

Will Resilience **Overcome Risk?**

Special Focus: Agriculture for Development



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EAST ASIA AND PACIFIC UPDATE

1. Summary

Growth in Emerging East Asia is expected to exceed 8 percent in 2007 for a second year in succession and to moderate only slightly in 2008.¹ (Table 1). Our projections for regional growth in 2007 and 2008 have been substantially increased compared to six months ago, mainly due to the unexpected and large domestic-demand-led acceleration of growth in China. Growth also picked up in most of the other larger economies of the region, again a result of more buoyant investment and consumption spending. Concerns about the impact of the US sub-prime crisis and the renewed surge in oil prices have clearly increased downside risks. Nevertheless we expect that the stronger growth momentum in the region will carry through 2008. There are as yet few signs of a significant pick-up in underlying core inflation pressures or of other domestic constraints or imbalances that would require a marked slowing of growth. And it is worth noting that this year's pick-up in East Asia has occurred despite an already substantial decline in US import growth, and some (more modest) slowing in the region's own exports. Consensus forecasts are still for overall OECD growth in 2008 to continue at the same modest pace as in 2007 – around 2.2 to 2.3 percent. It seems reasonable to expect that East Asia could also sustain its recent pattern of growth through next year.

Downside risks to the outlook have also increased. There is a significant probability that the sub-prime crisis, the associated credit squeeze and rising oil prices could force a more substantial downturn in the developed world, in particular in the US. This would lead to a more significant cyclical slowdown in East Asia. But a review of the region's performance in previous global downturns suggests that the impact on East Asia is unlikely to be especially severe or protracted, given the region's strong macroeconomic fundamentals and in the absence of a major downturn in global high tech demand such as occurred in 2001.

The region's ability to weather near term global volatility allows countries to remain focused on advancing long term development goals. Poverty in East Asia continues to fall, but, as the Special Focus in this Update on "Agriculture for Development in East Asia" explains, it is also now a largely rural problem. A widening urban-rural income divide is also contributing to rising inequality. This is one reason why governments in countries like China are renewing their focus on rural and agricultural development issues. At the same time it has

been East Asia's rapid growth that has been primarily responsible for its remarkable success in lowering poverty. Maintaining this growth remains key and to this end continued improvements in the investment climate, financial systems, public service delivery, and education and innovation systems remain priorities in much of the region.

Table 1. East Asia Economic Growth

	2005	2006	2007	2008
Emerging East Asia	7.7	8.3	8.4	8.2
Develop. E. Asia	9.2	9.8	10.1	9.7
S.E. Asia	5.1	5.4	5.7	5.8
Indonesia	5.7	5.5	6.3	6.4
Malaysia	5.0	5.9	5.7	5.9
Philippines	4.9	5.4	6.7	6.2
Thailand	4.5	5.0	4.3	4.6
Transition Econ.				
China	10.4	11.1	11.3	10.8
Vietnam	8.4	8.2	8.3	8.2
Small Economies	7.8	7.2	6.4	6.2
Newly Ind. Econ.	4.9	5.5	5.1	5.1
Korea	4.2	5.0	4.8	5.1
3 other NIEs	5.5	5.9	5.4	5.1
Japan	1.9	2.2	2.0	1.8

World Bank East Asia Region; October 2007. Consensus Forecasts for NIEs. Regional averages are GDP weighted.

East Asia Regional Outlook

East Asian growth accelerated in 2007, led by domestic demand. Economic growth in Emerging East Asia accelerated to 8.4 percent in the first half of 2007, up from 7.8 percent in the latter part of 2006, exceeding earlier expectations by a wide margin. The acceleration in the first half of 2007 was especially sharp in China, with growth averaging 11.5 percent, up from around 10.5 percent in the latter part of 2006, mainly due to faster domestic demand growth, in particular investment. Growth also continued to run at solid 7-10 percent rates in several low income economies of the region such as Cambodia, Lao PDR, Mongolia and Vietnam, powered by across-the-board strength in exports and domestic demand. Growth also picked up in several middle income economies in South East Asia, notably Indonesia and the Philippines, where first half growth picked up to 6.1 percent and 7.3 percent respectively, while continuing to run in a 5 ½-6 percent range in Malaysia.

The outbreak of the US sub-prime crisis has had little adverse impact on East Asia so far. Preliminary assessments suggest that direct exposures of East Asian financial institutions to sub-prime risks are

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).

relatively limited, although risks may increase if the global instability and tightening of credit markets intensifies and leads to further declines in prices of various other structured assets held by banks. The main transmission channels to East Asia and other emerging markets in the immediate aftermath of the sub-prime crisis were instead heightened uncertainty and a reassessment of risk, reflected in stock market declines, depreciation of currencies and widening sovereign bond spreads. The initial pullback from emerging market assets proved temporary, with asset prices recovering their initial losses between mid August and mid October, as international investors took a more positive view of macroeconomic fundamentals in emerging markets and the potential for continued strong growth in these economies. Volatility again increased in early November as US financial institutions announced larger than expected losses on sub-prime related assets. Frequent and large reassessments of risk and high volatility in asset prices are likely to remain a part of the scene for some time.

The impact of the sub-prime crisis on East Asia through slower import growth in the developed countries should be modest.

The US sub-prime crisis and the associated tightening of global capital markets have led us to reduce projections for US and OECD growth in 2008 by 1 and ½ percentage points respectively compared to projections six months ago. OECD growth in 2008 is now projected at 2.2 percent, slightly down from 2.3 percent in 2007 - in other words a continuation of the more sluggish developed country conditions already seen in 2007, which however have not had much adverse impact on East Asia so far. US import growth has already fallen to near zero in real terms since the latter part of 2006 and East Asian export growth has also moderated. Nevertheless East Asian output growth accelerated in 2007 due to stronger domestic demand and the baseline forecast reflects a continuation of this pattern through 2008. A number of factors should continue to support resilience in domestic demand going forward. Capacity utilization is at much higher levels now than it was in the last global downturn in 2001 and profitability and balance sheets in the region's corporations are also stronger, providing a favorable footing for investment. Current account surpluses and very high levels of foreign reserves also mean that most economies are much less vulnerable to sudden volatility in capital flows.

New highs for oil prices will test the solidity of the East Asian and global economic expansions in 2008.

Crude oil prices have moved almost continuously higher over the course of 2007, from \$53.4 per barrel in January to over \$90 in early November (for an average of Brent, Dubai and West Texas intermediate crudes). The tightness in the oil market is underpinned by both demand and supply factors. Although rising prices have curbed

demand growth in developed countries, demand for oil in developing countries continues to grow by 3-4 percent year. The supply response to higher prices has also turned out to be more sluggish than expected due to rising input costs in oil capacity development and significant political and investment climate uncertainties in many producing countries.

Oil prices are likely to remain elevated and volatile over 2008-09.

Prices are currently assumed to average \$72 a barrel in 2008 and just under \$70 in 2009, although, given the tight market conditions, speculative demand and political risk factors, there is a significant risk that prices could remain above \$90 for a more extended period, adding to pressures for a global slowdown, especially in economies like the US already weakening for other reasons. However there is some comfort in the relatively limited impact on world growth of the more than doubling in oil prices over the last 3-4 years. One factor here is that the rise in prices has been spread out over several years, avoiding sudden shocks to consumer and business confidence. Many economies have also become more energy-efficient and more flexible in their ability to adjust to higher oil prices. We calculate that higher oil prices led to a loss of income in East Asia due to worse terms of trade of around 0.8 percent of GDP per year in 2004-06. But this did not prevent regional growth accelerating to 8 percent from around 6 percent in the preceding three years. We calculate that an average oil price of \$90 in 2008 would be associated with an income loss in East Asia of about 1.1 percent of GDP, which, while costly, would not be much larger than the annual losses already experienced over the last 3-4 years of fast growth.

Downside risks to the outlook have clearly increased. If a US recession were to materialize it would likely be accompanied by a significant but not severe decline in East Asian growth.

It is possible that the difficulties in credit markets may turn out to be deeper and take longer to resolve than expected in consensus forecasts. This, together with the risk of significantly higher oil prices, means that the likelihood of a more severe downturn or outright recession in the US economy has also increased. An event study shows that in the last three US recessions median East Asian growth fell on average by around 0.5 percentage points for every 1 percentage point decline in US growth. Thus a fall in US growth to, say, zero in 2008 (a 2 percentage point growth decline) might be accompanied by a 1 percentage point fall in median East Asian economy growth from around 6 percent to 5 percent - significant but no disaster. East Asian growth was more seriously affected during the US recession of 2001, which was accompanied by an extremely severe sector-specific cyclical contraction in global high tech demand, in the aftermath of the global high tech bubble of the late 1990s. However there are

few signs of such a cycle in global high tech at present; if anything high tech demand was rebounding quite smartly in the third quarter of 2007. East Asian policy makers should also have considerable room to undertake counter-cyclical easing of monetary and fiscal policies in the event of an unexpectedly severe downturn in exports. On the other hand, the impact of a developed world downturn could also be more severe than in the past if it were accompanied a rising protectionism.

A poverty milestone: the number of people living below \$2 a day in East Asia is estimated to have fallen below 500 million in 2007. The poverty headcount rate at the \$2 a day level is estimated to have fallen to about 27 percent, down from 29.5 percent in 2006 and 69 percent (over 1 billion people) in 1990. Strong economic growth is providing an essential underpinning for poverty reduction. But, as the review of individual country experiences in the report indicates, poverty in East Asia is now overwhelmingly a rural problem, with poverty reduction also tending to occur unevenly because particular social groups or geographical regions are doing less well than overall trends. And even as poverty falls, it is often the case that lower income groups experience slower income growth than higher income ones, resulting in widening income inequality. Governments in the region are therefore looking at policies that can foster poverty reduction in more targeted and cost effective ways. Concerns about a widening urban-rural income divide are one reason why governments in countries like China are renewing their focus on rural and agricultural development policies, while also exploring ways to strengthen the human capital development of the poor and to provide more effective insurance and income support mechanisms.

The international and regional environment

Developed world growth has already slowed and could slow further. Growth in the OECD countries is forecast to slow from 2.8 percent growth in 2006 to 2.3 percent in 2007, led a by a one percentage point fall in US growth. Looking forward, growth projections for 2008 have been reduced for all the main developed regions, most emphatically for the US, where they have been cut from a forecast of 3 percent six months ago to only 2 percent now.. This hefty adjustment reflects the depressing effects of the sub-prime crisis and the associated tightening of credit markets that began in August, the unexpectedly deep recession in the US housing market and the impact of higher than previously forecast oil prices. But growth projections have also been tuned lower for the Euro area, which is also likely to feel the effects of the credit squeeze flowing from the sub-prime crisis, and Japan, where consumer spending has remained sluggish, belying earlier expectations of a revival (with both Europe and Japan also suffering from

the impact of higher oil prices). World trade volume growth is projected to dip from over 10 percent in 2006 to around 7 ½ percent in 2008.

China's growth is expected to remain strong.

Growth in China rebounded to an average 11.5 percent rate in the first three quarters of 2007, reversing the trend in the latter half of 2006 when growth had decelerated to 10.5 percent reflecting administrative tightening measures. A new acceleration in investment spending provided the main impulse for the rise in GDP growth in 2007, reflecting fundamental factors such as rapid profit growth, rising profit margins and still relatively low lending rates. Growth is expected to slow only modestly to 10.8 percent in 2008. Among domestic trends of concern to the authorities, headline inflation has picked up this year, although this seems to be mainly due to specific supply factors, including a sharp rise in food prices. The surge in China's trade surplus over the past three years has led to rapid growth in its foreign exchange reserves, which is contributing to liquidity expansion, which the authorities are obliged to mop up through bond issues, higher bank reserve requirements and higher interest rates. However, while these trends bear careful watching, none appears serious enough at present to derail the current momentum of growth, or to cause the authorities to make major policy changes that would lead to a marked slowing in the near term. China's growth has been little affected by past US recessions. Although the impact would be greater today because of the greater importance of exports, it is worth noting that exports in value-added terms are significantly lower than the gross numbers suggest, due to the importance of imported components. In addition, given China's strong macroeconomic position, domestic policies could also be eased to support domestic demand, should this be needed in the event of an export slowdown.

Domestic trends and policy challenges

Foreign exchange reserves in Emerging East Asia are likely increase by a record amount in 2007.

Foreign reserves for the 9 largest economies increased by \$451 billion in the 9 months to September 2007, reaching \$2.5 trillion. About four-fifths of this increase was in China, but reserves were also rising at solid rates in most other economies. The greater part of the overall surplus in the first half of 2007 (the period for which we have detailed balance of payments data) came from rising current account surpluses, which reached an aggregate \$322 billion or 8.9 percent of regional GDP. China's current account surplus reached \$163 billion, or close to 12 percent of GDP in the first half of 2007. Net capital inflows (inclusive of errors and omissions) made little contribution to the region's overall balance of payments surplus in 2005 or 2006, but they increased substantially in the first half of 2007. Official data suggests that China

in particular saw its capital account move from virtual balance in 2006 to a surplus of a little over \$100 billion in the first half of 2007 (although swap operations and other ad hoc transactions appear to have played a significant role in 2006 and the first half of 2007). Net capital inflows to economies such as Indonesia, Malaysia and Philippines also increased, principally because of higher portfolio capital inflows.

Economies face difficult policy tradeoffs in managing balance of payments inflows on this scale.

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 inflows on the present enormous and accelerating scale raise concerns about a potential loss of control over domestic monetary conditions at some point, which could then lead to problems of macroeconomic overheating, asset price bubbles and the emergence of vulnerabilities in the financial sector. Although the signs of such problems are limited at present, they could grow into significant concerns. Thus, for example, while there are few signs of any pickup in core inflation so far, previously existing spare capacity in the economies has now been largely used up, making the possibility of over-heating more of a concern for the future. Equity prices and price-earnings ratios have surged to historic highs in China, although in most other economies price-earnings ratios, while rising, are still significantly less than the levels reached in the run-up to the 1997-98 financial crises. Banks are also playing a much more

muted role in intermediating capital inflows than they were before the crisis. Still, with balance of payments inflows reached a striking 12.1 percent of regional GDP in the first half of 2007, policy makers are increasingly likely to rely on more exchange rate flexibility as a direct way of adjusting to these pressures.

Financial sector trends and issues. In recent years bank lending to the domestic private sector in the former crisis affected countries of East Asia has fallen in importance, while holdings of government or foreign assets have increased. This is likely to change if the recent strengthening of domestic demand in the region gathers pace, leading to stronger loan demand, especially from the business sector. In this context it will be important to ensure that faster loan growth is not accompanied by deterioration in loan quality and a build up of new vulnerabilities. Banking sector asset quality, profitability and capital adequacy in the region have indeed improved significantly in recent years. The average non-performing loan (NPL) ratio for the five formerly crisis affected countries has fallen from over 10 percent in 2002 to under 5 percent by the middle of 2007, although NPLs remain significantly higher than in developed economies or in some other developing regions, Latin America for example. The region has also 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 continued efforts are needed to converge to international standards.

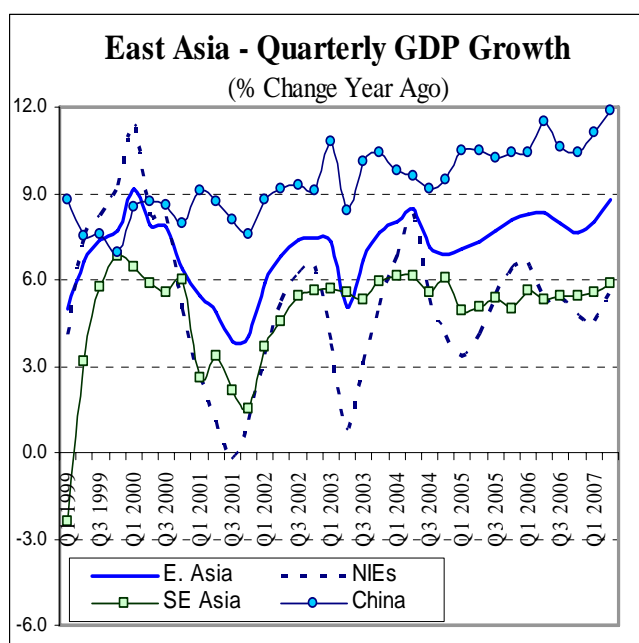
EAST ASIA AND PACIFIC UPDATE

2. East Asia Regional Outlook

2.1. Growth accelerates, led by domestic demand

Economic growth in Emerging East Asia² accelerated to 8.4 percent in the first half of 2007, up from 7.8 percent in the latter part of 2006, exceeding earlier expectations by a wide margin. (Exhibit 1). This strong performance reflected a more rapid increase in domestic investment and consumption spending, which offset moderating export growth in a number of economies. The near term outlook is more uncertain than six months ago, though, and downside risks have increased with the outbreak of the US sub-prime crisis in the third quarter of 2007 and the resulting deterioration in credit markets, the further surge in oil prices to near \$100 in October and the potential impact of these events on US and global growth.

Exhibit 1



The acceleration in the first half of 2007 was especially sharp in China, with growth averaging 11.5 percent, up from around 10.5 percent in the latter part of 2006, and continuing to run at 11.5 percent in the third quarter. While net exports continued to contribute between three and four percentage points to overall growth, much of

² 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).

the acceleration in China was due to faster domestic demand growth, in particular investment spending. Growth also continued to run at solid 7-10 percent rates in several low income economies of the region such as Cambodia, Lao PDR, Mongolia and Vietnam, powered by across-the-board strength in exports and domestic demand. Growth is also running at above historical trend rates in some of the smaller island economies, due to high commodity prices and, in some cases, improved economic management. But political instability and social tensions continue to undermine performance in some of these economies, for example Fiji, where output is expected to contract this year.

The stronger growth dynamic was also apparent in some of the middle income economies in South East Asia, notably Indonesia and the Philippines, where first half growth picked up to 6.1 percent and 7.3 percent respectively, while continuing to run in a 5 ½-6 percent range in Malaysia. (See Appendix Tables 1 - 4 for details of growth and its components). Growth in these three economies was underpinned by a marked acceleration in personal consumption and domestic investment spending. The investment upturn is especially notable given the long period of weakness in this sector in the aftermath of the 1997-98 financial crises. Thailand remained an outlier in this respect, with domestic demand remaining weak, principally because of continued political uncertainties. More robust domestic demand also helped buoy first half growth of around 5.1 percent in the high income newly industrialized economies (NIEs), offsetting somewhat weaker export growth in some economies. Singapore was emblematic, with growth accelerating to 7-8 percent in the first half, and to 9.4 percent in the third quarter, despite a slowdown in net export growth to virtually zero.

Limited impact of the sub-prime crisis – so far

The turmoil in financial markets in the third quarter represents another stage in the tightening of the global credit cycle that began two years ago, and a return towards more disciplined market conditions after a long period of extraordinarily easy credit conditions and low risk premiums. The turmoil in the third quarter was triggered by rising defaults in the US sub-prime mortgage market. A sizeable proportion of these sub-prime mortgages have been securitized in collateralized debt obligations (CDOs). With the rise in sub-prime loan defaults, risk premiums and yields on CDOs began rising sharply towards the end of July, leading to a loss in the value of these instruments. Uncertainty about exactly who holds what and the magnitude of the risk exposure led to a drying up of credit to financial institutions—not only to mortgage lenders, but also to investment funds and other financial institutions: a

so-called “credit squeeze”, reflected in a sharp contraction in asset-backed commercial paper markets. With widening risk aversion, yields on lower investment grade corporate bonds and other high yield assets also rose. These developments have resulted, overall, in a significant tightening of credit availability, especially in the US and the Euro Area.

We consider three channels through which East Asian (and other emerging market economies) have been or could potentially be affected by the credit crisis: direct exposure of East Asian banks to sub-prime or related risks; the impact of increased uncertainty and risk aversion on regional financial markets; and, lastly, the impact on real economic activity in the region of a marked slowdown or recession in the US. Our conclusion is that the overall impact of the credit crisis on East Asian economies has been limited, at least during the three months since the start of the crisis in mid July. While volatility in regional financial markets has increased, asset prices have rebounded and even exceeded levels earlier in the year. It remains to be seen how much further the credit crisis slows growth in the US. The consensus view is that it will result in a slowdown in US growth to 2 percent or less through 2008, but not a recession. Here it is worth noting that US output and import growth had *already* slowed quite sharply in the first half of 2007. But, while East Asian export growth also slowed, regional GDP growth accelerated, due to strengthening domestic demand, suggesting the possibility that the region could weather a further period of dampened external demand growth relatively well.

Table 2. East Asia - Financial Sector Share Prices in 2007

	% Change	% Ch. Relative to Total Market	
	Jan 1 – Oct. 22	Jan 1 – July 19	July 19 – October 22
China	118.3	17.4	-12
Indonesia	19.7	-7.7	-4.5
Korea	14.5	-6.1	-8.1
Malaysia	24.5	-3.2	-2.1
Philippines	12.4	-3.5	-5.3
Singapore	13.1	-2.2	-5.2
Thailand	15.1	-1.8	-8.2
Memo: USA	-10.4	-10.6	-5.7

Source: Datastream.

Looking first at *direct exposures of East Asian financial institutions to sub-prime risks*, initial assessments by national regulators, credit rating agencies and investment banks suggest that these are limited, although these estimates are subject to much uncertainty and risks may increase if the global instability intensifies and leads to further declines in prices of various other structured assets held by banks. The Fitch Ratings agency, for example, noted that East Asian exposures generally amount to a few percent of banks’ capital, which will dent earnings but do

not pose a risk to soundness.³ The movement of equity prices for East Asian financial institutions this year is consistent with this evaluation. As Table 2 indicates, equity price indexes for the financial sectors in East Asian economies were all higher at the end of October compared to the start of the year. However these indexes generally underperformed the overall market, reflecting the expectation of some deterioration in bank profits.

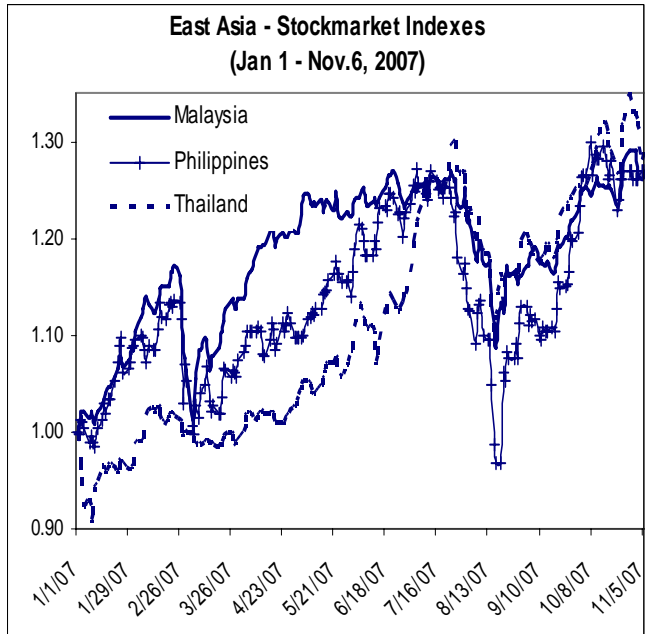
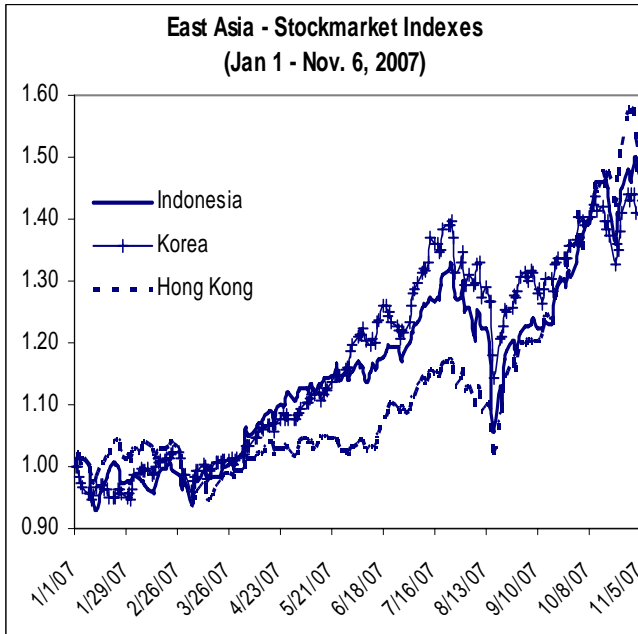
Among individual economies, *China* is the largest overseas holder of US mortgage backed securities - around \$260 billion - mostly through its international reserve holdings and also through holdings of commercial banks. However, nearly all of these holdings are backed by US government agencies such as Fannie Mae and Freddie Mac. Among commercial banks Bank of China disclosed an exposure of almost \$10 billion to assets backed by US sub-prime mortgages, over 17 percent of its equity capital. But since most of these exposures are “AA” rated or higher, actual losses are expected to be much smaller, perhaps no more than 1 percent of equity.⁴ Generally Chinese banks are expected to be able to absorb potential losses on these assets relatively comfortably, given the very rapid growth in their overall profits. In the *Philippines* the central bank reported that collateralized debt obligations (CDOs) comprise only 0.2 percent of banking sector assets, (about 2 percent of system equity). Some financial institutions are also significant holders of Credit Default Swaps related to foreign currency denominated bonds issued by the government. Spreads on these derivatives rose sharply in July and August from around 100 basis points to over 200. Concerns about potential losses related to these instruments abated in September, however, when spreads fell back to a range of 120-140 basis points.

The main transmission channels to East Asian and other emerging markets in the immediate aftermath of the sub-prime crisis were *heightened uncertainty, a reassessment of risk and a flight to quality*, reflected in stock market declines, depreciation of currencies and widening sovereign bond spreads. These fluctuations were not out of line with – and in some cases were rather less – than similar bouts of volatility in emerging markets in recent years. Even more significantly, the initial pullback from emerging market assets proved temporary, with asset prices recovering some, all or more than all of their initial losses between mid August and mid October, as international investors appear to have taken a more positive view of macroeconomic fundamentals in emerging markets and the potential for continued strong growth in these economies. Markets remain highly volatile, though, as new information emerges about the extent of the underlying disruption in advanced economy credit markets and the likely impact on advanced economy growth.

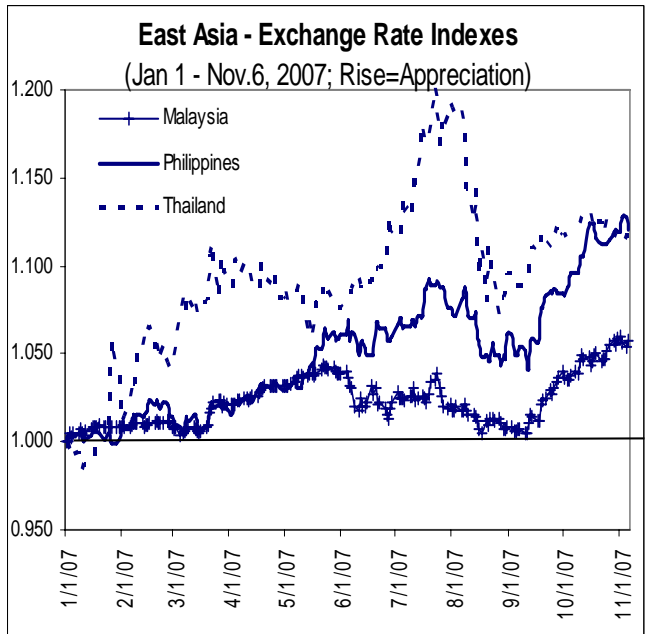
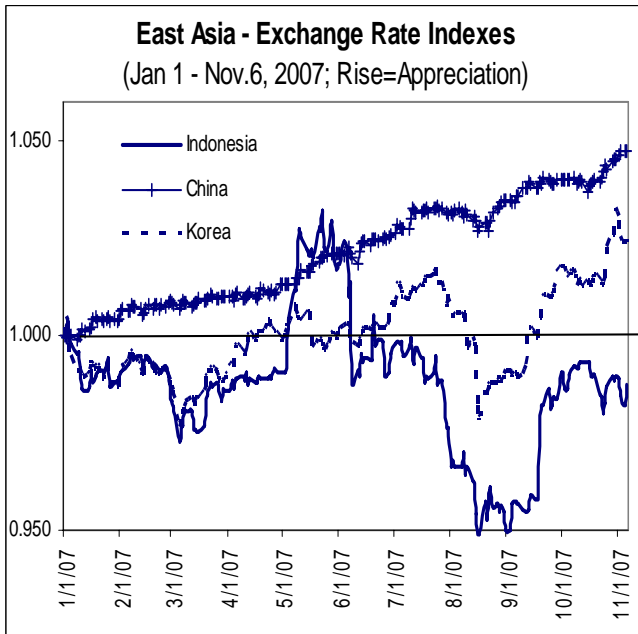
³ Fitch Ratings Press Release 8/22/07: Limited Direct Impact on Asia-Pacific Banks from Subprime Exposure.

⁴ UBS Investment Research: Asian Banking Strategy. September 2007.

