Governors of the Federal Reserve System. International Finance Discussion Paper Number 667. (December).

²⁰ Caroline Freund. (2006). "The Effect of China's Exports on East Asian Trade with the World." Mimeo. World Bank..

export to the outside world. This kind of intra-industry trade has been closely associated with flows of FDI and the establishment of regional production networks. It is also at the heart of the rapid increase in intra-regional trade in the region in the decade since the crisis. As Table 7 indicates, the rise in intra-regional trade has been entirely due to an increase in the share of other East Asian economies' exports going to China (and Hong Kong), which surged from 13.3 percent in 1995 to 22.5 percent in 2005, reflecting the rise in exports of components and other inputs. (The share of these economies' exports to each other remained relatively flat, as did the share of China's exports to these other East Asian economies).

Investment weakness in other middle and high income Asia

The slower pace of output growth in several East Asian economies has been accompanied by much more pronounced differences in investment spending across economies. While investment spending growth in China has continued running at double digit rates, in many of the other middle and high income economies of the region the recovery of investment after the 1997-98 crisis and the 2001 slowdown has often been weak and erratic. This has led to very different policy concerns around the region. Unlike policy makers in China, who are concerned to ensure that the present investment boom there does not lead to overheating, policy makers in many of the NIEs and middle income South East Asian economies are concerned about the causes of continued relative weak investment. Table 8 indicates investment growth has averaged only around 3 percent or less in the four NIEs, Malaysia and Philippines in the post crisis recovery period 2002-06.

**Table 8. East Asia
Real Fixed Investment Growth**

	1980 -89	1990 -96	1997 -01	2002 -06
China	8.2	15.2	9.9	12.4
South East Asia				
Indonesia	8.9	11.5	-5.9	6.3
Malaysia	7.0	17.7	-6.6	3.3
Philippines	0.4	5.3	0.2	1.0
Thailand	8.5	12.3	-14.5	7.7
NIEs				
Hong Kong, China	5.3	9.3	-0.2	2.5
Korea	8.6	11.5	-1.8	2.1
Singapore	6.3	13.1	0.6	3.0
Taiwan (China)	7.4	9.2	1.7	1.4

Source: World Bank. Compound annual average growth.

There is not yet a consensus about the causes of slower growth in investment among East Asian economies (ex-China) in the post-crisis period. Systematic econometric studies find it is not explained by economic fundamentals such as the fiscal balance, demographics,

financial development, financial openness, legal development, trade openness, terms of trade volatility, GDP growth, interest rates and credit flows.²¹ Up to a point, the cyclical "boom and bust" aspects of investment performance in the region can go some distance towards providing a useful explanation for the weakness of investment. In particular one can point to the high levels of spare capacity that were built up in the investment boom before the crisis, the huge negative demand shock released by the financial crisis and the further negative demand shock from the 2001 global high tech recession. Ballooning corporate sector debt, bad debt in the financial system and the need for painful corporate and financial sector restructuring also magnified and protracted the economic shock.

Nevertheless, these kinds of cyclical explanations become less plausible as the time elapsed since the crisis increases. For example, capacity utilization has been rising in most economies and is now near conventional definitions of full capacity in some. Corporate indebtedness has now fallen to levels similar to those in industrialized economies and should not be a constraint going forward. Over the last 5-6 years banks in the previously crisis-affected East Asian countries have also achieved substantial improvements in capital adequacy, asset quality and profitability. Although bank lending has remained sluggish in a number of economies, this now appears to be mainly a question of sluggishness in corporate demand for loans rather than in the capacity of banks to supply credit.

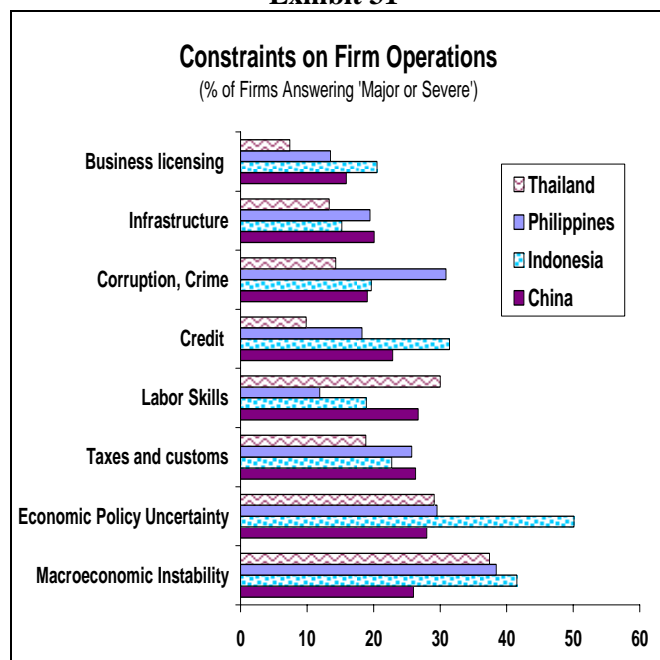
Other analysts have emphasized the role of *uncertainty* in checking new investment. They point for example to the high volatility of export earnings in a region that has become increasingly dependent on often highly cyclical electronics and high tech exports.²² One can add the possibility that uncertainty may also have increased because of the large and rapid changes in export market opportunities and comparative advantage experienced by East Asian firms over the past decade, and especially in the past five years, due in part to the rapid growth and intensification of competition from China (as discussed in the previous section). As a result many East Asian firms and economies are going through a period of structural adjustment, pulling back in a range of sectors and markets where they were previously competitive (an impact which may be felt immediately), while also having to invest time and resources (sunk costs) in seeking out the new sectors and market channels where there are investment opportunities created by the rise of China. Such a structural adjustment process may generate significant uncertainty, which may lead to new investment being delayed during an interim adjustment period during which firms try to learn

²¹ For example, M.D. Chinn and Hiro Ito. (2005). "Current Account Balances, Financial Development and Institutions: Assaying the World 'Savings Glut'". NBER Working Paper 11761. November 2005.

²² IMF. (2006). Asia and Pacific Regional Outlook. May 2006. Chapter V. "Asia's Investment Decline."

more about the new environment, although later it may also stimulate stronger investment, as firms become more familiar with new patterns of comparative advantage and market opportunities.

Exhibit 31



The quality of the *investment climate* in the region is also likely to play an important role. Regular firm-level investment climate surveys conducted by the World Bank in recent years provide a useful 'firm's eye view'. Exhibit 31 shows the proportion of firms in various economies that felt that a particular issue was a major constraint on their operations. In most economies shown the issues that concerned the largest number of firms as a major constraint on their operations are to do with uncertainty: *concerns about macroeconomic instability and about economic policy uncertainty*. For example, even though macroeconomic conditions have greatly improved since the 1997-98 financial crisis, some 42 percent of Indonesian firms in 2005 still cited concerns about macroeconomic instability as a major concern, although this proportion is down from 50 percent in 2003. These continued concerns may relate to firms' long memories of the crisis and also to occasional episodes of renewed volatility in exchange rates, interest rates and inflation that have occurred in the post crisis period, in particular in 2000/01 and in 2005. Firm concerns about macroeconomic instability have also been high in the Philippines, where the government's efforts to reduce a large fiscal deficit and high public debt have been at the center of attention. These examples underline the continued central importance of macroeconomic stability in firms' perception of the investment climate.

The investment climate surveys also highlight the importance of uncertainty about the content, interpretation

and implementation of rules and policies by government officials and in the courts. Some 50 percent of firms were concerned about this sort of policy uncertainty and arbitrariness in Indonesia in 2003, but it was also a concern for close to 30 percent of firms in China, Philippines and Thailand. On a related theme, concerns about corruption and crime are also particularly important for firms in the Philippines. In this connection, IMF (2006) also notes some deterioration in the World Bank's indicators of governance for East Asia over the last decade (Kaufman, Kraay and Mastruzzi, 2006), which may also suggest an increase in policy uncertainty.

Among other investment climate issues, concerns about the cost of and access to credit are prominent in Indonesia and, to a lesser extent, China (31 and 23 percent of firms respectively). Infrastructure, especially unreliable power supply, is flagged as a particular concern in the Philippines and China. Some 30 percent of firms in Thailand find the inadequate skills and education level of available workers to be a major constraint on their operations. The proportion is also relatively high in China, where over a quarter of firms find this to be a major constraint.

How important are investment climate variables for the operations of firms? To take just one example, econometric analysis shows that adverse investment climate variables in Indonesia have had a large and significant negative impact on firm level total factor productivity (TFP) and investment (measured here as the probability of undertaking a new investment). Total factor productivity is adversely affected by a wide range of investment climate conditions such as regulatory burden, policy uncertainty, poor financial market development, excessive labor disputes, and poor infrastructure. Since TFP is an important determinant of the return to capital, these factors can also be seen as having an indirect negative impact on investment. Among the factors having the largest direct negative impacts on investment are poor functioning of the judiciary (which has obvious negative implications for the security of property rights, for example), corruption, lack of security and lack of financial sector development. A one standard deviation improvement in security or financial development would increase the probability of a firm undertaking a new investment by almost one third, for example.²³

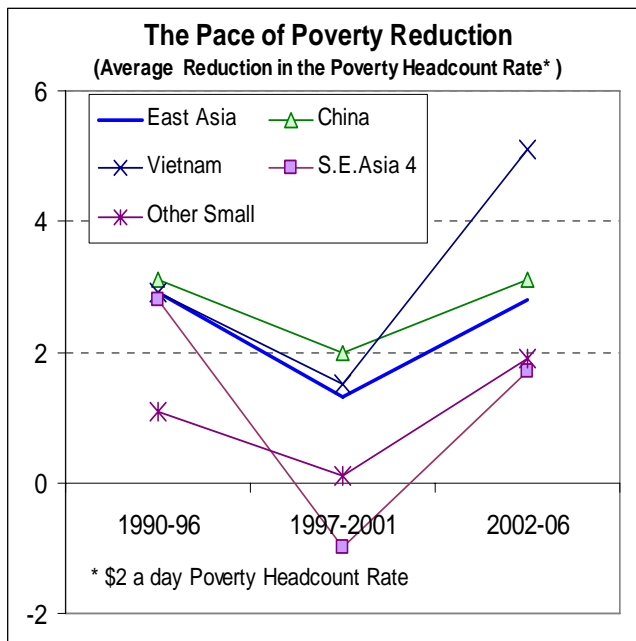
These results suggest that, although they are sometimes politically difficult and time consuming to implement, investment climate and governance reforms to reduce the scope for uncertainty about policies and laws and improve other aspects of the business climate can have significant payoffs for investment and growth. Such efforts are at the core of the agenda for revitalizing growth in the post crisis middle income economies.

²³ World Bank Indonesia Investment Climate Assessment 2003.

Poverty and Inequality - a 10 year perspective ²⁴

One of the distinctive features of the ‘East Asian Miracle’ of recent decades has been its ability to combine rapid growth with a relatively equitable distribution of the benefits of growth, reflected particularly in a rapid pace of poverty reduction. We find that for the region as a whole, the pace of poverty reduction in the period after the financial crisis has been just as rapid as before it. However the pace of poverty reduction is not equally robust everywhere. A still fairly large proportion of the region’s population continues to subsist at fairly low living standards. And inequality in income and consumption has risen significantly since the 1990s.

Exhibit 32



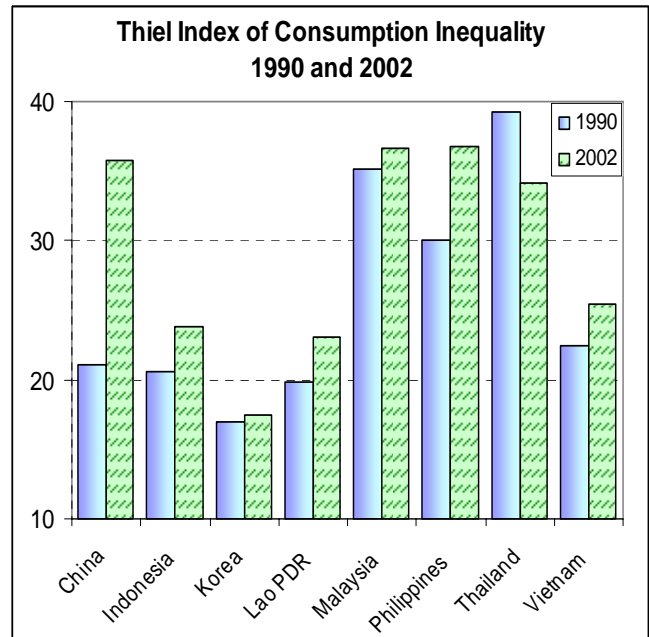
As Exhibit 32 indicates, the \$2-a-day poverty rate in East Asia was falling on average by close to 3 percentage points a year in the pre-crisis boom period 1990-96. The number of poor below this income line fell from 1.07 billion (two thirds of the population) in 1990 to 851 million (half the population) in 1996. The rate of poverty reduction slowed all over the region during the financial crisis. Poverty rates increased sharply in the crisis-affected middle income economies such as Indonesia, Philippines and Thailand. There was also a slowdown in the pace of poverty reduction elsewhere, even in economies that had not themselves fallen into crisis.

In the post-crisis period 2002-06, though, the pace of poverty reduction has once more picked up to close to 3 percentage points a year, bringing the \$2-a-day poverty headcount down further, from 43 percent in 2001 to 29 percent in 2006 (an estimated 552 million people). Within

²⁴ Recent developments in poverty reduction and human development are discussed on pages XX of this World Bank East Asia Update, while Appendix Tables 7 and 8 below provide detailed historical and forecast data on poverty.

the region, though, the revival of poverty reduction has been uneven and corresponds to differences in the pace of economic growth. In low income economies like Vietnam, Cambodia and Lao PDR economic growth and poverty reduction have both accelerated to exceed pre-crisis rates. In the previously crisis-affected middle income economies in South East Asia, though, both growth and the pace of poverty reduction have been somewhat lower than in the pre-crisis period.

Exhibit 33



While East Asian poverty continues to fall, a potentially more disquieting trend is that inequality of income and consumption has increased in most economies of the region. Exhibit 33 shows that the Thiel Index of within-country inequality increased markedly between 1990 and 2002 in China, Indonesia, Lao PDR, Philippines and Vietnam, and fell only in Thailand. A closer look at the increase in inequality in China finds that the largest part of the increase was contributed by an increased in inequality between urban and rural areas, with additional significant contributions from increased inequality within rural areas and within urban areas. Indeed the rural-urban divide is emerging as a key focal point of inequality in the region, with 75-80 percent or more of poverty at the \$1-a-day level being concentrated in rural areas.

A recent analysis of rising inequality in East Asia argues that many of the same forces that are contributing to rapid growth and more global integration are also the forces that are shaping unevenness in growth.²⁵

- A key factor underlying the rise in inequality within the region has been an expansion in wage inequality. In particular, as in many countries around the

²⁵ The discussion of inequality in this section follows Gill and Kharas (2007) *op.cit.*, Chapter 6: ‘Cohesion.’

world, there has been a large increase in the wage premium paid to education and skills. For example the wage premium for college graduates over senior high school graduates in China increased from 12 percent in 1988 to 37 percent in 2001.

- Increased global integration has increased the relative demand for skilled labor, in particular as foreign direct investment (FDI) has concentrated in skill-intense sectors and has introduced new technologies. Relative wages for skilled labor have also tended to increase because of the less elastic supply of such labor.
- Enterprise reforms and downsizing of the state owned enterprise sector in economies like China and Vietnam has reduced the proportion of employment in the public sector. As workers move into private sector employment, their wages become more closely related to their skills, leading to more wage dispersion. Some former SOE workers drop out of the job market, accept lower wages (especially if they are older) or become employed in the urban informal sector.
- Spatial disparities between dynamic urban areas and lagging rural areas are exacerbated by so-called location and agglomeration effects. Coastal areas and cities with other good transport links to global markets attract the lion's share of FDI. Firms and workers in urban agglomerations benefit from their closeness to each other in various ways, enhancing their productivity and incomes and further attracting modern firms and FDI. About 80 percent of FDI in China in 1989-2003 was concentrated in the coastal provinces, which also enjoyed faster income growth than the rest of the country.
- The trend towards fiscal decentralization in much of East Asia during the 1990s has tended to increase disparities in the fiscal resources available to local governments and in their ability to provide public services of importance to the poor such as health and education services.
- Massive internal migration from rural areas to fast growing urban areas has been a powerful equalizing force through its effect on reducing wage and income differentials across regions and sectors. However workers may lack the minimum levels of assets, education, skills and information needed to migrate. Migration may also be impeded by policies that deny them access to public services in the cities they want to migrate to.

Should people in East Asia care about rising disparities? After all, some of the factors that have been responsible for rising disparities are also the ones contributing to growth. Arguably, as the modern sector continues to grow and absorb ever larger proportions of low-productivity labor from other sectors, the disparities will eventually decline. Values surveys show there is a fair degree of support among East Asians for disparities that provide incentives for effort. Nevertheless there are still reasons for concern about the growth of excessive

disparities in the region. Current inequalities may become entrenched through inequality of opportunity across generations. There is also growing evidence that inequality may hamper productive investments and growth: poor people without access to credit may be unable to exploit investment opportunities that would benefit society. Excessive disparities may also be a source of political instability and social unrest. The last section of this discussion looks at approaches that may be helpful in addressing inequality.

Managing Vulnerability

Are East Asian economies still vulnerable to capital market and financial crises? In many respects it is fair to say that they are much less vulnerable to the specific *kind* of crisis that hit these economies in the second half of 1997 and in 1998. But that is not to say that they are not subject to any risks.

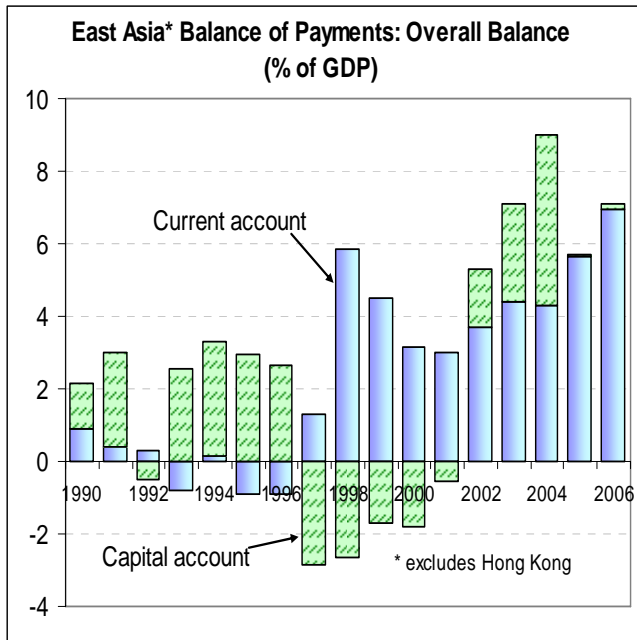
Here it may be worth briefly summarizing how East Asia got into trouble in the 1997-98 crisis. The lead up to the crisis involved growing private capital flows to emerging markets - an emerging markets boom - encouraged in part by the prevailing low interest rates in the developed world. In many instances governments had recently liberalized financial institutions, although without building up a sufficiently strong financial supervisory and regulatory capacity. These poorly regulated financial institutions took on excessive external debt, especially short term, foreign currency debt, which they intermediated to local borrowers (who also borrowed abroad directly), stimulating a surge in domestic credit, investment and asset prices. Strong asset prices and growth in turn attracted more foreign capital inflows. Vibrant domestic demand growth also led to the emergence of significant deficits on the balance of payments current account. The crisis began when a sharp change in foreign investor sentiment in mid 1997 led to a sudden stop in capital inflows, a severe liquidity squeeze, the emergence of massive bad debts, a collapse in investment and severe recession.

Economies in the region have pursued two broad strategies to manage vulnerability and reduce the risk of crisis. First, they have generally run current account surpluses and built up large foreign exchange reserves as a buffer or insurance policy against crises. Second, they have sought to strengthen fundamentals, for example by maintaining prudent macroeconomic policies and, in particular, by strengthening the financial sector.²⁶ Among the kinds of risks that might persist or new risks that might emerge are potential unwanted side-effects from the mix of policies used to support recovery after the crisis, or risks associated with only incomplete implementation of reforms.

²⁶ IMF (2006) "Country Insurance: The Role of Country Policies" presents a framework for analyzing the kinds of policies that countries can implement to protect themselves from adverse economic shocks.

Exhibit 34 shows the distinctive evolution of East Asia's overall balance of payment in the recent post crisis period, with large current surpluses being joined by significant capital account inflows, especially in 2002-04. (See the detailed discussion of recent balance of payments trends on pages 18-22 above). The Exhibit highlights the contrast with the period of the pre-crisis boom in the early-mid 1990s just described, when large net capital inflows to the middle income South East Asian economies and Korea were partly offset by significant current account deficits.²⁷

Exhibit 34



Exhibits 35 and 36 below show that the underlying forces driving large current account surpluses are very

Exhibit 35

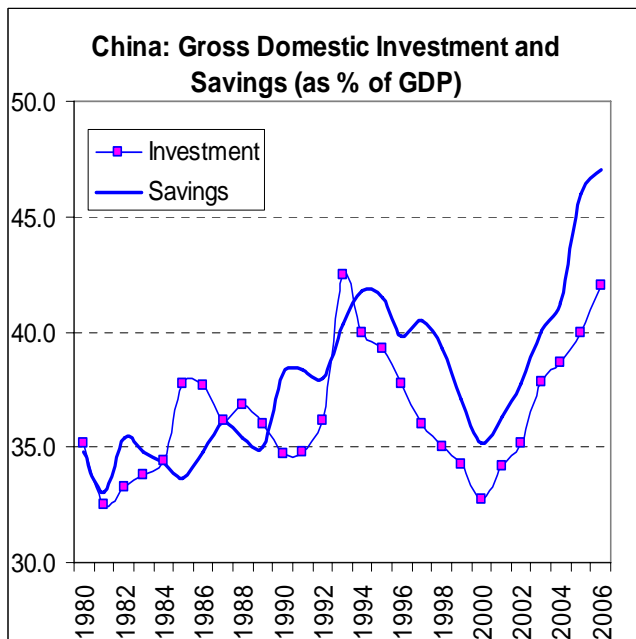
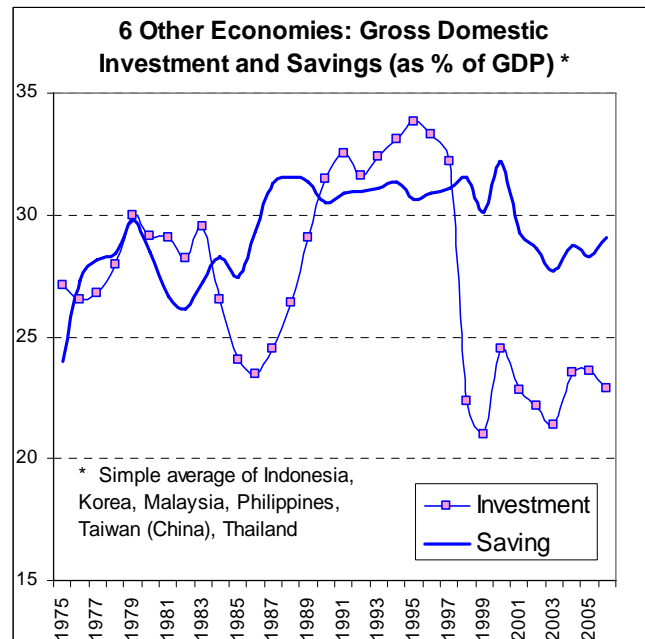


Exhibit 36



different in China compared to the post-crisis economies of the region. In China the current account has surged despite very high levels of investment, due to a sharp increase in domestic savings. The largest part of the savings increase in China has derived from an increase in business profits and savings. Among the post-crisis economies, on the other hand, saving has been relatively stable but the current account surplus has surged due to the large decline in investment after the crisis.

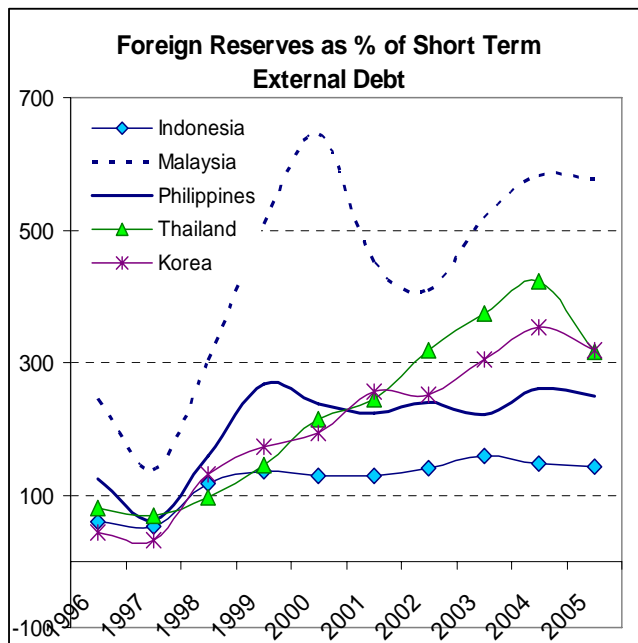
Reserve Accumulation as Crisis Defense

As the earlier discussion of recent balance of payments argued, most economies in the region have resisted upward pressure on the exchange rate caused by large balance of payments surpluses by intervening in the foreign exchange market, resulting in the rapid build up of foreign reserves in recent years. For one thing, governments have been concerned about the potential adverse impact of exchange rate appreciation on competitiveness, exports and employment.

The build up of record foreign reserves in East Asia can also be viewed as a form of precautionary saving, buffer or self-insurance against the risk of balance of payments crises. Exhibit 37 shows the large increase in the ratio of foreign reserves to short term foreign debt among the five crisis economies in the decade since the crisis. In all cases reserves stand well above the 100 percent ratio recommended by the so-called Greenspan-Guidotti rule of thumb for reserve management, in most cases 2 1/2 to 5 times above it. Jeanne and Ranciere (2006) present evidence that developing economies typically use reserves to smooth domestic demand and growth during a balance of payments crisis.²⁸ In addition to mitigating the impact of a crisis, high reserve levels might also serve to prevent crisis. Jeanne and

Ranciere develop a formal model to determine the optimal level of reserves. The optimal level increases with the probability of a ‘sudden stop’ in capital flows, which, in turn is found empirically to increase with the extent of financial integration, the ratio of public debt to GDP and the extent of real exchange rate appreciation. They find that the optimal level of reserves in Emerging Asia has indeed increased substantially over the last decade, principally due to the region’s growing financial integration, and is estimated to be about 25 percent of GDP in 2005. However, East Asian reserves actually averaged around 46 percent of GDP, exceeding the proposed optimal level by a wide margin.

Exhibit 37



The large build up of reserves can however create unwanted vulnerabilities or side-effects. Purchases of foreign exchange with local currency lead to an increase in domestic base money, which, if left untreated, can underpin a broader expansion of credit and aggregate demand, contributing to economic overheating, higher inflation and unwarranted euphoria or bubbles in asset markets, potentially compromising the central bank’s ability to pursue an independent monetary policy. To avert these consequences many East Asian governments have tried to mop up excessive liquidity (“sterilization”) through large bond issues, sometimes amounting to several percentage points of GDP, as well as increases in commercial bank reserve requirements. But these expedients can also have undesirable side effects (discussed in more detail in section on recent balance of payments developments earlier in the report).

Faced with these complications, policy makers in the region have been gradually moving towards greater exchange rate flexibility. China and Malaysia widened the band for their currencies in the middle of 2005, followed by

an appreciation of 7-8 percent since then. The Korean, Philippines and Thai currencies have also seen appreciable increases over this period. Continued movements towards greater flexibility would improve the ability of economies to adjust to external shocks more smoothly and would also allow central banks greater independence in the conduct of monetary policy.

Financial Sector Strengthening

The decade since the crisis has seen substantial changes in the size, diversity, efficiency and stability of financial systems in East Asia. If prior to the crisis the focus of attention was on mobilizing finance, now the it has shifted to the efficiency of resource allocation, diversification of supply, and improving the robustness of financial systems to withstand a range of shocks

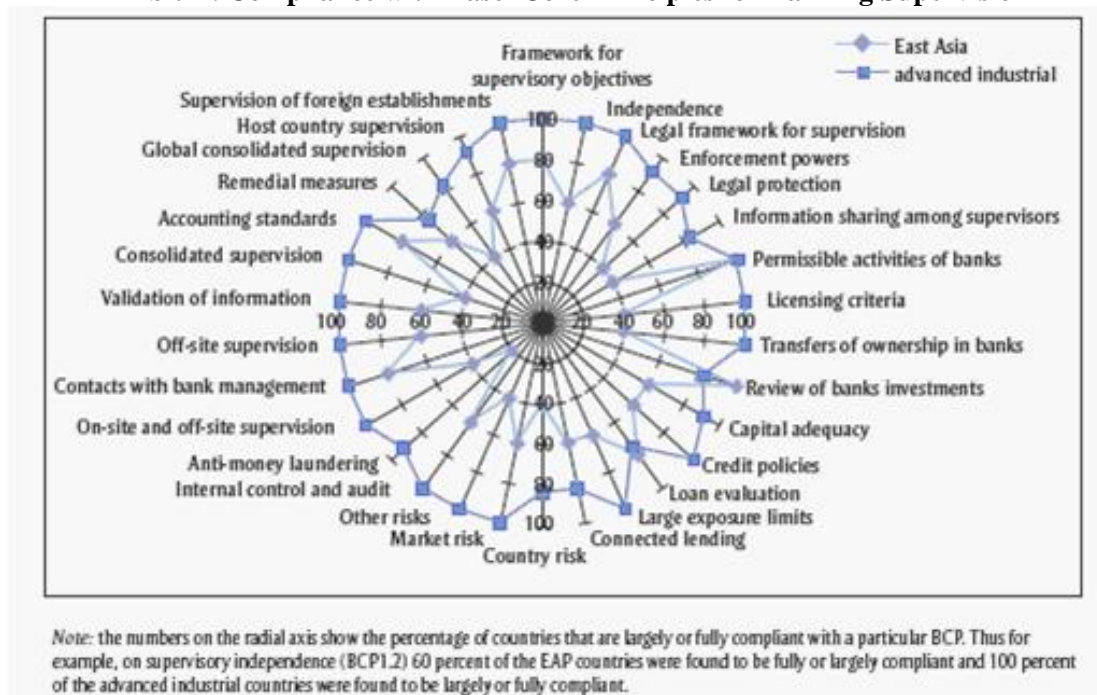
The assets of East Asian financial systems reached \$9.6 trillion in 2005, over one fifth the size of US markets and almost half the size of Japan’s.²⁹ Financial markets have also become more diversified. The importance of a more diversified financial system is that, given sufficient market depth, it can serve to enhance efficiency, since financial intermediaries and securities markets perform the core functions of resource mobilization, resource allocation and risk management in different specialized ways. By offering a wider array of risk-sharing mechanisms, diversification can also increase the overall risk-bearing capacity of the economy.

Reflecting increased diversification, equity markets in the region have tripled since the crisis—from a market capitalization of US \$0.8 trillion in 1997 to almost US\$ 2.9 trillion in 2005. The region’s bond markets have also seen sizable growth over the past nine years, albeit with considerable variation across countries. For the region as a whole, bonds outstanding amounted to US\$1.5 trillion in 2005—up from US\$ 0.4 trillion in 1997. Despite the impressive (300 percent) growth in the securities markets over the past nine years, the banking sector, with US\$5.5 trillion in assets, still dominates. On average the banking sector accounts for almost 60 percent of total financial sector assets.

Significant structural changes have taken place in the banking sectors of crisis affected countries, as a result of policy efforts to address issues of capitalization, governance, risk management and operational efficiency. Banking sectors have generally become more consolidated, with a fall in the number of banks in most middle income countries, as well as an increase in their median size. Although banks have yet to reap the benefits of scale and scope, efficiency measures such as the ratio of operating costs to assets have improved and compare favorably to banks in other regions. As the earlier section in this report on recent financial sector trends discusses in more detail, banks in the previously crisis-affected East Asian countries

²⁹ Swati Ghosh: (2006). “East Asian Finance: The Road to Robust Markets.” World Bank.

Exhibit X. Compliance with Basel Core Principles for Banking Supervision



have achieved substantial improvements in capital adequacy, asset quality and profitability. Average NPLs in the five crisis countries fell from close to 30 percent in 1998 to only about 6 percent in 2006, although this remains higher than in some other developed and developing regions.

The region has undertaken significant efforts to improve prudential regulations and supervision to strengthen the stability of the banking system, but this is a work in progress and several areas still need to converge to international standards. Based on a review of the implementation of the Basel Core Principles for Banking Supervision (BCP), there are several areas in which fewer than 60 percent of the countries are compliant or largely compliant. Such areas, where more focus and policy effort is needed include:

- The independence, powers, and resources of banking supervisors;
- Criteria and processes for licensing banks;
- Prudential regulations and requirements, including rules for evaluating asset quality and the adequacy of loan-loss provisions and reserves; and systems to monitor, and control country risks and all other material risks;
- Remedial measures and exit which requires supervisors to have and promptly apply remedial measures when banks do not meet prudential requirements.

- Cross-border banking, which requires supervisors to apply global consolidated supervision over internationally active banks.

In terms of strengthening securities markets, the key constraints that need to be addressed in East Asian securities markets are limited liquidity and low efficiency. Three key factors affect liquidity and efficiency—and ultimately the role that securities markets play in the region, namely: the availability of information to price securities accurately, transactions costs, and the size and heterogeneity of the investor base

- The availability of good information to price securities accurately is affected by corporate governance and the degree and quality of disclosure. Countries in the region have made considerable progress in strengthening the legal and regulatory framework for corporate governance and disclosure requirements, and in strengthening accounting and auditing standards. But a stronger focus on implementation and enforcement are needed;
- Factors affecting transactions costs include withholding taxes and fees, the efficiency of intermediaries, market infrastructure and institutional arrangements. While the region fares quite well in market infrastructure with fairly advanced clearance and settlements systems, strengthening of the intermediaries and further development of the supporting markets and institutional arrangements such as repo markets, securities lending, and derivatives markets, is needed;
- A broader and more diversified investor base, will depend on further developing the domestic institutional

investor base—pension funds, insurance and mutual funds—as well as fostering greater regional financial integration. Securities markets have become more integrated both globally and within region over the past 10 years. However, in several economies, a sizable proportion of shares remains inaccessible to cross border investors. This, coupled with the fact that a significant proportion of shares is closely held, means that in some economies only a relatively small percentage of shares is freely available to potential investors. In turn this can significantly dampen liquidity and efficiency in the stock markets.

Some Policy Perspectives

The preceding discussion has touched on a variety of policies and ideas that may assist economies in East Asia maintain robust growth in a sustainable way, reduce poverty, strengthen equity and manage vulnerability. Bringing some of these points together:

- The importance of *prudent monetary and fiscal policies* to maintain or improve macroeconomic stability cannot be underestimated. Investment climate surveys show macro instability to be one of chief constraints on operations perceived by firms, and it is as well one of the chief sources of vulnerability to crises.
- *Governance reforms* to reduce arbitrariness and uncertainty in the formulation and implementation of policies and laws would also help address one of the major concerns of firms in the region. Grouped with this is the need for continued progress in combating corruption and crime, as well as regulatory reforms to reduce, simplify or eliminate needlessly burdensome and complex regulations, which add unnecessarily to the costs of doing business and are also important sources of uncertainty for firms. But reforms that reduce arbitrariness, corruption and needless red tape would perhaps be of even greater importance in accelerating poverty reduction and improving equity, for example by helping improve delivery of basic services for the poor, or in fostering entrepreneurial activity among the poor.
- *Financial sector and capital market development.* Economies in the region have made substantial progress in restoring the capital adequacy, asset quality and profitability of their banking sectors. The challenge now is to strengthen the corporate governance of financial institutions and further bring the quality of prudential regulation and supervision up to advanced standards. This will become increasingly important in ensuring that risk transfer among financial institutions through new financial instruments—which has been a major innovation globally—takes place appropriately. Also important is to continue to foster the development of deeper, more diversified capital markets. Such a development would not only reduce vulnerability to crises but would also enhance the efficiency, capacity for specialization and growth potential of the economy. Since financial intermediaries and markets perform the core functions of resource mobilization, resource allocation and risk management in different ways, they may each be better at certain aspects of these functions. A more diversified financial sector and capital market are especially important to support investment not just in well-known old lines of business, but especially investment in new, more uncertain, more innovative and long term projects. At the same time, the financial constraints faced by poor households are a key impediment to their taking advantage of income-generating opportunities. Improving access to credit and other financial services for the poor may be a major step in promoting a more equitable distribution of the benefits of economic growth
- Availability of *high quality infrastructure services* is increasingly important as a competitive element determining firms' investment decisions. It is estimated that East Asia has infrastructure needs of approximately \$200 billion annually over the next five years, 65 percent in new investment, with the remaining 35 percent channeled toward maintenance of existing assets. Government has a critical role to play in developing the long range vision for infrastructure, coordination between key players (public-private partnerships, central versus local government levels etc), developing the fiscal space for the appropriate public sector roles, enhancing competition and strengthening the quality of regulation.
- *Skilled labor shortages* are an increasingly important constraint on firm operations, especially in the region's middle income economies. While East Asia has made big strides in primary education over the last two decades, enrollments at the secondary and tertiary levels remain relatively low in many countries and there are large disparities within countries. Education and other forms of human capital development are a fundamental underpinning for both domestic innovation activity and the capacity of the economy to absorb knowledge from abroad. Strengthening quality and enrollment in secondary and tertiary education, improving labor force training capabilities and, more generally fostering development of national innovation systems are an increasingly important part of the region's policy agenda. Because imperfect access to credit and other impediments may prevent poor people from improving themselves through higher education, policies that improve access to higher education will also promote a more equitable distribution of the benefits of growth.
- *Facilitating internal migration* has the potential to become a major force for greater equity within

countries, in addition to its contribution to a more flexible business environment and to growth. Impediments that hamper migration include the low human capital base of potential migrants, de facto restrictions on the movement of people across regions, and the poor access to basic services (education of children, housing, and health) for migrants in destination areas.

- *The development of social protection systems.* Greater economic integration has tied the fate of people in East Asia to changes in the world and regional economies, thus exposing populations to new sources of vulnerability. The coverage of formal social protection systems is limited in most countries, while the demands on the systems have risen because of expanding urbanization and migration and the aging populations in several countries. Improving the coverage and performance of unemployment insurance, health insurance, and pension systems, as well as targeted income-transfer programs, is likely to assume more importance in the future.

COUNTRY SECTIONS

Major Economies³⁰

China

Economic growth eased slightly in the second half of 2006, as strong external trade offset much of the impact of slower investment. Real GDP growth was 10.5 percent (yoy) in the second half of 2006, which brought growth for 2006 as a whole to 10.7 percent, compared to an upwardly revised 10.4 percent in 2005. Preliminary data suggests growth remained very strong in early 2007. Investment cooled in the second half of 2006 in response to tightening measures introduced mid-2006. Consumption has continued to grow robustly, but still slower than overall GDP.