Exhibits 2a and b. East Asia – Stock Market Indexes - 2007



Exhibits 3 a and b. East Asia – Exchange Rate Indexes – 2007 (Rise=Appreciation)



Thus stock markets in the main East Asian economies (ex China) fell a median 14 percent between July 19 and August 17, only to be followed by a surge to new highs in most cases, with equity prices rising a median 22 percent by mid October. (Exhibits 2a and b). Economies that experienced the largest initial declines like the Philippines and Indonesia also experienced among the largest rebounds. In China, where stocks on the Shanghai Exchange gained a further 55 percent between mid July and mid October, on top of a 46 percent gain earlier in the year. However volatility reemerged when new information on larger than expected sub-prime related losses among US

financial institutions led to sharp pull backs in the US stock market in late October and early November, followed by declines in East Asian and other emerging markets. Frequent large reassessments of risk and high volatility in asset prices are likely to remain a part of the scene for some time.

A broadly similar pattern emerged in the foreign exchange and sovereign bond markets. Some East Asian currencies experienced substantial 3-6 percent depreciations against the dollar from mid July to mid August, notably Thailand, Philippines, Indonesia and

Korea. (Exhibits 3a and b). In several cases the declines only partly offset large appreciations earlier in the year. Indeed the depreciation even represented a relief for some economies that have been grappling with upward pressure on exchange rates and domestic credit caused by large balance of payments inflows (like China, Korea, Malaysia and Thailand). This relief only proved temporary, though, as more sanguine risk assessments, continued current account surpluses and renewed portfolio inflows once more pushed currencies higher from the middle or latter part of August. Central bank interventions in the foreign exchange market to slow the pace of appreciation resulted in a pickup in the pace of foreign reserve accumulation, with reserves reaching \$2.5 trillion in September for the 9 largest economies, up from a little over \$2 trillion at the end of 2006. (Section 4.1 below looks in more detail at the continuing challenge of managing large and growing balance of payments inflows in the region).

Table 3. Emerging Market Sovereign Bond Spreads

	2005	2006	2007 1-5	End June 2007	Mid Aug 2007	Mid Oct. 2007.
EMBIGLOBAL	301	197	170	181	235	207
EAP Average	155	119	94	97	142	123
China	59	63	50	54	85	87
Indonesia	274	207	165	165	255	205
Korea	73	70	65	69	92	95
Malaysia	84	83	70	75	100	101
Philippines	403	230	162	155	221	174
Thailand	35	35	38	40	52	58
Vietnam	190	148	109	122	192	138
Max - Min	368	194	127	125	203	147
Turkey	273	224	209	189	231	217
Mexico	165	136	114	111	131	127
Argentina	2475	335	235	325	450	364

EMBI indexes, except Korea and Thailand, which are eurobonds.

Spreads on emerging market external debt also moved modestly higher in the aftermath of the sub-prime crisis, although still remaining far below historical standards. A simple average of spreads for 7 East Asian economies rose by around 50 basis points between July and August, but gave back about half of the increase by mid October, when they averaged around 120 basis points. At these levels spreads remain close to the extremely compressed levels achieved in 2006 and early 2007 (Table 3). Increased global volatility also appears to have had little perceptible impact on domestic interest rates in most East Asian economies, an outcome likely facilitated by letting exchange rate depreciation take most of the adjustment. In Indonesia the yield on domestic government bond rose by about 75 basis points in the month to late August, but then fell back to near pre-turbulence levels.

The positive assessment of East Asia and other emerging markets by investors in the wake of the sub-prime crisis appears to reflect several factors. First, the new types of financial instruments at the center of the financial turbulence in advanced markets are less common in emerging markets. Second, many emerging economies have reduced their vulnerability to volatility in capital inflows and other external shocks in recent years. Most East Asian economies have run current account surpluses for the last 10 years and have accumulated foreign reserves that are generally much higher than optimal levels suggested by prudential financial rules. Other broad indicators of macro-financial performance such as fiscal deficits, public debt, external debt, banking system capital adequacy and asset quality and corporate indebtedness have also generally been in a sustainable range or improving. Nevertheless, investors' assessments of emerging markets remain very sensitive to their evaluation of the seriousness of the credit crisis, its impact on the advanced economies and the potential knock-on effects on emerging markets. Markets are likely to remain highly volatile for some time.

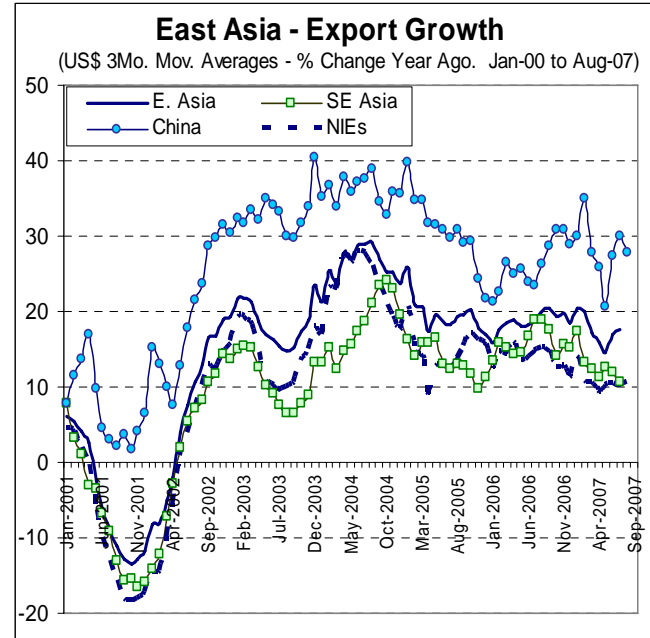
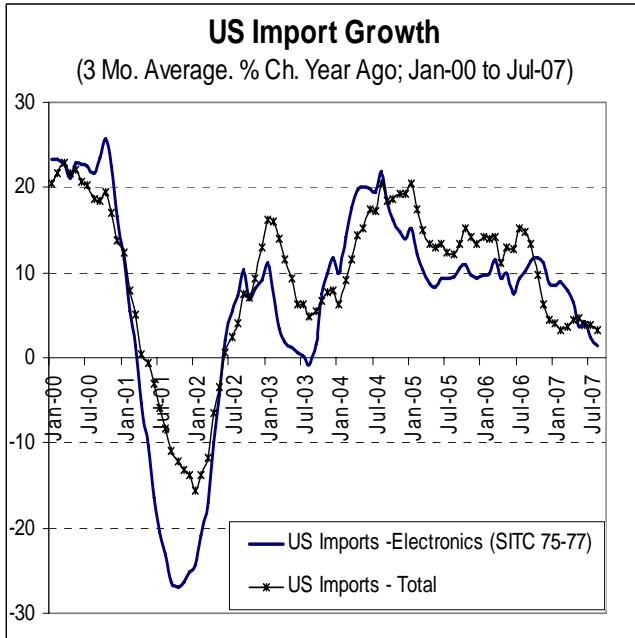
The export slowdown is already here (and gone?)

A key uncertainty in the outlook is the extent to which the credit squeeze will slow US growth and import demand. Here it is worth noting that the US contribution to world import demand had already fallen to negligible levels in the first part of 2007. US GDP growth fell to a year on year 2 percent pace in the first three quarters of 2007, while import growth fell to 2.2 percent (compared to 6.4 percent in the first half of 2006).⁵ Real imports have been virtually flat on a quarter to quarter basis since the middle of 2006. Exhibit 4a shows that US merchandise import growth in dollar terms in July-August 2007 was down to a year-on-year pace of around 3 ½ percent. Still, this is far different from the recession of 2001 – after the bursting of the global high tech boom – when US imports contracted sharply, led by 20-30 percent declines in the electronics and high tech products that are East Asia's major export category. In the current cycle US high tech import growth has slowed, but so far imports have not contracted as they did in 2001.

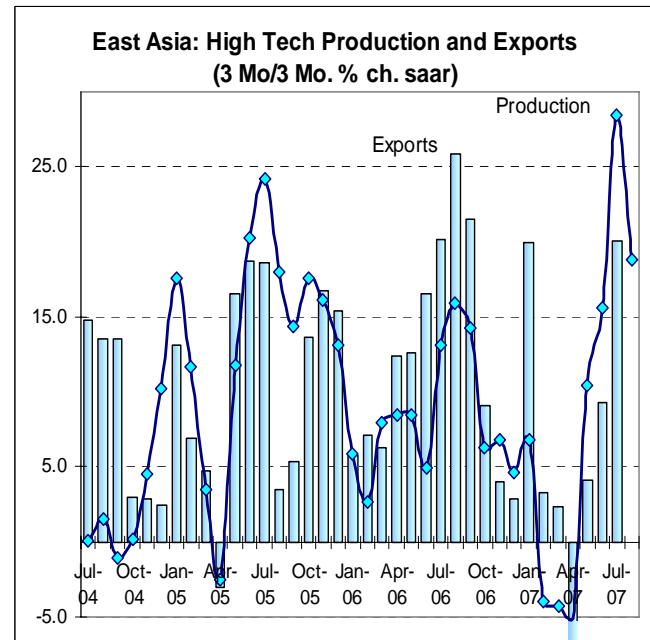
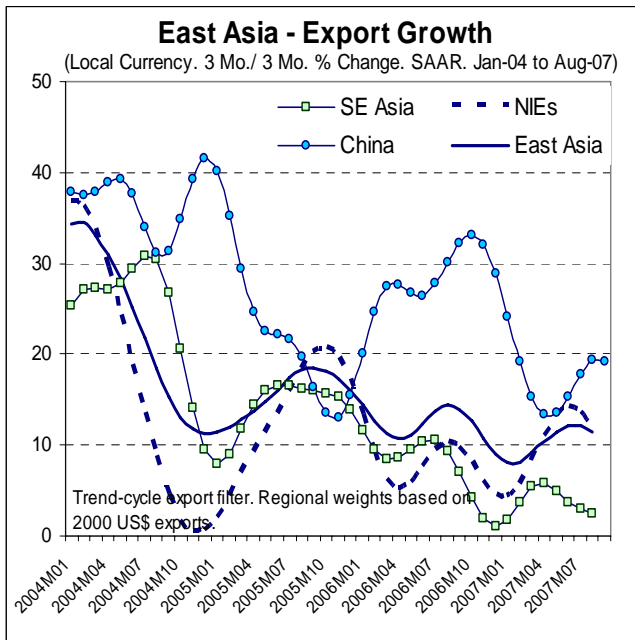
The slowdown in the US economy has already affected East Asian export growth, but is still permitting regional export growth in local currency terms of around 10-15 percent, and in dollar terms of 15-20 percent. Export growth in dollar terms slowed to around a 10 percent pace in the second quarter in the NIEs and the middle income South East Asian economies, while still running at around 30 percent in China. (Exhibit 5b). Dollar growth rates may not provide the most accurate picture of regional export performance, however, since most East Asian currencies have been appreciating against the dollar in recent years. Export growth in seasonally adjusted local currency terms

⁵ Real national income account imports of goods and services.

Exhibits 4a and b. US Import and East Asian Export Growth



Exhibits 5a and b. East Asian Export Growth: Local Currency and High Tech



(from one three month period to the next) suggests that export momentum in the region was already slowing in the latter part of 2006 and bottomed in the first quarter of 2007. Indeed export momentum was showing some pickup in the second and third quarters. (Exhibit 5a). This may be because global semiconductor demand has rebounded from the middle of the year and East Asian high tech production

and exports have rebounded quite sharply to meet the upturn in global demand.⁶ (Exhibit 5b and Section 3.3).

Outlook: Robust growth expected to continue through 2008

Growth in Emerging East Asia is expected to reach 8.4 percent in 2007, slightly up from 2006. This is about a percentage point higher than our projection last April, an

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

upgrade almost entirely due to the unexpected and large acceleration of growth in China in the first half of the year, driven mostly by stronger domestic demand. Growth in China is now projected to reach 11.3 percent in 2007, up a little from 2006. Growth in the middle income economies of South East Asia is also expected to gather strength in 2007, with faster growth in the Philippines and Indonesia in the 6-7 percent range, and continued solid growth in a 5-6 percent range in Malaysia. Stronger personal consumption and investment growth are also at the center of the improving growth projections for these countries, as they are in the NIEs, where consensus projections have been notched higher to 5.1 percent in 2007. Looking forward, Emerging East Asian growth is expected to slow modestly to 8.2 percent in 2008. The underlying pattern of growth is expected to be similar to that in 2007, with strong domestic demand growth in the lead, supported by export growth that, while less than during the upswing of the global cycle in 2003-06, would still continue at reasonable positive rates: perhaps in a 10-20 percent real growth range for China and a 5-10 percent range in the other larger middle and high income economies.

One reason for this relatively robust forecast for East Asian growth in 2008 is the assumption that a continuation of the current modest pace of OECD growth into 2008 will also allow East Asia to continue the relatively modest (but solidly positive) export growth it has been experiencing in 2007. Overall OECD growth is forecast to fall by half a percentage point to 2.3 percent in 2007, but then to continue to grow at about the same rate in 2008. Consensus forecasts for the US economy suggest that the credit squeeze is mostly expected to *extend* the period of slow growth in the US economy through 2008, rather than forcing a further sharp slowdown. (See section 3.1 below.)

The other main reason is the growing evidence of strengthening domestic demand growth in the region. Both personal consumption and investment growth rates accelerated in 7 of the 8 main economies outside of China in the first half of 2007 (the exception being Thailand). This contrasts with outcomes during the 2001 global slowdown and high tech recession, when domestic demand in the East Asian economies outside China proved highly sensitive to exports, so that overall GDP growth fell to only 1-2 percent. A number of factors seem to be providing 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. Thanks to tighter monetary policies from mid 2004 to the early part of 2006, core inflation rates are low and stable and have generally been running at lower levels in 2007 than in 2006 (although headline inflation rates have turned up in some countries due to higher imported food price inflation). (Table 4). This has allowed central banks to keep policy interest rates stable, or to lower them, as in Indonesia and Thailand. In the event of an unexpectedly severe export slowdown,, not only do central banks have room to ease monetary policy but governments can also undertake countercyclical fiscal policies. 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 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.

Table 4. Inflation (% change year ago)

	2004 Year	2005 Year	2006 Year	2007 Q2	2007 Q3	Latest Month
"Headline" Consumer Price Inflation						
China	3.9	1.8	1.5	3.6	6.1	6.2
Indonesia	6.1	10.5	13.1	6.0	6.5	7.0
Korea	3.6	2.8	2.2	2.4	2.3	2.3
Malaysia	1.5	3.0	3.6	1.5	1.8	1.9
Philippines	6.0	7.6	6.3	2.4	2.5	2.7
Thailand	2.8	4.5	4.6	1.9	1.6	2.1
"Core" Inflation						
China	0.4	0.9	0.8	0.9	0.6	0.7
Indonesia		4.2	8.8	5.6	5.8	6.0
Korea	2.9	2.3	1.8	2.3	2.3	2.3
Philippines	4.8	7.0	5.6	2.6	2.8	2.7
Thailand	0.4	1.6	2.3	0.9	0.7	0.8

Source: World Bank data.

In the case of China, the strong domestic demand growth momentum of 2007 is expected to carry through to 2008, resulting in another year of growth of over 10 percent. Here a moderate slowdown in export growth would help by mitigating pressures on inflation and the trade surplus, while China's strong macroeconomic position provides room to compensate with higher domestic demand if necessary.

Risks to the forecast are on the downside

There is clearly a significant possibility that the sub-prime crisis and the resulting credit squeeze could lead to a recession in the US and a much more significant slowdown in the OECD countries as a group. Another uncertain factor impacting domestic demand is the outlook for oil prices. Our current central projection is for oil prices to average \$68 in 2007, up from \$64.3 in 2006, rising to \$72.4 in 2008. But the surge in oil prices to over \$90 in October is a reminder of the more serious downside risks attached to this aspect of the outlook.

A number of recent studies look at the potential impact a US recession on the rest of the world, including by the IMF in its April 2007 World Economic Outlook report.⁷ We replicate one part of that analysis in Table 5 below, an event study relating US recessions and growth in East Asia.

⁷ IMF World Economic Outlook, April 2007. Chapter 4: "Decoupling the Train? Spillovers and Cycles in the Global Economy."

The table shows the three most recent US recessions, in 1982, 1991 and 2001. In these three US recessions median East Asian growth fell on average by about 0.5 percentage points for every 1 percentage point decline in US growth. Thus a fall in US growth to zero in 2008 (a 2 percentage point growth decline) might be accompanied by a 1 percentage point fall in median East Asian economy growth from around 6 percent to 5 percent – significant but no disaster. East Asian growth was more seriously affected during the US recession of 2001, which was accompanied by an extremely severe sector-specific cyclical contraction in global high tech demand, in the aftermath of the global high tech bubble of the late 1990s. However there are few signs of such a sharp cycle in global high tech at present; if anything high tech demand was rebounding quite smartly in the third quarter of 2007. (Section 3.3).

Table 5. Change in GDP Growth: USA and East Asia

	Recessions			Average All Recessions	Ratio to US
	1982	1991	2001		
USA	-4.5	-2.1	-2.9	-3.2	1.00
East Asia (median)	-0.6	0.2	-4.2	-1.5	0.48
China	3.9	5.4	-0.1	3.1	-0.97
Indonesia	-7.0	-0.1	-1.3	-2.8	0.89
Korea	1.2	0.2	-4.6	-1.1	0.34
Malaysia	-1.0	0.5	-8.5	-3.0	0.95
Philippines	0.2	-3.6	-4.2	-2.5	0.80
Taiwan					
(China)	-2.8	1.9	-7.9	-2.9	0.93
Thailand	-0.6	-2.6	-2.6	-1.9	0.61

Source: World Bank data and staff estimates

The IMF complements this event study approach with more rigorous econometric analyses that come to qualitatively similar estimates. A cross-country growth model finds a one percentage decline in US growth to be associated with around a 0.1 percentage point decline in Emerging Asian growth. A dynamic vector autoregression model finds that a 1 percentage point fall in US growth leads to around a 0.5 percentage point decline in growth in the East Asian NIEs and the ASEAN 4 after one quarter, with most of the impact dying out after 3 or 4 quarters. A separate recent study by researchers at the European Central Bank also comes to similar results, with Emerging Asian growth falling by 0.2 – 0.4 percentage points for a one percentage point of GDP fall in US domestic demand.⁸

Finally, to these downside risks, one should also add possible risks associated with success and with ‘too much of a good thing’. In recent years many economies in the region have been grappling with how to manage the

macroeconomic and financial consequences of sharp increases in foreign reserves, originating from both large current account surpluses, as well as rising capital inflows. If not properly managed, this trend could ultimately entail a loss of control over domestic monetary conditions, overheating, the formation of asset price bubbles and the emergence of serious financial sector and macroeconomic vulnerabilities. These issues are explored further in section 4.1 below.

2.2. Poverty reduction and human development

2007 should mark a milestone for poverty reduction in East Asia. The number of people living below \$2 a day in the region is now estimated to have fallen below 500 million for the first time, down from an estimated 540 million in 2006 and over 1 billion in 1990. The poverty headcount rate at the \$2 a day level is estimated to have fallen to about 27 percent in 2007, down from 29.5 percent in 2006 and 69 percent in 1990.⁹ (Appendix Table 5, Exhibit 6). Poverty declines are widespread across countries, including both low income economies such as Cambodia, Lao PDR, PNG and Vietnam, as well as middle income economies such as China, Indonesia and Thailand.

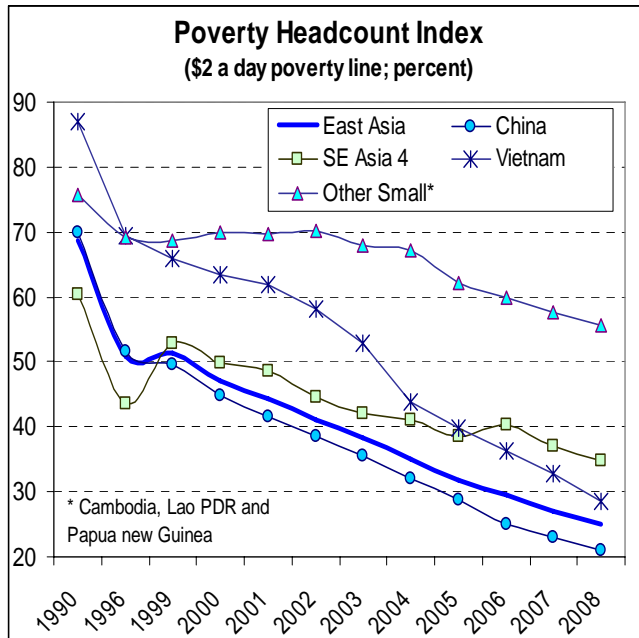
Strong economic growth – reaching an estimated 10.1 percent for developing East Asia in 2007 – is providing the underpinning for poverty reduction. But, as the review of individual country experiences below indicates, poverty in East Asia is now overwhelmingly a rural problem, with poverty declining unevenly because particular social groups and geographical regions. And even as poverty continues to fall in the aggregate, it is often the case that lower income groups experience slower income growth than higher income ones, resulting in widening income inequality.¹⁰ Governments in the region are therefore looking at policies that can foster poverty reduction in more targeted and cost effective ways. As the Special Focus in this Update on ‘‘Agriculture for Development in East Asia’’ explains, concerns about a widening urban-rural income divide are one reason why governments in countries like China are renewing their focus on rural and agricultural development policies, while also exploring ways to strengthen the human capital development of the poor and to provide more effective insurance and income support mechanisms.

⁹ The calculations for poverty headcount rates at the aggregate East Asian level over the period 1990-2006 in the report are slightly higher than in previous editions of the World Bank East Asia Update. This is purely a presentational effect due to the removal of Korea as one of the countries previously included in the calculation of the regional average. The effect has been to increase the East Asia regional aggregate poverty rate at the \$2 a day level by around 0.9 percentage point in recent years.

¹⁰ Income inequality in developing East Asia is now slightly higher than in the rest of the world. The median Gini coefficient in a group of 8 developing East Asian economies in recent years is 0.397, compared to a median 0.39 in a group of 93 developed and developing countries in the world as a whole.

⁸ Stephane Dees and Isabel Vansteenkiste: ‘‘The Transmission of US Cyclical Developments to the Rest of the World’’. ECB Working Paper Series No. 798. August 2007.

Exhibit 6



Cambodia

The percentage of Cambodia's population living under the national poverty line is estimated to have fallen by approximately a quarter, down from 45-50 percent at the time of the country's first household survey in 1993/94 to 35 percent at its most recent, in 2004. These changes have been driven by strong economic growth (averaging around 7 percent per annum between 1994 and 2004, with double-digit growth in each of the last three years) and improved service delivery. Using the international standard dollar a day poverty line, we estimate poverty has fallen further from 19 percent in 2004 to under 10 percent in 2007.

However inequality has also risen considerably in the transition from an isolated socialist state wracked by civil war to a fast-growing and globally well integrated market economy. Within those parts of the country that can be directly compared, the living standards of the poorest quintile rose by only 8 percent between 1993/4 and 2004, while those of the richest quintile rose by 45 percent. As a result, the Gini coefficient increased from 0.35 to 0.40. More encouragingly, a recent World Bank report on *Equity and Development* in Cambodia found that this rise occurred primarily in the earlier years of the decade (between 1993/4 and 1997), before stabilizing between 1997 and 2004. Although the gap between urban and rural living standards has widened, the rise in inequality appears to have been driven by a rise in inequality *within* the rural population, as more accessible villages got connected to urban areas earlier and pulled ahead of more remote villages, and as households with better endowments of assets, skills, access to capital and (perhaps) government connections diversified into higher-income off-farm production and trading. By contrast, while intra-urban inequality is much higher than

rural inequality, it also appears to have been relatively stable, changing little over time.

With the reallocation of public spending away from defense and security and towards basic services, human development indicators have also shown marked improvements since 2000. Infant and under-five mortality rates fell by around a third between 2000 and 2005 while primary school enrolment increased dramatically. The rise has been faster amongst girls than boys, closing the gap between male and female enrolment and literacy rates. Despite this progress, health and education outcomes in Cambodia remain amongst the worst in the region. Dropout rates are very high and education participation rates (particularly for girls) fall rapidly after primary level. Considerable progress still needs to be made if Cambodia is to meet the Millennium Development Goal derived targets set out in the 2006-2010 National Strategic Development Plan (NSDP).

China

China recently concluded its 17th National Congress of the Communist Party of China with President Hu Jintao's report highlighting the continuing challenges of addressing poverty and inequality in the country. The latest official estimate puts the number of rural poor in China—those with per-capita annual incomes below the official poverty line of 693 yuan - at 21.5 million at the end of 2006, about 6.7 million less than at the time of the 16th National Congress in 2002. Just how poverty in China should be defined has been a subject of policy debate in the country of late, though. China's official poverty line is only about 70 percent of the dollar-a-day (in purchasing power parity terms) international standard, in contrast to many poorer countries whose national poverty lines exceed the dollar-a-day threshold. Using the dollar-a-day threshold, the estimates in this Update indicate the number of poor in China in 2006 was about 101 million.

Taking up this question, a recent report by the think tank China Development Research Foundation (CDRF) argues that the current Chinese poverty line corresponds to no more than what is needed to buy minimal food and clothing for survival.¹¹ Making an allowance for basic expenditures on education and health, whose burden on household budgets has increased substantially since the 1990s, the report recommends that the poverty line should be around 1100 yuan per person per year (about 10 percent higher than the dollar-a-day threshold whose value in August 2007 prices comes to a little over 1000 yuan). The CDRF also reports findings from a 2006 survey of about 4000 poor households in 72 villages nationwide that the three leading causes of poverty included poor incomes from agriculture, growing expenditure on healthcare, and the high

¹¹ China Development Research Foundation (2007). *China Development Report 2007: Eliminating Poverty in Development*. Beijing, October.

cost of children's education. About 72 percent of the respondents listed low returns from crop income as the major reason for poverty, about half referred to the burden of medical expenditures, and about 36 percent pointed to the cost of children's education.

These recent policy discussions in China have highlighted not only the need for a higher poverty threshold but also for a broader perspective on poverty, and the need to supplement traditional area-based poverty alleviation programs with policies to invest in human development of the poor and further develop a social protection system for the poor. Many recent policy initiatives have moved in this direction, for instance through the elimination of agricultural taxes and fees, waiving of tuition fees for nine-year compulsory education in western regions, expanded coverage of rural health insurance and a minimum income support program.

Indonesia

Headcount poverty in Indonesia (measured at the national poverty line) fell 1.1 percentage points to 16.6 percent of the population in the year to March 2007. The decline followed an unexpected increase of 1.8 percentage points in 2006 driven mainly by large increases in the price of rice, a major item of expenditure in the budgets of the poor. Strong growth, falling inflation, and targeted cash transfers all contributed to the decline in poverty. Inflation, which reached 15.7 in 2006 due to large fuel price increases, fell to 6.5 percent in 2007 as the fuel price increase fell out and as the pace of inflation in rice prices slowed. A conditional cash transfer (CCT) program for poor households, designed as compensation for the fuel price increases, also helped reduce poverty in 2007. Roughly 75 percent of the transfers, which consisted of grants of \$30 per month to poor households, were disbursed in 2006 and 2007.

Some other trends are more problematic. Per capita consumption is growing less quickly among the bottom income quintiles than at the top. The Gini coefficient rose from 35.4 to 37.6, continuing a trend in which growth has become less pro-poor since 2002. A large percentage of the population also remains vulnerable to poverty, being clustered near the poverty line. For example, raising the national poverty line 20 percent from roughly \$1.50 to \$1.80 per capita per day would increase the poverty rate from 17 to 29 percent. Small price changes in goods consumed by poor households can have relatively large effects on the proportion of households classified as poor.

Large gaps remain between the poorer east and the more prosperous west. The incidence of poverty is highest in the eastern islands of Papua, the Malacca Islands, and Nusa Tenggara, reaching 41, 26, and 23 percent respectively. In contrast, poverty rates are 16.5 percent in Java and Sumatra. However, Java and Sumatra are the most populous regions, and contain over three quarters of the country's poor. There is also a continuing disparity between urban and rural regions, as the poverty rate is 20 percent in

rural areas, as opposed to 13 percent in urban areas. The urban-rural poverty gap remained constant between 2006 and 2007, as poverty fell by roughly 1.1 percentage points in each area.

Indonesia is currently piloting two major conditional cash transfer programs, one directed at households and the other at communities. The household CCT provides poor household with an average transfer of about \$140 per year, conditional upon utilizing a basic set of health and education services. The community CCT builds upon Indonesia's accumulated experience with community driven development programs, in particular the World Bank funded Kecamatan Development Project and Urban Poverty Project. Communities receive a grant to increase utilization of the same basic services targeted by the household CCT. Part of the block grant in the second and subsequent years is dependent on exceeding community-specific targets established in the initial year.

Thailand

Thailand's latest national Poverty Report shows that poverty fell between 2004 and 2006, but at a relatively slow pace. The poverty headcount ratio fell from 11.2 in 2004 to 9.6 in 2006, leaving 6.1 million people living below the national poverty line of 1,386 Baht/person/month. Apart from the increase in poverty after the financial crisis from 1997 - 2000, the recent reduction in the poverty rate of 1.6 percentage point in 2004-06 was the lowest since 1990. Part of the reason was low or negative growth of farm income in 2004-2005 as a result of low crop production, especially in main crops such as rice, rubber, sugarcane, maize and cassava (although farm income did rebound in 2006). Higher fuel input prices relative to prices for agricultural output also eroded farm incomes. Almost half of poor households derive their incomes from agriculture, fishing and forestry. Another important group among the poor is the elderly – the age of the head of household is highly correlated with poverty, especially in rural areas. Viewed geographically, poverty remains highest in the North East, with a poverty headcount rate of 16.8 percent, although this is down from 24.5 percent in 2006. Poverty in rural areas is down to 12 percent of the population – almost half the rate in 1996 – although this is still over 3 times as high as the 3.6 percent rate in urban areas.

Income inequality in Thailand as measured by the Gini coefficient declined slightly from 0.426 in 2004 to 0.418 in 2006. Over a longer time horizon, the Gini coefficient fell from an average 0.44 in 1988-96 to 0.42 in 2000-06. While this may seem a modest decline in inequality, it was greater than three quarters of countries for which data is available over a comparable period. The level of income inequality in Thailand is however moderately high by international standards, a little above the international median.

3. The international and regional environment

The outlook for global growth in 2007 is similar to that presented in the previous April 2007 East Asia Update - decelerating from 3.9 percent in 2006 to 3.5 percent in 2007 (from 5.3 to 5.1 percent respectively in purchasing power terms). The main difference from six months ago is that 2008 is now likely to be a year of further mild deceleration in growth (easing to 3.4 percent), rather than one of mild revival, (Table 6) while the risk of a more serious downturn has also increased. Growth projections for 2008 have been reduced for all the main developed regions, most emphatically for the US, where they have been cut from 3 percent six months ago to only 2 percent now.. This hefty adjustment reflects the likely depressing effects of the sub-prime crisis and the associated tightening of credit markets that began in August, the unexpectedly deep recession in the US housing market and the impact of higher than previously forecast oil prices. But growth projections have also been tuned lower for the Euro area, which is also likely to feel the effects of the credit squeeze flowing from the sub-prime crisis, and Japan, where consumer spending has remained sluggish, belying earlier expectations of a revival (with both Europe and Japan also suffering from the impact of higher oil prices). World trade volume growth is projected to dip from over 10 percent in 2006 to around 7 ½ percent in 2008.

Table 6. International Economic Environment

	2005	2006	2007	2008
% Change from previous year, except interest rates				
GDP Growth				
World	3.4	3.9	3.5	3.4
World (PPP Weights)	4.7	5.3	5.1	5.0
OECD	2.4	2.8	2.3	2.2
United States	3.1	2.9	1.9	2.0
Euro Area	1.5	2.8	2.5	2.1
Japan	1.9	2.2	2.0	1.8
Developing Econ.	6.8	7.5	7.3	7.0
World Trade (Volume)	7.8	10.2	9.2	7.5
CPI Inflation - G7 ^{a/}	2.0	2.0	1.7	1.7
Oil Price - \$/bbl	53.4	64.3	68.0	72.4
- % Change	41.5	20.4	5.7	6.6
Non-oil Commodity Prices				
LIBOR - US\$. 6 Mo.	3.7	5.2	5.3	4.8
-Euro 6 Mo.	2.2	3.2	4.3	4.0
Source: World Bank DEC Prospects Group October 2007. a/ In local currency aggregated using 2000 weights.				

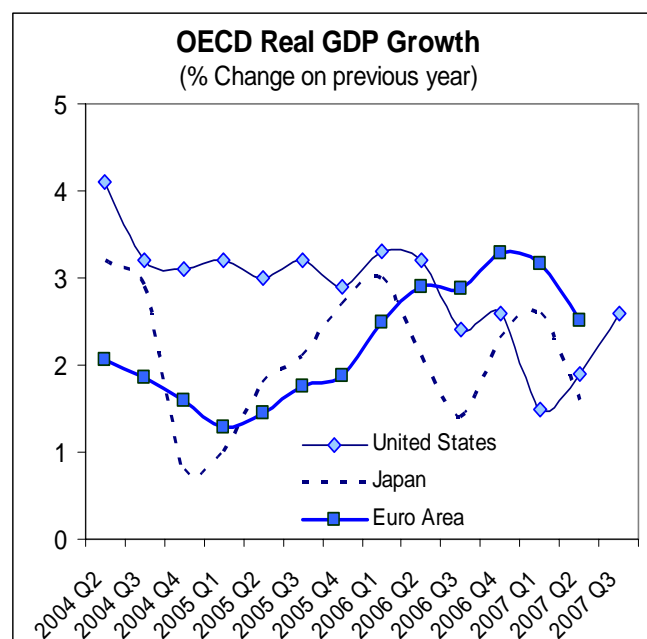
Yet, despite the more somber outlook for world growth in the near term, there are also countervailing elements in the global picture that suggest resiliency and the potential for recovery. For one thing, despite its slower trend, the US economy continues to show obstinate strength, picking up to 3.9 percent growth in the third quarter of 2007, for example. While US import growth has already slowed to a crawl in 2007, this does not seem to have had

much discernable impact on growth in China, the rest of East Asia, or developing countries as a group, which have been relying more on domestic demand to offset slower export growth. Unlike in 2001, the slowdown in world growth is not spearheaded by a recession in the global high tech industry, which is by far East Asia's most important export sector. Indeed global high tech demand appears to have been rebounding in the third quarter of the year. Recent research also confirms that the world economy has become a lot more resilient to high oil prices, with the estimated impact on developed economies in the last two decades half or less than half of what it was in previous times.

3.1. A slowing trend in the developed world

Growth in the *United States* fell to 1.7 percent (year on year) in the first half of 2007, down by almost half from a 3.3 percent pace in the first half of 2006. (Exhibit 7). Two thirds of the fall in growth was due to housing investment, which contracted by 16.5 percent from a year earlier. Growth in business equipment and software investment also fell to virtually zero in the first half of the year. Continued steady growth in personal consumption in the 3 percent range helped prevent a more severe downturn in overall activity, as did an upturn in net exports. Exports continued to grow at a 7-8 percent year on year pace while import growth slowed to 2 ½ percent in the first half of 2007 from around 6 ½ percent a year earlier. US growth in the third quarter surprised to the upside, rising 3.9 percent from the second quarter (saar, or 2.6 percent on a year earlier). The growth rebound in the third quarter reflected a pickup in personal consumption and non-residential investment, as well as a large and rising contribution from net exports, all adding up to more than outweigh a continued steep decline in housing.

Exhibit 7



However, despite the rebound in the third quarter, other events in the quarter were mostly adding to the risks of a renewed weakening in demand and activity in coming quarters. The sub-prime crisis is contributing to further decline in the already weak housing market, as borrowing restrictions increase and housing credit conditions tighten. Housing starts tumbled 10.2 percent in September, the biggest monthly fall in more than a decade, to stand 31 percent below year earlier levels, and almost 50 percent down from their peak in January 2006. The S&P Case/Shiller Composite 10 City Index of house prices has been falling since mid 2006 and was 4.5 percent below year earlier levels in July 2007. Durable goods and capital goods orders, which are a good proxy for business fixed investment, also took a sharp turn lower in August. Looking forward there are concerns that investment may be curtailed by the impact of the sub-prime crisis on high yield spreads, on the profits and balance sheets of banks and hence on new lending in the wider economy.

Labor market conditions are also gradually easing. In the six months through September monthly gains in non-farm employment have averaged around 110,000 jobs, down from gains of over 200,000 per month in late 2005 and early 2006 (although October surprised to the upside, with a gain of 166,000 jobs). The unemployment rate has been creeping up, from 4.4-4.5 percent in the early part of the year to 4.7 percent in September and October. Retail sales during the third quarter show that US consumers remained surprisingly resilient, with sales in September 2007 continuing to run 6 percent up on year earlier levels. However consumer sentiment has swung lower during the third quarter and consumer spending, the bedrock of the US economy, could weaken if the sharp rise in oil prices in October is sustained, and as home prices continue to fall, credit conditions in the housing market tighten and labor market conditions ease.

Consensus views for US economic growth have been reduced for both 2007 and 2008. We now project US growth of only 1.9 percent in 2007, with only a modest pick up to 2 percent in 2008, even factoring the impact of rising US net exports and a declining current account deficit. Risks to the forecast are mostly to the downside, given large uncertainties about the full extent of disruptions in credit markets that could result from the sub-prime crisis and the recent surge in oil prices.

The *Japanese economy* has been growing at around 2 percent since 2003, although often with volatile movements from one quarter to the next, with non-residential investment spending and net exports providing the largest contributions to growth. Strong investment has reflected the substantial restructuring undertaken by firms over the past decade and more, and the stronger profitability and balance sheets that have resulted. Consumer spending has however remained relatively weak. Consumer confidence fell sharply in the second and third quarters of 2007 as households remain concerned about the increasing use of part time workers and declining nominal wages. Slowing consumer spending growth was one factor behind

an unexpected 1.2 percent decline in GDP in the second quarter of 2007 (quarter on quarter, saar). Residential and non-residential investment also fell. Looking forward, growth is expected to moderate from 2 percent in 2007 to 1.8 percent in 2008, as export growth moderates in line with slower world growth and as consumer spending remains sluggish.

Europe has enjoyed a broad based acceleration in growth since the end of 2004, with year on year Euro Area growth exceeding 3 percent in late 2006 and early 2007. Growth slowed to 2 ½ percent in the second quarter, or only 1.4 percent on a quarter to quarter basis, mainly reflecting a falloff in investment. Looking forward, growth is expected to moderate from 2.5 percent in 2007 to 2.1 percent in 2008. Hitherto strong export growth should moderate with softening world demand and the impact of a strong euro exchange rate. European banks have also been more exposed via off-balance sheet investments to sub-prime problems, and the resulting losses and constraints on new lending could adversely affect housing and business investment.

3.2. China - growth expected to remain strong

Growth in China exceeded earlier expectations by a wide margin through most of 2007, running at 11.1, 11.9 and 11.5 percent in the first, second and third quarters respectively. Earlier expectation had been for a continuation of the trend seen in 2006, when growth decelerated modestly to around 10.5 percent in the second half of the year, mainly reflecting administrative tightening measures that helped slow nominal fixed asset investment growth from around 30 percent in the first half of 2006 to around 20 percent in the second half.¹² This pattern of moderating investment growth did not continue into 2007, however. Instead a new acceleration of investment growth (to around 27-28 percent in nominal FAI terms) has provided the main contribution for the rise in overall GDP growth so far in 2007. Despite the administrative tightening measures, the underlying incentives for investment remain strong. Profit margins have been rising while industrial profit growth remains at high levels, as does growth in credit. Interest rates have been raised several times, with one year nominal lending rates now at 7.3 percent, which however remains low relative to estimated rates of return on investment. This year's rapid growth is also supported by personal consumption (retail sales are growing at about 12 percent in real terms) and net exports, contributing 3-4 percentage points to overall growth.

Looking forward, China is projected to grow 11.3 percent in 2007 and to slow only modestly to 10.8 percent growth in 2008. Although there are some macroeconomic and financial trends that could pose a risk to this strong growth forecast and which need careful watching, none

¹² 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.

appears serious enough at present to derail the current momentum of growth, or to cause the authorities to make major policy changes that would lead to a marked slowing in the near term. (These domestic trends and risks are discussed further in the paragraphs on China in the Country Sections later in the report).

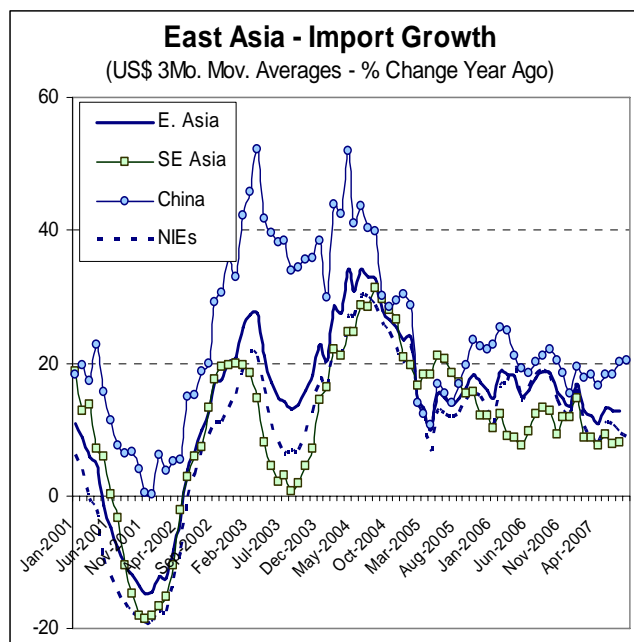
External conditions are no doubt a greater source of risk to the robust growth forecast for China in 2008 than are current domestic conditions. Nevertheless, as the earlier discussion of regional growth indicated, although US import growth has already slowed to near zero over the course of 2007, the impact on China's export growth has been relatively modest, in part as China has continued to gain market share in US imports and in as part as slower growth in exports to the US has been offset by continued or accelerating export growth to other markets, notably Europe, which is now a larger export market than the US for China. The current global forecasts assume only a modest further slowdown in the world economy. China's export growth is also expected to slow only moderately, dipping to around 18 percent in real terms from 23 percent in 2007. Indeed a moderate global slowdown could have some beneficial effects for China, helping to moderate aggregate demand growth, inflation risks and the rise in the trade surplus.

Clearly exports would be more seriously affected in the event of a US recession and a more severe slowdown in the world economy, although the impact on output growth may be more limited. During the 2001 recession, for example, world imports contracted 3.5 percent (in dollar terms), while China's export growth also slowed sharply to around 7 percent, from 28 percent the year before. But China's GDP growth was hardly affected, running at 8.3 percent in 2001 compared to 8.4 percent in 2000. China would likely be more significantly affected by a sharp export slowdown today because exports are now a bigger share of GDP than in 2001, although it is worth noting that exports in value-added terms are significantly lower than the gross numbers suggest, due to the importance of imported components. In addition, given China's strong macroeconomic position, domestic policies could also be eased to support domestic demand, should this be needed in the event of an export slowdown.

China's growing importance in the world economy and the likelihood that it could maintain relatively fast growth during a global slowdown has raised the question to what extent it could provide an independent locomotive for the world economy. China now comprises around 15 percent of world GDP in purchasing power parity terms and it made the largest single arithmetical contribution to global growth during the first half of 2007, measured at both market exchange rates and in purchasing power parity terms. For arithmetical reasons (if no other) this contribution would likely increase during a global slowdown, as growth in other parts of the world fell. However the locomotive effect of growth in China on stimulating export growth in the rest of the world may be more limited than suggested by

its recent contribution to world GDP growth. First, China's share of world imports is rather smaller than its share of world GDP, only 7 percent in 2006. Thus if China's imports continued growing at about 20 percent in nominal dollar terms, as they have been in the last two years, (Exhibit 8), they would contribute only about 1-2 percentage points to world nominal import growth. Second, China's economy is already growing at over 11 percent. It could not grow much faster than it is now and therefore could not offset a sharp slowdown in global demand elsewhere in the world.

Exhibit 8



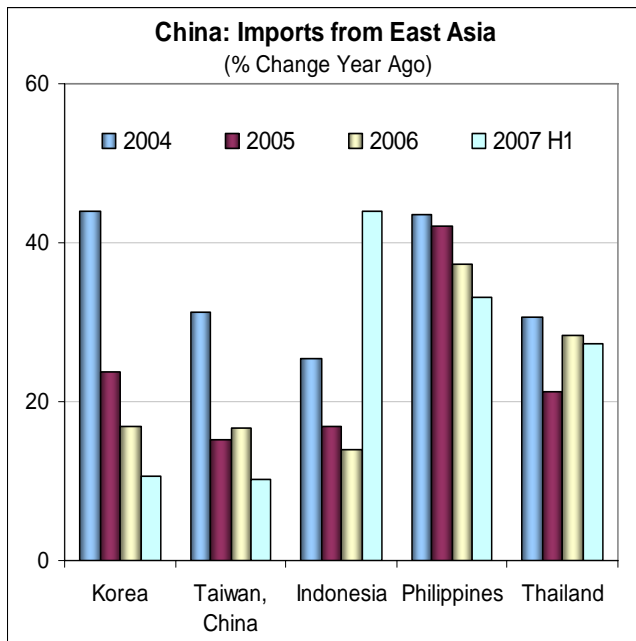
The impact of growth in China on sustaining exports from the rest of East Asia would undoubtedly be greater. In 2005 some 22.5 of exports from 7 other main East Asian economies went to China and Hong Kong, up from 13.3 percent in 1995. Nevertheless, as many researchers have observed, a large proportion – perhaps half – of other East Asian exports to China are various kinds of components for use as inputs in China's own exports.¹³ Thus a slowdown in China's exports to the rest of the world tends to be swiftly reflected in lower imports of inputs from the rest of East Asia, even though China's own domestic demand may continue growing rapidly. During the 2001 global high tech recession, for example, when China's exports to the US slowed, its imports from the rest of East Asia fell from 36 percent the year before to almost zero in 2001, despite GDP growth in China of over 10 percent.

But even this pattern of links between China's exports to the wider world and its imports from East Asia is subject to change. Observers have noted that China's increasingly sophisticated domestic production capacity is allowing it source more of its input needs from within

¹³ World Bank East Asia and Pacific Update, November 2005.

China. This has led to an increasing delinking of imports from exports in the last 2-3 years, a slowing in import growth to substantially less than the pace of export growth and a sharp rise in the trade surplus. Exhibit 9 shows that growth in China's imports from Korea and Taiwan (China) – among its more sophisticated suppliers - has slowed quite sharply. Cui and Syed (2007) provide a more systematic econometric demonstration of this effect. They find that the association of China's imports with its exports fell sharply in both size and statistical significance between 1994-99 and 2000-05, while the association with domestic demand increased just as dramatically.¹⁴ This trend represents both a threat and an opportunity for the rest of East Asia. The new challenge for the rest of East Asia will be in successfully making the transition from supplying inputs for China's exports - a process that was helped along by the international supply chains of multinational companies that have a foot in both China and the rest of East Asia – to also directly supplying the Chinese domestic market, something that might require significantly different research, production, branding and marketing skills and channels.

Exhibit 9



3.3 Oil and other Commodity markets

Oil markets

Crude oil prices have moved almost continuously higher over the course of 2007, from \$53.4 per barrel in January to \$81.4 in October, a monthly record in nominal terms, reaching nearly \$90 at the end of the month.¹⁵

¹⁴ Li Cui and Murtaza Syed: "The Shifting Structure of China's Trade and Production." IMF Working Paper WP/07/214. September 2007.

¹⁵ This reference price is an average of Brent, Dubai and West Texas Intermediate (WTI) crudes.

(Exhibit 10). In inflation adjusted terms the average oil price in October 2007 was about 21 percent lower than the record of \$102 per barrel (in 2006 US prices) set in the fourth quarter of 1979. (Exhibit 11).

Exhibit 10

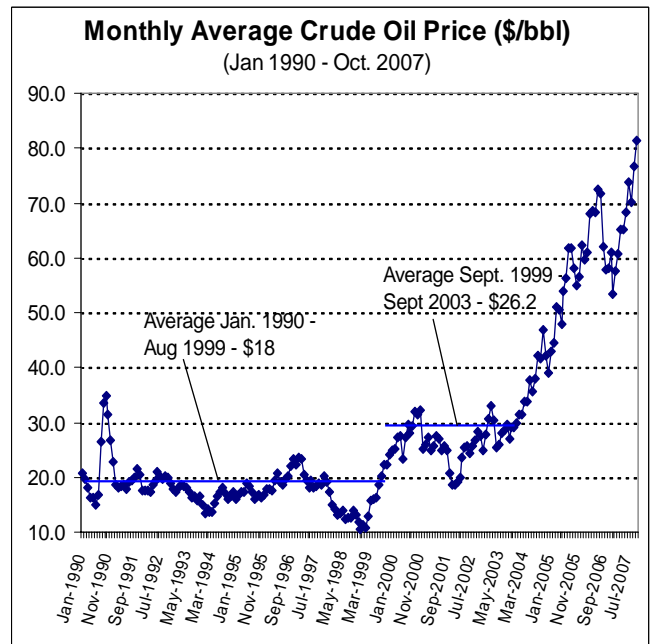
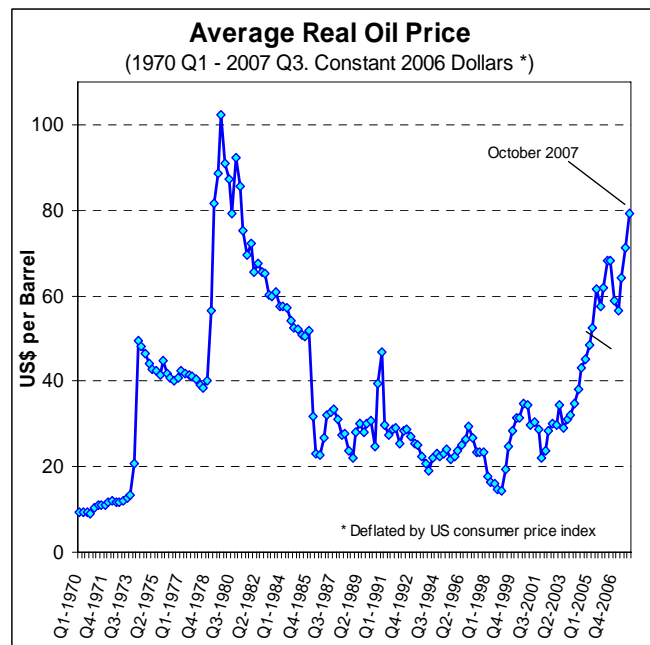


Exhibit 11



The tightness in the oil market is underpinned by both demand and supply factors. World demand is continuing to grow despite the 130 percent rise in crude oil prices between 2003 and the average of the first 10 months of 2007, primarily because of demand in developing economies. Although high prices have curbed consumption

in OECD countries – which fell 1.1 percent in 2006 and is forecast to be flat in 2007 – oil demand in developing economies is expected to rise 3 - 4 percent this year, with China increasing oil consumption by 4-5 percent.¹⁶ Based on the IEA's assumptions, world demand will have increased by 6.3 million barrels per day between 2003 and 2007, with China alone accounting for 32 percent of the increase and other developing (non OECD) economies accounting for another 57 percent.

While demand continues to grow, the supply response to higher prices has turned out to be more sluggish than previously expected due to rising input costs in oil production capacity development and uncertainties about political conditions and the investment climate in a range of developing economy oil producers. IEA estimates suggest that world oil production in the first three quarters of 2007 was running at about the same pace as in 2006. Production declines in OECD countries (mainly due to falling North Sea production) and in OPEC – where production (ex Angola) was down 1.8 mb/d in June compared to a year earlier – were only partly offset by higher production in non-OECD countries outside OPEC (mainly Russia and other economies of the former Soviet Union). With demand growth exceeding supply, crude oil stocks in OECD countries fell sharply in the third quarter (although remaining near the upper edge of their five year range). In addition to tightening fundamentals oil prices have also been boosted by strong speculative investment demand.

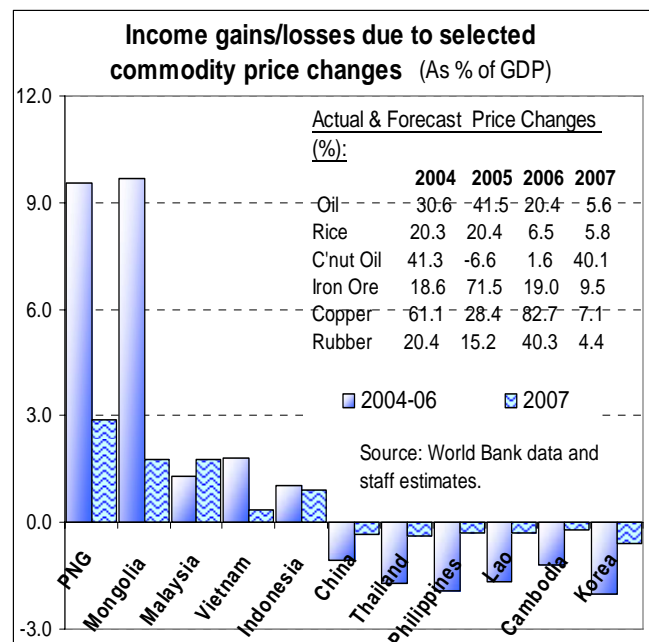
Looking forward, oil prices are likely to remain elevated and volatile over 2008-09, although perhaps not at the levels of the recent spike. Oil prices are currently forecast to average \$72 a barrel in 2008 and just under \$70 in 2009, rather less than the near \$90 per barrel reached at the end of October 2007. The fundamental factors that could support some easing from recent highs include the continued moderate slowing in OECD country growth (due to the housing recession in the US and the drawn out impacts of the sub-prime crisis and credit squeeze), as well as gradual moderation in China's growth towards its potential rate. Rising upstream investment in both OPEC and non-OPEC countries should result in new capacity that matches or exceeds demand growth, although, as the unexpectedly sluggish supply response of oil production in the recent past indicates, there are significant risks that unplanned project delays and cost overruns could lead to new disappointments.

Higher oil and non-oil primary commodity prices are estimated to have generated aggregate income losses in Emerging East Asia due to worse terms of trade of about 1 percent of regional GDP per year on average in 2004-06. Within the region net energy and non-energy primary commodity exporters such as Indonesia, Malaysia and Vietnam are estimated to have received windfall terms of trade gains of 1-2 percent of GDP per year in 2004-06,

rising to 9-10 percent of GDP in an economy like Papua New Guinea, which benefited not only from higher oil prices but also from surging copper and gold prices. (Exhibit 12). Mongolia too is estimated to have received net terms of trade gains worth 9-10 percent of GDP per year, with large gains in metal prices overriding its higher import bill for oil. On the other hand significant net oil importers like Korea, Lao PDR, Philippines and Thailand are estimated to have experienced terms of trade losses of 1.5-2 percent of GDP in 2004-06. China is estimated to have experienced more moderate income losses of about 1 percent of GDP per year.

The pattern of terms of trade losses and gains in 2007 is expected to be qualitatively similar to that of the last three years, although smaller in size. Terms of trade losses for the main net oil importers are generally expected to be less than 0.6 percent of GDP. The reason is that year average price changes for key commodities like oil and metals are likely to be rather smaller this year than in the previous years. Thus, while oil prices have risen sharply during the course of 2007, they had also fallen sharply in the latter part of 2006. Average oil prices in the first 10 months of 2007, for example, were only 4.5 percent up on 2006.

Exhibit 12



The renewed surge in oil prices in the latter part of 2007 has once more renewed concerns about negative impacts on global growth. However there is some comfort in the relatively limited impact on world growth that the more than doubling in oil prices over the last 3-4 years has had. One main reason for the muted impact appears to lie in the fact that oil prices in 2004-07 have been mostly pulled higher by strong world demand growth, particularly in developing countries, rather than pushed higher by a sharp reduction in supply. In this context higher oil prices are serving to ration available oil supplies to growing world demand (and to moderate growth to less than what it would

¹⁶ International Energy Agency. World Oil Market Report. October 11, 2007.

otherwise be), as well as provide a price stimulus for investment in new oil production capacity.

A second factor is that the rise in oil prices has been spread out over several years, avoiding sudden shocks to consumer and business confidence. Nordhaus (2007) calculates that the negative income effect of higher oil prices in the US has been about 0.7 percent of GDP per year in the recent period, which is only one third or less than the size of the annual income effects in the 1974-75 and 1979-80 oil shocks.¹⁷ As we showed above, the initial income effects of oil and non-oil commodity price changes for the Emerging East Asia region as a whole have averaged around 1 percent of GDP in 2004-06, during which period regional growth accelerated to 8 percent from around 6 percent in the preceding three years.

Recent research also suggests that the sensitivity of growth in developed countries to a given oil shock has fallen sharply in the last two decades. This is important for East Asia and other developing economies because it suggests that the indirect effects of an oil shock operating via reduced exports to developed countries are now smaller than in the past. Blanchard and Gali (2007) estimate that the impact on GDP growth in the US of a \$10 rise in the oil price fell from a decline of around 0.7 percent in the period before 1984 to around 0.3 percent in the period after it. They suggest a number of reasons for the reduced sensitivity of growth to oil shocks.¹⁸ First, a trend towards more flexible labor markets means that resources can be reshuffled to new uses more easily in the wake of an oil price shock, and the loss of output associated with stabilizing inflation is less than in the past. Second, the credibility of central banks in keeping inflation low has greatly increased over the last two decades. Global inflation expectations have remained well anchored in recent years, requiring less monetary tightening to keep inflation in check. Third, the oil and energy intensity of the world economy has fallen by over 30 percent in the last 25 years.

Energy intensity among major East Asian economies is clustered around 0.22-0.23 kilograms of oil equivalent per dollar of PPP GDP. (Table 7). This is roughly the same as in the US but about 20 percent higher than for developed economies as a group (and close to 50 percent higher than in Japan), meaning the region remains somewhat more vulnerable to oil and other energy price shocks. As regards trends over time, energy intensity for the region as a whole fell by close to 60 percent between 1980 and 2005. But nearly all of this dramatic improvement was due to China, where the transition from a planned economy to a market based economy has yielded enormous improvements in energy efficiency. Vietnam has also scored substantial gains during its market transition. However other East Asian economies that did not start out

burdened with an inefficient planned economic structure have seen energy intensity fall only modestly (Indonesia), remain flat (Korea) or even increase over the course of 1980-2005 (Malaysia, Philippines, Thailand). These trends in energy intensity are the result of many factors, including energy prices, taxes, regulations and other policies affecting energy use, per-capita income growth and evolving demands for more energy intensive products (household appliances, personal transportation, air-conditioning etc) and the rising share of the (relatively energy intensive) industrial sector in many economies.