Exports continued to outpace imports by a wide margin through February 2007, and in the second half of 2006 external demand largely offset the growth impact of the investment slowdown. The external surplus reached new highs: we estimate that China's current account surplus has overtaken Japan's in 2006 to be the world's largest. Processing export growth, which is predominantly done by foreign-invested firms, trended down in 2006 following slower global trade, but processing import growth declined even more. As a result, the processing surplus increased and now accounts for all of the trade surplus. China's deficit in non-processing trade declined from US\$ 73 billion in 2004 to US\$8 billion in 2006, as non-processing exports powered ahead. In addition to the current account surplus, inward FDI also provided a steady stream of inflows, and foreign exchange reserve accumulation continued apace. Surging stock prices prompted government measures to slow the amount of new funds moving in the stock market.

Consumer price inflation has picked up recently, led by higher food prices, especially grain. Since WTO accession, grain prices in China have been moving more in line with international prices, which rose sharply in late 2006. Chinese grain prices have recently risen less than international prices, though, in part because the government released grain on the market from its grain reserves. Non-food consumer price inflation remains modest at around 1 percent.

China's stock markets have risen sharply since mid-2006, although a correction took place end February. Besides continued strong profit growth, progress in equity market reform, notably the reduction in the overhang of non-tradable shares, has boosted stock prices. The rapid stock price increases have re-ignited the public's enthusiasm for investment on the stock market, and the amount of funds flowing into mutual funds increased rapidly. The

government temporarily halted approval for new mutual funds in December and banned banks from extending loans for buying stocks in January. The end-February sell off of Chinese stocks seemingly triggered, for the first time, a global sell off. Chinese equity markets remain volatile, as do markets in other countries.

Near term economic prospects remain favorable. Chinese exporters and manufacturers have been affected by several recent policy measures to rebalance the economy, including tax measures and appreciation, and more such measures are likely to follow. However, continued productivity growth and a resilient world economy promise only a minor export slowdown. Indeed, export growth remained very strong in early 2007. Domestically, the fundamental drivers of investment growth remain in place, and investment is therefore unlikely to slow drastically in 2007, while boosting consumption will remain challenging, particularly in rural areas. In all, our projection for GDP growth in 2007 remains unchanged at 9.6 percent. The external imbalance is unlikely to shrink much in the near term, and a significant surge in inflation seems unlikely. Measures to rebalance the economy as announced by government could temporarily slow growth further in 2008.

China's internal macro challenges remain manageable, but the external imbalance is on the rise. Thus, the preferred policy measures to address domestic concerns are those that also reduce the external imbalance. The government has already decided on a dividend policy for SOEs and a more rapid increase in spending on health and education, and stepped up the pace of currency appreciation. These measures tend to reduce investment and increase consumption, and are thus steps in the right direction. Meanwhile, containing investment growth and inefficiency on a more sustainable basis calls for structural policies that address the underlying causes of inefficiency and excess investment.

At the annual session of the National People's Congress in March, the government presented its Work Plan for 2007, which includes several initiatives to rebalance the pattern of economic growth. Rebalancing aims to make growth less intensive in resources and energy, less damaging for the environment, more evenly distributed and more led by domestic demand and domestic consumption.

In terms of the overall economic strategy, rebalancing involves a shift in the pattern of growth. This shift means more growth of the services sector instead of industry and a larger role for consumption instead of investment and exports. This would meet the aim to make growth less intensive in energy, raw materials, and resources, and less tough on the environment. It would also make growth less capital intensive, allowing China to grow with lower saving, and more consumption. Moreover, it would mean more labor intensive urban growth, and thus

³⁰ More detailed individual Country Briefs for the major economies can be found at the World Bank website: <http://www.worldbank.org/eapupdate/>

less excess labor in agriculture and the related poverty and urban-rural inequality. Finally, it would ameliorate the pressures for overproduction of goods and current account surpluses.

Several rebalancing policies were discussed at the March meetings. They include unification of the corporate income tax (between foreign and domestic enterprises); a property law; significant increases in government spending on education, health, and agriculture, farmers, and rural areas.³¹

The third national financial work conference held in January set out directions for major financial sector reform. Key reforms discussed were in rural finance, foreign exchange management, and policy banks. On rural finance, it was decided to reduce the access thresholds for financial institutions to attract a more diverse set of providers and to continue the reforms of the Agricultural Bank of China. Looking ahead, rural finance would also benefit from interest rate liberalization and further reforms in existing providers. On foreign exchange reserve management, the meeting decided to explore ways to more actively manage part of the country's foreign exchange reserves.

Indonesia

Economic indicators are signaling a strong pickup in economic growth at the end of 2006 and into 2007, although recent natural disasters may dampen the upturn in the near term. Flooding in the greater Jakarta area in February forced more than 300,000 people from their homes and caused widespread economic disruption. The government estimates losses of 0.1-0.2 percent of GDP. Other incidents included flooding in Flores, more earthquakes in Sumatra and a series of air and sea transport accidents.

Growth is recovering from a slowdown in the last quarter of 2005 and the first half of 2006 caused by the removal of fuel subsidies and the accompanying increase in fuel prices (an average of 114 percent) and interest rates (up 400 basis points). Growth dipped to 5 percent through mid 2006, but then recovered to 5.9 percent and 6.1 percent respectively in the third and fourth quarters of 2006, leaving growth for 2006 as a whole at 5.5 percent. Growth in the second half of 2006 was led by a pickup in private consumption and investment, while exports also remained strong. Imports picked up rapidly in response to reviving domestic demand. Rebounding automobile and motorbike sales, capital goods imports and consumer confidence all suggest that growth is continuing to accelerating.

Exports exceeded US\$100 billion in 2006 for the first time, growing 18 percent over 2005 in US dollar terms. Non-oil and gas exports grew 20 percent while oil and gas

exports increased 10 percent. High international commodity prices contributed to strong growth in non-oil primary commodity exports (e.g. rubber, palm oil and coal). The current account surplus rose to US\$9.6 billion in 2006, much higher than 2004 (US\$1.6 billion) and 2005 (US\$0.3 billion). International reserves rose from US\$35 billion in 2005 to US\$43 billion in 2006.

Markets are increasingly confident. The rupiah exchange rate has traded in a stable range between Rp.9,000-9,200 against the US dollar for some time. Yields for government bonds continued to fall at all maturities in early 2007, reflecting a positive outlook for inflation and further cuts in interest rates. The Jakarta Stock exchange continues to trade near all time highs. Inflation fell to 6.6 percent at the end of 2006, lower than Bank Indonesia's target of 7-9 percent but higher than expected due to recent increases in food and especially rice prices. These pressures spilled into January and February when inflation remained at worryingly high 1.2 and 0.6 percent rates over the previous month. As the base effect of higher year on year inflation created by the fuel price in 2005 has worked its way out of comparisons, Bank Indonesia lowered policy rates by 375 basis points from a high of 12.75 percent to 9.0 percent by March 2006. However, the rise and fall in administered rates was not reflected in a proportional changes in lending rates.

Government spending continued to run below budget and the debt to GDP ratio fell dramatically. The preliminary 2006 results show a budget deficit at 1.1 percent of GDP, lower than the earlier estimates at 1.3 percent of GDP. The government debt to GDP ratio dropped to 41 percent from 45 percent in 2005. The lower deficit sent a positive signal to markets but unfortunately also reflects below-budget government capital spending. While central government capital spending rose to 1.9 percent of GDP, significantly higher than 2005's 1.2 percent, it was still below target by 0.3 percent of GDP. Regional government spending is also likely to undershoot budgets by an even greater amount.

In August the President announced major new poverty initiatives including: a program to provide block grants to every village in Indonesia by 2009 (PNPM); and a pilot conditional cash transfer program (PKH). The PNPM initiative is designed to create employment, stimulate the local economy and build community participation. The PKH pilot should support demand through conditional cash transfers designed to improve health and education outcomes. Research has shown that poverty outcomes are very sensitive to rice prices. Recent increases in rice prices, as well as the termination of the unconditional cash transfer program could slow poverty reduction or even lead to an increase in poverty in 2007 despite higher growth. However the government's decision to undertake some imports of rice appears to be stabilizing prices. Unemployment appears to have stabilized at a little over 10 percent (10.4 percent in February 2006 and 10.3 percent in August 2006).

³¹ A package of potential rebalancing policies can be found in the World Bank's November 2006 China Quarterly Update (pp 15-17).

The government continued to push forward on its economic policy packages. After much debate Parliament has passed a new investment law providing, among other things, equal treatment between domestic and foreign investors, binding international arbitration, the elimination of forced divestiture, land use rights up to 95 years (from 35 years previously), and extended residency permits for foreign investors. However, important tax laws remain under discussion in Parliament. The latest package on the financial sector includes a decree to allow state-banks to write-off non-performing loans, which should accelerate lending from this source. Infrastructure achievements include a Risk Management Unit in the Ministry of Finance that is assessing limited public guarantees for projects and an agreement to develop 10 model projects for Public Private Partnerships. But there are still relatively few large infrastructure projects actually getting underway.

Growth is expected to pick up to 6.3 percent in 2007. Externally, while a slowdown in world growth is expected, consensus projections are for it to be relatively modest. Indonesia is also less export dependent than other East Asian economies. Domestically there may be some further room for interest rate declines, especially in lending rates which have remained high. Central and regional government fiscal policy should be more supportive as spending catches up to budgeted levels.

Korea

The Korean economy expanded by 5 percent in 2006. Growth was supported mainly by stronger private consumption (4.2 percent), growth in facility investment (7.5 percent) and strong exports (13.0 percent). In the past few months, however, the economy has slowed, easing to 4.0 percent growth in the final quarter from 4.8 percent and 5.3 percent in the third and second quarter, respectively, principally due to weaker domestic demand. Private consumption moderated in the final quarter from recovery at a faster pace than household income since 2005. Slow growth in employment and income is likely to restrain private consumption growth in the near future. Fixed investment growth remained sluggish in 2006 with negative growth in construction investment, partly affected by government measures to curb speculation in real estate, although construction investment did begin to pick up slightly in the fourth quarter. Exports continued robust growth averaging 16 percent in the first two months of 2007, but is expected to slow with a slowing overall export environment.

Inflation has been subdued partly thanks to lower oil prices and the strengthening of the won. Headline inflation was 2.2 percent in February 2007, below the lower range of the central bank's medium term target of 2.5-3.5 percent. The Bank of Korea kept its target for the benchmark call money interest rate at 4.5 percent over the last seven months, after an earlier increase in rates by a cumulative 125 basis points. More subdued inflation, moderation in growth and high real estate prices are among

the factors likely to determine the direction of monetary policy. Concerns about housing prices have led the government to speed up housing supply and to propose a housing bill that requires builders to disclose housing construction costs and to put price ceilings on new housing. Given the sluggish economy, the government has frontloaded government expenditure in the first half of 2007. The fiscal balance excluding the social security fund will continue to run a deficit of around 1 percent of GDP in 2007.

Even with robust exports and lower oil prices, the current account stayed at near balance, running a surplus of US\$ 150 million in December 2006 and a deficit of US\$ 500 million in January 2007, the latter due to increased consumer goods imports and a widening travel account deficit. This balanced current account trend is likely to continue through 2007. The capital account registered a surplus of US\$ 18.6 billion in 2006 due to the increase in short-term borrowings by banks, despite net outflow of foreign portfolio investment and more overseas securities investment by domestic investors. Large net inflows of capital could serve to further strengthen the won and to further expand foreign exchange reserves, which reached US\$ 242.8 billion as of February 2007. To mitigate the pressure, the government encouraged capital outflows by easing regulations on overseas direct and real estate investment, and by expanding tax incentives for overseas equity funds.

Moderating domestic and export demand is expected to result in slower GDP growth of 4.4 percent in 2007, a little lower than in 2006. The North Korean nuclear issue, volatile housing prices, won appreciation and higher oil prices could still pose a downside risk to the economy although recently those risks have been mitigated somewhat. The possibility of a sharper slowdown in the US economy and Presidential elections in December also could pose uncertainties to the economy.

Malaysia

The Malaysian economy achieved robust 5.9 percent GDP growth in 2006, up from 5.2 percent in 2005. Manufacturing expanded 7 percent (5.1 percent in 2005), with the fastest-growing products being electronic and electrical (E&E), petroleum, rubber, and metal products, although there was some slowing in the second half (H2), resulting from high stocks and weaker external, especially US, demand. Agricultural output increased 6.4 percent (2.5 percent in 2005), reflecting higher natural rubber and crude palm oil production. The services sector expanded 6.5 percent, supported by growth in government, finance, and business services. Spurred by higher household disposable income and commodity prices, private consumption rose by 7.0 percent. Public consumption also expanded at a similar rate, accelerating to a 40 percent increase in the second half. Gross fixed capital formation expanded by 7.9 percent (4.7 percent in 2005).

Gross exports in 2006 rose 10.3 percent to RM 589 billion. E&E exports, which accounted for about half of total exports, increased by 6.4 percent. Natural rubber and palm oil exports were also strong as a result of increases in both volumes and prices. Crude oil and liquid natural gas also strengthened mining exports. Gross imports increased by a similar magnitude as exports, leaving the trade balance at RM 108 billion, an 8.7 percent increase from 2005. Despite strong full-year performance, gross exports fell slightly in Q4 (E&E exports dropped by 4.7 percent). In Q1-Q3 2006, the current account surplus reached RM 65.3 billion (11 percent higher than the same period in 2005), while the balance on capital and financial accounts swung to a deficit of RM 23.5 billion from a surplus of RM 9.7 billion in 2005. Gross foreign direct investment inflows increased steadily in 2006, reaching RM 18.1 billion at the year-end. Despite higher FDI inflows, the swing to deficit on the overall capital account arose from a significant increase in the short-term loans extended by non-resident controlled companies to their related companies abroad (as part of centralized treasury operations). The overall balance of payments in the first three quarters of 2006 registered a surplus of RM 27.9 billion, a 44.0 percent decline from the same period in 2005. Net international reserves at end-2006 reached RM 290.4 billion, up 9.5 percent from 2005. Meanwhile external debt dropped 8.3 percent from 2005, mainly attributed to a significant decrease in banking sector debt and debt repayment by the public sector.

Fueled by higher petroleum-related revenues and individual income taxes, federal government revenue rose 20.2 percent in the first three quarters of 2006. On the expenditure side, while operating expenditure grew moderately, development expenditure expanded by nearly 26 percent, reflecting larger spending on trade and industry and public utilities. Overall, the government recorded a budget surplus of 2.7 percent of GDP compared with a deficit of 0.4 percent of GDP in Q1-Q3 2005. Meanwhile, federal government debt reached RM 245.8 billion, an 8.0 percent increase from 2005.

Consumer price inflation in 2006 picked up slightly to 3.6 percent (3.0 percent in 2005). Following lower oil prices and easing price levels in Malaysia's trading partners, inflation moderated in H2. The Malaysian ringgit continued to appreciate modestly against the US dollar. At end-2006, the exchange rate was RM 3.53 from RM 3.78 per US dollar at end-2005. Monetary policy has been tight but stable. The Overnight Policy Rate (OPR) has remained at 3.50 percent since its last change in April 2006. The average overnight inter-bank rate rose from 2.72 percent in 2005 to 3.38 percent in 2006, while the average lending rate of commercial banks increased slightly.

Asset quality in the banking sector continued to improve. Based on the 3-month definition, the NPLs ratio declined from 5.8 percent in 2005 to 4.8 percent in 2006. Supported by higher incomes from fees, trading and investment, the banking sector enjoyed a 12.7 percent increase in its pre-tax profits, while the annualized rate of

return on assets was sustained at about 1.4 percent. The capital position of banking system (including Islamic banks) remained strong in 2006. The risk-weighted capital ratio of the banking system fell modestly to 13.0 percent (14.4 percent in 2005) due to a large increase in total asset value. The core capital ratio also dropped slightly from 11.4 percent to 10.3 percent.

Underpinned by stable inflation rate, robust corporate earnings, and large equity investment inflows, the stock market was bullish in 2006, especially in H2. At end-2006, the Kuala Lumpur Composite Index (KLCI) reached 1,096, a 21.8 percent increase from end-2005 and is the highest level since 1996. The daily average turnover also recorded a 41.2 percent increase. The index continued to rise in early 2007 until the late February worldwide turbulence on stock markets, when stock prices pulled back sharply, although as of mid-March they still remained higher than end 2006 levels.

Looking forward, real GDP growth in 2007 is expected to moderate to 5.6 percent, largely due to lower growth in US demand for E&E products. The prospect for 2008 remains healthy with 5.8 percent growth. While the external sector will slow, growth should be sustained by domestic demand. Strong consumer spending is likely, underpinned by lower inflation, high commodity prices, stable interest rates, robust equity market, and rising wages. An accommodative fiscal policy, as part of the Ninth Malaysia Plan, should also help to strengthen demand. As inflationary pressure from higher fuel prices subsides and external demand softens, the central bank will likely maintain the OPR at 3.50 percent for the coming months to boost domestic demand. It is expected that the Malaysian Ringgit will continue to appreciate against the US dollar, reflecting the weaker US dollar and sustained large current account surpluses.

Philippines

Market sentiment towards the Philippines improved during 2006, aided by the major fiscal adjustment during 2005-06 and abundant global liquidity. Equity prices and the peso rose significantly (until the global correction in late February 2007), as did foreign direct investment, portfolio inflows and international reserves, while interest rates and inflation fell. Real GDP grew by 5.4 percent in 2006 and real GNP by 6.2 percent, marking the first time that three consecutive years of growth of 5 or more percent was recorded since the 1970s. Higher growth was underpinned by strong growth in business process outsourcing, electronics exports, remittances and consumption.

Public consumption also expanded in 2006, despite a reenacted budget, due mainly to first quarter pump priming and fourth quarter supplemental budget spending. Investment grew marginally in 2006, but continued its decline as a share of GDP to below 15 percent. Moreover the slight increase in investment was tilted towards public

construction, while private construction and acquisition of durable equipment contracted. On the supply side, agriculture grew by 4.1 percent in spite of two severe typhoons in the fourth quarter of 2006. Service sector growth of 6.3 percent was led by the financial sector and private services. Manufacturing output continued to grow on pace with GDP but, in contrast to recent years, mining witnessed a contraction.

Inflation fell to 4.3 percent by end-2006 and to 2.6 percent by February 2007, aided by the stronger peso and relatively stable food and oil prices. Average inflation in 2006 fell to 6.2 percent from 7.6 percent in 2005. The central bank (BSP) did not explicitly lower its overnight rates but instead reintroduced a “tiering scheme” in November, whereby bank deposits placed at the BSP receive progressively lower rates on balances above P5 billion and P10 billion than the 7½ basic rate.

Employment growth in 2006 slowed to 2 percent, less than growth of the working age population. The growth of wage and salaried workers was higher, at 2.9 percent, but their share of total employment is still only about 50 percent, and fell relative to 2004. By contrast, the proportion of unpaid family workers, prevalent in agriculture and private households, increased. Under the old definition, unemployment had dropped slightly to 11 percent as of October 2006, in part due to a decline in the labor force participation rate. Underemployment, however, grew to 22.7 percent from 17.6 percent two years ago. About 1.1 million Filipino workers are estimated to have left the country in 2006 for employment overseas, which in part reflects the lack of domestic employment opportunities, as well as higher wages abroad.

The consolidated public sector deficit (CPSD) is estimated to have fallen to about 0.7 percent of GDP in 2006 from 1.8 percent in 2005 and 4.9 percent in 2005, implying a primary public sector surplus in 2006 of over 5 percent of GDP. The reduction of the CPSD was essentially due to a larger cut in the National Government deficit. The NG deficit, targeted for balance by 2008, was reduced to 1 percent of GDP in 2006 from 2.7 percent in 2005. In contrast to the 2002-05 period, when NG deficit reduction was driven primarily by expenditure compression, in 2006, the bulk of the adjustment was due to implementation of the VAT reforms which raised tax revenue by 22 percent, increasing the tax/GDP ratio from 13 percent in 2005 to about 14.3 percent in 2006—marking the first significant increase in tax effort since the post-Asian crisis collapse of tax revenue. In the first two months of 2007, the budget deficit fell to P18.6 billion, versus P40.4 billion through February 2006. Revenue in February was boosted by proceeds from the P25.2 billion sale of the Government’s stake in Philippines Telecommunications Investment Corp. However, tax revenue through February was 0.5 percent below collections in 2006 as opposed to the targeted 14 percent increase. With Congressional approval in January of the 2007 budget, non-interest spending is slated to

increase as a share of GDP after continuous compression since 2002.

Falling GOCC (Government Owned and Controlled Corporations) deficits, continued surpluses in the two major pension funds, and a rising surplus for local governments also contributed to the consolidated deficit reduction. In particular, the deficit of the National Power Corporation, traditionally the largest GOCC deficit contributor was held in check, reflecting tariff increases in 2004-05 and aided by recent peso appreciation (given its large external debt). By contrast, the National Food Authority’s deficit increased to be the largest single contributor to the GOCC deficit (about 0.4 percent of GDP). The non-financial public debt/GDP ratio fell from 87 percent in 2005 to an estimated 77 percent in 2006 reflecting both real growth and real appreciation of the peso.

The strong performance of electronics exports and remittances far outweighed the impact of higher imported oil prices on the current account—the current account surplus in 2006 jumped to \$5 billion from \$2 billion in 2005—while rising foreign direct and equity investment also contributed to gross reserve accumulation to \$24.4 billion by February 2007, from \$18.5 billion in 2005. Net FDI inflow rose to \$2.35 billion in 2006, nearly double the 2005 level, and net portfolio inflows also accelerated following the May-June sell-off. A 20 percent increase in remittances to \$12.8 billion in 2006 underscores the vital role of remittances and transfers for the balance of payments: through these flows, which together account for over 13 percent of GDP, large trade deficits have been transformed into current account surpluses, which in 2006 grew to over 4 percent of GDP.

Boosted by foreign capital inflow, the Philippine stock market was among the top East Asian performers in 2006, and continued to ascend towards pre-Asian crisis highs—prior to the global correction of equity prices that began in the last week of February 2007 which saw the stock market index lose more than 12 percent of its value in one week. However equities had recovered 6-7 percent of their post-correction losses by the latter part of March. The peso appreciated by about 7½ percent against the U.S. dollar in 2006, and strengthened further in early 2007 even as the BSP continued to build reserves as a net buyer of foreign currency. Interest rates in the peso market and Philippine spreads in the global market fell substantially, with the former prompting more investment into equities. The benchmark 91-day Treasury bill averaged 5.4 percent in 2006 and fell below 3 percent in February 2007. Sovereign spreads declined by 100 basis points in 2006 reflecting both lower public deficits and the falling spreads for emerging markets in general. In January 2007, the national government issued a \$1 billion 25-year bond at a yield of 6.55 percent. This completed the national government’s intended commercial borrowing for 2007.

Gradual strengthening of the banking sector has continued. Regulations are in closer alignment with

international standards and regulatory policies are more responsive to the growing sophistication and globalization of the banking industry. The extension of the Special Purpose Vehicle Act enabled universal and commercial banks to reduce their stock of NPLs by another 18 percent in 2006. BSP expects an additional P100 billion worth of NPLs/NPAs would be taken out from bank balance sheets during 2007. Capital adequacy requirements are also being brought in line with international norms.

Thailand

Thailand grew by 5 percent in 2006, slightly better than 4.5 percent in 2005, on the back of strong export growth and a sound macro and fiscal situation. This means that average annual GDP growth rate in the last two years was 1.3 percentage points below the average for the previous three years. This is in part because the easy gains from increased utilization of excess capacity were exhausted and in part because investor and consumer confidence remains depressed. Exports grew by 8.5 percent (4.3 percent in 2005) while imports grew by only 1.6 percent (9 percent in 2005), contributing to most of the growth last year, as total domestic demand grew by only 1 percent. Inflation is expected to fall by more than 2.5 percentage points this year. GDP growth is forecast at 4.3 percent in 2007.

Growth in private investment was only 4 percent, down from 11 percent in 2005, and is projected to be not much better in 2007. Even this low growth was owed mainly to foreign investment expanding at a real rate of 25 percent in 2006 – continuing the momentum it has shown in the post-recovery period – as private domestic investment experienced negative growth. Domestic Thai investors, in both tradable and non-tradable sectors, have remained skittish throughout the recovery period because of structural factors -- in part greater market uncertainty arising from China's WTO accession and in part investment climate constraints like high regulatory burden, inadequate availability of right skills and a growing deficit in infrastructure that kept investors costs in Thailand high relative to competitors.

Shorter-term factors have worsened investor confidence, especially the perception of heightened policy uncertainty resulting from recent changes. Higher oil prices from 2004 onwards have imposed adjustment costs on investors. The increased political uncertainty -- political disturbances in 2005, followed by coup in 2006 and impending transition in 2007 – is contributing to the wait-and-see attitude of investors. In the last four months investors' perception of greater *policy* uncertainty has been added to the above list, which is likely to affect private investment in 2007 adversely. This was due mainly to the December 2006 capital controls to stem the real bhat appreciation - even though most of these controls have now been relaxed -- and the January 2007 Cabinet approval of amendments to the Foreign Business Act (viewed as making foreign investment more restrictive than before).

Public investment growth is unlikely to offset this significantly, as good governance is a key policy plank of the Government, which will slow public funds disbursement. Several measures are being put in place to make public procurement more transparent and accountable, which is commendable. The Ministry of Finance nevertheless plans to make every effort to raise public investment, especially in appropriate infrastructure thereby increasing aggregate domestic demand and catalyzing additional private investment. However, public investment is projected to rise by 5 percent in 2007, given the additional scrutiny and the transition to better procurement practices.

The challenge going forward is to improve private investor confidence in Thailand through quick policy actions. Unless the Government adopts measures to address the sources of the policy uncertainty, it is likely to linger in 2007. The signing of the Japan-Thailand FTA (following recent approval by National Legislative Assembly) will no doubt contribute to improving investor perceptions, especially the Japanese. The approval of a modified FBA amendment, that not only rationalizes the law but also includes liberalization of some key services sub-sectors critical to Thailand's development strategy, will also remove many of the misgivings of foreign investors. In addition, if the Government takes actions to reduce the regulatory burden – actions that were highlighted in the NESDB-World Bank investment climate assessment – investor confidence will improve.

Addressing the continuing pressures for real bhat appreciation in a manner that maintains market confidence would also help to improve business sentiments. The current account surplus is projected to continue in 2007 (1.3 percent of GDP instead of 1.6 percent in 2006) together with falling debt-service obligations. The Government will thus have to signal the use of other measures to support agricultural and labor-intensive manufactures – exporters who employ a large share of labor force and remain most vulnerable to appreciation – in the transition period, to enhance market confidence. Measures targeted at those sub-sectors will permit them to adjust gradually, either by enhancing productivity or by transferring employees to other sectors. In addition, increasing domestic demand to reduce the current account surplus can lower the pace of real appreciation (e.g. lowering nominal interest-rates; raising public investment, etc).

The Government has taken several actions recently, in respect of the energy and financial sector which needs to be implemented. The recent energy sector reforms are contributing to rationalization of that important sector. Similarly, the financial sector would benefit from the impending approval of several Acts: the recent cabinet-approved Central Bank Act, the Securities Exchange Commission Act and the Currency Act would have to be passed by the National Legislative Assembly and the Deposit Insurance Act and the Secured Transactions Act would have to be approved by both the cabinet and the assembly. This is expected to be followed by many of the

actions cited above, in order to strengthen investor and consumer confidence.

Vietnam

Two events dominated the economic landscape in the last six months, namely Vietnam's accession to the WTO and a dramatic boom in the stock market. Both events pose policy challenges for the government in the short- and medium-term, with the stock market already having attracted substantial short-term attention. GDP grew by 8.2 percent in 2006 with industrial value added increasing by 9.8 percent and services 8.3 percent. Within the industrial sector, the turnover of the domestic private sector expanded 23.9 percent while that of state-owned enterprises (SOEs) grew 9.1 percent.

The retail sales index grew by 20.9 percent in 2006 about the same as 2005. Implemented investment, which is different from the national accounts measure, is estimated at nearly 41 percent of GDP, growing 22.4 percent over 2005 in nominal terms. The investment share of the domestic private sector has risen from 23 percent in 2001 to 34 percent in 2006. FDI commitments, boosted by imminent WTO accession, surged to 10.2 billion dollars well above its 2005 level of 6.2 billion and surpassing the peak level of 9 billion in 1996. FDI commitments for 2007 have already reached 1.9 billion dollars.

Inflation trended down through most of 2006 reaching 6.6 percent in December, and 6.5 percent in February 2007. The moderation in prices resulted from both food and non-food components. The government has announced its intention to move towards market based pricing for petroleum products, steel, cement, coal, paper, and fertilizer. For gasoline such price adjustments have already become more market based. Electricity prices were raised by an average of 7.6 percent in January 2007, though low income households were shielded. Looking ahead, price pressures remain, as evidenced by the recent rise in steel and cement prices.

Export growth in 2006 stood at 22.8 percent about the same level as in the previous year. Exports of seafood, garments, and footwear were particularly strong, the latter despite of an antidumping suit in the EU. Import growth picked up in 2006 largely due to capital goods, in particular machinery and equipment for the Dung Quat oil refinery and industrial zone. The net result of these trends was a small trade surplus. With tourism and remittances remaining buoyant the current account is expected to have recorded a surplus of 1 to 1.5 percent of GDP. Inflows of FDI and ODA were also robust. ODA inflows reached 1.8 billion dollars while inflows of FDI, as recorded in the balance of payments, are estimated to have surpassed 2 billion dollars. Portfolio inflows also picked up in line with investment opportunities being offered by the growing domestic capital market. As a result foreign exchange reserves have seen a rapid rise: by end-December reserves had increased to over

12 billion dollars (11 weeks of next year's imports) compared with 8.6 billion dollars at end-2005.

The National Assembly ratified Vietnam's accession to the WTO in November, 2006 and the country was admitted in January 2007. In December, Vietnam was also accorded permanent normal trading relations (PNTR) or unconditional MFN by the US. Vietnam's tariff structure will witness major changes. The average tariff will decline from a current level of 17.4 percent to an average final bound of 13.4 percent. Average agricultural tariffs are to decline from 23.5 percent before accession to a final bound of 21 percent while industrial tariffs will fall from 16.6 to 12.6 percent. Tariff cuts are to be phased-in over periods ranging from 3 to 12 years, with most occurring within five years. On the services side, Vietnam will grant full trading and wide ranging distribution rights to foreign firms; it will allow 100 percent foreign owned banks; and will also significantly open up telecommunication services.

Fiscal revenues grew by 20 percent compared with 2005 and exceeded budgeted levels. Revenues from crude oil exports were buoyed by high international prices. Tax revenues from the private sector continue to rise, reaching 50 percent of non-oil revenues in 2006, up from 36 percent in 2001. On the expenditure side, minimum wage hikes have become an important contributor to the increase in recurrent outlays in the last three years. Minimum wages for state employees have been raised by a cumulative 214 percent since January 2003, the latest increase in October 2006. The minimum wage hike is also a basis for the adjustment of government pensions and other social security payments. The adjustments are designed to eliminate the minimum wage gap between domestic and foreign invested sectors by 2010 as part of international commitments. The budget deficit is estimated to have declined from 1.2 percent of GDP in 2005 to 0.7 percent in 2006. On-lending of ODA receipts to project implementing enterprises or agencies is expected to have attained 1.2 percent of GDP in 2006. Other items which contribute to public or publicly guaranteed debt, but are not included in the definition of the budget deficit amounted to 2.8 percent of GDP in 2006. Including these items, public debt is estimated around 44 percent of GDP at end-2006, a level considered to be within manageable limits.

Stock market capitalization surged from under 0.5 billion dollars in December 2005 to 13.8 billion (22.7 percent of GDP) by December 2006, and then to a current level of 24.4 billion. The number of listed firms rose from about 40 to nearly 200 at present. December alone witnessed more than 100 new listings as firms rushed to avail of tax incentives to be withdrawn in 2007. The stock price index shot up 144 percent in 2006 and has already seen an additional increase of 50 percent in the first two months of 2007. The market is set to expand further with 20 large state owned enterprises scheduled to list in 2007. The boom has inevitably led to concerns that stocks are being overvalued by inexperienced investors. The median price-earnings ratio stood at 21 in early 2007, with about a

quarter of the firms over 30. It is estimated that foreign stock holding is of the order of 4 billion dollars. The authorities have for now put to rest rumors that capital controls would be imposed in a bid to slow down foreign inflows or outflows. However measures have been announced to enhance disclosure by companies, clamp down on insider trading, and to limit bank lending against stocks.

Credit growth slowed from around 32 percent at end 2005 to 21 percent by mid-2006, but ticked-up somewhat to 25 percent by November 2006. The slower growth in 2006 was mainly attributable to more cautious lending by state owned banks as they adhered to stricter prudential standards. Lending from joint stock banks (JSBs) on the other hand grew by nearly 40 percent. Base money growth in 2006 was driven almost entirely by foreign inflows which were incompletely sterilized by the SBV. On the policy front, a new regulation stipulates that all joint stock, joint venture and foreign invested banks need to have a chartered capital of 1 trillion dong by 2008 and 3 trillion dong by 2010. For SOCBs a minimum chartered capital of 3 trillion dong is required by 2008. After nearly 15 months since the PM's decision to equitize Vietcombank and Mekong Housing Bank, the consultants to advise on the process have been hired. Under current plans the banks will conduct initial public offerings in the fourth quarter of 2007.

Smaller Economies

Cambodia

Cambodia's robust economic performance continued in 2006. Real GDP growth is estimated at about 10.5 percent, a third consecutive year of double-digit growth. Growth continues to be underpinned by garment exports, tourism, construction, and agricultural expansion. The garment sector, which employs 10 percent of the labor force and which accounts for 14 percent of GDP, expanded further, with exports rising by 20 percent in 2006. At the same time 20 percent growth in tourist arrivals resulted in a 26 percent jump in tourism receipts. Agriculture continued to expand (4.4 percent) while construction slowed slightly.

International and domestic conditions bode well for economic prospects in 2007. The four growth pillars—garments, tourism, construction, and agriculture—are expected to continue to thrive in 2007 with real GDP growth projected at about 9.0 percent and expected to remain strong in the medium term. Growing FDI and the discovery of offshore oil and gas reserves will likely bring about even higher growth (production is expected to start in 2009 or 2010). However, the garments sector is now facing stiffer competition from Vietnam's accession to the WTO and the possibility of greater competition from China in 2008. Agricultural growth in Cambodia has been particularly volatile in recent years, and is therefore somewhat

unpredictable. The new oil sector will also pose challenges for macroeconomic and fiscal management.

External developments were also positive. Despite pressure from high world oil prices, the current account deficit (excluding transfers) declined to -7.7 percent in 2006 (from -9.6 percent in 2005) and gross international reserves expanded by 20 percent to US\$ 1.1 billion. FDI continued its upward trend reaching a record high of US\$ 475 million. Consumer price inflation declined to 2.8 percent (from 6.7 percent in 2005), due to an easing of oil prices and a significant drop in food and clothing prices. The consumer price index is expected to remain low (below 5 percent) for 2007 and the riel (local currency) to remain stable both in terms of dollars and partner country currencies.

The fiscal front saw some improvement in 2006. Tax revenue grew modestly from 7.6 percent of GDP in 2005 to an estimated 8.0 percent in 2006. Non-tax revenue remained constant at 2.3 percent of GDP. Expenditure is estimated to have fallen slightly to 13.1 percent of GDP in 2006 (down from 13.6 percent of GDP in 2005) but greater emphasis continued to be put on the social sectors with a significant increase in nominal spending, though total capital spending declined in real terms. In the medium term, the overall budget balance is anticipated to be stable at around -3.7 percent of GDP (excluding grants).

Similarly, the financial sector saw some improvement in 2006. Combined deposits (in riel and foreign currency) of banks rose by 43 percent and the lending-to-deposit ratio has continued to trend upward, reaching 68 percent in 2006 (from 64 percent in 2005), reflecting growing business activities in 2006 (business registration grew by nearly 50 percent over 2005, for example). There are now 20 banks operating in Cambodia, up from 18 in 2005. Cambodia, however, remains a highly-dollarized economy with nearly 75 percent of broad money (M2) and 97 percent of banking deposits in US dollars. The commercial interest rate is still high at around 16 percent per annum.

On the structural reform agenda, the Government's Public Financial Management Reform Program continues to yield results. Following achievements in 2005 and 2006, a second wave of reforms started in January 2007, including: a streamlining of budget execution procedures to speed disbursements to spending agencies, the introduction of program budgeting to better align spending with priority National Strategic Development Plan objectives, and adoption of a new chart of accounts to improve expenditure reporting. These measures should improve the efficiency of the PFM system as well as reduce fiduciary risk by reducing the threat of corruption. From January 2007 import tariff rates have been reduced to reflect the ASEAN Harmonized System and the World Customs Organization Protocol Requirement. Though much remains to be done, banking reform has also shown progress. The Financial Sector

Development Strategy (FSDS) 2006-2015 will focus on a number of key challenges in the medium term, including improving financial institution operations, increasing intermediation, and strengthening the links between banking and microfinance.

Despite progress in many areas, Cambodia still faces difficult challenges in light of the Millennium Development Goals. The challenges include a high rural poverty rate, achieving high survival rates at all levels of the educational system, and improving access to quality health services, especially in terms of child and maternal health. However, a recently released demographic and health survey shows some progress. The infant mortality rate (per 1,000 live births) fell from 95 in 2000 to 66 in 2005 and child (under 5) mortality (per 1,000 live births) decreased from 124 in 2000 to 83 in 2005. HIV prevalence also appeared to have fallen remarkably. The notable lagging indicator is the maternal mortality rate, which likely remains unchanged over the past five years.

Fiji

A bloodless military coup ousted the elected Prime Minister and cabinet on December 5, 2006. A month later, Fiji's military commander who led the coup, was sworn-in as interim PM and has since installed a 16 member interim cabinet. The main priorities of the interim government include reforming the electoral process before holding the next general elections and establishing an anti-corruption unit to investigate alleged corrupt practices. In mid-February, the interim PM announced a 'roadmap' to democracy which could see the return to democratic rule in 2010. The roadmap includes plans for a review of Fiji's 1997 Constitution and an examination of electoral boundaries which will include a population census.

These events have drawn condemnation from several countries, some of whom have imposed sanctions on Fiji, such as suspension of part of their aid, and travel bans on the interim government officials. The Council of the Commonwealth suspended Fiji's membership, and the U.S. withdrew its support for the Fijian military's participation in new peace operations (although Fijian troops currently in Iraq are not affected). The interim government's 3-year roadmap has also been criticized with calls for speedier progress in restoring democracy.

Vigorous expansion in the services sectors, especially construction, led to a doubling of real GDP growth to 3.4 percent in 2006, notwithstanding a downturn in tourism and gold production that occurred later in the year. The tourist sector, Fiji's main foreign exchange earner, was adversely affected by the coup and the extended period of uncertainty that preceded it. Tourist visitor arrivals fell from 576,000 in 2005 to 545,000 in 2006. The closure of the Emperor Gold Mining Company's mining operations in early December 2006 occurred for commercial reasons—

gold production contracted by 50 percent and 1800 job losses are expected as a result. Sugar production in 2006 registered growth of 2 percent. In light of recent political developments, the European Union is however re-evaluating the nature of its F\$350 million (US\$208 million) adjustment support to the sugar industry. Inflation of about 3 percent has been well contained through tight monetary policy.