Table 7. Energy Consumption

	Energy Intensity		Net Energy Exports	
	Kg per \$ of GDP (PPP) *	% Change	Mtoe **	As % of Energy Use
	2005	1980-05	2005	2005
China	0.219	-72.2	-100.1	-5.8
Indonesia	0.238	-11.7	83.5	46.5
Korea	0.225	-0.8	-176.2	-82.5
Malaysia	0.25	12	33.4	54.5
Philippines	0.118	10.5	-20.4	-45.6
Thailand	0.201	4.0	-46.6	-46.5
Vietnam	0.226	-38.5	17.6	34.3
East Asia	0.217	-57.3	-208.8	-8.8
Japan	0.152	-14.4	-439	-82.8
USA	0.212	-40.0	-734.9	-31.4
OECD	0.185	-28.7	..	..
World	0.208	-30.5	..	..

* Kilogram of oil equivalent per dollar of PPP GDP. ** Million tones of oil equivalent, Source IEA Energy Balances and World Bank.

The impact of rising consumer demands and industry shares means that task of achieving substantial improvements in East Asian energy efficiency going forward will not be a straightforward one. In China, for example, the big declines in energy intensity seem to have eased off around the year 2000. The economy wide energy intensity ratio has been relatively flat since then. A renewed focus on strengthening energy sector policies is therefore an important priority going forward for both economic and environmental reasons. Thailand took important steps in this direction when it removed fuel price ceilings in 2004, as did Indonesia when it sharply reduced fuel subsidies in 2005.

Table 8 shows that retail prices for premium or super gasoline in most East Asian economies are now 10-30 percent higher than in the US, or have at least substantially reduced the subsidy element that previously kept their prices well below those in the US. (The retail US gasoline price is a useful reference point for a largely market determined price, since it is not much affected by subsidies or taxes, beyond highway charges, which average about 10 cents per

¹⁷ William Nordhaus. (2007). *Who's afraid of a big bad oil shock?* September. Brookings Panel on Economic Activity.

¹⁸ Olivier Blanchard and Jordi Gali. (2007). *The Macroeconomic Impact of Oil Price Shocks: Why are the 2000s so different from the 1970s?* (August). NBER Working Paper 13368.

liter). Retail gasoline prices in China are state controlled, but adjusted on an ad hoc basis to reflect significant changes in market fundamentals. Prices were raised by 8 percent on November 1, after the surge in global oil prices led to higher costs and losses among domestic refiners, and to the emergence of shortages.

Table 8. Prices for Premium (“Super”) Gasoline

	2002	2004	2006	2007
	(US Cents / Liter)			
Cambodia	63	79	101	104
China	42	48	69	71
Indonesia	27	27	57	73
Korea	109	135	165	173
Lao PDR	36	54	86	104
Malaysia	35	37	53	57
Mongolia	38	61	88	86
Philippines	35	52	76	98
Thailand	36	54	70	91
USA	40	54	63	81
	As % of USA			
Cambodia	157.5	146.3	160.3	128.4
China	105.0	88.9	109.5	87.7
Indonesia	67.5	50.0	90.5	90.1
Korea	272.5	250.0	261.9	213.6
Lao PDR	90.0	100.0	136.5	128.4
Malaysia	87.5	68.5	84.1	70.4
Mongolia	95.0	113.0	139.7	106.2
Philippines	87.5	96.3	120.6	121.0
Thailand	90.0	100.0	111.1	112.3

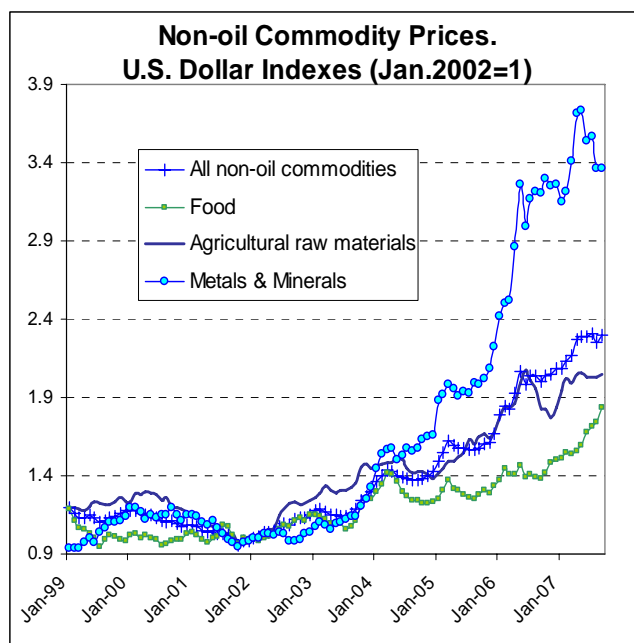
Source: GTZ “International Fuel Prices 2007” for November 2002, 2004, 2006. World Bank for October / November 2007.

Non oil commodity markets

Non-oil primary commodity prices continued to increase or remain at elevated levels in the first three quarters of 2007, although the pace of increase has moderated. The World Bank’s index of non-oil commodity prices in nominal US dollar terms increased 10 percent between the end of 2006 and September 2007, although there was much divergence in the performance of individual commodities. (Exhibit 13). While increases in metals and other industrial raw material prices had been at the forefront in earlier phases of the present commodity price boom, this year it is food prices that have made the running due to increased use of food crops for biofuels and weather related crop shortfalls. Edible oil and grains prices were up over 40 percent and 20 percent respectively in the first 9 months of the year. Metals prices have shown the largest gains over the period 2003-06 due to strong demand from China, underinvestment in earlier years and unexpected difficulties in bringing new capacity into production due to shortages of skilled workers and equipment. Metals prices have much more volatile this year, rising sharply in the first part of the

year and then giving up much of these gains after May. Metals prices are typically the most sensitive to the pace of global economic activity and credit conditions and are anticipated to peak in 2007 and decline by 6-7 percent in 2008 as global activity moderates and new supply capacity comes on stream.

Exhibit 13



The strength in metals prices has generated large windfall gains in small low-income mineral exporting economies such as Mongolia and Papua New Guinea over the course of 2004-06, and also to a smaller extent in 2007. Indonesia has also enjoyed smaller but still significant income gains from higher metals prices. The smaller heavily mineral dependent economies in the region in particular face the challenge of prudently managing the very large windfall terms of trade gains of recent years, especially as metals prices are expected to fall in 2008 and beyond. Agricultural exporters such as Malaysia, Indonesia and PNG are also enjoying significant income gains from higher prices for edible oils in 2007. Rubber prices are down from peak levels seen in 2006, but were still running at elevated levels of around 230 cents a kilogram in the third quarter of 2007, continuing to benefit exporters like Indonesia, Malaysia, Thailand and Vietnam. Estimates of overall primary commodity related income gains and losses in East Asia inclusive of oil prices were presented in the previous section.

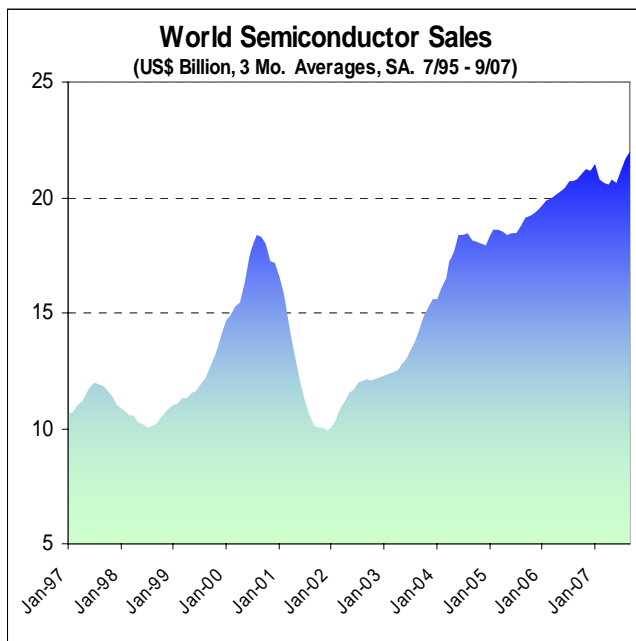
High tech

Global high tech markets – a key export sector for middle and high income East Asian economies – were lackluster in the first half of the year, but showed signs of a solid rebound in the third quarter. World semiconductor sales in the third quarter surged by 31 percent from the second (saar) after falling around 2 percent in the second

quarter. (Exhibit 14). The Semiconductor Industry Association noted that, in terms of end-products using semiconductors, demand for consumer electronic products remained robust. Demand for personal computers and cell phones, the two biggest drivers for semiconductors, remained very healthy. Orders for high tech goods in the G3 countries also picked up from a 9 percent decline in the first quarter to a 21 percent increase by July.

As the earlier discussion of exports indicates, the revival in global high tech demand has already been reflected in a rebound in high tech exports from East Asian economies. (Exhibit 5b above). Growth in high tech exports from 7 East Asian economies picked up to 21 percent (saar) in the three months through July, after having been virtually stagnant in the first quarter.

Exhibit 14



4.0 Domestic trends and policy challenges

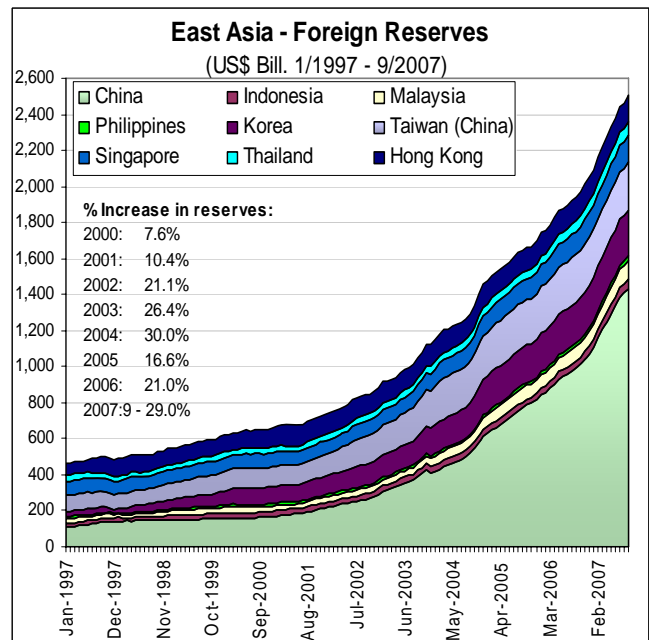
4.1 Balance of payments and financial markets

Emerging East Asia looks on the way to by far its largest ever increase in foreign exchange reserves (an overall balance of payments surplus) during 2007. Foreign reserves for the 9 largest economies increased by \$451 billion in the 9 months to September 2007, reaching \$2.5 trillion, compared to an increase of \$357 billion in all of 2006. (Exhibit 15). About four-fifths of the regional reserve increase was in China (\$365 billion in the first 9 months), but reserves were also rising at solid rates in most other economies.

The increase in regional reserves or overall balance of payments (BOP) surplus amounted to a 12.1 percent of regional GDP in the first half of 2007 – the period for which detailed balance of payments data are available - with BOP

inflows reaching an astonishing 19.2 percent of GDP in China. (See Appendix Tables 10a and 10b for details.) Overall inflows were not so large in most other economies, (although Malaysia came close with inflows worth over 18 percent of GDP), with most middle income economies in South East Asia seeing overall surpluses worth 4-5 percent of GDP. Overall inflows to the region have been running at over 5 percent of GDP since 2002. We look at the macroeconomic management challenges and potential risks posed by balance of inflows on this scale in the next section of this report, asking whether it amounts to “Too Much of a Good Thing?”

Exhibit 15

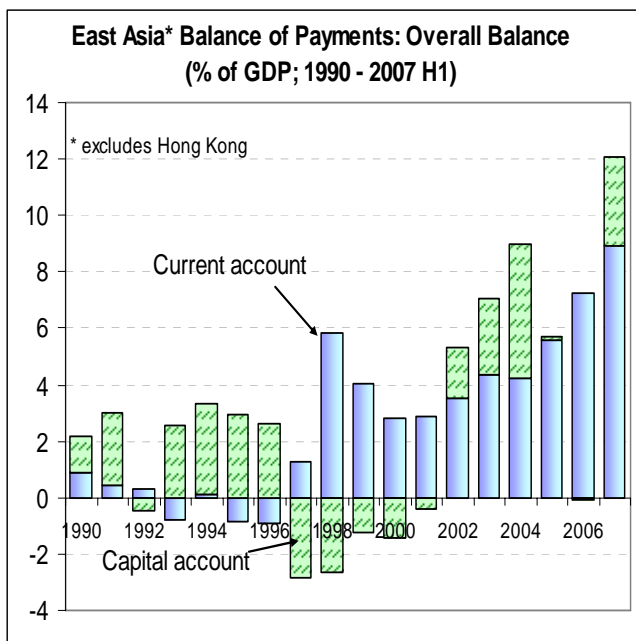


As in the last couple of years, the bulk of Emerging East Asia’s reserve accumulation in the first half of 2007 came from current account surpluses, which reached an aggregate \$322 billion (8.9 percent of GDP), almost as large as the regional current account surplus of \$356 billion in all of 2006. China’s current account surplus reached \$163 billion, or close to 12 percent of GDP. Current account surpluses on this scale are relatively recent in China, emerging only in 2005-06 as a result of large increases in domestic savings (especially in the business enterprise sector) outpacing exceptionally strong domestic investment. Growing technological sophistication has allowed firms to switch from imports to lower cost domestic sources for a growing range of industrial products, resulting in slower overall import growth (despite strong growth in domestic demand and a rising import bill for oil and other primary commodities).

Most of the other large economies in the region also continue to run significant current account surpluses - a median 5.7 percent of GDP in the first half of 2007 in the 8 main economies other than China. Most of these economies

experienced a large swing of current accounts into surplus at the end of the 1990s and in the early 2000s as investment fell steeply after the 1997-98 financial crisis. (Exhibit 16). More recently, however, the underlying trends affecting current accounts have become more diverse. In Indonesia, for example, current account surpluses are running at a modest 2-3 percent of GDP as growing inflows due to strengthening non-traditional exports and higher commodity prices are offset by stronger domestic demand leading to faster import growth, and by rising investment income payments on foreign direct investment in the country. In Thailand, on the other hand, the current account surplus is rising sharply as the weak domestic economy has led to slower import growth, while exports remain robust. The current account surplus in the Philippines has also risen by more than 3 percentage points of GDP since 2005, but in this case mainly because of rapidly growing inward remittances from Filipinos working abroad. In Malaysia the current account swung to and has remained in a surplus worth 10-15 percent of GDP ever since the financial crisis, as investment spending has remained around 20 percentage points of GDP lower than in the pre-crisis period.

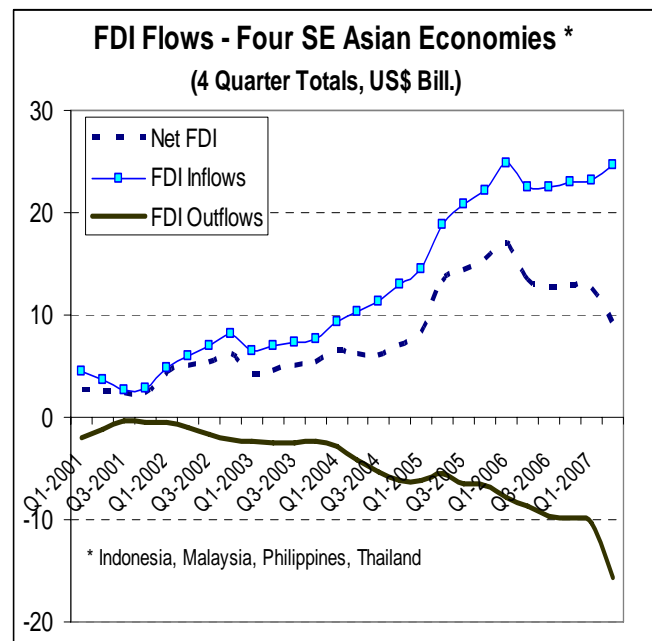
Exhibit 16



Net capital inflows (inclusive of errors and omissions) made little contribution to the region's overall balance of payments surplus in 2005 or 2006, but they increased substantially in the first half of 2007. China in particular saw its capital account move from virtual balance in 2006 to a surplus of a little over \$100 billion in the first half of 2007, the result of strong FDI and net other capital inflows, as well as a fall in net portfolio capital outflows (although swap operations and other ad hoc transactions appear to have played a significant role in 2006 and the first half of 2007). Net capital inflows to economies such as Indonesia, Malaysia and Philippines also increased, principally because of higher portfolio capital inflows.

Looking at the main types of capital flows in the economies other than China in more detail, net FDI inflows to the main South East Asian economies have been flat to slightly declining over the last 1-2 years in both dollar terms and as a percentage of GDP. This however is more a reflection of the growing financial integration of the region rather a decline in gross FDI inflows. As Exhibit 17 indicates, gross FDI inflows to the main South East Asian economies have revived strongly from around \$5 billion per year in 2001 to around \$25 billion in the year to the middle of 2007. These trends have reduced 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 these economies have also been growing quickly in the last 2-3 years, as firms implement cross-border investment and production strategies. Such FDI outflows are even more prominent in the high income economies of the region such as Korea and Taiwan (China). Taiwan (China) has been a net supplier of FDI for many years, whereas Korea became one in 2006, with net FDI outflows continuing to grow in the first half of 2007.

Exhibit 17



Emerging East Asia has been an aggregate net supplier of portfolio capital to the rest of the world over the last decade. The high income NIEs are the principal sources of these outflows, supplemented in recent years by portfolio outflows from China, while the South East Asian economies are net recipients of such inflows. Net portfolio outflows from Emerging East Asia fell significantly in the first half of 2007, principally as gross inflows to the region rose sharply, reflecting the surge in portfolio flows to emerging markets as a whole this year.

BOP inflows: too much of a good thing?

The emergence of large balance of payments inflows in several East Asian economies – both current account surpluses and capital inflows – draws attention to potential macroeconomic challenges that could develop as a result, such as possible domestic overheating pressures, asset price bubbles, loss of competitiveness and a build up of vulnerability to sudden reversals of capital flows down the road.

Such inflows place upward pressures on the exchange rate. The trade-off that countries then face is either to allow the exchange rate to appreciate—with possible consequences for the competitiveness of exports—or to intervene in the foreign exchange market to keep the exchange rate from appreciating, leading to rising foreign exchange reserves, and, other things equal, to an expansion of the domestic monetary base. Banks are then able to increase lending to domestic firms and consumers (unless there is a 100 percent reserve requirement). With rising domestic expenditures and asset prices, the value of firms' and households' collateral rises.¹⁹ This creates the potential for banks to lend further, and the potential for a reinforcing cycle of lending and higher asset prices. Under conditions of weak regulation and supervision, financial institutions could undertake increasingly risky lending and become vulnerable (Exhibit 18).

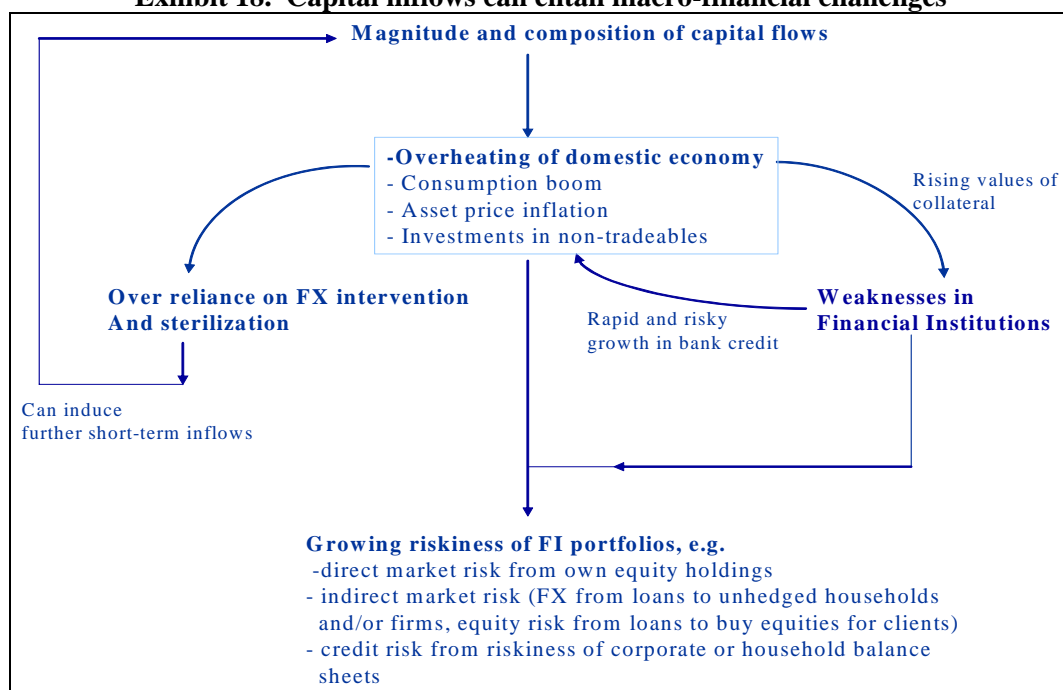
Countries often attempt to mitigate the monetary impact of exchange rate intervention by sterilizing—selling bonds to mop up liquidity through open market operations,

raising bank reserve requirements, or removing government deposits from the banking system and placing them with the central bank. However, sterilization entails quasi-fiscal costs—since the interest rates typically paid on the domestic assets are generally higher than those earned on international reserves. Sterilization through higher bank reserve requirements can also act as a tax on banks, which they pass on through higher lending rates and lower deposit rates. That in turn can contribute to disintermediation from the banking system to the non-bank financial sector which is generally more weakly regulated and supervised. Most importantly—from the perspective of managing balance of payments pressures—since sterilization prevents domestic interest rates from falling, it generally induces further capital inflows, especially portfolio flows or short-term flows that are particularly responsive to interest rate differentials.

These issues were also at play during the years leading up to the 1997 Asian financial crisis. This section examines whether such challenges are re-emerging in the region, the sources and magnitudes of balance of pressures, how these pressures are playing out in the domestic economy and policy responses so far.

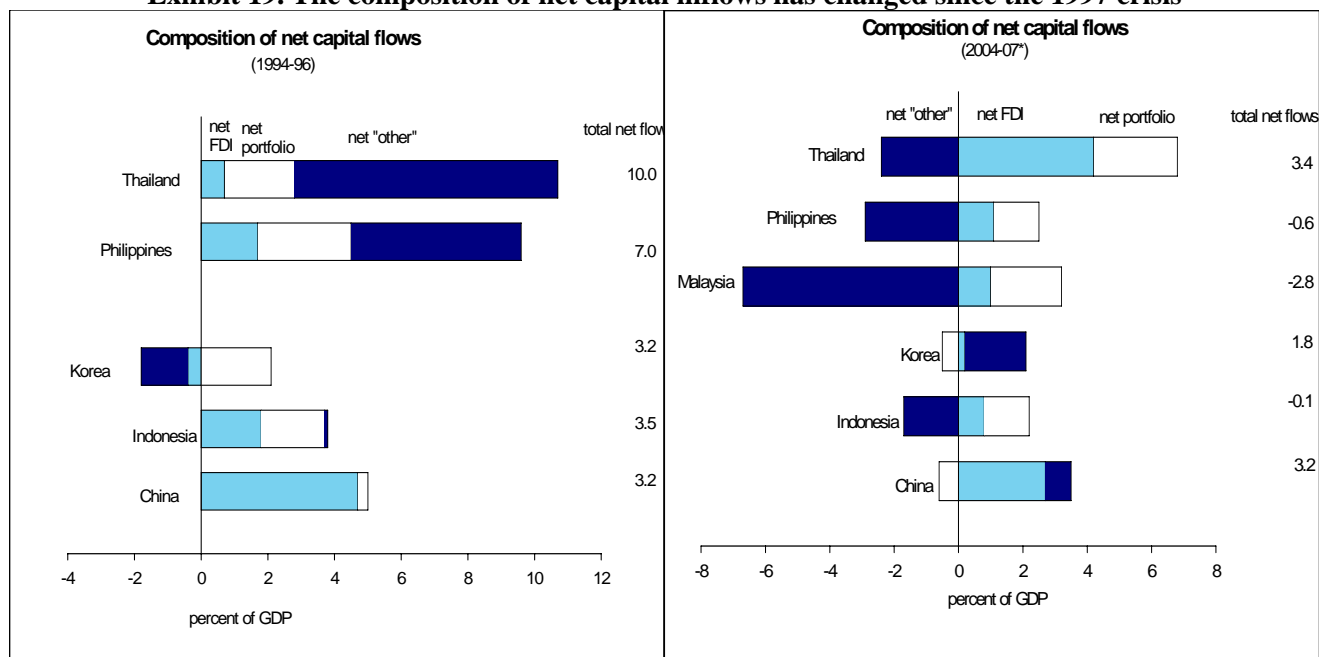
Large balance of payments pressures

There are two important differences between BOP inflows in the recent period and the pre-1997 crisis period. The first is that in the recent period, while countries have been receiving inflows, they have also become exporters of

Exhibit 18. Capital inflows can entail macro-financial challenges

¹⁹ In the presence of credit market frictions, cash flows and the conditions of balance sheets are important determinants of

Exhibit 19. The composition of net capital inflows has changed since the 1997 crisis



Source: World Bank data and staff estimates.

capital, both repaying external debt, and also investing abroad in the form of portfolio debt and equity flows. In some economies such as Korea, outflows have also included direct equity investment (FDI). On a net basis, East Asian economies have been receiving significant inflows of portfolio and FDI, while other flows (mainly commercial bank borrowing) have been negative (Exhibit 19).²⁰ The exception to the latter has been Korea which has recorded very significant net inflows of bank borrowing of around 6 percent of GDP during 2004-2006²¹. Total net capital inflows in countries in developing East Asia during 2004-first half of 2007 ranged from 0.7 percent of GDP (Indonesia) to 3.8 percent of GDP in China. (The exception is the Philippines which recorded a slight negative in capital flows on a net basis²²). These magnitudes are considerably lower than the net capital inflows that these economies received during 1994-96.

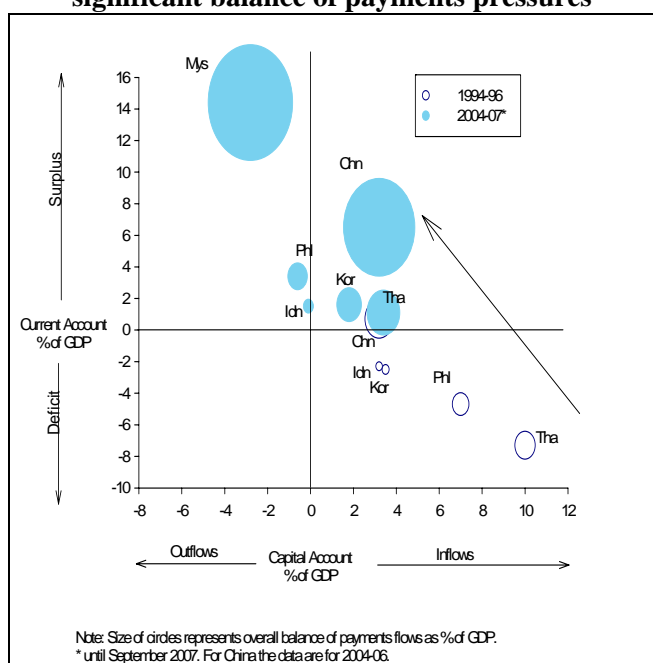
economic agents' ability to borrow and lend.

²⁰ The very large net other outflows in Malaysia also reflect residents' transactions with Malaysia's own Labuan Financial Center established in 1996. There were 53 banks operating in Labuan as of end 2006, as well as mutual funds, insurance companies and SPVs.

²¹ Korea's large net "other" inflows reflect hedging by Korean shipbuilders (a major source of exports) who have only begun to hedge their activities since 2004. Typically, exporters sell expected dollar receipts forward to domestic banks and foreign bank branches in Korea which then borrow dollars abroad to match their own currency exposure, thereby creating a capital inflow.

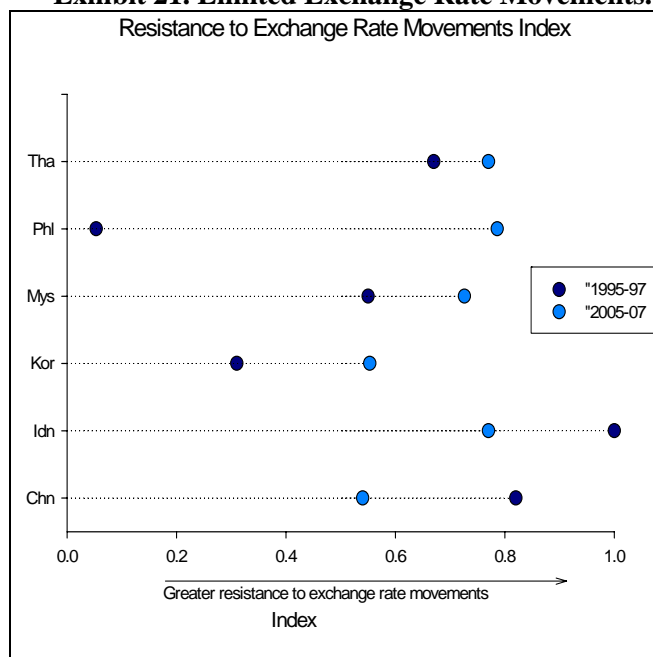
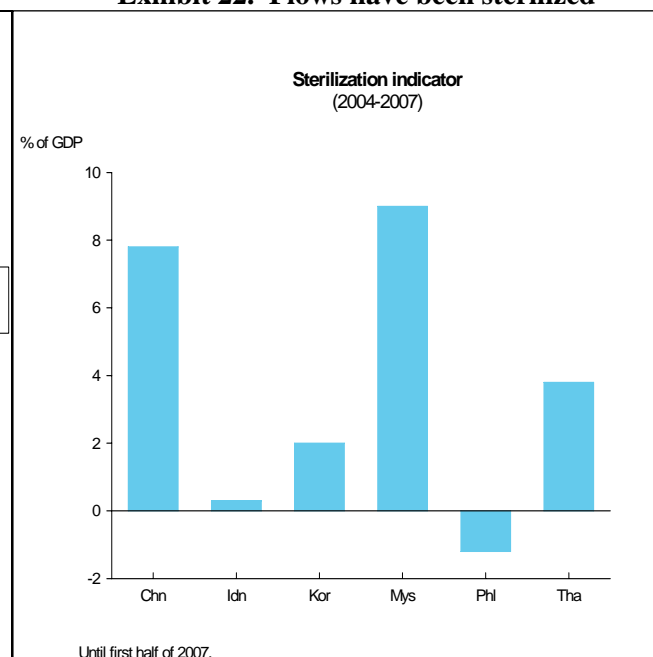
²² The decline in net other investment in the Philippines is due in part to the lower recourse to external borrowing given large remittance inflows.

Exhibit 20. Most economies are experiencing significant balance of payments pressures



Source: World Bank data and staff estimates

A second important difference is that East Asian economies have been running large current account surpluses since the 1997-98 financial crisis, whereas most countries were running large current account deficits before the crisis. Malaysia's current account surplus averaged over 14 percent of GDP from 2004 to the second quarter of 2007, while that of China averaged 7.3 percent of GDP. Other

Exhibit 21. Limited Exchange Rate Movements.**Exhibit 22. Flows have been sterilized**

Source: World Bank data and staff estimates.

Table 9. Reserve levels are high

	Measures of Optimal or Adequate Reserves (US\$ Billion)						Excess reserves (actual minus optimal or sufficient) US\$ Billion					
	Months of imports ^{1/}		Greenspan-Guidotti Rule ^{2/}		Jeanne-Ranciere Model ^{3/}		Months of imports		Greenspan-Guidotti Rule		Jeanne-Ranciere Model	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
China	213.2	266.2	63.1	80.0	265.7	303.0	608.3	802.3	758.4	988.5	555.8	765.5
Indonesia	23.7	26.7	20.3	21.8	36.8	42.0	11.0	15.9	14.4	20.8	-2.1	0.5
Korea	93.5	106.2	62.7	100.0	89.8	99.5	116.9	132.6	147.6	138.8	120.5	139.4
Malaysia	36.8	40.1	17.3	22.1	15.1	16.5	33.4	42.0	53.0	60.1	55.1	65.7
Philippines	14.1	15.1	12.9	10.0	11.8	12.7	1.8	4.96	3.1	10.0	4.1	7.3
Thailand	36.0	41.3	12.8	14.4	20.9	22.69	14.7	24.0	37.9	50.8	29.8	42.4

^{1/} Three months of imports of goods and services (period-ahead). ^{2/} 100% of short term debt (debt due within one year).

^{3/} Optimal reserve measure taking into account fundamental factors such as indebtedness, extent of financial integration and previous real exchange rate appreciation by Jeanne and Ranciere (2006).

countries have also recorded current account surpluses ranging from 2-4 percent of GDP.

While the large current account surpluses reduce the vulnerability to sudden stops and reversals in capital flows, they also add to the macroeconomic management challenges associated with foreign currency inflows. As Exhibit 20 shows, overall balance of payments inflows (from current account surpluses and capital inflows) are significantly larger than they were in the run up to the 1997 crisis.

Macro developments and policy response to date

One of the policy choices that countries have to make in the face of large balance of payments inflows is

how much to let the nominal exchange rate appreciate and how much to intervene in the foreign exchange markets (which of course results in an accumulation of foreign reserves). The choice that countries in the region have effectively made so far can be gauged by an index of resistance to exchange market pressures (EMP), based on a combination of movements in the exchange rate and international reserves. The index ranges from zero (no resistance to exchange rate movements) to 1 (full resistance to exchange rate movements)²³. As Exhibit 21 shows, in

²³ The precise definition of the Exchange Market Pressure (EMP) index varies across authors, but usually combines changes in the exchange rate with changes in reserve movements as a fraction of the monetary base. If countries were to allow the exchange rate to float freely, this index would be driven entirely by changes in the

most economies the extent of resistance to exchange rate movements in the recent period (2004-06) has actually been somewhat greater than during 1994-96. The exceptions are Indonesia and China where the resistance to exchange rate movements was greater in the earlier period.

Given the magnitude of balance of payments inflows and foreign exchange interventions, the level of reserves is at an all-time high in most economies. Most economies in the region hold reserve levels that are well in excess of “optimal” levels suggested by various criteria, although Indonesia and the Philippines are only marginally above these levels. (Table 9. The optimal reserve measure estimated by Jeanne and Ranciere (2006) explicitly takes into account the probability of a sudden stop in capital flows, based on factors such as the extent of financial integration, public and external indebtedness and the extent of previous real exchange rate appreciation).²⁴

Concerned with the potentially inflationary implications of foreign exchange market interventions and associated reserve accumulation, economies in the region have also engaged in significant sterilization. Exhibit 22 shows an indicator of sterilization (measured as the difference between changes in foreign reserves and changes in reserve money, as a percent of GDP). Several economies have undertaken close to full sterilization during 2004-07.

There has not been any clear indication of a marked pickup in the underlying trend of inflation in most economies, although in several cases there have been increases due to specific supply side factors, such as the recent rise in imported food prices. Staff calculations suggest that the large “negative output gap” created after the financial crisis (with actual output running well below potential output) has now been closed, and that actual output is now modestly higher than potential in most of the economies of the region. Even though these output gaps are significantly smaller than those during the pre-crisis boom period of 1994-95, policy makers now do need to be aware of the potential for domestic overheating. In addition, asset prices, especially stock market prices have increased significantly across countries in region. Exhibit 23 shows stock market prices and price-earnings (P/E) ratios during the run up to the 1997 crisis and during the more recent period (January 2005-September 2007). Both series are indexed to 100 at the beginning of each period. Stock

market prices have increased more rapidly in the latter period, particularly since the beginning of 2007 across the board. However P/E ratios remain below the pre-1997 crisis period in all economies except China (where P/E ratios are at historic highs and Indonesia (where the average P/E ratio for January 2007-September 2007 is almost the same as it was during 1994-96).

What role have the banks been playing in this process so far? The first point worth noting is that, in the formerly crisis-affected countries, a significant proportion of commercial banks’ assets are in the form of claims on the public sector. In large part this reflects bonds that were issued for financial sector restructuring. Banks also hold a sizable share in sterilization instruments (categorized as “other” in Exhibit 24). Second, compared to 1994-96, the share of foreign assets and reserves in total assets are also higher in almost all the crisis-affected countries. Third, the share of domestic credit to the private sector in total assets has declined sizably in most economies.

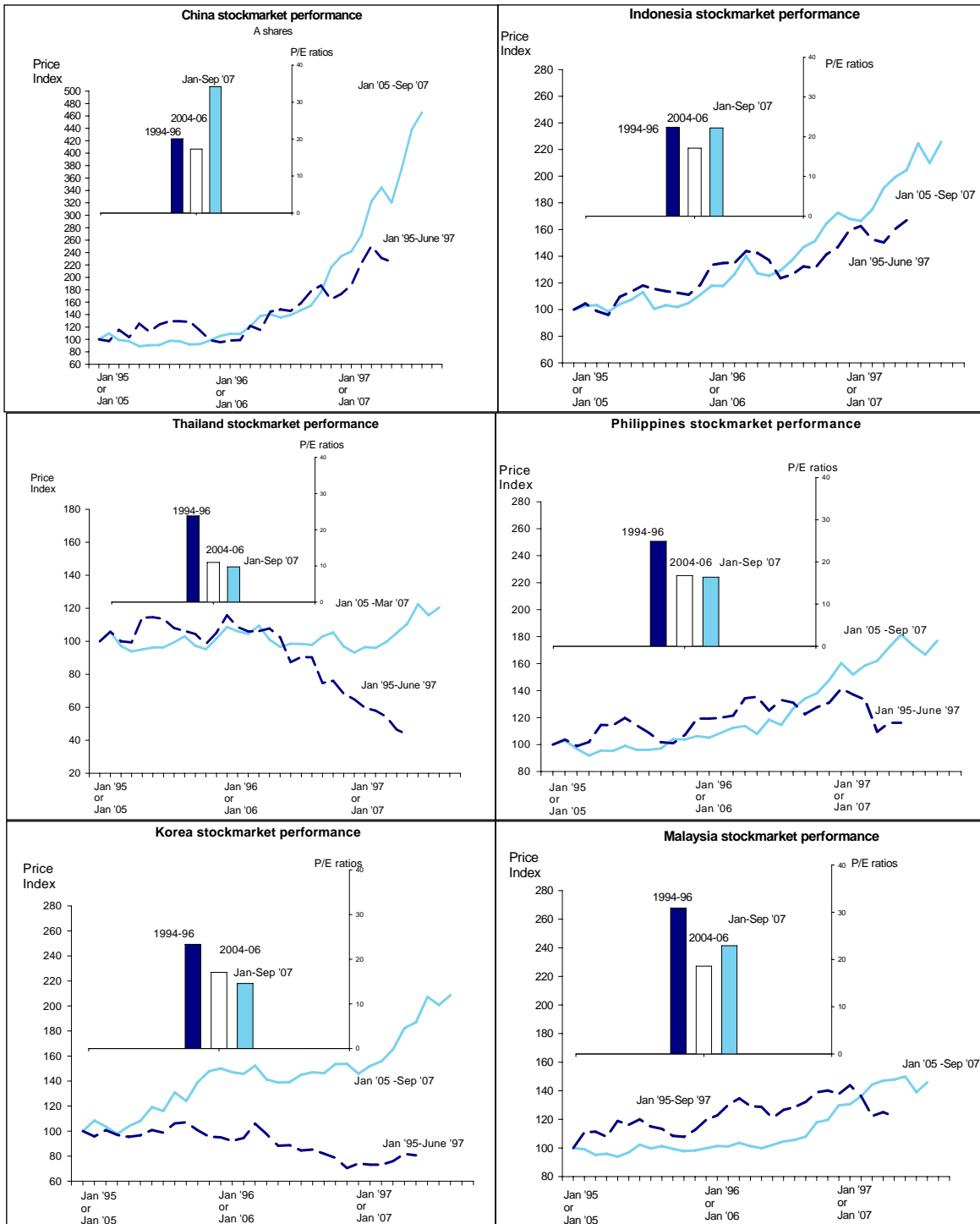
In fact, domestic credit to the private sector as a percentage of GDP is significantly lower in all formerly crisis affected countries except Korea and the growth rates of domestic credit to private sector are also generally a lot lower than pre-crisis (Exhibit 25). This reflects significantly lower lending to corporations. Corporations have not borrowed as much in part because investment rates have been much lower than in the pre-crisis period and quite erratic, although more recently they have started to pick up. In part, it also reflects the broadening of sources of finance for corporations—firms have not only relied on retained earnings but have also raised capital in the equity markets and (albeit to a much lesser extent) the bond markets.

An increasing part of commercial bank lending since the crisis has been to consumers and in several economies to SMEs. The bulk of consumer lending has been for mortgage finance (although in Indonesia, housing accounts for the lower share and loans for vehicles for the larger proportion of consumer finance). Credit card lending has grown quite rapidly although it typically remains quite a small proportion of consumer lending. Despite the recent fairly rapid growth in consumer lending, household indebtedness is still relatively low in East Asia in comparison to industrial countries and so far, NPL ratios for household loans remain relatively low. In the corporate sector, leverage ratios have declined substantially, reducing the vulnerability of corporations and the credit risk that they may pose to banks.

exchange rate. At the other extreme, if the exchange rate was fully pegged, the exchange rate would not move and the change in this index would be driven by changes in reserves. Dividing the changes in foreign reserves by the EMP yields a ratio measuring the proportion of exchange market pressures that are resisted through intervention which has then been standardized to create an index of the degree of resistance to changes in the exchange rate that ranges in value between 0 and 1, where a value closer to 1 implies a greater degree of resistance. See for example Evan Tanner: “Exchange market pressure, currency crises and monetary policy”. (2002). IMF WP/02/14

²⁴ Olivier Jeanne and Romain Ranciere: “The optimal level of reserves for emerging market countries: formulas and applications.” (2006). IMF WP/06/229

Exhibit 23. Stock Market Prices and PE Ratios 1994-06 and 2004-06



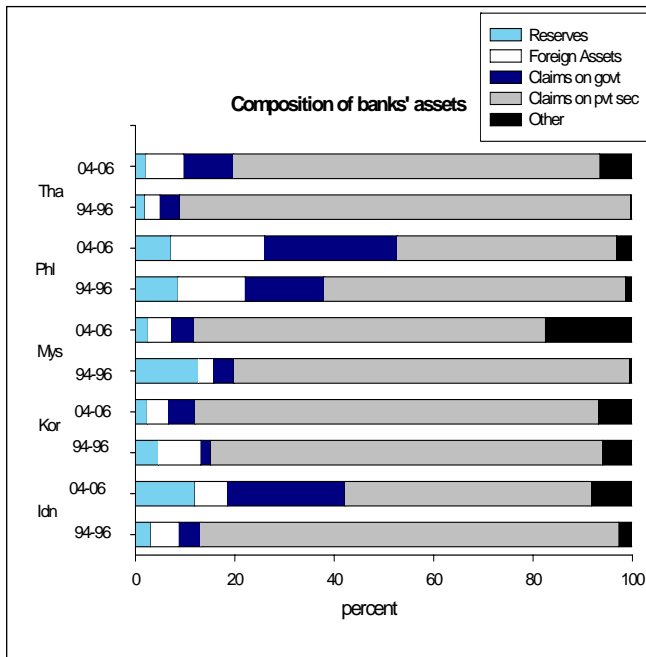
Source: World Bank data and staff estimates.

Banks' direct exposure to foreign exchange risk has decreased considerably across the region as Exhibit 26 shows. However, banks may be exposed indirectly to foreign exchange risks, especially since, in general, households, and very often SMEs, are not hedged.

At present it appears that banks are playing a muted role in the intermediation of capital inflows. The pace

of growth of loans to the private sector—which when high is often accompanied by a deterioration in loan quality—has been relatively modest so far. Indeed, banks have still to fully resume their intermediation function in several of the economies. However, banks may be playing a more active role through their off balance sheet activities. And, in terms of overall risks in the financial sector, what is happening

Exhibit 24. Bank intermediation has declined



Source: World Bank data and staff estimates.

Exhibit 25. Growth in domestic credit to the private sector is also lower

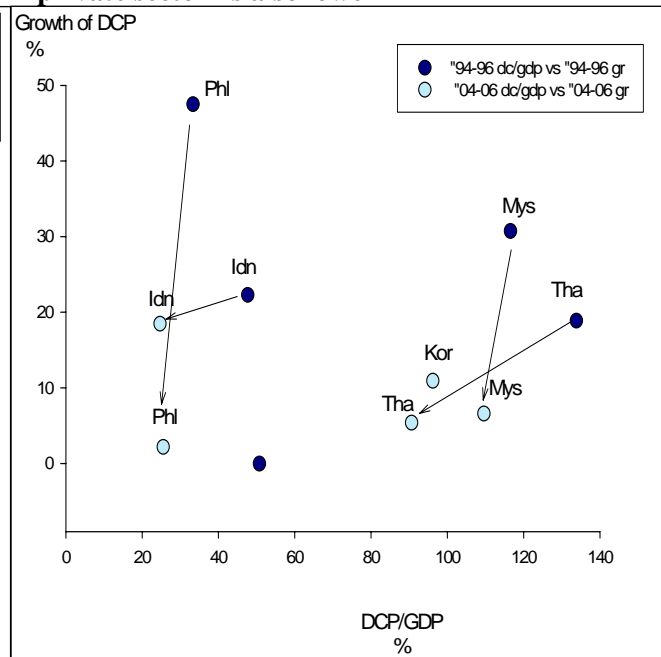
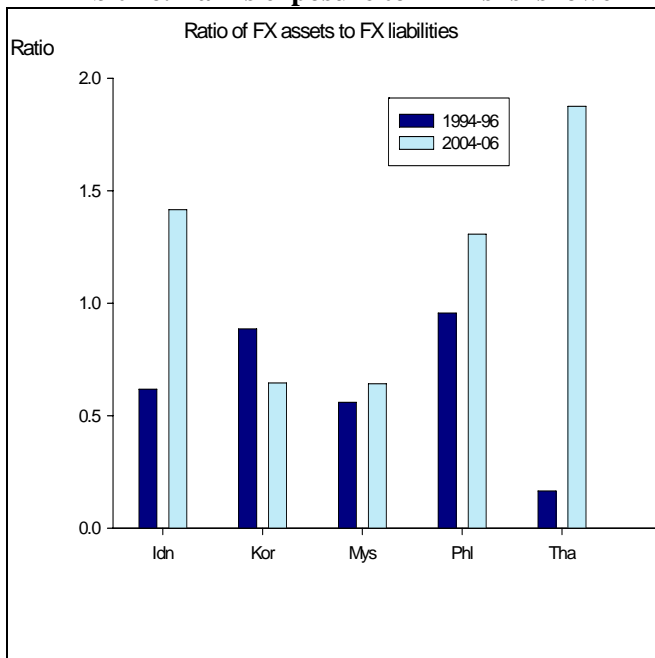


Exhibit 26. Banks exposure to FX risks is lower



Source: World Bank data and staff estimates.

through non-bank financial institutions also needs to be explored.

To sum up, many economies in East Asia are experiencing large balance of payments inflows. And, although the bulk of these pressures are coming from current account surpluses, most economies have also

received substantial capital inflows, particularly net portfolio flows. In choosing between allowing the exchange rate to appreciate and intervening in the foreign exchange markets, most economies have chosen to limit the appreciation of the nominal exchange rate. They have also undertaken significant sterilization to mop up increases in domestic liquidity that would otherwise occur. While there are few overt signs of significant overheating, asset prices, in particular those for equities, have increased significantly. On the whole the role of banks in intermediating balance of payments inflows seems to be muted so far, and growth in credit to the domestic private sector has been generally sluggish. On balance, then, the problems of economic overheating and growing banking sector vulnerability that could arise with sustained inflows do not seem to be major immediate issues, but are ones that could become so in future if they are not carefully monitored and the underlying forces contributing to these pressures are left unaddressed.

The policy measures that are appropriate in dealing with the underlying pressure of large balance of payments inflows will undoubtedly differ from one economy to the next, depending on their structure and circumstances. Nevertheless some general considerations are likely to be relevant. First, greater exchange rate flexibility will continue to provide a useful instrument in adjusting to sustained inflows in most cases. Even if countries intervene in the foreign exchange market to prevent nominal appreciation, the real rate will tend to appreciate through the more disruptive mechanism of higher domestic inflation. It should also be recognized that sterilization tends to become less effective as financial integration deepens, and is in fact

likely to encourage further inflows of short-term capital, thereby increasing both the costs of sterilization and potential vulnerability.

Another option that a number of countries are exploring is to further liberalize capital outflows. Indeed Korea implemented several measures early in 2007, including extending the ability of pension funds to invest in overseas securities. Given adequate supervisory, regulatory and market infrastructure, such measures have the additional structural benefit of fostering greater regional and global integration. Countries have also occasionally considered controls on capital inflows, in particular as a way of dealing with sudden large surges in short term and portfolio flows. Experience suggests the effectiveness of such controls tends to diminish over time as market participants find loopholes in the system. Such controls also tend to be less effective in more sophisticated financial markets. Overall the evidence suggests that such controls are, for the most part, likely to be effective as short term measures. Finally, from the perspective of reducing the potential for a buildup of vulnerability in the financial system, strengthening financial sector prudential regulation and supervision remain key.

4.2. Financial sector trends and issues

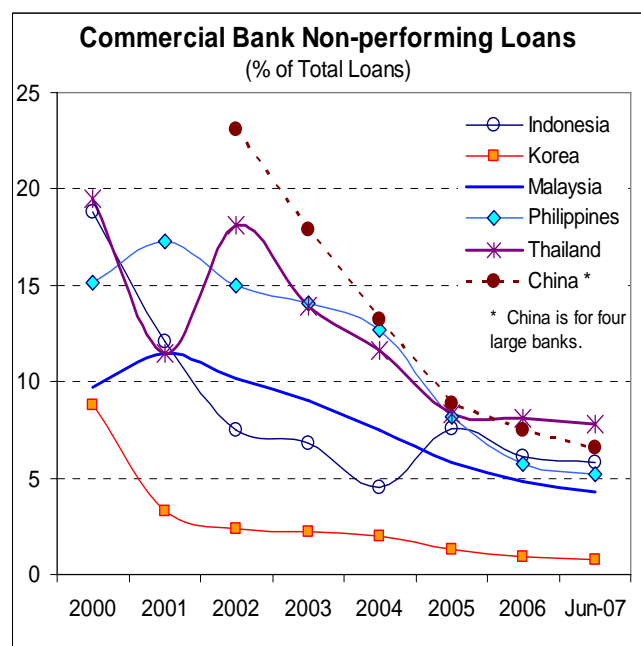
The discussion of banks in the preceding section showed that bank lending to the domestic private sector in the former crisis affected countries has diminished in importance over the last decade, while holdings of government or foreign assets have increased. This is likely to change if the recent strengthening of domestic demand gathers pace, leading to stronger loan demand, especially from the business sector. In this context it will be important to ensure that faster loan growth is not accompanied by deterioration in loan quality and a build up of new vulnerabilities. Banking sector asset quality, profitability and capital adequacy in the region have indeed improved significantly in recent years. The average non-performing loan (NPL) ratio for the five formerly crisis affected countries has fallen from over 10 percent in 2002 to under 5 percent by the middle of 2007, although NPLs remain significantly higher than in developed economies or in some other developing regions, Latin America for example. (Exhibits 27, 28). The region has also 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 continued efforts are needed to converge to international standards.

Looking further at developments in individual economies:

In *China*, the reshaping of the banking system continues at a fast pace. The massive restructuring and recapitalization in recent years of three out of the four major state-owned commercial banks, and to a lesser extent of second-tier banks, appears to be paying off. The NPL ratio for the major banks has fallen from near 25 percent of all loans in 2002 to under 7 percent by the end of 2006. The profitability of restructured banks has improved markedly,

with return on equity at the big 4 banks rising from less than 2 percent in 2003 to 12-13 percent in 2006. In August the Bank of China and Industrial and Commercial Bank of China disclosed exposure to US sub-prime assets of close to \$10 billion and \$1.2 billion respectively. However analysts expected the institutions to be able to absorb potential losses on these assets relatively comfortably, given rapid growth in the banks' overall profits. As part of the process of bank restructuring minority stakes of 10-25 percent in the three big restructured banks have been sold to major international banks and to public investors through IPOs. Strategic foreign investment has also been sought in smaller restructured banks, with international banks taking positions in around 25 smaller banks, mostly within the last two years.

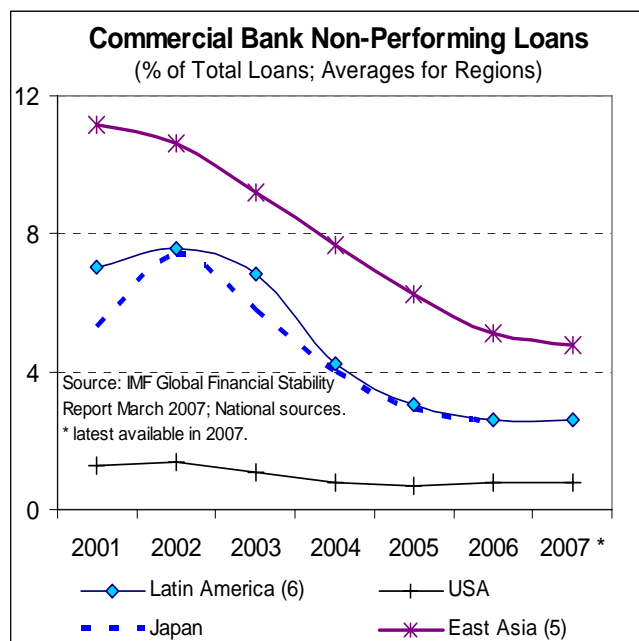
Exhibit 27



In *Indonesia*: bank loan growth accelerated from a sluggish 14 percent in 2006 to a 39 percent pace in the year to June 2007. Analysts anticipate continued strong loan growth, given growing business confidence and strengthening investment demand. Bank profitability continues to run at high levels, with interest margins close to 6 percent among the highest in East Asia. Capital adequacy ratios of over 20 percent are also among the highest in the region, while the reported non-performing loan ratio fell to below 6 percent of loans at mid-year. The government issued a second financial sector reform package in July 2007, following a first set of reforms a year earlier. Key areas covered by the packages include strengthening financial system stability including through greater coordination across regulators; improving financial intermediation through strengthening credit information systems; improving regulation and supervision of pension funds and insurance firms; increasing efficiency and liquidity of capital markets; and harmonizing regulations

and tax treatment across different segments of the financial sector. Progress on implementation has so far been largely on track.

Exhibit 28



Korea's financial sector also remains in good overall health, with asset quality, profitability and capital adequacy all continuing to rise. The commercial bank NPL ratio fell below 0.8 percent of total loans in June 2007, with NPL ratios declining for all types of loans. The capital adequacy ratio was close to 23 percent at mid-year, while banks' net income in the first half of 2007 was up 23 percent from a year earlier. Among areas of potential risk that are being more closely monitored by the authorities is mortgage lending in the housing market, where the pace of house price inflation has slowed sharply, although bank exposure is not high and NPLs are low. Lending to SMEs has also been growing quickly, but the pace is expected to moderate as tighter lending standards and stronger monitoring by regulators take effect.

Thailand's banking sector has continued to make progress despite the more challenging operating environment since 2005, when economic growth has fallen to a 4-5 percent range. Profitability has improved due to both higher net interest margins (around 3 percent in 2006 and the first part of 2007) and growth in more diversified non-interest income. The banking system NPL ratio edged down to 7.8 percent in mid 2007 from 8.1 percent at the end of 2006. The level of NPLs remains high relative to the average for East Asia or some other regions, however, and the pace of decline in non-performing and distressed assets has also been relatively slow.

COUNTRY SECTIONS

Major Economies²⁵

China

Economic growth remains rapid and the trade surplus continued to widen into the third quarter, under an unchanged pattern of growth. Boosted by a continued strong contribution of external trade and an investment driven recovery in domestic demand, GDP growth reached a particularly high 11.5 percent (yoy) in the first half of 2007 and 11.9 percent in the second quarter. The soaring trade surplus, which so far seems little affected by measures to contain export growth, constitutes the bulk of the rising balance of payment surplus. This surplus is adding to domestic liquidity and contributing to steady asset price increases, share prices in particular.

Consumer price inflation rose to a decade high because of higher food prices. This is in part due to high pork prices, which have shown regular spikes in the past, and which may be affected this year by a pig disease as well. However, prices of many other food items have risen in line with higher international food prices. So far, the price pressures have been confined to food. Indeed, producer price inflation has come down as industrial commodity price rises have moderated. China's raw material prices are overall affected by international ones. This means that the recent moderation in international commodity price increases, if continued, should help reduce domestic price pressures. Asset prices are still rising steadily, though, and the stock market indices are constantly setting new records.

The recent international financial market turmoil may affect China's economy, but China is well-placed to absorb the impact. The impact via losses of Chinese financial institutions holding overseas assets and, as evidenced by the continued challenge to mop up liquidity in the financial system, the transmission of financial turmoil to China's markets seems to be limited. The main impact of the international turmoil is likely to run via the real economy. Although the world economy still retains momentum, China will be affected more than most other large emerging markets by an economic slowdown in key markets, because of the large weight of exports in China's economy. At the same time, China is better placed than many countries to deal with the impact. A moderate global slowdown would mitigate pressures of concern to policymakers on overall growth, inflation, and the trade surplus, while China's strong macroeconomic position provides room to adjust the domestic policy stance, if necessary.

There are no indications that cost pressures are significantly affecting the competitiveness of China's exports. High international commodity prices have pushed up prices of manufacturing goods across the world, including in China, and China's industry has also faced domestic cost pressures. As a result, prices of China's exports are now rising in US dollar terms, but they are still rising by less than those of other countries.. In other words, China is still gaining competitiveness. Indeed, export volume growth has remained strong and profit margins in industry have continued to rise in 2007.

China's macroeconomic prospects generally remain good. Domestically, prospects remain buoyant. With profit and credit growth strong, investment is likely to continue to expand strongly. Consumption is expected to remain solid as well, although high consumer price inflation constrains real consumption growth. We now project GDP growth of 11.3 percent in 2007 and 10.8 percent in 2008. With international food price increases expected to remain substantial but producer price rises to moderate, we expect CPI inflation to gradually ease from later in 2007 onwards, although upward risks remain. We now project a current account of around 12 percent of GDP.