The fiscal deficit narrowed slightly to just below 4 percent of GDP in 2006, as targeted. The revised 2007 Budget, presented by the interim administration in early March, aims to reduce the fiscal deficit below 2 percent of GDP in 2007 (as was the target of the original 2007 Budget). The main measures to reduce public expenditure include a 5 percent civil service wage cut as well as reductions in capital expenditure, operating grants and transfers, and grants to the Fiji Visitors' Bureau. The VAT rate is maintained at its current level of 12.5 percent while customs tariff have been raised.

The revised budget aims to reduce the public debt level from 53 percent of GDP in 2006 to 45 percent of GDP in the medium-term, with most debt sourced domestically. Public external debt and debt service were below 5 percent of GDP and 2 percent of exports in 2006, respectively. However, interest payments on a US\$150 million international bond issue in September 2006—expected to mature in 2011—will increase debt servicing requirements.

The current account deficit widened through the year to November 2006. Merchandise exports (excluding mineral fuel re-exports) fell by 3 percent mainly due to lower earnings from sugar, while imports climbed by 17 percent owing to stronger consumption demand and higher cost of oil. This led to a downward slide in foreign exchange reserves, now estimated to stand at US\$457 million (equivalent to just over 3 months of imports) at end-January 2007.

A tight monetary stance is being maintained, with measures including interest rates hikes, credit ceilings on individual banks, exchange controls mainly on current account transactions, and the repatriation of the National Provident Fund's foreign assets. Overall, these measures appear to have safeguarded the reserves from further erosion.

Lao PDR

Lao PDR continues to enjoy rapid economic growth and impressive poverty reduction. Growth increased to 7.0 percent in 2005, up from 6.4 percent in 2004, and is estimated at about 7.5 percent in 2006. It is expected to remain at above 7 percent in the next few years - 7.1 percent for 2007 and 9.0 percent for 2008. Growth is being driven by FDI inflows in mining and hydro-power, by agriculture and processing industries as well as growing mineral exports. Non-hydro/mining sectors (agriculture, manufacturing and services/tourism) are expected to sustain growth and pick-up pace, due to rising FDI in those sectors.

The share of agriculture in GDP has been falling and is expected to drop further from 45 percent in 2005 to about 38 percent by 2008 while the contribution of industry should jump from 30 percent to 37 percent, with most of the growth coming from the power and mining sectors. Consumer price inflation continued to decline in 2006, falling to 6.8 percent on average (4.7 percent in December 2006) compared to 7.2 percent in 2005. It is expected to drop to around 4 percent in 2007 and 2008.

Macroeconomic conditions remain relatively stable, reflecting improved monetary and fiscal discipline, with inflation in single digits for the last a few years, and public expenditures under control. Budget revenues rose from 11.4 to 12.1 percent of GDP (FY2005/06), well above the original target of 11.4 percent. The budget deficit shrunk sharply, from 3.3 percent of GDP in FY2004/05 to 1.2 percent in FY2005/06 – especially due to capital expenditures below allocations. In FY2006/07, revenue is expected to increase to about 12.4 percent of GDP with the budget deficit at about 2 percent of GDP. The challenge for Lao PDR is to sustain this good revenue and fiscal performance in the future. The government has also continued to maintain a tight monetary policy stance and exchange rate stability in recent years. Reserves increased above the 3 months of imports mark in 2006 and should stay at that level in the coming years because of expected increases in mining exports, tourism receipts, and FDI inflows. However, the imports associated with large projects continue to push up the external current account deficit as a percent of GDP.

Lao PDR's external public debt burden remains high, but the debt service burden should be manageable with a prudent borrowing strategy. According to the latest joint Bank-Fund staff Debt Sustainability Analysis (DSA), at end-2004, Lao PDR's stock of public and publicly guaranteed external debt amounted to USD 2.1 billion in nominal terms and USD 1.36 billion in net present value (NPV) terms. This was equivalent to about 83 percent of GDP, or 55 percent of GDP in NPV terms (with indicative threshold of 30). The NPV of external debt comprised 199 percent of exports (with indicative threshold of 100) and 495 percent of fiscal revenues (with indicative threshold of 200). All three debt indicators exceed the indicative sustainability thresholds for countries with comparable CPIA ratings, placing Lao PDR in IDA's "high risk of debt distress" category. A prudent debt strategy would consist of borrowing on only concessional terms, supported by continuation of structural reforms, including SOE, banking and public financial management reform, together with stronger revenue collection and better prioritization of public expenditures.

The Government disseminated the final draft of the 6th National Socio-Economic Development Plan. The Plan presents a candid assessment of progress on structural reform in the last five years, and lays out the strategy for the next five years based on lessons learnt. After the Round

Table Meeting between the government and its development partners on November 28-29, it was decided that the Plan will be submitted as a Poverty Reduction Strategy (PRS). Progress has been good on the Public Financial Management reform agenda, with the Budget law drafted ahead of schedule. The Public Financial Management Strengthening Program (PEMSP) is gaining momentum. Efforts to improve public financial management are occurring on time before the point when revenues from the Nam Theun 2 project start coming on stream, in 2009/10. The Government is also trying to strengthen oversight of the State Owned Enterprises (SOEs). Good progress has also been achieved on private sector and trade reform. The new Enterprise Law has been approved but awaits the issuing of implementing decrees. Lao PDR is working on WTO accession. The legislative action plan has been prepared and initial offers on goods and services are being discussed in Geneva. Progress continues on commitments to reduce tariffs under AFTA and to introduce single window under ASEAN. At the Round Table Meeting, the Government presented a comprehensive strategy for private sector development and trade focusing on improving the investment climate and including reduction in cumbersome regulations and procedures at and behind the border.

Reform of state-owned banks has been slow, but there are new initiatives that will contribute to leveling the playing field in the banking sector. The SOE sector is borrowing less from banks and receiving lower subsidies from the government, while large SOEs are undergoing restructuring and adjustment in output prices. But the restructuring of state-owned commercial banks is not going well. The urgent priorities are to implement the modified Governance Agreements and make better use of the International Banking Advisors, strengthen the oversight and supervision of banks and reduce NPLs. There is also need to obtain private strategic partners. The government has already received several offers from international investors. There is also a need to 'level the playing field' for all state-owned and private banks, but progress on this account has been slow. The government has prepared the new Financial Institutions Law which seeks to level the playing field for all banks.

Some risks remain at the macro level: mainly fiscal pressures and upcoming boom in large projects. It will be a continuous challenge to sustain and improve revenue performance. New exemptions introduced on imports of petroleum products will tend to erode the revenue base. There is a need to widen the non-resource revenue base. There are also pressures to raise wages, albeit from a relatively low base. Another potential risk is the upcoming boom in mining and hydro-power investment which may bring some standard risks such as Dutch disease. In addition, the GOL is taking equity stakes in all new hydropower projects, in addition to royalties and taxation. Given the limited public resources available and the speed

of expansion in this sector, such policy may eventually undermine Lao PDR's debt sustainability as well as financial sustainability of the state electricity company (EDL, *Electricité du Laos*) through which these stakes are taken. The accumulation of arrears to utility companies should be kept under control. The government should consider using increased revenues to cover these obligations.

Mongolia

In 2006 Mongolia's GDP grew by 8.4 percent in real terms, of which 2.0 percentage points were contributed by agriculture, another 2.0 points by industry and the remaining 4.4 percentage points from services, bringing Mongolia's GDP per capita up to \$1,037 at the end of the year. Good weather conditions benefited Mongolia's livestock sector as well as agricultural production. As a result, livestock, which accounts for 21.7 percent of Mongolia's GDP, grew by 14.4 percent and crop production increased by 63.4 percent in 2006. The mining sector continues to benefit from high international gold and copper prices, which have led to new mine exploitation and increased production. Real growth in this sector reached 2.7 percent due in particular to a newly operating zinc mine as well as copper and gold extraction. The partnership agreement with the EU and the recovery of domestic food and cashmere industries contributed to a rise in manufacturing production. Trading sector real growth is estimated at 6.9 percent in 2006, benefiting in particular from strong real growth in hotel and restaurant services (30 percent percent) related to increased activity in tourism accompanying the 800 year Chinggis Khan Empire anniversary, and in telecommunications (14 percent) following the entry of a new cell phone operator.

Annual inflation reached 6 percent at the end of 2006, down from 9.5 percent in 2005. Contributing factors to this moderate rate were a sustained meat supply, a stable exchange rate leading to a moderate increase in the price of imported goods and a decrease in communication prices by 13.4 percent. Compared to 2005, money supply (M2) increased by 34.8 percent, due to increased export revenue and official and non official foreign inflows. Credit to private sector grew by 44.8 percent in 2006. Local currency commercial interest rate on loan declined to 24.5 percent in December 2006 from 28.3 percent in 2005.

Given the favorable conditions in the livestock and mining sectors, total Mongolian exports increased by 43.6 percent in 2006 while imports increased by 25.7 percent, leading to a trade surplus of \$39.6 million or 1.4 percent of GDP. This, combined with sustained remittances from overseas Mongolian workers as well as official transfers, led to a current account surplus of \$145 million at the end of 2006. With sustained capital inflows, including private investment and official capital inflows, net international reserves increased by 130.6 percent (reaching \$ 687mln) in 2006. As a result, Mongolia's freely floating exchange rate

has appreciated slightly against the US dollar (increasing by 4.5 in 2006 to reach Tg1,164 per US\$).

A fiscal surplus was recorded in 2006 for the second consecutive year, reaching 9 percent of GDP. General revenue and expenditure amounted respectively to 42.7 percent and 38.7 percent of GDP in 2006. The main factors contributing to this surplus were the exceptionally high level of copper and gold prices leading to an increase in foreign trade tax collection and dividend earnings, the introduction of the windfall tax which in the short term lead to increased revenue, an overall increase in tax collection due to a higher level of economic activity, as well as improved budget expenditure control and strengthened government financial management. Overall budget expenditure increased by 37 percent in 2006. Main contributing factors were a 30 percent wage increase since February 1, 2006 and the extension of welfare transfers.

Following the adoption of anticorruption legislation, an anticorruption agency was established early 2007 and should gradually begin operations in the course of the year. The agency is responsible for corruption prevention and public education, investigation of corruption cases as well as the collection, review and disclosure of financial statements for high-ranked public officials.

In 2006, 4 large state-owned enterprises were privatized and bought by foreign investors: the Gobi cashmere factory, the State Circus and Saving Bank. The largest commercial bank "TDB" changed ownership to a domestic investors' group.

Papua New Guinea

Papua New Guinea has experienced four consecutive years of moderate expansion, with real GDP growth rising to an estimated 3.7 percent in 2006. Inflation and interest rates on government securities remain modest, employment increased significantly in 2006, government debt has fallen sharply as a share of GDP, and foreign reserves have grown to more comfortable levels. High world prices for key export commodities (oil, copper and gold) have clearly helped economic performance, and contributed to significant fiscal and external current account surpluses in 2006. But prudent fiscal management has also played an important role. The forthcoming elections in July 2007 will mark the first time in Papua New Guinea's history that the Government will have remained in office for its full term. At the same time, poverty remains high, human development indicators weak, the quality of education and health care delivery poor, and the incidence of HIV/AIDS has increased sharply.

Growth of over 4 percent is forecast for 2007, reflecting an expansion in mineral production as new mines are opened, and a more expansionary fiscal stance. The non-mineral sector is expected to continue to grow by about 4 percent. Employment rose sharply across most sectors in 2006 with employment in non-mining and mining sectors up

by 8 and 6 percent, respectively—though urban unemployment remains very high.

A budget surplus of 6.4 percent of GDP in 2006 is attributable to increased mineral tax receipts and lower than budgeted development spending due in part to delayed supplementary budgets. A smaller fiscal surplus is projected for 2007 owing to a decline in projected mineral tax revenue and higher spending in the lead-up to the general elections. To maintain fiscal discipline, the 2006-07 budgets allocate spending away from current expenditure to one-off development expenditure mostly in infrastructure and human capital. Restrained fiscal policy in recent years—spending/GDP declined even as revenue/GDP has grown—has facilitated a significant reduction of central government gross debt from over 60 percent of GDP in 2003 to below 40 percent in 2006.

Average inflation increased somewhat in 2006 to 3.5 percent and may do so again in 2007 as higher government spending places upward pressure on prices. But it will likely remain within the Central Bank's medium-term inflation target range of 2.5 to 4.5 percent. Private credit growth remains strong while Treasury bill yields have declined slightly to the 3-4 percent range as issuance of Treasury bills ceased after May, in light of the continuing cash surplus.

The current account surplus nearly doubled as a share of GDP to about 7½ percent in 2006, benefiting from high commodity prices, but also reflecting strong growth of non-mineral exports. The kina remained broadly stable in 2006, appreciating by about 3 percent against the U.S. dollar. International reserves rose by about 90 percent in 2006 to nearly US\$1.5 billion, and amounted to over 8 months of mineral imports (and nearly 4 months of total imports).

While the macroeconomic outlook remains favorable, uncertainty has increased as a result of the looming general elections and the relatively frequent recent cabinet changes. The A\$8 billion (K20 billion) PNG-Australia gas pipeline project, which was due to begin construction in late 2006, has been called off following a commercial reassessment by foreign partners.

Solomon Islands

The formation of the new four-party Coalition for Change Government in May 2006 quelled the violent civil unrest that occurred in April 2006, following national elections and announcement of the initial choice of Prime Minister by the newly elected Parliament. The political situation however, remains fluid. Concurrently, a series of diplomatic rows between the Solomon Island and Australian governments has raised the possibility that this may constrain the Australian-led Regional Assistance Mission to Solomon Islands (RAMSI) operation in the country.

Economic growth of about 5 percent in both 2005 and 2006 has been aided by increased production of palm oil, higher (but unsustainable) rates of logging as well as expansion in the services sector, especially construction. The presence of RAMSI has also boosted demand for goods and services. Inflation of about 8 percent in 2006 reflected robust growth in private credit and strong demand from the expatriate community.

A current account deficit of 16 percent of GDP in 2006 resulted from high oil prices and an increase in non-oil imports used in investment projects. Foreign reserves stood at US\$98 million at end-2006, equivalent to just over 5 months of import cover. While the current account deficit is expected to remain high in 2007, gross reserves are not expected to be adversely impacted, given increased FDI linked to the palm oil and gold mine projects, as well as continued strong official development assistance.

A 25 percent increase in government revenue, aided by improved tax compliance and a growing economy, resulted in a budget surplus of 0.6 percent of GDP in 2006. However, further efforts will likely be needed to maintain fiscal discipline in the medium term. Fiscal risks include the impact of recent large public service wage increases, declining logging tax receipts, lower import duties and aid flows, recurrent expenditure needs, the fragile financial situation of state-owned enterprises and provincial governments and the potential impact of future fiscal decentralization.

Total public debt fell from 80 percent of GDP in 2005 to 70 percent in 2006, while external debt declined from 54 to 50 percent of GDP in the same period. Factors contributing to the reduction in debt include some debt relief received through the Honiara Club negotiations, and the agreement with the Central Bank of Solomon Islands to settle interest arrears and outstanding advances. Debt levels are still high, however, as is the risk of debt distress.

Timor Leste

Timor-Leste slid into crisis in April 2006, after over 40 percent of the army went on strike to protest alleged discrimination, after which they were dismissed by the Government. The ensuing violence was centered in Dili and left about 160,000 internally displaced, 35 dead and over 2,000 houses burnt. The violence exposed tensions within the military, between military and police, and between eastern and western parts of the country, and the country was forced to call upon international forces to restore order. While the conflict subsided after the arrival of foreign troops, security conditions remain fragile and incidents of violence, often gang related, have continued.

The security crisis led to a political crisis, forcing the resignation of former Prime Minister Alkatiri in mid-2006, his replacement in July by former foreign minister Ramos-Horta, and the house-arrest of the former interior minister on charges of distributing arms. UN supervised

Presidential elections are scheduled for April 9, 2007, with parliamentary elections to follow in June-July 2007. Amidst a fragile political environment, concerns of possible violence during or after the elections however remain.

There are still an estimated 30,000 people displaced in camps in Dili. Government and international agencies are continuing to provide humanitarian assistance, but many of the displaced are fearful of going back to their homes amidst concerns of insecurity.

The economy in 2006 was set back by the unrest with the closure of some government departments and disruption in private sector activity. Coffee production, the main non-oil export commodity, fell by about 20 percent, although the offshore oil and gas sector was undisturbed. Real non-oil GDP is estimated to have declined by nearly 2 percent in 2006, notwithstanding a year-end boost from higher public spending and international aid. CPI inflation spiked to nearly 7 percent by end-2006, reflecting supply disruptions and higher transportation costs. With the buildup of the new UN mission and higher government spending, non-oil GDP growth is expected to increase in 2007.

The implementation of Government's investment program has been hampered by delays in capital budget execution due to weak capacity. Private investment and job creation have also been weak. Unemployment in Dili, where about a quarter of the formal labor force resides, was estimated at 27 percent, and with 53 percent of the population under age 17, urban youth unemployment of 40 percent (aged 15-24) is a particular problem that appears to

have exacerbated the intensity of the recent conflict. A critical challenge therefore is to improve budget execution so that spending priorities can be better realized.

The fiscal and current account balances in 2006 each recorded surpluses of over 100 percent of non-oil GDP, and are projected to increase during 2007/08 reflecting large and growing revenue and royalties from offshore oil and gas fields. The FY2006/07 Budget provides for higher government spending, particularly for emergency assistance, wage bonuses for civil servants, and an increased subsidy to the state-owned electricity company (offsetting a reduction in electricity prices). Capital spending, particularly for infrastructure projects, is budgeted to more than triple, but actual spending is again expected to be well below budget reflecting the aforementioned constraints. Deposits accumulated in the Petroleum Fund had reached \$1 billion by February 2007.

The country faces the challenge of rebuilding trust and addressing the security situation and the rule of law. Adequate response to basic humanitarian needs and development requirements is also vital. In parallel, there is a need to jump-start the economy and respond to basic humanitarian needs and development requirements. Strong governance over the rapidly accumulating Petroleum Fund will need to be maintained, as will reforms to spur non-oil private sector activity.

APPENDIX TABLES
Appendix Table 1. Quarterly Real GDP Growth - % Change Year Ago

	China	Hong Kong	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan (China)	Thailand	East Asia
Q1 2001	9.1	2.4	3.9	3.5	2.9	1.3	4.6	0.6	1.7	5.5
Q2 2001	8.7	1.6	5.8	3.7	0.2	2.0	-0.7	-3.1	2.2	4.8
Q3 2001	8.1	-0.3	3.4	3.4	-1.2	1.4	-6.6	-4.6	2.1	3.8
Q4 2001	7.6	-1.0	1.6	4.6	-0.5	2.3	-6.2	-1.5	2.7	4.1
Q1 2002	8.8	-1.0	3.5	6.5	1.3	4.2	-0.5	1.3	4.5	5.8
Q2 2002	9.2	0.4	4.2	7.0	4.2	4.6	4.9	4.2	5.0	6.8
Q3 2002	9.3	2.9	5.6	6.8	6.0	3.3	6.5	6.1	5.8	7.3
Q4 2002	9.1	4.8	4.7	7.5	5.8	5.5	5.9	5.3	6.0	7.4
Q1 2003	10.8	4.4	4.9	3.8	5.0	4.8	3.1	3.4	6.9	7.2
Q2 2003	8.4	-0.7	5.0	2.2	4.7	4.3	-2.2	0.1	6.6	5.1
Q3 2003	10.1	4.0	4.6	2.3	5.3	5.4	3.7	4.2	6.7	6.7
Q4 2003	10.4	4.8	4.6	4.1	6.8	5.1	7.8	5.9	8.3	7.6
Q1 2004	9.8	8.1	4.1	5.4	7.9	6.5	8.8	7.6	6.7	8.0
Q2 2004	9.6	12.4	4.4	5.7	8.5	6.9	12.5	9.0	6.6	8.5
Q3 2004	9.2	6.7	4.5	4.7	6.8	6.0	7.4	5.5	6.2	7.2
Q4 2004	9.5	7.6	7.2	3.3	5.9	5.5	6.9	2.5	5.7	6.9
Q1 2005	10.5	6.3	6.1	2.9	6.1	4.2	3.7	2.5	3.5	7.1
Q2 2005	10.5	7.5	5.9	3.4	4.1	5.4	6.1	2.9	4.7	7.3
Q3 2005	10.2	8.4	5.8	4.8	5.3	4.8	8.2	4.2	5.5	7.7
Q4 2005	10.4	7.8	5.0	5.5	5.2	5.3	8.3	6.4	4.3	8.0
Q1 2006	10.4	8.0	5.0	6.3	5.9	5.7	10.1	4.9	6.1	8.2
Q2 2006	11.5	5.5	5.0	5.1	6.2	5.8	8.0	4.6	5.0	8.3
Q3 2006	10.6	6.7	5.9	4.8	5.8	5.3	7.0	5.0	4.7	7.9
Q4 2006	10.4	7.0	6.1	4.0	5.7	4.8	6.6	4.0	4.2	7.6

Source: Haver Analytics and national sources. Quarterly data for China is estimated using new annual production side GDP data.