The external balance remains China's main macroeconomic issue. While there are no serious demand and price pressures yet, the very strong growth risks eventually outpacing supply. Thus, the authorities are rightly aiming at avoiding excess demand and the spillover of high food prices into generalized inflation, and mopping up liquidity and raising interest rates will continue to be needed. However, the main macroeconomic task remains to contain the rising trade surplus, and a stronger real exchange rate is the most obvious tool. Indeed, reducing the external imbalance may become an important contribution from China to world growth, if a sharper than expected US slowdown was to occur. The government has taken some—largely tax-based—measures to slow export growth. However, given the size of the surplus and the drivers behind the surplus, significantly more policy action is likely to be needed.

In the long term, the key challenge remains to rebalance the economy. The package of policies to deal with these challenges would include real exchange appreciation, with, over time, more exchange rate flexibility; monetary policies that tighten liquidity and increase interest rates; a change in the composition of fiscal spending, with more spending on health and education; further financial sector reforms; structural policies that change the relative attractiveness of manufacturing versus services; and removal of remaining obstacles to rural-urban migration.

²⁵ More detailed individual Country Briefs for the major economies can be found at the World Bank website: <http://www.worldbank.org/eapupdate/>

While continued rapid growth would eventually lead to a drying up of surplus labor, there are several reasons to think that China may not yet be close to a labor shortage. These are discussed in the Special Focus of the [September 2007 China Quarterly Update](#). Most analysts on the issue focus on demographics, and note that there are fewer under-thirty educated rural agricultural workers left, which are the ones most likely to migrate to cities. However, in addition to demographics, policies and individual choices also affect labor supply. In preparing for less labor abundance, it is therefore important to take into account the impact of policies, including those on vocational education, rural land and pensions, on the labor supply.

Indonesia

The last six months have witnessed a pick-up in the momentum of growth. After a moderate slowdown in 2005, economic growth in Indonesia has increased appreciably. By 2Q 2007, year-on-year growth was up to 6.3 percent compared with 5 percent in early 2006. Most monthly indicators signal a further rise in the third quarter of 2007, despite recent turbulence in international financial and oil markets.

The main drivers of recent growth have been investment and net exports. Investment growth has been running around 7-8 percent *per annum* since 2Q 2006 with indications of a further pick-up in the near-term. For their part, net exports were neutral or a slight drag on growth in the second half of 2006. In the first half of 2007, they added more than 1 percent to growth in GDP. In nominal terms, exports have surged to record levels, owing only in part to the world commodity price boom. Exports of agricultural and mining and mineral commodities (accounting for about 1/3 of merchandise exports) increased by 18 and 42 percent in US\$ terms respectively earlier this year. Exports of manufactured products (which account for almost half of the total) also increased at a robust rate of 15 percent; with forestry products up by 24 percent.

Reflecting the strength in exports, the current account surplus is projected to widen further to US\$10.8 billion in 2007 (some 2 1/2 percent of GDP) versus virtual balance in 2005. Some of these recent gains have been offset by the capital account, which is currently projected to record a narrower surplus in 2007 than the year before. Net international reserves have climbed steadily during this period, to almost US\$53 billion in late September, compared with US\$42.6 billion at end-2006.

Financial markets quickly absorbed the recent turbulence in international markets with what appears to be minimal disruption of overall economic performance to date. As examples, the Jakarta Stock Exchange, after plunging by 20 percent in the 3 weeks between late July and mid-August, rebounded quickly and was back at record highs by mid-October. The rupiah exchange rate, which was around 9000/US\$ in the months prior to the turmoil, slid to 9500, before recovering to 9100 by early October.

Medium- and long-term interest rates rose by some 200 basis points across the yield spectrum during the crisis. As of early September, the yield curve had reversed about half of the rise, and there was a further moderate improvement (especially at the shorter end of the spectrum) through early October.

Inflation has been a growing concern recently. It fell dramatically in the wake of the major 2005 fuel price increases from a high of 18.4 percent (y-o-y) to 5.3 percent in November 2006. However since then inflation has been creeping higher, reaching 6.9 percent by October, very near the upper end of Bank Indonesia's target band of 5-7 percent by end-2007. Foodstuffs, which account for almost 25 percent of the CPI in Indonesia, have been the main source of inflation in the past several months; they have outpaced general inflation since early 2006, often by several percentage points. By contrast, administered prices (fuel, transportation and electricity among others) have been holding down inflation during the past year, running at less than 2 percent (measured on a 12-month basis).

Reflecting concerns about inflation, Bank Indonesia held its key policy rate steady at 8.25 percent since early July. This shift in stance followed a series of cuts in steps of 25-50 basis points from a peak of 12.75 percent in April 2006. Reflecting the stronger economy, including investment, credit growth has accelerated in 2007, reaching 22 1/2 percent (y-o-y) by August.

Fiscal deficits have narrowed significantly in recent years, from above 4 percent of GDP in 1998 to 0.5 percent in 2005. However, the deficit widened a little to 0.9 percent of GDP in 2006, and it looks likely to widen further in 2007, to 1.5 percent of GDP. This wider deficit stems, in part, from temporary factors (e.g., large, once-only settlements of arrears in payment of VAT refunds and spending for disaster relief). But it also reflects more lasting factors, e.g., increased spending on priorities, including health, education and infrastructure. Notwithstanding these wider deficits, the ratio of government debt to GDP is projected to continue to decline, from 39 percent at end-2006 to less than 35 percent by end-2007, owing to continued strong growth.

The incidence of poverty dropped in 2007, to 16.6 percent from 17.8 percent in 2006. This reverses about 75 percent of the deterioration in 2006. Analysis of this latest data is underway but it appears that strong economic growth, falling inflation and targeted cash transfers contributed to the decline in 2007. Nevertheless, a large proportion of the population remains vulnerable with many households tightly clustered around the poverty line. Viewed in relation to the eight Millennium Development Goals (MDGs), poverty alleviation (as measured by the percentage of the population living on US\$1/day) is one of Indonesia's successes. Other MDG successes include: enrollment in primary schools; child mortality; and access to improved water facilities. Other indicators are less positive,

but overall the majority of Indonesia's indicators are on-track to achieve the MDGs

Reform momentum continues, especially in budgeting and investment climate reforms. The Government is using increased fiscal space to scale up spending on poverty alleviation through a large National Community Empowerment Program and two conditional cash transfer pilots, one directed at households and the other at communities. The 2008 budget proposes a substantial reallocation of spending to priority areas, including infrastructure, education and social assistance. In July 2007 the Government issued an integrated economic policy package aimed at improving the investment climate and building upon a series of individual policy packages issued in 2006 covering investment policy, infrastructure, financial sector reform and SME policy. The Government has established teams to monitor progress on each part of the package and has designated a minister responsible for each item. There have been a number of specific reform initiatives as well, including passage of an investment law and associated regulations on the negative list designed to improve transparency. There was also a new tax administration law that addresses business concerns about arbitrary treatment and a Government Regulation in lieu of Law that clarifies the status of Batam (Indonesia's largest and most active free trade zone).

Looking ahead, growth is expected to reach 6.3 percent for 2007 as a whole and to rise a bit further, to 6.4 percent in 2008. Investment is expected to remain strong, but exports are expected to slow modestly, due to the projected slowdown in the world economy. A mild fiscal stimulus will help growth prospects with the slight widening of the budget deficit to 1.8 percent of GDP. Spending on pro-poor programs and key priority areas such as infrastructure and social programs (poverty reduction) while increase (in part through a reallocation from fuel subsidies), while achieving reductions in government debt (measured as share of GDP).

Korea

The Korean economy continues to expand. Real GDP growth, which had slowed to 4 percent year on year in the first quarter of 2007, recovered to 5 percent in the second quarter (the same pace as in 2006 as a whole). Growth was mainly led by improving domestic demand, as well as continued strength in exports. Exports have maintained a double-digit real growth thanks to solid demand from the Euro zone and China, in the face of strong won appreciation against the dollar. Facility investment and consumption rose respectively by 11.9 percent and 4.2 percent in the second quarter, backed by strong exports and solid equity prices. Construction investment returned to positive growth, up 3.5 percent at the first half of 2007. Robust exports and a steady rise in domestic demand are expected to sustain the momentum of growth in the latter part of 2007 and in 2008t, resulting in GDP growth of 4.8 percent in 2007 and 5.1 percent in 2008.

Headline consumer price inflation has been stable, running at 2.3 percent in the third quarter of 2007, below the central bank's medium term target range of 2.5-3.5 percent. Although consumer prices remain subdued, the Bank of Korea raised the overnight call rate twice by 0.25 percentage point to 5.0 percent in July and August. The overnight call rate target had been held at 4.5 percent for the previous 10 months. The BOK expects that inflation pressures may increase from the second half of this year into the first half of 2008 due to economic recovery, higher asset prices, the growth of liquidity and higher international oil prices. Given the sluggishness of the economy in late 2006 and early 2007, the government frontloaded fiscal expenditure in the first half of this year. The fiscal balance excluding social security funds is expected to remain in a very modest deficit of around 1 percent in 2007 and 2008.

The current account remains broadly in balance while net capital inflows continue at moderate rates. Double-digit export growth has been offset by high oil prices and a widening services account deficit. The services account deficit continued to expand as the demand for travel and education abroad increases. For the first eight months of 2007, the current account totaled a surplus of US\$ 0.5 billion, with a surplus of US\$ 19.0 billion on goods and a deficit of US\$ 14.7 billion on services. The current account is likely to continue in broad balance this and next year. The capital account recorded a surplus of US\$ 11.7 billion for the first eight months of this year. Short-term external borrowing, surged by US\$ 37.9 billion during this period, and was a main factor in the overall net capital surplus, given net outflows of direct investment and portfolio investment. Net capital inflows are anticipated to moderate as demand for hedging by shipbuilders slows and capital outflows by domestic investors increases, thanks in part to easier regulations and expanding tax incentives for overseas investment. Meanwhile, foreign exchange reserves reached US\$ 257.2 billion in September 2007, up US\$ 18.3 billion over the end of 2006.

Malaysia

The Malaysian economy slowed marginally in the first half (H1) of 2007, registering 5.6 percent GDP growth (y-o-y), down from 6 percent in H1 2006. This was mainly due to slower exports, which expanded only 2.5 percent relative to 6.2 percent in H1 2006. Growth was thus supported by private and government consumption, and by investment, which increased 10.8, 8.8 and 8.1 percent respectively. On the supply side, the services sector accelerated to 9.4 percent, underpinned by consumer spending, finance and insurance, and real estate. After two years of negative growth, output in mining and construction also picked up rather strongly in H1 2007. In contrast, agricultural and manufacturing outputs expanded at a much lower pace (0.6 and 1.8 percent respectively). Output in export-oriented industries contracted by 0.8 percent (5.1 percent for

electrical and electronics products, E&E, alone), while output in domestic-oriented industries rose by 7.1 percent.

Exports in the first 7 months (7M) of 2007 increased only 1 percent to RM 334 billion (11.3 percent in 7M 2006). Although key agricultural exports expanded by 7.4 percent due to higher prices of crude palm oil and liquid natural gas, Electronics and Electrical exports, which accounted for nearly half of total exports, fell by 4.9 percent. This is partly attributed to weaker demand in the United States, which had nearly 20 percent of market share in 2006. Exports to the United States declined by 11.5 percent in H1 2007 relative to H1 2006. As gross imports rose by 3.4 percent, the trade balance in 7M 2007 was RM 51.7 billion, 10.4 percent lower than the same period last year. In the fourth quarter of 2006 and the first quarter of 2007, the current account surplus amounted to RM 27.9 billion, a 65.5 percent increase from the same period a year earlier, as the net balance on travel and investment income improved. Reflecting more favorable foreign direct investment and portfolio investment, the balance on capital and financial accounts also improved, recording a deficit of RM 20 billion from RM 46.7 billion in the earlier period. The overall deficit in the balance of payments therefore fell to RM 2.7 billion from RM 36.2 billion in the earlier period. Meanwhile, net international reserves rose steadily to RM 334.1 billion in August 2007, a 14.7 percent increase from August 2006.

Compared to H1 2006, federal government revenue rose by only 2 percent in H1 2007 due to much lower personal income tax revenue, although corporate income and petroleum income tax revenues increased. As both operating and development expenditures increased at significant rates (19.4 and 55.8 percent, respectively), government overall surplus fell to RM 974 million, a remarkable 91 percent lower than H1 2006. Higher operating expenditures included on emoluments, supplies and services, and grants and transfers, whilst development spending primarily involved agriculture and rural development, trade and industry, and transport. Meanwhile, the government debt increased to RM 260.1 billion at the end-Q2 2007, an 8.3 percent rise from end-Q2 2006.

The CPI inflation rate fell to 2 percent in the first 8 months (8M) of 2007 (8M 2006: 3.9 percent), as prices of most commodities and services increased only slightly. The Malaysian Ringgit continued to appreciate against the US dollar, although only moderately compared to other Asian currencies. At end-August 2007, the exchange rate was RM 3.50 per US dollar, appreciating from RM 3.53 and 3.78 at the end of 2006 and 2005, respectively. Monetary policy has been stable. The Overnight Policy Rate (OPR) is still kept at 3.5 percent since its last change in April 2006.

Based on the 3-month definition, the share of non-performing loans (NPLs) in total loans of the banking sector decreased from 4.8 percent in December 2006 to 3.6 percent in August 2007. The risk-weighted capital ratio, which reflects the degree of capital adequacy, stood at 13.3 percent

in August 2007, which is a slight increase from end-2006. During this same period, the core capital ratio however dropped marginally. As for the stock market, the Kuala Lumpur Composite Index (KLCI) fell rather heavily (7.3 percent) in August 2007 from July 2007 due to the worldwide financial turmoil led by the sub-prime loans crisis in the United States. The market has however rebounded since, and reached 1,369 as of 9 October 2007, which is about 25 percent up from end-2006.

Looking forward, real GDP growth in 2007 is expected to moderate to 5.7 percent, after growing 5.9 percent in 2006. Although export performance has so far been weak in 2007, domestic demand should help to sustain growth. Strong private consumption is likely, given favorable consumer sentiments, low inflation, high commodity prices, stable interest rates, and a recent pay hike for government officials. Similarly, an expansionary fiscal policy, following a recently announced government budget 2008, should also strengthen growth. The outlook for 2008 is more positive with a 5.9 percent growth rate. This prospect however depends largely on how significantly economic conditions in the United States worsen in the coming months. The sub-prime crisis appears to have had a limited effect on the Malaysian financial sector so, although its impact on export performance could be more significant over time.

Philippines

Philippine GDP growth increased to 7.3 percent in the first half of 2007, highest among the middle-income countries of Southeast Asia, while GNP growth reached 8 percent. This performance indicates that growth for the year could reach or exceed the 6.7 percent upper end of the Government's original target range for 2007. Growth performance and prospects have improved following the substantial fiscal adjustment, public debt reduction and balance of payments surpluses of recent years. By October 2007, financial markets had largely recovered from the US sub-prime crisis-induced volatility, notwithstanding a spate of corruption scandals featuring prominently on the political landscape. A shortfall in targeted tax revenue in 2007, unless rectified, could undermine official aspirations to strengthen infrastructure and eliminate the National Government deficit in 2008.

Stronger first half growth was driven by 8.6 percent growth in the services sector, which accounts for more than half of GDP. Industry expanded by 7.2 percent, but this was due to strong growth in mining and construction whereas expansion in manufacturing slowed to 3.8 percent. The agriculture and fishery sector also slowed to 3.9 percent. Investment began to pick up, albeit unevenly: both private and public investment in construction increased significantly, but investment in durable equipment remained lackluster. Meanwhile, personal consumption expanded by 6 percent, benefiting from large and growing remittances.

Unemployment fell to 7.8 percent from 8.1 percent in 2006 according to the July round of the labor force survey. Underemployment also fell marginally from 23.4 percent to 22 percent. The share of wage and salaried workers increased slightly to 53 percent while the share of unpaid family workers diminished somewhat, suggesting some improvement in the quality of employment. Within wage and salaried workers, the largest increase was in the public sector, where election related hiring might have been a factor.

The consolidated public sector deficit was eliminated in 2006, and a P32 billion consolidated public sector surplus recorded in the first half of 2007, about 1 percent of GDP, driven in large part by higher surpluses of the social security funds and local government units. The National Government (NG) deficit of P40 billion through September 2007 was smaller than targeted, aided by P42 billion of privatization receipts, and despite lower-than-targeted tax revenue. Following a significant policy induced increase in 2006, the tax effort fell in the first half of the year relative to target, recovering only partially in the third quarter. Through September, tax revenue had grown by 7.8 percent, notwithstanding growth of over 15 percent in the third quarter. Non-interest NG spending increased significantly thus far in 2007, reversing the trend of past years, but overall growth in government spending was moderated by lower interest payments that reflected both a declining debt ratio and lower interest rates for government borrowing. Non-financial public sector debt fell to 74 percent of GDP in 2006 and this ratio is expected to fall further in 2007 given strong economic growth and an appreciating currency.

Philippine financial markets were significantly impacted by the sub-prime crisis, with the stock market index losing 24 percent of its value by mid-August from its peak in early July. Even though local banks have minimal direct exposure to US sub-prime-linked assets, bank balance sheets were impacted by the falling prices of foreign exchange denominated government bonds (ROPs) during July-August, in which the banks are significant investors. By early October, however, financial markets had largely recovered from the sub-prime-induced volatility. Equity prices reached a new record high in the following week. The peso resumed its appreciation in September and has appreciated the most against the US dollar through early November among East Asian currencies this year (nearly 15 percent). Recovering ROP prices have also benefited the banks in recent months, although bond spreads remain higher than prior to the onset of the sub-prime crisis. The 91 day T-bill rate averaged 3.3 percent in September, 2 percentage points lower than September 2006. Following the U.S. rate cut in September, the BSP reduced policy rates by 25 basis points in October to 5.75 percent for its overnight deposit rate, facilitated by declining inflation through much of 2007. The consumer price index increased by an average of 2.6 percent in the first nine months of the year, versus 6.8 percent in during the same period in 2006.

Finally, bank lending which has consistently lagged GDP growth, expanded by 7.5 percent in August, the highest monthly growth this year, and the central bank forecasted a further increase to about 10 percent growth by year end.

Gross international reserves reached \$32.4 billion in October 2007, up from \$23 billion at the end of 2006, reflecting rising surpluses on both current and capital accounts. The current account surplus rose sharply on account of large remittance inflows and a smaller trade deficit. Remittances increased by 15 percent to \$9.3 billion through August. By contrast, export growth slowed to 6.6 percent in the first half and decelerated further in July and August. Import growth has also slowed, which, coupled with the appreciation of the peso and the prospect of slower OECD growth, has raised some concern about prospective export growth. Strong inflows were also recorded in the capital account. Net foreign direct investment reached \$1.6 billion through July 2007, up 70 percent from 2006. Net portfolio inflows jumped 143 percent to \$3.4 billion through September despite a substantial outflow in August.

Thailand

Thai real GDP is expected to grow by 4.3 percent this year, down from 5 percent in 2006, before rising slightly to 4.6 percent in 2008. Both last year and so far this year growth has been principally supported by robust net exports, while domestic demand growth has remained weak due to declining consumer and investor confidence, political and policy uncertainties, and higher oil prices. Net export growth was however slower than in 2006 and this is the main reason for the slower pace of GDP growth this year. Exports of goods and services are expected to grow by 6.5 percent in real terms (8.5 percent in 2006), while import growth should pick to around 2.5 percent (1.6 percent in 2006). Inflation has slowed to around 2 percent this year, a 2.7 percentage-point decline from last year. Growth is forecast to increase modestly to 4.6 next year as domestic uncertainties begin to clear up and domestic demand picks up. However there remain many downside risks related to both global environment (oil prices and external demand) and the domestic political and policy environment.

Private investment growth has slowed from last year. Weak domestic and foreign demand, policy uncertainties, less crowding-in from public investment, and the rapid appreciation of the baht, which has affected export growth, have delayed capacity expansion by firms. High oil prices and greater global uncertainty related to the US sub-prime crisis are not helping either. Foreign direct investment is likely to have contracted this year for the first time after 2003 and overall private investment growth will likely register no growth this year, the lowest since 2000. Capacity utilization, which has been rising since 2004, is now approaching pre-1997 crisis levels.

Clearer policy direction from the new government after the December 2007 elections should help improve investor sentiment and raise investment growth next year.

Even though actual investment has been weak, Board of Investment (BOI) investment promotion applications and approvals for both local and foreign firms have reached record highs this year. This may indicate improved investor sentiment and a potential investment recovery next year. However, the extent of actual investment will also likely depend on reduced perceptions of policy uncertainty. These had increased this year after the December 2006 introduction of capital controls to stem baht appreciation – even though most of these 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 has also been low this year. Investment budgets have increased only marginally and tighter governance rules have slowed disbursement. The Central Government's investment budget increased by only 4.5 percent in 2007 (compared to 8.7 percent in 2006). In addition, several new measures to make public procurement more transparent and accountable have also tended to slow disbursements. Disbursement of the government and state-owned enterprises are expected to be around 70 percent and public investment is projected to rise by 6.8 percent in nominal terms and 4.5 percent in real terms this year (10 percent and 4.5 percent in 2006). The carry-overs from this year will be spent next year, and the central government investment budget for 2008 has been raised by 8 percent. But there could still be delays in decisions on large investment projects as the new government will assume office only around February next year. Due to the delay in the disbursements, the fiscal balance is in deficit this year by 0.8 percent of GDP compared to the planned 1.8 percent budget deficit. The deficit will likely be much less next year as revenues collection are projected to be stronger in line with higher GDP growth (although the budget has been programmed to be in deficit).

Exports of goods and services remain the key driver of growth this year and will remain so next year. Growth in exports of goods and services in real terms this year has decelerated from last year's 8.5 percent to 6.5 percent due to the slow increase in agricultural price, appreciation of the baht and the deceleration of US demand, which is Thailand's largest export market (15 percent of total exports). Growth of merchandise export is projected to be 7 percent in real terms and 14.5 percent in value (9 percent and 17.4 percent in 2006). Political uncertainty and the 2006 New Year's Day bombings have also affected tourism numbers and receipts. Tourist arrivals increased by only 2.8 percent in the first 9 months of this year. Looking forward, real merchandise export growth is expected to slow slightly down to 6.6 percent in real terms, in line with modest growth in world demand and a still strong baht. Tourism receipts should recover as elections take place and political uncertainty declines. Exports of goods and services in real terms could reach a slightly stronger 7.2 percent growth in 2008.

The current account surplus will reach a record high this year, but should decline next year as import growth speeds up. Import growth has slightly increased this year to 8 percent in value terms (7 percent in 2006), mainly from the imports of raw materials, and is expected to speed up to 15 percent next year as investments pick up. As a result, the current account this year will reach almost US\$12 billion or 4.9 percent of GDP. Next year, the current account surplus will decline to around US\$5.7 billion or 2.2 percent of GDP. The large current account surplus this year has contributed to the accumulation of Thailand's international reserves to almost US\$80 billion by the end of September 2007 and also to the baht's appreciation. The baht would likely remain strong next year as the current account remains in surplus and as less political uncertainty attracts more investment inflows.

Some reforms have been undertaken this year but other measures have adversely affected investors' confidence. The Japan-Thailand Economic Partnership Agreement (JTEPA) was signed in April this year. Moreover, the Privatization and Corporatization Act and the Deposit Insurance Act have been approved by the Cabinet and will likely be passed by the National Legislative Assembly this year. The National Productivity Master Plan, aiming to raise productivity at the both the sectoral and aggregate levels, has been drafted by a high-level national committee and approved by the Cabinet. However, the still undecided amendments to the Foreign Business Act and remaining capital controls have dampened foreign investors' confidence. Boosting investor's confidence through the improvements in the business climate, which includes the reduction of regulatory burden and further liberalization of certain services industries, will be key to Thailand's future growth. In addition, policies to improve the productivity of the service sector which would help unleash the large potential growth of the services sector needs to be undertaken to provide an additional engine of growth for Thailand.

Vietnam

Vietnam's economic growth remains strong in 2007, mainly fueled by strong non-oil exports, investment and private consumption. GDP grew 8.3 percent year on year in the first nine months of 2007, with industry and manufacturing expanding by 10.2 and 12.5 percent respectively. Agricultural growth stood at 3 percent, with a record growth of aquaculture (9 percent) compensating for a slowdown in the poultry and livestock sub-sector. The last few months have witnessed new avian influenza outbreaks. While these have been marginal, this is an area that will require vigilance by the authorities. The service sector has also recorded high growth in the first nine months of the year (8.5 percent) thanks to strong performance of retail trade, tourism, transportation and financial services.

Domestic consumption and investment have also been strong. Gross and retail sales grew by nearly 23 percent in the year to September 2007. The share of the

state sector continues to decrease and represents only about 11 percent of the total by now. Total investment rose by 16.3 percent in the first nine months of 2007. In current prices, it now represents 42.5 percent of GDP. Investment by the domestic private sector increased by nearly 28 percent and now accounts for about 17 percent of GDP.

Foreign Direct Investment (FDI) commitments surged to 10.2 billion dollars in 2006 and US \$9.6 billion in the first 9 months of 2007, a 38 percent increase on a year ago. FDI commitments have clearly received a boost from Vietnam's accession to the World Trade Organization (WTO). FDI disbursement rose by 20 percent on the year to September 2007, representing about 6.8 percent of GDP. While investment by foreign companies and by the domestic private sector has increased strongly, disbursements from the capital state budget are still low, reflecting the slow preparation and implementation of public investment projects.

Export earnings continue to grow rapidly (19.4 percent year-on-year), despite a 10 percent decline in crude oil exports due to production capacity constraints. On the other hand, there has been a strong pick-up in exports of agricultural products, seafood, garments, and footwear (even though seafood and aquaculture exports have faced food safety concerns related to antibiotic residues, as well as environmental problems in the breeding areas). Exports now account for roughly 72 percent of GDP. Among trade partners the United States is the biggest market, absorbing nearly a fifth, followed by EU, ASEAN and Japan. The garments sector, one of the main drivers of export growth in recent years, saw its sales abroad increase by nearly 32 percent in the first nine months. Vietnam is by now one of the top ten garment exporters in the world, with the United States its largest market, accounting for almost 60 percent.

Imports grew by 30 percent in the year to September 2007, driven by a strong investment demand and the input needs associated with industrial expansion. The rapid growth of imports has resulted in a widening trade deficit, estimated to reach 7 percent of GDP in 2007. The current account deficit is expected to reach 3 percent of GDP this year, compared to 0.3 percent in 2006. However, the balance of payments situation remains sound, with the current account deficit largely financed by non-debt creating FDI inflows, official development assistance (ODA) and private remittances. In addition, the high levels of commitments mean that actual inflows could be accelerated if there were concerted efforts to ease implementation constraints. Portfolio inflows also witnessed a sharp increase in 2006 and early 2007, attracted by rapidly developing capital markets, including a booming stock market. Foreign exchange reserves have built up rapidly from \$8.6 billion in 2005 to \$11.5 billion in 2006 and an expected near 20 billion by the end of 2007. External debt accounts for 31 percent of GDP in nominal terms, and 22 in present value terms. Under plausible scenarios, Vietnam remains a country with low external risk.

Inflation has accelerated in recent months, generating considerable debate among policy makers on the appropriate response. The Consumer Price Index (CPI) increased by 8.8 percent in the year to September (7.3 percent from beginning of the year). The annual figure for 2007 is likely to remain in the single digits, but barely. Given Vietnam's very open economy and an exchange rate policy amounting to a peg to the dollar, part of the acceleration in inflation is related to the increase in the price of internationally tradable goods. The index for food and foodstuff products grew by 13.3 percent on an annual basis, the fastest increase since April 2005. There are also concerns that an excessive loose monetary policy might have fueled increases in the prices of non-tradable goods. Credit growth rose sharply, from 25 percent in 2006, to around 35 percent (on an annual basis) towards mid-2007. Growth rates are higher in the case of joint stock banks, and there are concerns about the quality of lending. The State Bank of Vietnam (SBV) expects credit growth to slow down in the coming months, and targets an annual increase of 30 percent for the year as a whole. For now, the main instrument to reduce credit growth has been increasing reserve requirement for banks (from 4 to 10 percent, effective on June, 2007).

The substantial inflow of capital, from FDI, remittances, portfolio investments and ODA has also forced the SBV to purchase large amounts of foreign currency to avoid an appreciation of the exchange rate. While this policy is sometimes justified by the need to preserve the competitiveness of exports, it has also been defended as a way of reducing excessive exchange rate volatility in a country where in a country where the structure of possible currency mismatches on the balance sheets of enterprises and financial institutions are not well known and where financial instruments to hedge against exchange rate risk are limited. However, buying large amounts of foreign exchange has resulted in an increase in the money supply. The government has tried to mop up excess liquidity by issuing short-term bonds, but interest rates have not been attractive enough for this policy to be fully effective. In addition, in the medium term the increase in the price of non-tradable goods and services can be expected to be higher than that of tradables. Vietnam is a cheap country, in international terms, and rapid economic growth will be associated with real exchange rate appreciation. Labor earnings, in particular, will grow faster than the CPI, exerting a pressure on labor costs. With an exchange rate policy amounting in practice to a peg, real exchange rate appreciation can only occur through higher domestic prices. This establishes a floor for inflation, even under a tighter monetary policy.

Budgetary revenues and expenditures remained on track during the first nine months of 2007. Using the international definition, the government's objective for the fiscal deficit in 2007 is 3.2 percent of GDP. On current trends, this objective remains attainable. A quarter of the

deficit is expected to be financed by the external sources and the rest by domestic sources.

Vietnam's stock market experienced a dramatic boom over the last two years. At the end of 2005, only 41 firms were listed, with a market capitalization of less than a billion dollars, or 1.2 percent of GDP. By the end of September 2007, the number of listed firms had risen to 206, while stock market capitalization had surpassed 22 billion dollars, or 32.4 percent of the estimated GDP. The 2006 Law on Securities was an important milestone in this process.

Whether the market is overvalued remains a hotly debated issue, but fears of a crash have receded. Compared to GDP, stock market capitalization remains below that of India (45 percent) or China (70 percent). Price-to-earnings ratios are not unusually high for a rapidly growing economy and also tend to be inflated by the fact that data on earnings is available with a considerable lag. The earnings of listed companies have actually been increasing very rapidly. After a period of exuberance, until March 2007, the market now appears to be settling. A major state-owned insurer did not do well at its much anticipated initial public offering. The announced listing of several large state-owned enterprises and commercial banks in the coming months could exert substantial downward pressure on equity prices. The government is considering postponing some of those listings for fear of depressing stock prices too much. Foreign players have remained net buyers, but on declining amounts. Given the downtrend, capital control measures that had been mulled earlier appear to have been shelved for now. However, stronger disclosure requirements, better investor protection and higher caps for foreign investors may be needed to keep up the momentum.

Smaller Economies

Cambodia

Cambodia's economic performance continues to be solid. After three years of double-digit growth, the economy is expected to grow 9.5 percent in 2007, underpinned by strong exports, private investment, and consumption. From a sectoral point of view, growth continues to rely on apparel, tourism, agriculture, and construction. In 2007, garment exports continue to expand (by an expected 17 percent) and tourist arrivals are estimated to grow 25 percent.

The outlook for 2008 is positive, with growth projected to ease only slightly to 7.5 percent, and several factors should also help sustain rapid growth over the medium term. These include large foreign direct investment inflows (6 percent of GDP or more over the last 3 years), the possible exploitation of underground resources (oil, gas, and mining), sound macroeconomic management and progress

in structural reforms, despite some uncertainty due to the national elections scheduled for July 2008. Cambodia's narrow export base remains vulnerable to external developments however. The garment sector faces renewed competition, including when 'safeguard' measures on China are lifted by the end of 2008. The exploitation of underground resources also needs to be managed cautiously from a transparency, fiscal, and macroeconomic point of view if Cambodia is to benefit fully from their potential.

External developments have supported rapid growth and good macroeconomic performance in 2007. The nominal exchange rate remained stable, and foreign reserves continue to grow, possibly reaching US\$1.4 billion by the end of 2007, worth 2.3 months of imports of goods and services. Despite pressure from high world oil prices, the current account deficit (excluding transfers) fell to -7.2 percent in 2006 (from -9.4 percent in 2005) and is expected to stabilize at -7.5 percent in 2007.

Broad money increased by 38 percent in 2006 and is projected to grow by 49 percent for 2007, reflecting rapid economic growth and an increasing demand on the financial sector. Inflation has been picking up from a low 2.8 percent in 2006 to a projected 6.0 percent in 2007, even though this has not yet triggered concerns about price instability.

The financial sector is growing: 23 commercial banks are operating with a total lending-to-deposit-ratio of 68 percent (up from 64 percent in 2005), and 17 micro-finance entities providing an estimated US\$50 million of credits to micro and small businesses. Several important laws were passed in 2007, including laws on anti-money laundering, combating terrorist financing, the issuance and trading of non-government securities and on bankruptcy. Cambodia obtained its first sovereign debt rating from Moody's and Standard & Poor's (a B-plus, i.e. two notches lower than Vietnam). There remain many issues nevertheless. Cambodian entrepreneurs still find it a challenge to access credit - the interest rate for a one year term loan is above 15 percent. Issues such as concentration of the financial sector and the exposure of the main banks to a single sector (real estate) and, in some cases, a few large customers also require the central bank to step up its efforts to supervise the rapidly-growing banking sector.

The fiscal deficit before grants declined from 3.4 percent of GDP in 2005 to 2.5 percent in 2006, and is projected to further decrease to 1.5 percent in 2007. The joint IMF/WB debt sustainability assessment concluded that Cambodia had only a "moderate" risk of debt distress (against a high risk in the previous assessment). The ratio of total revenue to GDP grew from 10.3 percent in 2005 to 11.5 percent in 2006, with a projected increase to 11.8 percent in 2007 and 12 percent in 2008. This increase owes mainly to the modernization of collection processes. Spending remains stable, at 13.7 percent of GDP in 2005, 14.0 in 2006, and a projected 13.3 and 14.9 in 2007 and

2008. Public investment remains low, while recurrent expenditures are slowly increasing in an attempt to adjust public wages to more effective level. Despite good progress, Cambodia is still a highly aid-dependent economy with per capita aid of US\$33 on average between 1999 and 2005. Foreign financing accounted for 33 percent of total spending in 2006. In June 2007, the first Cambodia Development Cooperation Forum was organized and, in a break from the Consultative Group meetings it replaces, it was chaired and fully prepared by the Government. An aggregate pledge of US\$700 million was received from donors, targeting activities in line with the National Strategic Development Plan (NSDP) for 2006-2010.

In July 2007, the World Bank approved a first Poverty Reduction and Growth Operation, which has been prepared jointly with a group of donors that are expected to cofinance it. The first area of reform is public financial management, a reform area led by the Ministry of Economy and Finance (MEF) and involving some 13 donors, which has been instrumental in delivering some of the progress on the fiscal side. Budget execution is improving, pilots programs for budgeting have been introduced, procurement is being strengthened, and public financial management increasingly relies on the banking system. Progress in this area is also underpinned by an innovative Merit-Based Pay Initiative in MEF. Second, in the area of private sector development, some progress is being made toward improving trade facilitation and investment promotion. The customs law and the law on concessions were passed in 2007. Electronic customs declaration through a Single Administration Document (SAD) will be piloted at the end of 2007 and rolled out in 2008. The new ASEAN Harmonized Tariff Nomenclature (AHTN) with 8,314 tariff lines and average un-weighted tariff of 14.3 percent was implemented in July. There is also progress on land and natural resource management, such as rapid land titling and initial steps toward disclosure of economic land concessions, although substantial challenges remain.

Cambodia has also made progress in social sectors in recent years. The national poverty rate fell from 47 to 35 percent between 1994 and 2004. In education, the gross primary enrollment rate (124 percent) has risen faster than the low-income country average (104 percent) while the gap in adult literacy relative to other East Asian countries has fallen. But completion and literacy rates still remain low. The infant mortality rate fell from 95 per 1,000 live births in 2000 to 66 in 2005. HIV prevalence also appears to have fallen remarkably. The notable lagging indicator is the maternal mortality ratio, which remains high and unchanged.

Fiji

Since the military takeover of Fiji's Parliament on December 5, 2006, an interim government has been installed

with the military commander as interim Prime Minister. National elections have been set for 13 March, 2009, in accordance with the recommendation of the Forum-Fiji Joint Working Committee. The targeted timeline for the elections is subject to the redistribution of constituency boundaries following the 2007 census, an update of the registers of voters, and voter education and information programs. External partners are providing financial aid and technical assistance to support Fiji's return to democratic rule. However, international sanctions—which include the suspension of some aid and defense cooperation, immigration restrictions, and travel bans—are being maintained by a number of donors.

Fiji's economy is officially forecast to contract by 3.1 percent in 2007 compared to real GDP growth of 3.6 percent in 2006. The recent political uncertainty appears to have affected the tourism sector, Fiji's main foreign exchange earner, with tourist arrivals falling by 5 percent in the first half of 2007. As a result, construction activity fell 26 percent in the first quarter of 2007, and tourism-related activity also slowed. Lower government expenditure is also anticipated.

The main traditional exports—sugar and garments—remain weak. Sugar production fell 11 percent in the year to July 2007. The industry continues to face land tenure and low productivity issues. In addition, the European Union (EU)'s package of F\$350 million (US\$208 million) to assist the industry adjust to phased reduction in subsidies is uncertain. Garment production dropped by 25 percent since the expiry of preferential access agreement in 2005. On a positive note, official remittances reached 6 percent of GDP in 2006, and the re-opening of the gold mine (closed in December 2006 for commercial reasons) may create an estimated 600 jobs.

A budget surplus of 1 percent of GDP was achieved in the first quarter of 2007, mainly due to a reduction in capital expenditure. The interim government targets a fiscal deficit of 2 percent of GDP for 2007. Public debt increased from 47 percent of GDP in 2006 to 51 percent as of June 2007.

The current account deficit is projected to narrow from 21 percent of GDP in 2006 to 13 percent in 2007, as the trade balance improves. Merchandise export earnings increased by 7 percent in the first half of 2007 led by mineral water, fish and timber. Thanks to tightened credit conditions (following the imposition of credit ceilings on commercial banks), import payments fell by 7 percent during the same period. However, the import cutback is driven by investment goods, suggesting lower investment in 2007 compared to the 19 percent of GDP estimated for 2006.

Foreign reserves increased to US\$530 million (equivalent to 4 months of imports) as of August 2007. Interest rates are showing a downward trend. The commercial bank lending rate fell from 9.20 percent in June to 8.84 percent in August while the Policy Indicator Rate

remains at 4.25 percent. The real effective exchange rate appreciated by 5.3 percent in the year to July 2007. Projected inflation for 2007 has been revised up to 7 percent, reflecting continued upward pressure on prices of domestic market products following supply shocks (flood and cyclone-related losses which occurred earlier in the year), as well as global price movements.

Looking forward, the economy is officially projected to rebound by 2 percent in 2008, with the services sector the main driver of growth. Downside risks include uncertainty about the EU's sugar adjustment support and weakening investor confidence.

Lao PDR

Lao PDR macroeconomic performance remains strong, while the impact of resource sectors growth is becoming stronger. Real GDP growth speeded up to 7.6 percent in 2006, up from 7.1 percent in 2005. While manufacturing and other non-resource sectors continued to grow moderately, economic growth is increasingly driven by the resource sector, especially by expansion in copper extraction and construction of the large hydropower projects. Growth is expected to remain high at above 7 percent in the coming years. On a year-to-year basis, inflation fell below 4 percent in recent months, due to favorable oil and food prices and the lagged impact of exchange rate appreciation. Average inflation is expected to drop from 6.8 percent in 2006 to about 4 percent this year. The current account deficit narrowed, reflecting buoyant resource exports and rising tourism. Higher foreign direct investment and official development assistance further added to an improvement in the balance of payments. By end-June 2007, gross international reserves increased to about US\$460 million, equivalent to 4.6 months of non-resource imports. As a result, reserve and broad money growth accelerated to 45 and 39 percent respectively, by end-May 2007. This rapid growth of monetary aggregates may put upward pressure on inflation.

Fiscal performance strengthened, resulting in lower deficit and net domestic borrowing. Fiscal revenues grew, driven by higher than anticipated resource revenues, as well as by non-resource revenues, which were boosted by lagged impact of 2005 tax law implementation. Domestic expenditures remained on track. This resulted in an overall cash surplus and a low non-resource deficit. In 2005/06 the overall budget deficit declined to 3.7 percent of GDP compared to 4.4 percent in 2004/05 and is expected to drop to 1.3 percent in 2006/07. Strong revenue and contained domestic expenditure led to a decline in net domestic borrowing.

According to the recent DSA, Lao PDR is at high risk of debt distress, although the debt burden has declined and debt service remains manageable. The external public debt as percentage of GDP remains high, but the trend is declining. In 2006, it decreased to 69 percent of GDP

compared to 77 percent in 2005 and is projected to decline further in 2007 to about 63 percent of GDP.

The economic reform agenda has progressed, but lagged somewhat on implementation. Several laws for reforming the budget system (such as the Budget Law on centralization of the Treasury, tax and customs administration and intergovernmental relations) have been approved, but implementation measures have been delayed due to administrative adjustments at the MOF. The implementation of the Enterprise Law continued, although progress has been slower than envisaged earlier. The Law on Commercial Banks, as well as the Revised Presidential Decree Law on Management of Foreign Exchange and Precious Metals have been approved by the Government. In general, there has been a delay in finalizing the respective implementing decrees and regulations as compared to previously agreed timelines.

Public financial management reform continued. A new Budget Law was signed by the President in February 2007, and the Prime Minister issued a Decree on restructuring of the Ministry of Finance to allow more effective implementation of the Budget Law. The new law aims to transform the intergovernmental fiscal transfer mechanism and also mandates more extensive reporting of budget information to the National Assembly. The Public Expenditures Management Strengthening Program (PEMSP) program document and work plan for FY2006/7, which is the umbrella public finance management reform program, was adopted in February 2007. Progress with implementation of PEMSP remained on-track. Implementation of the new Budget Law and the PEMSP will require significant technical capacity and sustained political support for this on-going reforms.

Progress on trade and private sector development has been strong, although more attention was needed to the inter-agency coordination. The government continued its work on WTO accession: after preparation of the initial offer for goods, the MOIC has drafted the initial offer for services. With respect to implementing AFTA commitments, in February 2007 the National Assembly's Standing Committee ratified the last (fifth) installment of the Inclusion List and the actual applied tariff (MFN rates) will be reduced to 0-5 percent by 2008. Export and import related procedures are being simplified, in particular significant progress has been made to prepare implementing regulations to simplify business start-up procedures including preparation of the Negative List, abolition of factory establishment license and reduction in number of days required to approve operating license for manufacturing sector.

Reform of SOEs and state-owned commercial banks has also continued. According to SOEs performance monitoring and assessment reports by MOF, SOE performance has been improving and the number of loss-making SOEs is on a steady decline. The government has made the independent audits of the major loss-making SOEs

according to international standards a regular exercise, and is planning to streamline the results of these audits into the future restructuring programs. The Lao banking sector is opening up with the entry of ANZ Bank and IFC into a joint venture with a local private bank. The new banking law will provide a level playing field for all banks and ensure competitive entry into the sector. The Government is working on its Financial Sector and SOE Reform Strategies.

Mongolia

Mongolia continues its rapid growth but inflationary pressures have emerged. Real GDP growth rate was 8.6 percent in 2006 and is projected to be around 8.5 percent this year. As of August 2007 gross industrial output increased by 13.6 percent in real terms compared to the corresponding period last year, led by manufacturing (33.7 percent), grain mill and fodder products, dairy products, and basic metals. While most of the foreign direct investment (FDI) coming into Mongolia continues to go to mining, its output grew by only 3.9 percent this year (mainly from coal extraction). Mining is also the main source of government revenues. The revenues from the mining windfall tax accounted for 18.5 percent of total central government budget revenue in August 2007. Inflation (CPI) picked up from a low 4.2 percent in January 2007 to 11.3 percent in August, due to rapid monetary growth, public sector wage increases and increases in the price of some main imports (e.g. petrol). As of August 2007, broad money increased by 45 percent and credit to the private sector by 53 percent.

High international prices for copper and gold have sustained Mongolia's export earnings in 2007. Total exports increased by 27 percent and total imports by 40 percent in August 2007 compared to the same time a year ago. Mineral products exports rose by 36.7 percent during this period with copper concentrate contributing to 44.3 percent and gold exports to 16 percent of total export volume, respectively. Meanwhile the togrog depreciated somewhat vis-à-vis the U.S. dollar and reached an exchange rate of Tg 1,187.3/USD at end-August 2007.

The government's fiscal surplus has continued, mainly due to revenues from trade and income taxes. As of end-August 2007, the government budget recorded a surplus of 172 billion togrog. Government revenues reported an increase of 50 percent compared to the same time last year, while government expenditure had increased by 54 percent during this period (y-o-y). The main factors contributing to this surplus were the prevailing high levels of copper and gold prices which led to an increase in foreign trade and income taxes, and dividend earnings from the Erdenet Copper plant that were transferred to the Government, its owner (Tg 59 billion). Meanwhile, government revenues from the other main taxes, such as Personal Income taxes (PIT), navigation, royalty and land fees were below budget targets. VAT refunds are on the rise as well.

Fiscal policy, as outlined in the amended 2007 budget, is going to be significantly expansionary.

Government expenditure is budgeted to increase by 80 percent due to another public sector wage increase, and renewed spending on social welfare programs and public investment programs. This raises concerns about the efficiency, sustainability and quality of these expenditures, partly since any analyses of the trade-offs involved in the government's spending plans are not readily available to the public to facilitate debate. Questions also have been raised by businesses about the nature of implementation of the Windfall Tax for gold and the instability it has caused in the investment climate in the mining sector. Many have called for a review of the mining tax legislation. Meanwhile, Parliament has started discussions on draft investment and shareholder agreements for the two large mining deposits Oyu Tolgoi and Tavan Tolgoi. A joint Parliamentary and Government Working Group has been set up to re-visit these agreements.

Mongolia is at moderate risk of debt distress over the medium term. The debt burden looks sustainable assuming no major negative terms of trade shock and only concessional borrowing. The total public debt was equivalent to 42.3 percent of GDP as of end-2006, and 31 percent in Net Present Value terms (NPV).

Governance reforms are underway. Asset and Income Declarations of high level government officials had been collected by the Anti-Corruption agency and made publicly available according to the Anti-Corruption Law that was adopted by Parliament last Fall. In the financial sector, Parliament recently approved a Law that partly covers the half of the losses of the victims of the failed Savings and Credit Cooperatives (SCC).

Papua New Guinea

Papua New Guinea's macroeconomic performance has remained strong, aided by favorable terms of trade trends and fiscal discipline. Growth in 2007 is expected to accelerate with positive repercussions for employment. The government budget and balance of payments are projected to remain in surplus in 2007, public debt continues to decline and international reserves are increasing. However, weak governance, inadequate delivery of education and health care services, and a high and rising HIV/AIDS incidence result in poor human development indicators and continue to present difficult development challenges.

The political situation has stabilized. The national elections held in July 2007 proceeded more smoothly than previous elections. A new coalition has been formed, with Prime Minister Somare returning to office for a second term. The elections also marked the first time since independence that an incumbent government had completed its term.

Real GDP growth in 2007 is projected to rise above 5 percent compared to 2.6 percent in 2006. After contracting by 8 percent last year, mining and quarrying production is now leading the growth and is expected to

expand by 14 percent in 2007. Agricultural production is also projected to accelerate in 2007, to over 3 percent, aided by the recovery in export-oriented agricultural production (coffee, copra, copra and palm oil). The construction sector is expected to grow by 8 percent. While formal employment growth has accelerated across most sectors over the past two years (non-mining employment is rising by 10 percent on an annual basis), urban unemployment remains high.

Despite some volatility earlier in 2007, world prices for key export commodities (oil, copper and gold) have remained strong and reached new highs by late summer, contributing to continued significant budget and current account surpluses in 2007. Higher mineral tax receipts, together with collection of tax arrears, are expected to lead to a budget surplus of around 5 percent of GDP in 2007. This follows a surplus of around 7 percent of GDP in 2006 notwithstanding additional appropriations through two supplementary budgets in August and November 2006. Fiscal restraint is also playing an important role in the strong fiscal performance. In particular, the national elections this year were not marked by significant overspending as during past elections. The non-mineral fiscal balance is expected to increase only slightly in 2007 – to just over 8 percent of GDP (from 7.7 percent in 2006).

Restrained fiscal policy, including use of fiscal surpluses to reduce domestic and external public liabilities, together with economic growth in recent years has led to a significant reduction of public debt – from over 60 percent of GDP in 2003 to an estimated 37 percent in 2007. Public external debt service has fallen from 8 percent of exports of goods and services to under 3 percent over the same period.

Inflation remains subdued although the quality of inflation statistics needs to be improved. Consumer prices rose by an average of 2.3 percent in 2006 and are projected to increase by around 3 percent in 2007. The expected pick-up in inflation in part reflects strong monetary expansion: broad money grew by around 40 percent in 2006 and in 2007 it is expected to grow by around 25 percent. Both rapid accumulation of foreign exchange reserves and private credit growth as a result of record low interest rates are contributing to the monetary expansion.

The current account surplus, which reached 5.3 percent of GDP in 2006, is projected to remain high in 2007 as well, benefiting from favorable commodity prices, but also reflecting strong growth of non-mineral exports. The kina has been broadly stable over the past year, appreciating by about 2 percent against the U.S. dollar in nominal terms. International reserves increased from US\$1.4 billion at the end of 2006 to US\$1.9 billion as of September 2007, equivalent to about 4.5 months of imports of goods and services. The increase reflects the high foreign exchange inflows, mainly from mineral exports. The ratio of short-term debt to reserves has declined and is currently estimated at about 9 percent.

Solomon Islands

Macroeconomic stability has been maintained since the arrival of the Australian-led Regional Assistance Mission to Solomon Islands (RAMSI) in 2003 to help end the civil conflict in the country. Law and order has been restored and economic growth averaged 6 percent in 2003-06. However, the economy is heavily reliant on logging and foreign aid, and per capita income is the lowest in the region. The new coalition government was formed in May 2006 and emphasizes a bottom-up approach to development with a focus on rural areas. A review of RAMSI operations has recently been endorsed by Parliament.

Non-logging real GDP grew by 6 percent in 2006, aided by high fish catch rates, increased production of palm oil, and an expansion in the services sector, especially construction. The high economic growth is expected to continue in 2007, led by accelerated logging (10 percent of GDP and 70 percent of exports). However, the current unsustainable logging rate implies a depletion of timber stocks by 2014. Inflation has eased to about 7 percent, due in part to slower credit growth.

A budget surplus of 4 percent of GDP in 2006 was reached, attributable to higher revenues and investment under-spending. For the first time since 2003, the reference prices of logs were raised, contributing to higher logging revenue. Nevertheless, higher recurrent expenditure mainly stemming from an increase in the public wage bill is expected to narrow the surplus to ½ percent of GDP in 2007.

The current account deficit widened to 26 percent of GDP in 2006, as fuel and investment-related imports rose. The deficit is anticipated to widen further to 40 percent of GDP in 2007, on the back of gold mine-related imports. Gross foreign reserves are expected to remain at reasonable levels—covering around 4 months of next year's imports of goods and services—thanks to continued strong official development assistance and FDI linked to the palm oil and gold mine projects.

Government initiatives to regularize debt and its current policy of no new borrowing have helped to reduce debt levels. Total public debt declined from 81 percent of GDP in 2005 to 73 percent in 2006, and is anticipated to continue to decline in the medium term. The external debt service ratio is expected to fall from 7 percent of exports in 2005 to 4 percent in 2006-07. However, the current debt burden remains at high risk of distress.

Timor-Leste

Since the outbreak of conflict in April 2006, Timor-Leste has experienced prolonged political volatility culminating in the recent presidential and parliamentary elections held in April/May and June 2007, respectively. Following a second-round run-off election, Jose Ramos Horta became the country's new President. While no single

party gained enough seats to form a government on its own, the President invited a coalition, the Parliamentary Majority Alliance (AMP), headed by former President Xanana Gusmao to form the fourth constitutional government which took office on August 8, 2007. The appointment of the AMP government sparked violent protests in the east of the country by supporters of the former ruling party, Fretelin, which claimed a right to govern as the party with the largest number of votes polled, though lacking partners to form a majority coalition. The political unrest appears to have abated following the initial unrest, though the situation remains fragile.

There are still an estimated 30,000 people displaced in camps in Dili and it is estimated that the recent unrest has displaced a further 4,000 people since August. Stabilizing the security situation is thus an immediate priority for the new government, and the United Nations has been requested to continue its presence in the country, backed by foreign troops.

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 transport 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 the public investment program has been hampered by delays in 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 23 percent (in 2004), while unemployment amongst youth (15-29 year age group) is estimated at 40 percent. National

youth unemployment is also high at about 25 percent, which is of particular concern as regards the potential for further unrest. The majority of the population depends on subsistence agriculture, and many face seasonal food shortages. According to a recent report by FAO/WFP, up to 220,000 Timorese will need food assistance during the lean months of October 2007 to March 2008.

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. Deposits accumulated in the Petroleum Fund had reached \$1.4 billion by June 30, 2007. The growth of petroleum revenue has meant that "sustainable" budget spending is presently estimated at over \$300 million per year. The new government has prepared a transitional budget for the remaining period of the current year, paving the way for a proposed change in the budget cycle to the calendar year starting January 2008. While this gives the government some room to formulate its spending priorities, the critical challenge will be to improve budget execution so that those spending priorities can be better realized.

The country thus faces the continuing challenge of rebuilding trust and addressing the security situation and the rule of law, while also addressing the basic humanitarian needs of the displaced population and the restoration of their normal lives. In parallel, there is a need to jump-start the economy, the primary mechanism for which in the short term will have to be through increased government spending. The Government will thus need to substantially improve its ability to execute spending priorities as reflected in its annual budgets. There is also an urgent need to develop a social safety net to provide support to the poor and vulnerable segments of the population.

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
Q3-2001	8.1	-0.1	3.9	3.4	-0.4	1.4	-6.6	-4.6	2.1	3.9
Q4-2001	7.6	-1.7	1.0	4.6	0.2	2.3	-6.2	-1.5	2.7	4.0
Q1-2002	8.8	-1.0	3.4	6.5	2.7	4.2	-0.5	1.3	4.5	5.8
Q2-2002	9.2	0.5	4.1	7.0	4.7	4.6	4.9	4.8	5.0	6.8
Q3-2002	9.3	2.8	5.2	6.8	7.1	3.3	6.5	6.7	5.8	7.4
Q4-2002	9.1	4.8	4.7	7.5	6.9	5.5	5.9	5.7	6.0	7.4
Q1-2003	10.8	4.1	4.9	3.8	6.3	4.8	3.1	3.6	6.9	7.3
Q2-2003	8.4	-0.9	5.2	2.2	5.9	4.3	-2.2	-0.2	6.6	5.1
Q3-2003	10.1	3.8	4.6	2.3	4.6	5.4	3.7	4.1	6.7	6.7
Q4-2003	10.4	4.7	4.2	4.1	6.5	5.1	7.8	6.3	8.3	7.6
Q1-2004	9.8	7.7	4.1	5.4	8.2	7.2	8.8	8.0	6.7	8.0
Q2-2004	9.6	12.0	4.4	5.7	7.9	7.1	12.5	9.2	6.6	8.4
Q3-2004	9.2	6.6	4.6	4.7	6.4	5.6	7.4	5.4	6.2	7.1
Q4-2004	9.5	7.9	7.1	3.3	4.9	5.8	6.9	2.5	5.7	6.9
Q1-2005	10.5	6.2	6.1	2.9	5.4	4.4	3.7	2.5	3.5	7.0
Q2-2005	10.5	7.1	5.9	3.4	3.9	5.0	6.1	2.9	4.7	7.3
Q3-2005	10.2	8.1	5.7	4.8	5.2	4.6	8.2	4.2	5.5	7.7
Q4-2005	10.4	7.0	5.0	5.5	5.5	5.4	8.3	6.6	4.3	8.0
Q1-2006	10.4	8.2	5.0	6.3	6.0	5.7	10.1	5.0	6.1	8.3
Q2-2006	11.5	5.6	5.0	5.1	6.1	5.5	8.0	4.7	5.0	8.3
Q3-2006	10.6	6.4	5.9	4.8	6.0	5.1	7.0	5.1	4.7	7.9
Q4-2006	10.4	6.9	6.1	4.0	5.7	5.5	6.6	4.0	4.3	7.6
Q1-2007	11.1	5.6	6.0	4.0	5.5	7.1	6.4	4.2	4.2	8.0
Q2-2007	11.9	6.6	6.3	5.0	5.7	7.5	8.6	5.1	4.4	8.6
Q3-2007	11.5	..	..	5.2	..	..	9.4	..	..	..

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

Appendix 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	5.0	4.9	4.5	7.5	4.2	6.6	4.1	5.1	4.9
	2006	5.5	5.9	5.4	5.0	6.9	5.0	7.9	4.7	5.4	5.5
	2006 H2	6.0	5.9	5.3	4.5	7.0	4.4	6.8	4.5	5.4	5.0
	2007 H1	6.1	5.6	7.3	4.3	6.3	4.5	7.6	4.6	5.7	5.1
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 H2	3.4	7.0	5.5	2.6	5.0	3.8	2.6	1.3	4.6	3.2
	2007 H1	4.7	10.8	6.0	1.1	6.0	4.1	4.2	2.3	5.1	3.9
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 H2	4.6	6.5	2.2	2.8	9.9	4.5	13.8	5.1	4.1	6.3
	2007 H1	7.3	8.1	9.3	-0.6	8.0	6.9	21.7	6.1	5.6	8.1
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 H2	7.1	8.5	6.1	5.8	10.1	11.4	0.3	7.7	6.9	9.2
	2007 H1	9.4	2.5	6.8	6.8	9.8	10.9	0.4	5.4	6.9	8.3

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

* Singapore exports are net exports.