Appendix Table 2: East Asia: Merchandise Export Growth

(US \$; % change form a year ago)

	2005	2006	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07
East Asia (9)	18.0	19.8	17.0	19.8	19.4	21.6	18.4	16.0	23.0	16.4		
SE Asia	13.2	16.2	11.2	14.9	16.8	17.7	15.2	9.1	23.3	13.7		
Indonesia	19.7	17.7	13.9	12.9	17.2	20.7	18.2	9.6	29.5	18.3	10.5	
Malaysia	11.4	14.0	13.3	13.7	14.2	17.1	11.2	-0.8	22.9	13.0	16.5	
Philippines	4.0	13.9	3.5	13.4	19.5	15.9	7.4	15.5	10.7	-3.6	21.8	
Thailand	14.5	18.8	9.5	18.6	18.9	16.8	21.0	19.9	24.0	19.0		
China	28.4	27.2	21.7	26.6	24.0	28.7	28.9	29.5	32.7	24.8	33.0	51.7
NIEs	12.7	15.5	15.7	17.0	16.7	17.5	11.3	8.5	15.0	10.3	16.9	5.3
Hong Kong	11.6	9.4	10.4	12.8	5.6	8.2	11.5	7.5	13.8	13.4	8.5	10.8
Korea	12.0	14.6	11.4	10.5	16.9	16.4	14.4	10.7	18.7	13.8	20.9	11.3
Singapore	18.8	27.4	31.0	36.7	35.3	32.1	10.5	10.1	17.9	4.3	22.2	-0.6
Taiwan (China)	8.8	12.5	14.2	11.8	13.7	18.0	7.2	5.2	8.0	8.4	17.3	-3.8

Appendix Table 3. East Asia and the Pacific: GDP Growth Projections

	2000	2001	2002	2003	2004	2005	Estimate 2006	Forecast 2007	Forecast 2008
East Asia	7.8	4.6	6.9	6.8	8.0	7.6	8.1	7.3	7.1
Developing East Asia	7.7	6.7	7.9	8.9	9.1	9.0	9.5	8.7	8.1
South East Asia	6.0	2.4	4.6	5.6	6.0	5.1	5.4	5.5	5.7
Indonesia	5.4	3.8	4.4	4.7	5.1	5.7	5.5	6.3	6.5
Malaysia	8.9	0.3	4.4	5.5	7.2	5.2	5.9	5.6	5.8
Philippines	6.0	1.8	4.3	5.0	6.2	5.0	5.4	5.6	6.0
Thailand	4.8	2.2	5.3	7.1	6.3	4.5	5.0	4.3	4.5
Transition									
China	8.4	8.3	9.1	10.0	10.1	10.2	10.7	9.6	8.7
Vietnam	6.8	6.9	7.1	7.3	7.7	8.5	8.2	8.0	8.0
Small Economies	3.2	3.9	3.6	5.1	6.6	7.8	7.2	6.0	5.8
Cambodia	8.4	7.7	6.2	8.6	10.0	13.4	10.5	9.0	6.8
Timor-Leste	15.4	16.6	-6.7	-6.2	0.3	2.3	-1.6	5.0	3.5
Lao PDR	5.8	5.8	5.9	6.1	6.4	7.0	7.5	7.1	9.0
Mongolia	1.1	1.0	4.0	5.6	10.7	6.2	8.4	7.0	7.0
Fiji	-1.7	2.0	3.2	1.0	5.3	0.7	3.4	-2.5	2.0
Kiribati	1.9	1.8	-4.3	2.3	-1.4	0.3	0.8	0.8	..
Marshall Islands	0.9	5.5	4.0	1.8	0.4	3.5	4.0	3.5	3.0
Micronesia, Fed. Sts.	8.4	0.3	1.1	5.1	-3.8	0.3	1.0	1.0	..
Palau	0.3	1.3	-3.5	-1.3	4.9	5.5	5.7	5.5	4.8
Papua New Guinea	-1.2	-0.1	-0.2	2.2	2.7	3.3	3.7	4.3	3.7
Samoa	7.0	7.1	4.4	1.6	3.2	5.4	2.3	3.1	3.5
Solomon Islands	-14.3	-9.0	-1.6	6.4	8.0	5.0	5.3	6.2	3.3
Tonga	5.2	1.8	3.0	3.2	1.4	2.3	1.9	0.6	1.6
Vanuatu	2.7	-2.7	-4.9	2.4	5.0	6.1	3.0	2.4	2.4
East Asia NIEs	8.0	1.1	5.2	3.2	6.0	4.8	5.4	4.6	5.0
Hong Kong (SAR)	10.0	0.6	1.8	3.2	8.6	7.5	6.8	5.3	5.1
Korea	8.5	3.8	7.0	3.1	4.7	4.0	5.0	4.5	5.0
Singapore	10.1	-2.4	4.2	3.1	8.8	6.6	7.9	5.5	5.6
Taiwan (China)	5.8	-2.2	4.2	3.4	6.1	4.0	4.6	4.1	4.6
Japan	2.8	0.2	0.1	1.8	2.7	2.6	2.2	2.3	2.4

Source: World Bank data and staff estimates. East Asia is the sum of Developing East Asia and the Newly Industrialized Economies.

Appendix Table 4: Primary Commodity Prices

(US Dollars - % change from a year ago)

Commodity	Actual								Projections		
	1980-90	1991-98	2000	2001	2002	2003	2004	2005	2006	2007	2008
Crude oil average	0.0	-5.7	56.2	-13.7	2.4	15.9	30.6	41.5	70.4	-12.2	-3.6
Non-Energy Commodities	-0.8	0.4	-1.4	-9.1	5.3	10.2	17.5	13.4	0.0	24.6	-1.0
Agriculture	-1.9	0.8	-5.7	-9.1	8.6	9.6	10.5	7.9	24.6	12.0	0.0
Cocoa	-7.3	4.0	-20.2	18.0	66.4	-1.5	-11.5	-0.8	2.7	0.5	-0.8
Coffee, arabica	-3.6	12.6	-16.2	-28.5	-1.2	4.3	25.3	42.7	42.2	0.3	-1.7
Coconut oil	-1.4	10.6	-38.9	-29.4	32.4	11.0	41.4	-6.6	-8.1	15.3	-1.9
Palm oil	-3.0	12.3	-28.8	-7.9	36.6	13.6	6.3	-10.4	1.5	12.9	-2.3
Rice, Thai, 5%	0.8	2.1	-18.5	-14.6	11.0	3.0	20.3	20.4	28.3	5.0	-3.1
Sugar, world	16.4	-2.8	30.6	5.6	-20.3	3.0	1.1	37.8	106.3	-21.7	-2.0
Logs, Malaysia	1.9	3.4	1.5	-16.3	2.7	14.5	5.4	3.0	21.4	14.9	5.5
Sawnwood, Malaysia	4.1	-0.1	-1.0	-19.1	9.4	4.6	5.5	13.2	28.9	11.4	5.4
Rubber, RSS1, Singapore	-1.7	0.5	6.2	-13.8	33.0	41.5	20.4	15.2	61.6	-14.6	-3.1
Metals and minerals	2.9	-2.6	12.6	-9.6	-3.1	12.7	37.1	26.7	0.0	50.9	-2.3
Tin	-6.7	-0.7	0.6	-17.5	-9.5	20.5	73.9	-13.3	3.1	13.9	-15.0
Copper	4.3	-4.1	15.3	-13.0	-1.2	14.1	61.1	28.4	134.6	-10.7	-25.0

Source: World Bank DEC Prospects Group.

Appendix Table 5: East Asia: Exchange Rates (LCU/\$)

	China	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan, China	Thailand	Yen
Apr-2006	8.02	8775.00	945.70	3.63	51.83	1.58	31.91	37.52	114.30
May-2006	8.02	9220.00	947.40	3.63	52.65	1.58	32.02	38.13	112.24
Jun-2006	8.00	9300.00	960.30	3.68	53.59	1.59	32.40	38.22	114.95
Jul-2006	7.97	9070.00	953.10	3.65	51.62	1.58	32.76	37.85	114.80
Aug-2006	7.96	9100.00	959.60	3.68	50.94	1.57	32.91	37.58	117.32
Sep-2006	7.91	9235.00	945.20	3.68	50.39	1.59	33.10	37.54	117.80
Oct-2006	7.88	9110.00	944.20	3.65	49.81	1.56	33.26	36.75	117.65
Nov-2006	7.84	9165.00	929.90	3.62	49.76	1.54	32.43	36.02	116.40
Dec-2006	7.81	9020.00	929.60	3.53	49.13	1.53	32.60	36.04	118.95
Jan-2007	7.78	9090.00	940.90	3.50	49.03	1.54	32.95	35.80	121.68
Feb-2007	7.74	9160.00	938.30	3.51	48.29	1.53	32.95	35.45	118.54
Mar 28- 2007	7.73	9150.00	940.78	3.46	48.12	1.52	44.30	32.11	116.92

Appendix Table 6: East Asia: Foreign Reserves Minus Gold (US\$ Billion)

	China	Indonesia	Malaysia	Philippines	Thailand	Hong Kong (SAR)	Korea	Singapore	Taiwan, China	Total
Dec-1996	107.039	19.281	27.009	9.905	37.810	63.808	33.201	76.847	88.038	462.938
Dec-1997	142.762	17.396	20.788	7.178	26.254	92.804	20.369	71.289	83.502	482.341
Dec-1998	149.188	23.516	25.559	9.273	28.825	89.650	51.975	74.928	90.341	543.255
Dec-1999	157.728	27.257	30.588	13.282	34.063	96.236	73.987	76.843	106.200	616.185
Dec-2000	168.278	29.394	29.523	13.090	32.016	107.542	96.131	80.132	106.742	662.848
Dec-2001	215.605	28.016	30.474	13.476	32.363	111.155	102.753	75.375	122.211	731.428
Dec-2002	291.128	32.039	34.222	13.329	38.055	111.896	121.343	82.021	161.656	885.689
Dec-2003	408.151	36.296	44.607	13.655	41.077	118.360	155.282	95.746	206.632	1119.806
Dec-2004	614.500	36.320	66.418	13.116	48.665	123.540	198.994	112.232	241.738	1455.523
Dec-2005	821.514	34.724	70.203	15.926	50.692	124.244	210.317	115.794	253.290	1696.704
Oct-2006	1012.008	39.895	79.345	19.440	60.685	131.181	229.387	131.553	261.820	1965.314
Nov-2006	1040.926	41.579	79.500	19.658	62.756	132.661	234.183	134.308	265.140	2010.711
Dec-2006	1068.489	42.586	82.164	20.025	65.292	133.168	238.882	136.717	266.148	2053.471

Source: Haver Analytics, Datastream

Appendix Table 7: Regional Aggregates for Poverty Measures in East Asia

	\$1 -a-day			\$2-a-day		
	Mean Consumption (1993 PPP\$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)	Population (mill.)
EAP						
1990	68.03	28.8	456.9	66.9	1,060.8	1585.4
1996	99.84	14.7	252.1	49.6	851.2	1716.0
1999	101.93	15.5	274.8	49.9	884.8	1772.4
2000	113.40	13.9	247.9	45.8	820.0	1789.6
2001	121.50	12.9	233.7	43.2	780.1	1805.6
2003	139.67	10.5	192.9	37.3	686.3	1838.0
2004	149.78	9.4	173.2	34.1	631.3	1850.2
2005	162.39	8.1	151.4	30.9	576.8	1865.5
2006	175.19	7.6	142.9	29.4	552.4	1880.7
2007	188.56	6.9	131.3	27.5	521.6	1896.2
2008	200.81	6.3	119.4	25.8	490.9	1906.1
EAP less China						
1990	96.44	21.8	96.3	59.1	261.2	442.1
1996	136.25	10.4	51.3	44.6	219.6	492.1
1999	123.58	11.0	56.4	50.8	261.2	514.5
2000	132.13	10.2	53.1	48.4	252.6	522.2
2001	135.59	9.6	50.8	47.3	250.5	529.3
2003	145.78	7.5	40.8	41.3	225.6	545.7
2004	150.14	7.3	40.0	39.0	214.9	550.4
2005	155.84	6.2	34.4	36.5	203.4	557.8
2006	158.90	6.7	38.1	37.3	210.6	565.4
2007	164.68	6.2	35.5	35.4	202.9	573.1
2008	167.25	5.5	31.5	33.4	191.9	575.3
S.E.Asia 4						
1990	82.33	17.8	56.0	60.3	189.7	314.6
1996	111.23	7.9	27.5	43.6	152.7	350.2
1999	97.26	10.1	36.9	52.8	193.5	366.2
2000	102.89	9.2	34.4	49.9	185.5	372.0
2001	104.27	8.6	32.4	48.7	183.7	377.2
2003	114.10	6.7	26.2	42.2	164.3	389.2
2004	118.71	6.9	27.3	41.0	161.8	394.8
2005	124.03	6.0	23.9	38.5	154.1	400.4
2006	124.33	7.1	28.9	40.4	164.0	406.1
2007	128.65	6.6	27.2	38.6	158.8	411.8
Lower Income EA (Cambodia, Laos, PNG, Vietnam)						
1990	45.21	47.7	40.3	84.6	71.6	84.6
1996	64.62	24.6	23.7	69.4	66.9	96.4
1999	68.68	19.1	19.5	66.5	67.6	101.6
2000	71.72	18.1	18.7	64.9	67.0	103.2
2001	74.40	17.5	18.3	63.7	66.7	104.8
2003	81.66	13.3	14.5	56.3	61.2	108.7
2004	89.39	11.7	12.6	49.4	53.1	107.5
2005	94.84	9.6	10.4	45.1	49.3	109.1
2006	99.98	8.2	9.1	42.0	46.6	110.8
2007	105.20	7.3	8.2	39.2	44.1	112.5

Appendix Table 8: Poverty in East Asia - Country Estimates

	\$1 -a-day			\$2-a-day		Gini Coefficient	Population (mill.)
	Mean Consumption (1993 PPP\$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)		
Cambodia							
1990	55.95	32.5	3.4	76.3	7.9	--	10.3
1996	66.43	24.2	2.8	69.3	8.1	--	11.7
1999	70.67	21.0	2.6	66.6	8.3	--	12.5
2000	70.42	22.6	2.9	67.8	8.6	--	12.7
2001	71.88	21.4	2.8	66.8	8.7	--	13.0
2003	74.33	18.9	2.6	64.6	8.7	--	13.5
2004	76.56	19.0	2.6	63.9	8.8	41.7	13.8
2005	86.02	12.4	1.7	56.2	7.9	--	14.1
2006	90.88	10.9	1.6	53.6	7.7	--	14.4
2007	95.03	10.0	1.5	52.0	7.6	--	14.6
2008	99.38	9.4	1.4	50.3	7.5	--	14.9
China							
1990	57.05	31.5	360.6	69.9	799.6	36.0	1,143
1996	85.20	16.4	200.8	51.6	631.6	39.3	1,224
1999	93.07	17.4	218.4	49.6	623.6	42.6	1,258
2000	105.69	15.4	194.8	44.8	567.4	43.9	1,267
2001	115.65	14.3	183.0	41.5	529.6	44.9	1,276
2003	137.09	11.8	152.2	35.7	460.7	--	1,292
2004	149.63	10.3	133.2	32.0	416.4	--	1,300
2005	165.18	8.9	117.0	28.6	373.5	--	1,308
2006	182.19	8.0	104.9	26.0	341.7	--	1,315
2007	198.90	7.2	95.9	24.1	318.7	--	1,323
2008	215.31	6.6	87.9	22.5	299.0	--	1,331
Indonesia							
1990	61.58	20.6	36.7	71.1	126.7	28.9	178.2
1996	86.62	7.8	15.4	50.5	99.6	36.5	197.2
1999	66.80	12.0	24.9	65.1	135.0	31.0	207.4
2000	72.53	9.9	20.9	59.5	125.3	--	210.5
2001	73.44	9.2	19.7	58.7	125.2	--	213.2
2003	83.98	6.6	14.5	50.1	110.0	34.1	219.4
2004	85.58	7.4	16.5	49.0	109.1	34.7	222.7
2005	90.21	6.0	13.6	45.2	102.1	34.9	226.1
2006	85.65	8.5	19.5	49.6	113.8	35.4	229.5
2007	87.96	8.2	19.0	47.9	111.5	--	232.9
2008	92.05	7.2	17.1	45.1	106.7	--	236.4
Laos							
1990	39.16	53.0	2.2	89.6	3.7	--	4.2
1996	48.27	41.3	2.0	83.1	4.1	--	4.9
1999	51.56	36.6	1.9	80.5	4.2	--	5.3
2000	53.31	33.9	1.8	79.4	4.3	--	5.4
2001	55.48	31.3	1.7	77.4	4.3	--	5.5
2003	59.03	25.5	1.5	73.1	4.2	--	5.8
2004	61.40	22.9	1.4	71.1	4.2	--	5.9
2005	64.24	20.0	1.2	68.6	4.2	--	6.1
2006	67.40	17.5	1.1	65.9	4.1	--	6.2
2007	70.24	15.1	1.0	63.4	4.0	--	6.4
2008	74.89	12.1	0.8	58.7	3.8	--	6.5

Appendix Table 8: Poverty in East Asia - Country Estimates (Continued)

	\$1 -a-day			\$2-a-day		Gini Coefficient	Population (mill.)
	Mean Consumption (1993 PPP\$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)		
Malaysia							
1990	195.32	2.0	0.4	18.5	3.4	--	18.2
1996	261.87	0.8	0.2	13.1	2.8	--	21.1
1999	271.70	< 0.5	--	12.6	2.9	--	22.7
2000	304.27	< 0.5	--	9.7	2.3	--	23.3
2001	304.09	< 0.5	--	9.7	2.3	--	23.8
2003	325.57	< 0.5	--	8.1	2.0	--	24.7
2004	353.60	< 0.5	--	6.3	1.6	--	25.1
2005	379.36	< 0.5	--	4.8	1.2	--	25.5
2006	399.58	< 0.5	--	3.8	1.0	--	25.9
2007	416.24	< 0.5	--	3.0	0.8	--	26.2
2008	434.43	< 0.5	--	2.3	0.6	--	26.6
PNG							
1990	82.18	29.7	1.2	59.4	2.3	--	3.9
1996	93.15	24.6	1.1	54.4	2.5	48.4	4.6
1999	78.35	30.7	1.5	61.6	3.1	--	5.0
2000	71.87	35.3	1.8	65.0	3.3	--	5.1
2001	66.43	38.0	2.0	69.2	3.6	--	5.3
2003	63.35	39.2	2.2	70.8	3.9	--	5.6
2004	63.78	38.8	2.2	70.6	4.0	--	5.7
2005	63.68	39.0	2.3	70.6	4.1	--	5.9
2006	64.24	39.2	2.4	70.1	4.2	--	6.0
2007	65.25	38.6	2.4	69.0	4.3	--	6.2
2008	65.90	38.1	2.4	68.0	4.3	--	6.3
Philippines							
1990	90.32	19.1	12.0	53.5	33.5	--	62.6
1996	107.15	14.8	10.6	46.5	33.4	--	71.9
1999	107.20	13.5	10.0	46.9	34.9	--	74.4
2000	106.93	13.5	10.3	47.2	36.0	46.2	76.3
2001	106.10	13.5	10.5	46.7	36.3	--	77.9
2003	106.35	13.1	10.6	45.6	36.9	44.5	81.1
2004	110.88	11.7	9.6	43.4	35.8	--	82.4
2005	113.87	10.8	9.1	42.1	35.3	--	83.7
2006	118.60	9.6	8.1	39.9	34.0	--	85.1
2007	123.30	8.4	7.3	38.0	32.9	--	86.5
2008	128.20	7.4	6.5	36.1	31.7	--	87.9
Korea							
1990	301.09	< 0.5	--	< 0.5	--	29.88	42.87
1996	480.46	< 0.5	--	< 0.5	--	29.71	45.52
1999	450.06	< 0.5	--	< 0.5	--	30.00	46.62
2000	496.18	< 0.5	--	< 0.5	--	--	47.01
2001	520.51	< 0.5	--	< 0.5	--	--	47.35
2003	549.12	< 0.5	--	< 0.5	--	--	47.85
2004	544.02	< 0.5	--	< 0.5	--	--	48.08
2005	557.48	< 0.5	--	< 0.5	--	--	48.29
2006	583.01	< 0.5	--	< 0.5	--	--	48.50
2007	606.91	< 0.5	--	< 0.5	--	--	48.69

Appendix Table 8: Poverty in East Asia - Country Estimates

	\$1-a-day			\$2-a-day		Gini Coefficient	Population (mill.)
	Mean Consumption (1993 PPP\$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)		
Thailand							
1990	102.88	12.5	7.0	47.0	26.1	43.8	55.6
1996	143.92	2.2	1.3	28.2	16.9	43.4	60.0
1999	123.50	3.1	1.9	33.6	20.7	--	61.7
2000	125.42	5.2	3.2	35.6	22.0	43.2	61.9
2001	131.21	3.6	2.2	32.0	19.9	--	62.3
2003	145.46	1.6	1.1	24.0	15.3	--	64.0
2004	151.53	1.8	1.2	23.8	15.4	42.5	64.6
2005	154.50	1.9	1.2	23.8	15.5	--	65.1
2006	158.50	1.8	1.2	23.2	15.3	--	65.7
2007	164.84	1.4	0.9	20.6	13.6	--	66.2
2008	170.89	1.1	0.7	18.6	12.4	--	66.8
Vietnam							
1990	41.73	50.8	33.6	87.0	57.6	--	66.2
1996	63.66	23.6	17.7	69.4	52.2	--	75.2
1999	68.90	16.9	13.4	65.9	52.0	--	78.9
2000	73.16	15.2	12.1	63.5	50.7	--	79.9
2001	76.62	14.6	11.8	61.8	50.1	--	81.0
2003	85.63	9.9	8.3	52.9	44.3	--	83.8
2004	95.36	7.8	6.4	43.9	36.0	37.0	82.0
2005	100.77	6.2	5.2	39.7	33.0	--	83.1
2006	106.50	4.9	4.1	36.3	30.6	--	84.2
2007	112.45	4.0	3.4	33.0	28.2	--	85.3

Notes for Appendix Tables 7 and 8

The poverty lines in Tables 7 and 8 are set at \$1.08 and \$2.15 per person per day (in 1993 PPP\$) for all countries. For most countries, 1993 World Bank PPP estimates are used. The PPP for the Philippines is from the Penn World Tables, while that for PNG is the 1996 World Bank PPP. PPPs for Vietnam, Lao PDR and Cambodia have been further adjusted using a calorie price ratio between Indonesia and Vietnam. Projections are based on World Bank growth rate forecasts for 2003-2004.

Wherever possible, the projections utilize information on sectoral GDP growth rates, changes in the food CPI relative to the general CPI, changes in the GDP deflator relative to the CPI, and changes in the consumption-income ratio. The projections assume that there is no change in relative inequalities *within* sectors. For China, the projections are done separately for rural and urban China, and then aggregated using population shares. Estimates for all countries except Malaysia and China are based on surveys of household consumption. The estimates for Malaysia and China use income surveys. For China, a survey-based estimate of mean consumption is used in conjunction with the income Lorenz curves to derive poverty estimates. These poverty estimates differ from those commonly found in national poverty assessments for two main reasons. First, country assessments use national poverty lines that differ from the uniform international poverty lines used here. Second, national poverty lines also typically allow for spatial cost of living differentials within countries, but such adjustments are omitted here to maintain a consistent methodology across countries. For instance, in the case of Thailand, these differences explain why the above estimates indicate a small increase in poverty between 1998 and 2000 (in spite of adjusting the CPI by the change in the national poverty lines over this period), while national poverty line-based estimates indicate a decline. Also for Thailand, the 2002 estimate is based on a longer consumption module, which could lead to a small overestimation of consumption relative to 2000. Poverty estimates for the Philippines for the years 2001 and 2002 are an average of a "forward" projection using survey data for 2000 and a "backward" projection using survey data for 2003.

Appendix Table 9: NPLs of Commercial Banks
(% of total loans)

	1997 Dec	1998 Dec	1999 Dec	2000 Dec	2001 Dec	2002 Dec	2003 Dec	2004 Dec	2005 Dec	2006 Dec
Indonesia a/	7.2	48.6	32.9	18.8	12.1	7.5	6.8	4.5	7.6	6.1
Korea b/	6.0	7.3	13.6	8.8	3.3	2.4	2.2	2.0	1.3	0.9
Malaysia c/	..	10.6	11.0	9.7	11.5	10.2	9.0	7.5	5.8	4.8
Philippines d/	4.7	10.4	12.3	15.1	17.3	15.0	14.1	12.7	8.5	6.0
Thailand e/	..	45.0	39.9	19.5	11.5	18.1	13.9	11.6	8.3	8.1

(a) Excludes IBRA's AMC; end-3Q 2006 data is as of Aug. (b) Excludes KAMCO/KDIC. The NPL ratio increased in 1999 due to the introduction of stricter asset classification criteria (forward looking criteria); (c) Excludes Danaharta. NPL series used by Bank Negara Malaysia, which is net of provisions and excludes interest in suspense; (d) From September 2002 onwards, the NPLs ratios are based on the new definition of NPLs (as per BSP Circular 351) which allows banks to deduct bad loans with 100 percent provisioning from the NPL computations; (e) Excludes transfers to AMCs. (Note that the jump in headline NPLs in December 2002 was a one-off increase, reflecting a change in definition and did not affect provisioning requirements).

Special Focus

Sustainable Development in East Asia's Urban Fringe

Introduction

Two features that make East Asia's urbanization¹ notable in comparison with other regions are the overall low urbanization level and the high population density of its mega cities. East Asia is remarkably under-urbanized in comparison to regions such as the Americas and Europe. Even if one takes into account income figures, several countries in East Asia are still relatively under-urbanized. For example, China has about 75 percent of Brazil's real gross domestic product (GDP) per person in purchasing power parity (PPP) terms but while 84 percent of the Brazilians live in cities, only around 40 percent of the Chinese do so. Even richer East Asian economies such as Korea, while having more than 2.5 times Brazil's per capita real PPP GDP, is slightly less urbanized (81 percent).² Yet, if one looks at the East Asian mega cities, not only are they comparably large but they are also more densely packed. Average urban densities in East Asia range from 10,000 to around 15,000 persons per sq km -- about double the urban densities of Latin America, triple those of Europe, and ten times those of US cities. In other words, not many East Asians live in cities, but those who do are crowded into a relatively small area.

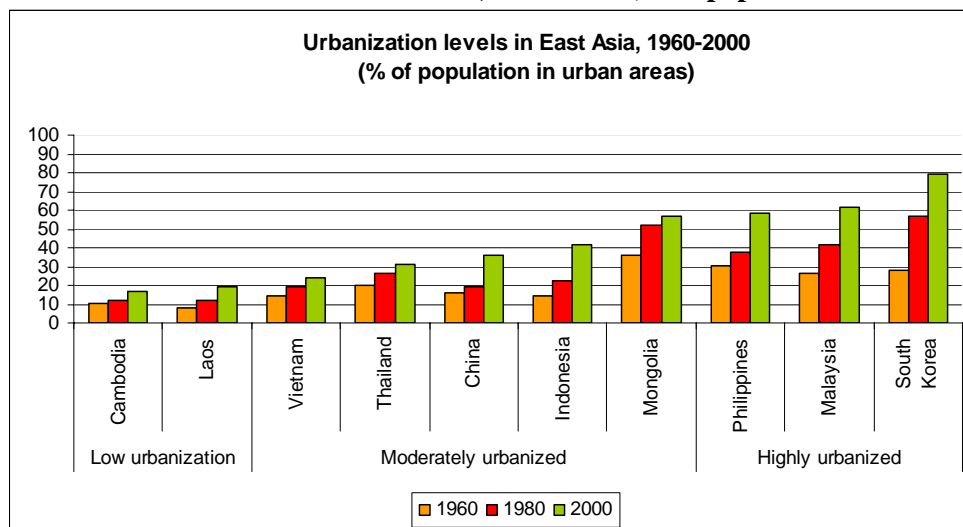
At the same time, policymakers in several East Asian countries perceive that the path out of poverty is the path of urbanization. There are several reasons for this view. Urbanization facilitates the provision of services such as health, education and infrastructure, increasing opportunities for knowledge sharing and learning,

diminishing transaction costs, among others. Agglomeration economies help create internationally connected mega cities, concentrating production and generating economic growth. As elsewhere in the world, agglomeration economies are present in East Asian countries, even if they are under-urbanized. In Vietnam, where only about 25 percent of the population is urban, towns and cities contribute 70 percent of the national output. In China, 120 cities contribute 75 percent of the country's GDP. In the more urbanized countries of the region, the same is true. In Korea, about half of the country's GDP comes from the capital area of Seoul (Fujita and Thisse 2002), and Metro Manila and surrounding areas account for about 60 percent of the Philippines' economic growth (Webster 2004).

A Snapshot of Urbanization in East Asia

Urbanization has been occurring at different degrees in East Asian countries throughout the last century. Yet, as indicated in Figure 1, in 1960 most countries of the region were under-urbanized. By 2000, countries could be grouped into three categories: "high" urbanization (over 50 percent of the total population in urban areas) -- Korea, Malaysia, the Philippines; and Mongolia; moderate urbanization (25 - 50 percent) -- Vietnam, Thailand, China, and Indonesia and low urbanization (under 25 percent) -- Laos and Cambodia.

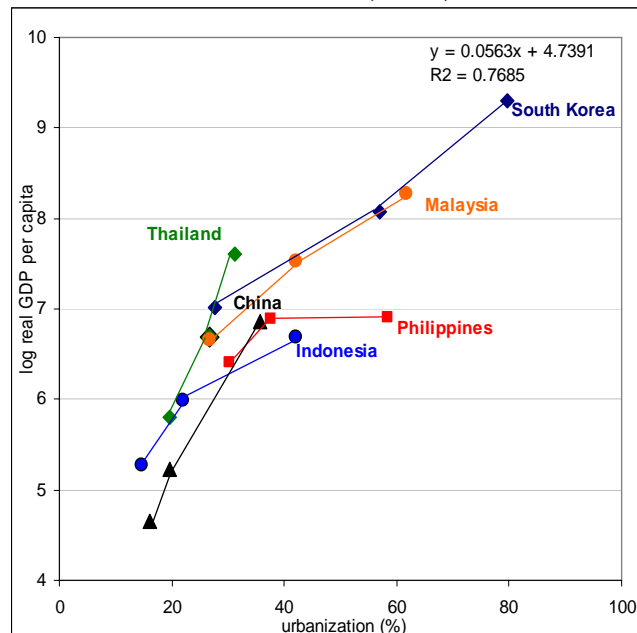
Figure 1: Urbanization Levels in East Asia, 1960-2000 (% of population in urban areas)



While the pace of urbanization varies among countries, Figure 2 clearly shows that, as countries urbanize they also grow richer. One East Asian country however is an exception – although the Philippines witnessed most of its urbanization between 1980 and 2000, the country’s real GDP per capita changed little over the period. It is unlikely that a single factor can fully explain this phenomenon, but the highly concentrated nature of the country’s urbanization, coupled with the haphazard fashion in which it has been occurring (and perhaps the fragmentation of its geography – a characteristic also shared by Indonesia), may offer some clues. Perhaps public “bads” associated with unmanaged urbanization such as congestion and pollution, among others, are neutralizing many of the benefits of agglomeration.

East Asia’s under-urbanization is likely to change significantly and at an increasing pace over the two coming decades. Between 2000-2025, according to the United Nations Population Division, the total population of East Asia is expected to increase by about 17 percent, while its urban population is expected to increase by around 65 percent, or by 500 million people. As Table 1 indicates, by 2030, over 60 percent of China’s population will be urbanized. In the Philippines, almost 80 percent of the population will be living in cities. By 2030, in East Asia as a whole, most people will be urbanized.

Figure 2: Log real GDP per capita and urbanization in 1960, 1980, and 2000



Most of this growth will be happening on the urban fringe. In China, according to Webster (2004), peri-urban areas alone are expected to grow by approximately 250 million persons over the next three decades. The social, environmental and economic consequences and implications of this trend region-wide are likely to outweigh most other major development issues in the coming decades. This note provides a special focus on development in East Asia’s urban fringe, which will play a central role in the region’s efforts to grow through middle-income levels.

Table 1: Projected Urban Population Growth in East Asia, 2000-2030

Country	Urban Population (1,000)		Geographical Distribution 2030 (%)	Increase 2000-2030		Average Annual increase 2000-30 (1,000)	Urbanization level 2030 (%)
	2000	2030		(1,000)	(%)		
China	456,527	877,565	60	421,038	92	14,035	61
Indonesia	88,855	187,913	13	99,058	111	3,302	68
Philippines	44,291	86,598	6	42,307	96	1,410	76
Vietnam	18,987	45,954	3	26,966	142	899	43
Korea	37,281	43,136	3	5,856	16	195	86
Thailand	18,948	35,449	2	16,502	87	550	47
Malaysia	14,215	27,308	2	13,094	92	436	78
Cambodia	2,222	8,692	1	6,470	291	216	37
Lao PDR	1,019	3,546	0	2,527	248	84	38
Mongolia	1,415	2,335	0	920	65	31	67
E Asia	804,641	1,471,101	100	666,460	83	22,215	62

Source: UN (2004)

The Urban Fringe

What is it?

There are several definitions of urban fringe. One of the first definitions to appear in the literature dates back to the Second World War period and focuses on the conflict between urban and rural uses that is often pervasive in the urban fringe: “areas of transition between well recognized urban land uses and the area devoted to agriculture” (Wehrwein 1942). Other definitions take a more urban-centric view. For example, Chicoine (1981) defines urban fringe as areas that “generally include those areas bordering central cities, surrounding close-in suburbs and noncontiguous nearby towns, and extending into the adjacent, open countryside.” The urban-centric view can be associated with geographical distance as in Webster (2002), where peri-urban areas are usually considered to start just beyond the contiguous built-up urban area and extend as far as 150 km from the core city center, or as in the Chinese case as far as 300 km. The geographical focus is also present in some definitions of government agencies as in the case of the US Census Bureau, for which “the urban fringe generally consists of contiguous territory having a density of at least 1,000 persons per square mile. (c. 400 persons per sq. km). The urban fringe also includes outlying territory of such density if it was connected to the core of the contiguous area by road and is within 1 ½ road miles of that core, or within 5 road miles of the core but separated by water or other undevelopable territory. Other territory with a population density of fewer than 1,000 people per square mile is included in the urban fringe if it eliminates an enclave or closes an indentation in the boundary of the urbanized area.”³

The above definitions fail to provide insights on the social and economic forces in place in the process of urban fringe occupation. More helpful perhaps in understanding the processes at work is a simple economic definition where the urban fringe is defined as: “...the frontier in space where the returns to land from traditional and customary urban land uses are roughly equal to the returns from traditional and customary rural land uses. In theory, such a frontier should always exist, although its exact location on the ground may not be easily fixed (Hite 1998).⁴ This definition, however, does not take into account the existence of market failures.⁵ This is important if policymakers aim at designing instruments to adequately mitigate problems associated with the processes at work on the urban fringe. The definition of the urban fringe should thus go beyond equating rates of return between urban and rural uses to include at least some sources of market failures. Thus, for the purpose of

this note, the urban fringe is defined as areas subject to urban expansion on the edge of cities (often called “rural-urban” areas or “peri-urban” areas), and environmentally fragile urban areas (e.g. river banks, canal edges and floodplains) which are unstable and unfit for occupation and should be protected to provide ecological services to cities.” Broadly speaking, this definition encompasses primarily marginal land (unstable and unfit for occupation) and land in the periphery of urban areas.

Why is it important?

The urban fringe is frequently ignored as a specific area within the studies of urbanization. As stated by Stren (1994), it is symptomatic that “urban studies” and “rural and regional studies prevail over ‘fringe studies.’” One potential difficulty is that the urban fringe is conceptualized and defined in many ways in the literature, as seen above.

Nonetheless there are several factors that suggest the importance of the urban fringe as deserving greater attention on the part of policy makers. In most developed countries, increases in, household incomes, urban subdivision codes, infrastructure investment patterns, open space undervaluation, and commuting under-pricing, among other factors, translate into urban expansion on the urban fringe. Some of these factors are present in the urban expansion taking place in East Asia as well. In addition, as illustrated by Table 2, it is important to factor in rural-urban migration, whose impact on urban expansion will tend to increase in future years as a result of continuing urbanization linked to substantial declines in the overall rate of natural increase of the population. In Korea and China, for example, by 2030, the rate of natural increase will be negligible, meaning that virtually all urbanization will result from migration. But there are exceptions, as in the case of Malaysia and the Philippines, where higher rates of natural increase are associated with already high urbanization levels.

Occupation of these peripheral or marginal areas generates substantial demands for shelter and services, including environmental ones. In Vietnam, between 2004 and 2010, the generation of urban solid waste is expected to increase from 6 million tons to 12.6 million tons (World Bank 2004). In China, without increased provision of low cost housing and social services, migrants are considered to be at risk of descending into poverty.⁶ In addition, the urban fringe is frequently the dumping ground for industrial enterprises forced out from the city centers either through laws and regulations or due to economic factors such as rising land prices.

Table 2: Contribution of Migration/Reclassification to Urban Growth in East Asia, 1950-2030 (%)

Country	1950s	1960s	1970s	1980s	1990s	2000s	2010s	2020s
Cambodia	23	35	33	24	40	53	57	59
China	45	39	45	65	72	76	80	86
Indonesia	44	46	53	62	67	66	63	61
Malaysia	46	46	45	44	44	41	35	34
Philippines	24	26	35	46	48	43	38	37
Korea	55	59	65	65	54	48	61	85
Thailand	28	32	41	40	34	47	67	75
Vietnam	50	44	29	28	44	57	65	72
East Asia	46	42	45	58	64	68	72	76

Source: Derived from UN (2004)

Over 30 percent of the East Asian urban population already lives in slums (approximately 270 million people)⁷, and even if the rate of slum formation is halved, by 2030 this number will increase by 80-90 million.

While many already occupy the urban fringe and will do so in the future, it should be noted that not all slum areas are in the urban fringe according to the definition used in this note. As Table 3 indicates, the situation is heterogeneous, with slum areas located both on public and private land, and in diverse types of building structures, in the four cities chosen below.

Table 3: Slum Areas in Four East Asian Cities (% of urban population living in slums)

City	Slum Areas	Comment
Bangkok (2%)	Shanties located on public land along river channels	Major reduction in slums in recent years due to relocation and tenure regularization policies.
Chengdu (38%)	Traditional one storey housing. Old co-operative-walk up tenements. Migrant accommodation in peripheral areas.	Major programs to relocate river side housing now completed; current programs to remove old-style housing and 1950s tenements. This is a common feature of cities throughout China. Main 'problems' are over-crowding and lack of in house sanitation. Water and electricity provision is almost universal. Over 1 million migrants are estimated to reside in peripheral areas.
Manila (44%)	'Buildings or areas that are deteriorated, hazardous, unsanitary or lacking in standard conveniences' and overcrowded / poorly-serviced areas.	Largely found in inner city, and in many different locations; not so prevalent in peripheral areas. Many but not all slums will be on illegally occupied land. Some slum areas have been in existence for many years. Over 60% of slums are not located in environmentally fragile areas. Major relocation programs for Pasig River and some railway alignments. 25% of residents of slums are not poor.
Phnom Penh (72%)	Housing located on marginal public land (e.g. railway tracks, wide roads, riversides), private land or houses, rooftops in central areas, peripheral areas (some on floodplains and some not on both public and quasi-private land).	Private ownership of land abolished in 1974 hence virtually all are squatters although some distinction between 'squatter' and 'urban poor'. Some have 'purchased' peripheral plots. Located throughout city. Many but not all in environmentally fragile areas. Relocation (and some land sharing) programs for city centre squatters from marginal and non-marginal areas.

A Bird's-eye View of East Asia's Urban Fringe

Figure 3 provides a simplified schematic representation of the development pressures on the urban fringe. This is illustrated in Figure 4, an aerial photograph of Bangkok's urban fringe, where well planned areas mix with parks, agriculture, and unplanned settlements, resulting in a complex and diverse land use pattern even in the absence of major natural obstacles such as mountains or large water bodies. Both figures, however, are unable to provide an adequate depiction of the potential social and environmental problems that may arise as a result, since pollution and slums are hardly visible. Figure 5, however, clearly displays the dismal living conditions of slums in Ho Chi Minh City and Manila, where poor housing is densely packed in environmentally sensitive areas such as canals.

Cities in East Asia will increasingly face trade-offs with respect to ensuring clean growth today versus cleaning up tomorrow. Avoiding road congestion and the associated local health (and global climate) impacts of air pollution are usually less costly than addressing the consequences in the future. Protecting natural systems that provide ecological services such as clean water sources and flood control are further examples where inter-temporal implications need to be taken into account by policy makers, as they affect the level of risk to which the urban population is subject and the likely costs of public services and infrastructure.

Figure 3: Development Pressures on the Urban Fringe

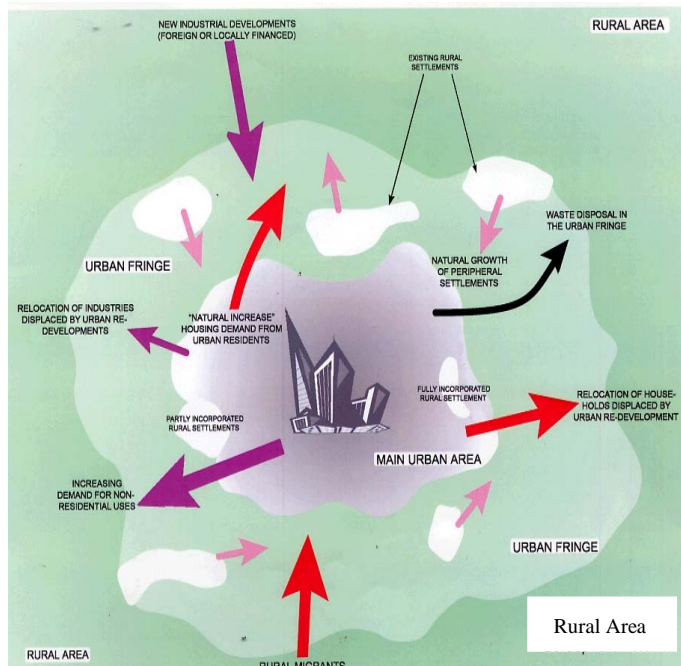
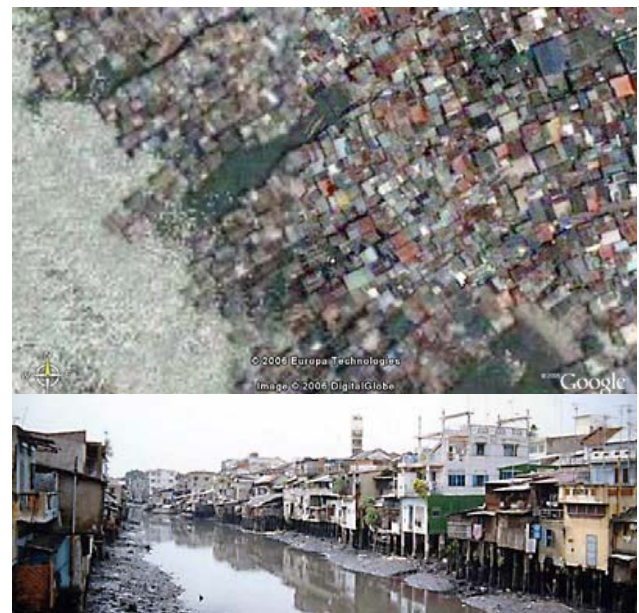


Figure 4. The Variety of Development on the Urban Fringe in East Asia – Bangkok



Figure 5. Encroachment into Water Areas - Manila and Ho Chi Minh City



Source: Belgian Technical Cooperation, 2003, downloaded from www2.btcctb.org/thlg/en/canal.htm.

A Conceptual Framework to Address the Sustainable Development of the Urban Fringe

Urban expansion in East Asia's urban fringe is already a reality. Yet, in order to take full advantage of the benefits of urbanization discussed above and achieve a sustainable occupation of the urban fringe, it is important to design policies that address the sources of economic, environmental, and social pressures in a balanced way.

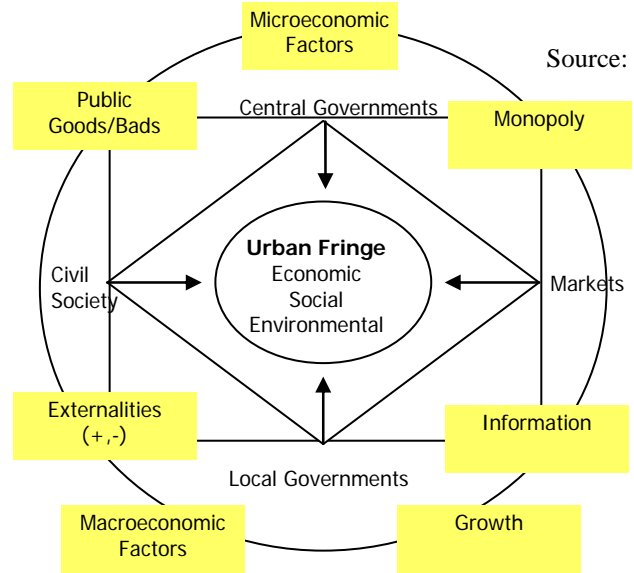
As with other development problems, and as recently recognized in the literature⁸, the balance is achieved at both the local and central levels and should be sensitive to the innate conditions of specific cities. Examples from different countries and regions serve to illustrate these ideas.

Figure 6 provides a schematic depiction of a conceptual framework to address sustainable development of the urban fringe.⁹ The outer ellipse contains key factors that influence the development of the urban fringe. They are all interrelated, hence the continuous line connecting them. For example, urban expansion is closely linked to financial markets liquidity and credit availability. This in turn may impact growth and individual preferences to move or migrate to the urban fringe. The inner rectangle connects the four key sources of market failures, which are prime targets for public policy and the use of instruments both for mitigating or stimulating their occurrence.¹⁰ The inner diamond connects the main actors influencing the economic, environmental and social issues in the urban fringe. They both influence and are influenced by the factors described in the outer ellipse. For example, while central governments may have greater (though not full) control over macroeconomic factors, their power over individual preferences is somewhat limited. Local governments and civil society through non governmental organizations (NGOs), on the other hand, have little control over macroeconomic factors, but may influence preferences through local infrastructure supply and local regulations to address pollution, among other instruments. These actors are potential regulators and social drivers in the broad sense, taking advantage of available instruments including policy ones to achieve the sustainable development of the urban fringe.

The unbalanced development of the urban fringe cannot be solely explained by market failures. Governments are often aware of these and design and implement policies and related instruments to alleviate market failures. Yet, some public sector responses may lead to unintended consequences which lead to a new set of problems; or the original instruments may be overly ambitious and fail to take into account institutional weakness to enforce them. The phenomenon of the slums in many countries can be at least partially explained by overly restrictive zoning, unrealistic infrastructure service standards and building codes, among others. The same is true for environmental policy instruments, such as sewerage treatment requirements, among others. These are all instruments often used by governments in the hopes of improving living conditions. In a worse case scenario, the instruments may also generate rent-seeking behavior,¹¹ which in turn makes changing them more difficult due to non-transparent political influences, corruption and broad governance problems. Policy

failures thus also play an important role in explaining the sub-optimal development of the urban fringe.

Figure 6: A conceptual framework for the Sustainable Development on the Urban Fringe

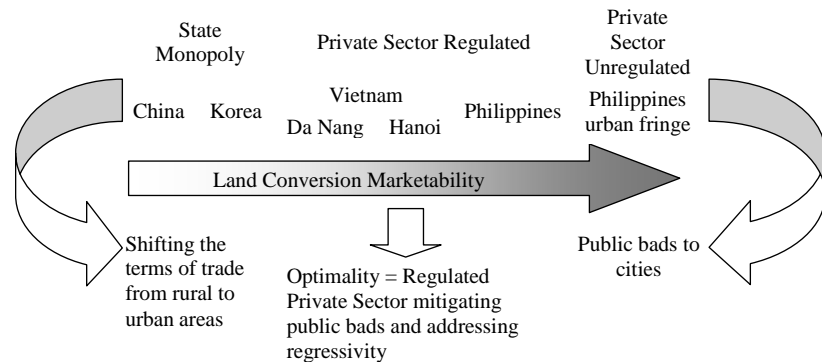


Author based in part on OECD 2002

Comparing Urban Fringe Policy Issues across East Asian Countries

This note focuses on the land conversion as an over-arching process indicative of the complexity and diversity of the issues affecting the urban fringe in the East Asia region. It illustrates this process through four country examples, chosen based on different levels of urbanization (and incomes). Figure 7 provides a schematic representation of the land conversion process and its potential consequences. Land conversion in the region follows a spectrum that ranges from state monopoly over the process to unregulated private sector occupation. Variations along this spectrum for Korea, China, Vietnam and the Philippines are indicated. .

Figure 7: Land Conversion Process



The conversion process in China and Korea follows roughly a monopoly model. China differentiates between rural land (“owned” by village collectives) and urban land (“owned” by the state). The conversion from rural to urban land happens through requisition, which is a monopoly of the state.¹² Land requisitioning both provides land for development and increases municipal revenues through the sale of land concessions at market values under the new land use following its purchase at current use values under the previous land use. While Korea allows for private ownership of land, land use conversion is also based on a compulsory approach compensating farmlands according to existing use value, as in China. On the one hand, the strict planning process in both countries has generated some positive results -- relatively better infrastructure standards and services, avoidance of some environmental degradation as they become apparent, securing the provision of some urban public goods, among other things. At the same time, the process has taken place, at least in part, at the cost of the rural sector, and has prompted the over-conversion of land and its urban under-utilization. This is the case especially in China, where municipalities depend significantly on this source of revenue. In Korea, municipalities benefit to a greater extent from central government transfers and thus need to rely less on land conversion revenues.

In Korea, after the urban sprawl problem became recognized in the 1970s, regulation of land conversion became so strict (with the creation of greenbelts, for instance) that it ended up generating a land shortage in Seoul. The continued population growth in the capital region led to the revision of land conversion regulations in the early 1990s. The development of ‘semi-agricultural zones’ was allowed, leading once again to urban sprawl in the 1990s, this time led by private sector, small-scale, residential development without proper infrastructure provision. These developments became known in Korean as “reckless development” due to the lack of social and transportation infrastructure.¹³

The Philippines, where 65 percent of the urban population lives in slums, lie on the other side of the spectrum. Land conversion occurs primarily via an unregulated or weakly regulated private sector. The absence of planning -- or its weak implementation -- translates into a number of public “bads” for the country’s major cities. Metro Manila for example is heavily congested and polluted, has limited infrastructure services, and around 40 percent of slum occupation in environmentally fragile areas. This has led to slum removal in major problem areas, as in the case of the Pasig River. Ultimately, interventions are ex-post, focusing on tenure regularization and upgrading, often involving a very active civil society.

Vietnam is attempting to take a path between China / Korea and the Philippines. Even within Vietnam, municipalities have taken different approaches to land conversion and urban expansion on the urban fringe, implying a greater degree of autonomy from the central authority. This is in part due to the initiative of municipal administrations but it is also due to policy instruments and laws set at the central level. Land in Vietnam belongs to the state but, in accordance with the recent land law, land use rights are set at the household level and are starting to be well established, traded and enforced. As in China, Vietnam adopted a pro-active and interventionist approach to urban expansion involving a strong planning system and the use of land requisitioning as a revenue source in the absence of an alternative municipal tax base (such as the property tax systems typical of most other countries). While a differential is still observed between the value at which land is requisitioned by government and that at which it is later made available to the market after conversion to an urban land use, over time this is likely to change, as markets for land use rights become better established

In Vietnam, the path followed by Da Nang municipality is more comparable to the Chinese approach, with its use of large-scale land requisitioning, due both to the dynamism of its city authorities and the availability of surplus state-owned enterprises and military land. It also exhibits similar problems to many Chinese cities -- such as over-requisitioning and premature provision of infrastructure (including luxury housing) which reflect the non-market responsiveness of the interventions. However, uncontrolled low-income residential development is also occurring in some Vietnamese cities -- a phenomenon largely absent in China, as the collective ownership of land precludes farmers developing on their leased agricultural plots in an extensive way. Ha Noi’s expansion has often been achieved by taking land only, keeping the villages. This avoids the need for relocation. The compensation that would otherwise have to be paid can be used for construction of new housing units, and their location adjacent to the expanding urban area and construction sites, increases the likelihood of new employment. There is, however, a danger that these villages in the Ha Noi area could develop into slums unless infrastructure is upgraded, and appropriate controls are imposed. Ho Chi Minh City, on the other hand, is clearly developing in a more unplanned way and exhibits several of the characteristics of other fast growing Asian cities -- a variety of land uses, high and low income residential areas, informal settlements, ribbon development, a patchwork of developed and undeveloped plots.

The Way Forward

East Asia is at a turning point of a major development phenomenon -- urbanization. If well

managed, urbanization can provide significant gains in terms of prosperity and poverty alleviation without the environmental and social costs that some countries are already facing. The phenomenon is likely to soon encompass even East Asian countries which are still largely rural, but are likely to rapidly urbanize over the next 25 years. In fact, Laos and Cambodia are expected to be the countries where urbanization will occur fastest in the future, simply because their base is currently very low.

Managing the urban transition effectively will call for significant policy reforms, the use of new instruments and processes, and the enhanced involvement of the private sector and civil society. Table 4 provides a concise view of the urbanization problems and some of the potential policy responses referred to in this note. It is a simplified menu and actual instruments need to be designed for local and national conditions. There are a

myriad of instruments being used around the world that can assist the East Asian policymakers in their quest to achieve urban expansion in a balanced and sustainable way. Some are already in use but may need to take into account new issues and objectives as the urbanization process unfolds. Important questions for policy makers in East Asia, as they consider new approaches, will be: How well has the menu of policy instruments worked? What did it take to design and implement them – in terms of resources, cost, time, technical capacity, and leadership? What are the basic pre-conditions (such as regulatory and institutional frameworks) for their effective launch and implementation? Relevance of the menu will vary according to the circumstances of specific countries and will need to be clarified. However, failure to act now and thus missing the opportunity to effectively manage the urban transition may be a costly proposition.

Table 4: Urbanization Problems and Policy Responses

Problems	Policy responses
<u>Economic</u>	
1. Economic enterprises are inappropriately located	Land use planning and financial incentives
2. Agricultural land is lost to less valuable urban uses or is retained despite more valuable urban uses	Land use planning, land conversion policies, and financial incentives
3. Excessive service and transportation costs due to inadequate infrastructure	Land use policies to increase densities and concentrate development Imposition of development impact fees to obtain developer contributions for offsite infrastructure
<u>Social</u>	
4. Development leaves existing residents less well off	Improvements in compensation rates, employment measures, and financial stake in ensuing development
5. Unserviced informal settlements	Tenure regularization, upgrading, relocation Low-cost housing construction, land management, land pooling Appropriate land subdivision and construction standards Direct and indirect subsidies Improved municipal finances for provision of infrastructure in low-income areas Requirements that developers provide quotas of affordable housing
<u>Environmental</u>	
6. Excessive pollution	Regulatory measures, including standards for pollution discharges and market-based instruments Licensing procedures Effective monitoring and enforcement
7. Encroachment on land that is better left undeveloped	Land use planning and environmental controls
Source: Adapted from Chapter 5 (“Cities”) in Gill, Kharas, and others (2007).	

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¹ Urbanization refers to increased number of urban dwellers. This comes about through natural growth of urban populations, migration, and the reclassification of rural to urban areas. Urban expansion refers to the shift in land use from rural to urban.

² World Bank data.

³ US Census Bureau 1995 at:

<http://www.census.gov/population/censusdata/urdef.txt>

⁴ In most developing country cities, the urban fringe now will not be the urban fringe in several years.

⁵ Failure of market forces to allocate the socially optimal level of urban fringe occupation and use among conflicting demands. The four main sources of market failures are: (1) public good / public bad, (2) externality, (3) imperfect information, and (4) monopoly. These will be defined as needed in the text.

⁶ According to Taylor (2004), the poverty rate among urban immigrants (after remittances) was 50 percent higher than among permanent urban residents in 2001.

⁷ The definition of slum is based on the absence of one or more of the following: durable housing construction, less than 3 persons per room, access to safe water, adequate sanitation, and tenure security. It embraces a wide variety of settlements, from shacks of non-permanent materials located in 'danger areas' which would be classified as 'unfit for human habitation' to areas of more robust housing on non-marginal land where improved infrastructure would provide an acceptable level of shelter. UN Habitat (2006).

⁸ Rodrik (2006)

⁹ It should be noted that a detailed discussion of this conceptual framework is beyond the scope of this paper due to its page limits. The examples provided in this paragraph are mainly focused on illustrating how the conceptual framework works in practice.

¹⁰ Take the example of a public bad such as pollution or a public good such as watershed protection. A public good [bad] or service is neither rival in consumption nor excludable in use. Society needs to find alternate ways of ensuring its socially optimal supply (in case of a public good) or mitigation (in case of a public bad).

¹¹ Rent-seeking behavior can be defined as "expenditure of resources to bring about an uncompensated transfer of goods or services from another person or persons to one's self as the result of a 'favorable' decision on some public policy." (OECD 2003)

¹² It should be noted that village collectives also engage in land conversion from rural to urban use, but the legality of this action is ambiguous.

¹³ KRIHS (forthcoming).