Appendix Table 3: East Asia: Merchandise Export Growth

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

	2005	2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	May- 07	Jun- 07	Jul- 07	Aug- 07	Sep- 07
East Asia (9)	18.0	19.8	18.2	20.3	18.4	17.1	17.1	16.6	16.6	19.6	14.4	
SE Asia	13.1	16.3	16.7	17.7	15.2	12.5	12.0	14.2	10.3	7.8	7.7	
Indonesia	19.7	17.4	17.4	20.7	18.2	15.2	14.2	16.0	11.0	11.2	8.1	8.4
Malaysia	11.3	14.0	14.2	17.1	11.2	7.7	7.7	9.3	6.3	6.6	5.8	6.9
Philippines	4.0	14.9	19.7	16.6	7.5	9.2	4.2	6.1	1.5	4.3	-4.8	
Thailand	14.5	18.7	18.4	16.5	21.1	17.6	18.5	21.8	17.9	8.0	14.2	10.5
China	28.4	27.2	24.0	28.7	28.9	27.8	27.5	28.7	27.1	34.2	22.7	22.8
NIEs	12.7	15.5	14.2	14.8	11.2	10.7	10.3	8.2	10.2	12.1	9.5	5.8
Hong Kong	11.6	9.4	5.6	8.2	11.5	8.3	11.1	11.2	10.4	8.0	6.9	8.5
Korea	12.0	14.6	16.9	16.4	14.4	15.3	14.7	11.9	14.6	17.8	14.4	-0.4
Singapore	18.8	27.4	22.4	19.0	10.5	9.9	7.2	4.0	4.1	14.0	6.1	5.8
Taiwan	8.8	12.5	13.7	17.9	7.2	8.2	6.7	3.7	11.2	8.1	10.6	11.3
(China)												

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

	2000	2001	2002	2003	2004	2005	2006	Forecast 2007	Forecast 2008
East Asia	7.8	4.6	7.0	6.8	8.0	7.7	8.3	8.4	8.2
Developing East Asia	7.7	6.7	8.0	8.9	9.0	9.2	9.8	10.1	9.7
South East Asia	6.0	2.4	4.8	5.6	5.9	5.1	5.4	5.7	5.8
Indonesia	5.4	3.8	4.4	4.7	5.0	5.7	5.5	6.3	6.4
Malaysia	8.9	0.5	5.4	5.8	6.8	5.0	5.9	5.7	5.9
Philippines	6.0	1.8	4.3	5.0	6.4	4.9	5.4	6.7	6.2
Thailand	4.8	2.2	5.3	7.1	6.3	4.5	5.0	4.3	4.6
Transition									
China	8.4	8.3	9.1	10.0	10.1	10.4	11.1	11.3	10.8
Vietnam	6.8	6.9	7.1	7.3	7.8	8.4	8.2	8.3	8.2
Small Economies	2.9	4.0	3.7	5.1	6.6	7.8	7.2	6.4	6.2
Cambodia	8.8	8.0	6.5	8.5	10.0	13.5	10.8	9.5	8.0
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	7.1	7.6	7.1	7.9
Mongolia	1.1	1.3	4.2	6.1	10.8	7.1	8.4	8.6	7.5
Fiji	-1.7	2.0	3.2	1.0	5.3	0.7	3.6	-3.1	1.9
Kiribati	1.9	1.8	5.8	1.4	-2.9	-0.2	5.8	2.5	1.6
Marshall Islands	0.9	5.5	4.0	1.8	0.4	3.5	3.0	3.5	3.0
Micronesia, Fed. Sts.	8.4	0.3	1.4	3.3	-4.4	1.5	-0.7	1.8	1.5
Palau	0.3	1.3	-3.5	-1.3	4.9	5.5	5.7	5.5	4.8
Papua New Guinea	-2.5	-0.1	-0.2	2.2	2.7	3.4	2.6	5.2	4.0
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	6.1	5.4	4.2
Tonga	5.4	2.6	3.0	3.2	1.4	2.3	1.4	-3.5	0.8
Vanuatu	2.7	-2.6	-7.4	3.2	5.5	6.5	7.2	5.0	5.0
East Asia NIEs	8.0	1.1	5.3	3.2	6.1	4.9	5.5	5.1	5.1
Hong Kong (SAR)	10.0	0.6	1.8	3.2	8.6	7.5	6.9	5.8	5.2
Korea	8.5	3.8	7.0	3.1	4.7	4.2	5.0	4.8	5.1
Singapore	10.1	-2.4	4.2	3.1	8.8	6.6	7.9	7.4	6.4
Taiwan (China)	5.8	-2.2	4.6	3.5	6.2	4.1	4.7	4.6	4.6
Japan	2.8	0.2	0.1	1.8	2.7	1.9	2.2	2.0	1.8

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

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

	Mean Consumption (1993 PPP\$/month)	\$1 –a-day		\$2-a-day		Population (mill.)
		Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)	
EAP						
1990	61.56	29.6	456.9	68.8	1060.8	1542.6
1996	89.50	15.1	251.6	50.9	849.8	1668.5
1999	92.55	15.9	274.3	51.2	883.2	1723.4
2000	103.12	14.2	247.5	47.0	818.4	1740.3
2001	110.81	13.3	233.4	44.3	778.6	1756.0
2002	120.51	12.0	212.1	41.2	729.9	1772.0
2003	128.86	10.8	192.6	38.3	684.6	1787.3
2004	138.97	9.6	173.2	35.1	632.8	1802.2
2005	151.54	8.4	152.1	31.8	578.6	1817.2
2006	165.45	7.6	139.2	29.5	540.4	1832.2
2007	181.93	6.6	122.4	27.1	499.9	1847.5
2008	198.62	5.9	109.6	24.9	464.6	1862.8
EAP less China						
1990	74.46	24.1	96.3	65.4	261.2	399.2
1996	101.34	11.4	50.8	49.1	218.2	444.6
1999	91.16	12.0	55.9	55.8	259.6	465.6
2000	96.23	11.1	52.7	53.1	251.1	472.9
2001	97.91	10.5	50.4	51.9	249.0	479.7
2002	103.97	9.2	44.7	48.2	234.7	487.5
2003	107.39	8.2	40.4	45.2	223.9	495.0
2004	112.63	7.9	39.9	42.8	214.8	502.3
2005	117.96	6.7	34.3	39.9	203.3	509.5
2006	119.33	7.3	38.0	40.7	210.4	516.9
2007	127.27	6.0	31.6	37.4	196.3	524.4
2008	133.24	5.3	28.1	34.9	185.4	532.0
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	104.31	8.6	32.4	48.7	183.7	377.2
2002	111.64	7.0	26.9	44.7	171.2	383.4
2003	114.42	6.7	26.2	42.2	164.2	389.2
2004	118.96	6.9	27.3	41.0	161.7	394.8
2005	124.25	6.0	23.9	38.5	154.0	400.4
2006	124.59	7.1	28.9	40.4	163.9	406.1
2007	133.19	5.7	23.5	37.1	152.6	411.8
2008	139.01	5.0	21.0	34.8	145.3	417.7
Lower Income EA (Cambodia, Laos, PNG, Vietnam)						
1990	45.21	47.7	40.3	84.6	71.6	84.6
1996	64.65	24.6	23.3	69.4	65.5	94.4
1999	68.67	19.2	19.1	66.5	66.1	99.3
2000	71.68	18.1	18.3	64.9	65.5	100.9
2001	74.35	17.5	18.0	63.7	65.3	102.5
2002	75.68	17.0	17.7	61.0	63.5	104.1
2003	81.54	13.5	14.2	56.4	59.7	105.8
2004	89.40	11.7	12.6	49.4	53.1	107.5
2005	94.86	9.6	10.4	45.1	49.2	109.1
2006	100.06	8.2	9.1	42.0	46.5	110.8
2007	105.63	7.2	8.1	38.9	43.7	112.5
2008	112.16	6.2	7.1	35.2	40.2	114.3

Appendix Table 6: Poverty in East Asia - Country Estimates

	Mean Consumption (1993 PPP\$/month)	\$1 -a-day		\$2-a-day		Gini Coefficient	Population (mill.)
		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
2002	70.76	23.7	3.1	68.1	9.0	--	13.3
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	91.57	10.6	1.5	53.1	7.6	--	14.4
2007	96.92	9.3	1.4	50.5	7.4	--	14.6
2008	101.34	8.7	1.3	48.9	7.3	--	14.9
China							
1990	57.05	31.5	360.6	69.9	799.6	36.0	1143.3
1996	85.20	16.4	200.8	51.6	631.6	39.3	1223.9
1999	93.07	17.4	218.4	49.6	623.6	42.6	1257.9
2000	105.69	15.4	194.8	44.8	567.4	43.9	1267.4
2001	115.65	14.3	183.0	41.5	529.6	44.9	1276.3
2002	126.79	13.0	167.4	38.5	495.2	45.7	1284.5
2003	137.09	11.8	152.2	35.7	460.7	--	1292.3
2004	149.15	10.3	133.2	32.2	418.0	46.4	1299.9
2005	164.63	9.0	117.8	28.7	375.3	--	1307.7
2006	183.58	7.7	101.2	25.1	330.0	--	1315.4
2007	203.59	6.9	90.9	22.9	303.6	--	1323.1
2008	224.75	6.1	81.5	21.0	279.1	--	1330.9
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
2002	81.72	7.2	15.5	53.5	115.6	34.3	216.2
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	95.26	6.7	15.5	45.2	105.3	37.6	232.9
2008	99.82	5.9	14.0	42.6	100.7	--	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
2002	56.91	28.1	1.6	75.0	4.2	34.6	5.7
2003	58.86	25.8	1.5	73.3	4.3	--	5.8
2004	61.51	22.8	1.4	71.0	4.2	--	5.9
2005	64.52	19.8	1.2	68.4	4.2	--	6.1
2006	67.89	17.1	1.1	65.4	4.1	--	6.2
2007	71.10	14.4	0.9	62.3	4.0	--	6.4
2008	74.81	12.2	0.8	58.8	3.8	--	6.5

Appendix Table 6: Poverty in East Asia - Country Estimates (Continued)

	Mean Consumption (1993 PPP\$/month)	\$1 -a-day		\$2-a-day		Gini Coefficient	Population (mill.)
		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	49.1	22.7
2000	304.27	< 0.5	--	9.7	2.3	--	23.3
2001	304.71	< 0.5	--	9.7	2.3	--	23.8
2002	313.79	< 0.5	--	8.9	2.2	--	24.3
2003	330.54	< 0.5	--	7.7	1.9	--	24.7
2004	357.46	< 0.5	--	6.0	1.5	--	25.1
2005	382.91	< 0.5	--	4.6	1.2	--	25.5
2006	403.40	< 0.5	--	3.6	0.9	--	25.9
2007	420.62	< 0.5	--	2.8	0.7	--	26.2
2008	439.42	< 0.5	--	2.1	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
2002	63.43	39.2	2.1	70.4	3.8	--	5.4
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	63.57	39.6	2.4	70.5	4.2	--	6.0
2007	64.95	38.8	2.4	69.5	4.3	--	6.2
2008	65.60	38.4	2.4	68.3	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
2002	109.12	12.4	9.9	45.1	35.9	--	79.5
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	124.63	8.1	7.0	37.5	32.4	--	86.5
2008	130.38	6.9	6.1	35.2	31.0	--	87.9
Korea							
1990	301.09	< 0.5	--	< 0.5	--	29.9	42.9
1996	480.46	< 0.5	--	< 0.5	--	29.7	45.5
1999	450.06	< 0.5	--	< 0.5	--	30.0	46.6
2000	496.18	< 0.5	--	< 0.5	--	--	47.0
2001	520.51	< 0.5	--	< 0.5	--	--	47.4
2002	559.60	< 0.5	--	< 0.5	--	--	47.6
2003	549.12	< 0.5	--	< 0.5	--	--	47.8
2004	544.02	< 0.5	--	< 0.5	--	--	48.1
2005	557.48	< 0.5	--	< 0.5	--	--	48.3
2006	583.01	< 0.5	--	< 0.5	--	--	48.5
2007	608.66	< 0.5	--	< 0.5	--	--	48.7
2008	637.27	< 0.5	--	< 0.5	--	--	48.9

Appendix Table 6: Poverty in East Asia - Country Estimates

	Mean Consumption (1993 PPP\$/month)	\$1 -a-day		\$2-a-day		Gini Coefficient	Population (mill.)
		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
2002	139.38	2.4	1.5	27.7	17.6	42.2	63.5
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	158.61	1.8	1.2	23.1	15.2	--	65.7
2007	163.88	1.5	1.0	21.4	14.1	--	66.2
2008	169.38	1.3	0.8	19.6	13.1	--	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
2002	78.67	13.6	11.3	58.2	48.1	37.5	82.6
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	112.65	4.0	3.4	32.9	28.1	--	85.3
2008	120.26	3.0	2.6	28.6	24.7	--	86.5

Notes for Appendix Tables 8 and 9:

The poverty lines in Tables A and B 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. For years for which household surveys are available, poverty estimates are directly based on the survey data. For non-survey years, either historical macroeconomic data from national statistical agencies or projections based on World Bank macroeconomic forecasts are used. 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 7: 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	20.4	5.6	6.7
Non-Energy Commodities	-0.8	0.4	-1.4	-9.1	5.3	10.2	17.5	13.4	0.0	24.6	13.0
Agriculture	-1.9	0.8	-5.7	-9.1	8.6	9.6	10.5	7.9	24.6	12.0	10.7
Cocoa	-7.3	4.0	-20.2	18.0	66.4	-1.5	-11.5	-0.8	3.5	19.4	-2.1
Coffee, arabica	-3.6	12.6	-16.2	-28.5	-1.2	4.3	25.3	42.7	-0.4	3.1	-2.3
Coconut oil	-1.4	10.6	-38.9	-29.4	32.4	11.0	41.4	-6.6	-1.6	40.1	-2.4
Palm oil	-3.0	12.3	-28.8	-7.9	36.6	13.6	6.3	-10.4	13.3	52.6	-2.4
Rice, Thai, 5%	0.8	2.1	-18.5	-14.6	11.0	3.0	20.3	20.4	6.5	5.8	2.3
Sugar, world	16.4	-2.8	30.6	5.6	-20.3	3.0	1.1	37.8	49.5	-31.9	9.2
Logs, Malaysia	1.9	3.4	1.5	-16.3	2.7	14.5	5.4	3.0	17.9	12.8	3.7
Sawnwood, Malaysia	4.1	-0.1	-1.0	-19.1	9.4	4.6	5.5	13.2	13.6	8.1	4.9
Rubber, RSS1, Singapore	-1.7	0.5	6.2	-13.8	33.0	41.5	20.4	15.2	40.3	4.4	-2.5
Metals and minerals	2.9	-2.6	12.6	-9.6	-3.1	12.7	37.1	26.7	0.0	50.9	14.0
Tin	-6.7	-0.7	0.6	-17.5	-9.5	20.5	73.9	-13.3	19.0	57.7	-13.4
Copper	4.3	-4.1	15.3	-13.0	-1.2	14.1	61.1	28.4	82.7	7.1	-9.7

Source: World Bank DEC Prospects Group. Projections as of 9/21/07.

Appendix Table 8: East Asia: Exchange Rates (LCU/\$)

	China	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan, China	Thailand	Yen
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	118.48
Mar-2007	7.73	9118.00	940.30	3.46	48.26	1.52	33.09	35.02	117.65
Apr-2007	7.71	9083.00	929.40	3.42	47.51	1.52	33.28	34.77	119.60
May-2007	7.65	8828.00	929.90	3.40	46.27	1.53	33.02	34.65	121.62
Jun-2007	7.62	9054.00	926.80	3.45	46.33	1.53	32.74	34.54	123.23
Jul-2007	7.57	9186.00	923.20	3.45	45.61	1.51	32.81	33.81	118.95
Aug-2007	7.56	9410.00	939.90	3.50	46.70	1.52	33.00	34.33	116.20
Sep-2007	7.51	9137.00	920.70	3.42	44.97	1.49	32.58	34.27	114.80
Oct-2007	7.47	9103.00	907.40	3.34	43.95	1.45	32.41	34.00	115.34

Appendix Table 9: East Asia: Foreign Reserves Minus Gold (US\$ Billion)

	China	Indonesia	Malaysia	Philippines	Thailand	Hong Kong (SAR)	Korea	Singapore	Taiwan, China	Total
Dec-1997	142.8	17.4	20.8	7.3	26.3	92.8	20.4	71.3	83.5	482.5
Dec-1998	149.2	23.5	25.6	9.3	28.8	89.7	52.0	75.1	90.3	543.4
Dec-1999	157.7	27.3	30.6	13.3	34.1	96.2	74.0	77.0	106.2	616.4
Dec-2000	168.3	29.4	29.5	13.1	32.0	107.5	96.1	80.2	106.7	662.9
Dec-2001	215.6	28.0	30.5	13.5	32.4	111.2	102.8	75.7	122.2	731.7
Dec-2002	291.1	32.0	34.2	13.3	38.1	111.9	121.3	82.2	161.7	885.9
Dec-2003	408.2	36.3	44.6	13.7	41.1	118.4	155.3	96.2	206.6	1,120.3
Dec-2004	614.5	36.3	66.4	13.1	48.7	123.5	199.0	112.6	241.7	1,455.9
Dec-2005	821.5	34.7	70.2	15.9	50.7	124.2	210.3	116.2	253.3	1,697.1
Dec-2006	1,068.5	42.6	82.2	20.0	65.3	133.2	238.9	136.3	266.1	2,053.0
Jul-2007	1,387.2	51.9	98.2	25.0	72.2	137.0	254.8	147.0	266.3	2,439.5
Aug-2007	1,410.6	51.4	96.5	27.4	72.6	138.0	255.2	147.6	261.4	2,460.7
Sep-2007	1,433.0	52.9	97.9	27.9	78.7	140.8	257.2	152.5	262.9	2,503.8

Source: Haver Analytics

Table 10 a - East Asia - Balance of Payments 2003-07 - Percent of GDP

	Overall Balance*				Current Account				Capital Account**			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
				H1				H1				H1
East Asia	8.7	5.5	7.1	12.1	4.5	5.7	7.4	8.9	4.2	-0.2	-0.3	3.2
China	10.7	9.2	9.4	19.2	3.5	7.0	9.0	11.8	7.1	2.2	0.4	7.5
S.E. Asia	4.6	1.0	4.6	7.1	3.3	2.1	5.2	6.0	1.3	-1.0	-0.6	1.1
Indonesia	0.0	-0.6	2.2	4.0	0.6	0.1	2.7	2.4	-0.6	-0.6	-0.6	1.6
Malaysia	17.5	2.8	7.7	18.5	11.9	14.6	16.3	14.7	5.6	-11.8	-8.7	3.8
Philippines	-0.6	2.8	3.5	5.2	1.6	1.9	4.2	5.2	-2.3	0.9	-0.8	0.0
Thailand	4.7	1.2	7.1	5.1	1.7	-4.5	1.6	5.7	3.0	5.6	5.5	-0.6
NIEs	7.8	1.9	4.5	2.8	6.5	5.5	5.6	5.7	1.3	-3.7	-1.1	-2.9
Hong Kong	3.1	0.4	4.7	3.2	9.5	11.4	10.8	11.9	-6.4	-11.0	-6.1	-8.6
Korea	6.4	1.4	3.2	2.6	4.1	1.9	0.6	0.0	2.3	-0.5	2.6	2.6
Singapore	15.2	3.1	15.2	10.6	20.1	24.5	27.5	31.0	-4.9	-21.4	-12.3	-20.4
Taiwan, China	10.6	3.3	3.5	-0.1	5.6	4.5	6.7	5.7	5.0	-1.2	-3.2	-5.7
Median for 9	6.4	2.8	4.7	5.1	4.1	4.5	6.7	5.7	2.3	-0.6	-0.8	0.0

* Equals change in foreign reserves..**Includes errors and omissions.

Table 10 b - East Asia – Capital Account Components - 2003-07 - Percent of GDP

	Net FDI				Net Portfolio				Net Other Capital			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
				H1				H1				H1
East Asia	1.5	2.2	1.7	2.5	-0.2	-0.9	-2.8	-0.6	1.5	-0.6	0.4	0.7
China	2.7	3.0	2.2	4.0	1.0	-0.2	-2.5	-0.3	2.0	-0.2	0.5	2.9
S.E. Asia	1.1	2.3	1.8	0.7	2.3	1.5	1.8	4.3	-2.0	-3.1	-3.9	-3.8
Indonesia	-0.6	1.8	1.1	0.3	1.7	1.5	1.0	3.6	-0.4	-3.3	-1.3	-1.9
Malaysia	2.2	0.8	0.0	0.3	7.1	-2.9	2.4	13.9	-5.3	-5.1	-9.8	-10.6
Philippines	0.1	1.2	1.9	-2.8	-1.7	3.6	2.3	1.9	0.0	-3.0	-5.8	1.3
Thailand	3.6	4.8	4.4	3.7	1.9	3.5	2.2	-0.2	-3.2	-1.1	-2.9	-5.1
NIEs	0.0	1.0	0.7	0.9	-3.3	-3.1	-5.7	-3.9	2.6	0.0	2.5	-0.5
Hong Kong	-7.0	3.6	-0.3	3.4	-23.7	-17.7	-17.5	-1.9	18.6	2.0	7.4	-11.4
Korea	0.7	0.3	-0.4	-0.8	1.3	-0.2	-2.5	-2.3	-0.6	0.9	5.4	6.0
Singapore	10.9	8.5	11.8	11.3	-6.6	-7.1	-10.7	-0.7	-11.3	-17.7	-16.7	-30.3
Taiwan, China	-1.6	-1.3	0.0	-0.2	-1.6	-0.9	-5.4	-10.3	5.4	3.0	0.1	1.0
Median for 9	0.7	1.8	1.1	0.3	1.0	-0.2	-2.5	0.3	-0.4	-1.1	-1.3	-1.9

Source: National sources and Haver Analytics.

Appendix Table 11: NPLs in the Commercial Banking System of the Crisis-Affected Countries
(% of total loans)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007		
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep
China						23.1	17.9	13.2	8.9	7.5	6.6	..	..
Indonesia a/	7.2	48.6	32.9	18.8	12.1	7.5	6.8	4.5	7.6	6.1	6.0	5.8	..
Korea b/	6.0	7.3	13.6	8.8	3.3	2.4	2.2	2.0	1.3	0.9	0.9	0.8	..
Malaysia c/	..	10.6	11.0	9.7	11.5	10.2	9.0	7.5	5.8	4.8	4.4	4.3	4.1
Philippines d/	4.7	10.4	12.3	15.1	17.3	15.0	14.1	12.7	8.2	5.7	5.3	5.2	..
Thailand e/	..	45.0	39.9	19.5	11.5	18.1	13.9	11.6	8.3	8.1	7.5	7.8	..

(a) Excludes IBRA's AMC; end-3Q 2006 data is as of Aug. (b) Excludes KAMCO/KDIC. (c) Excludes Danaharta. This NPL series, used by Bank Negara Malaysia, 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 under BSP Circular 351 which allows banks to deduct bad loans with 100 percent provisioning from the NPL computations; (e) Excludes transfers to AMCs. (The jump in headline NPLs in December 2002 was a one-off increase, reflecting a change in definition and did not affect provisioning).

Special Focus

Agriculture for Development in East Asia: Lessons from the World Development Report 2008

Introduction

The pace of economic growth and poverty reduction in the East Asia and Pacific (EAP) region during the past decades has been unparalleled. Rapid growth in agriculture has been credited with kick starting this process, fostering the acceleration of industrial growth in its early stages, and serving as a major force for poverty reduction.²⁶ Today, however, economic growth in most EAP countries is largely driven by industry and services, going hand in hand with increasing urbanization, while agriculture makes a much smaller contribution – only 5.3 percent of overall East Asian growth in 1993-2005. Yet, despite some neglect during the 1990s, agriculture is once again becoming important on the development agenda, with China, for example, tripling its spending on agriculture and rural development between 2000 and 2006.

One reason for the renewed attention to agriculture is that, as growth outside agriculture has taken off, the gap between rural and urban incomes has widened, leaving behind many people in rural areas generating social and political tensions. Today more than 90 percent of the 1\$-day poor in EAP live in rural areas, the vast majority working in agriculture. How to overcome the rural-urban divide while sustaining overall economic growth is one of the core questions addressed in the World Bank's most recent World Development Report 2008 "Agriculture-for-Development".

The first section of this Special Focus outlines the scale of the rural-urban divide, the forces that are driving it and the broad scope of different approaches to resolve this problem. It notes that historically there has been a temptation for countries to turn to agricultural protection and subsidies to tackle the divide, something that is also being observed in East Asia today. The report suggests that there may be more effective ways of reducing rural poverty and narrowing rural-urban income gaps. The two pillars of such an approach are, on the one hand, facilitating migration and more effective absorption of rural labor in the urban economy and, on the other, promoting faster rural income growth, something that is especially effective in reducing poverty. Rural income

²⁶ This was most recently observed in China, where rapid growth in agriculture in the early 1980s—thanks to the household responsibility system, the liberalization of markets and rapid technological change—was largely responsible for the precipitous decline in the official rural poverty rates, from 33 percent in 1978 to 11.1 percent in 1984 and 3.7 percent in 2000.

growth, in turn, requires attention to both agricultural development and development of the rural non-farm economy. Globalization and innovations in technology and institutions are creating exciting new growth opportunities for agriculture especially in high value products such as meat, fruit and vegetables. But there are also new challenges, in how to link poor farmers to sophisticated global supply chains, as well as from growing environmental pressures.

The second part of the Special Focus then takes up the emerging policy agenda in East Asia in more depth. The World Development Report proposes a comprehensive three-pronged rural development agenda that balances fostering agricultural growth (including in both new high value crops and staples), generating rural nonfarm employment and poor area development programs. It emphasizes decentralized, participatory, and multi-sectoral approaches for implementation. Investment in rural public goods (such as rural infrastructure, demand-driven research and extension services, rural education and training), improvements in the rural investment climate and greater involvement of the private sector (in part through public-private partnerships) are some of the entry points through which this three-pronged rural development agenda can be pursued.

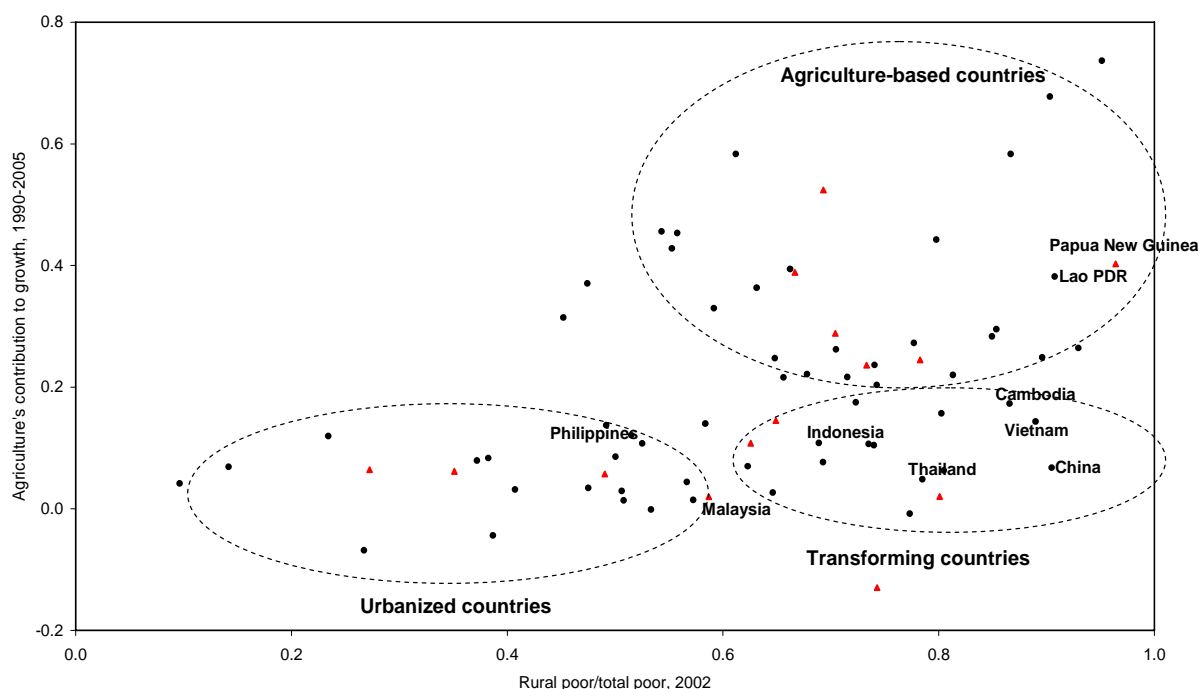
1. What can agriculture (still) do for development in East Asian countries?

1.1. The growing rural-urban divide

The World Development Report categorizes economies into three groups based on the share of aggregate growth originating in agriculture and the proportion of poor people (at the \$2-day level) in rural areas: agriculture-based, transforming and urbanized economies (Figure 1). Most EAP countries are "transforming economies", where agriculture is no longer a major source of economic growth, but poverty remains overwhelmingly rural, some 93 percent in the region as a whole. (Some exceptions include Lao PDR and Papua New Guinea, where agriculture is still a major source of growth. In the Philippines agriculture does not only contribute less to overall growth, but poverty is also more urbanized.)

A distinguishing feature of the transforming economies is a widening gap between rural and urban incomes. This is implicit in the well known structural transformation graph (Figure 2). As countries

Figure 1: In most of East Asia poverty remains overwhelmingly rural, but agriculture is no longer a major source of growth.



Source: World Development Report 2008.

develop, the share of agriculture in GDP and employment declines, but the share of agriculture in employment remains on average about twice as large as the share of GDP in agriculture, converging only late in the development process (at about US\$10,000 per capita). As a result, poverty remains concentrated in agriculture and rural areas.²⁷ Micro data confirm this picture of a widening gap between rural and urban incomes. Overall, the ratio of rural-to-urban poverty in EAP increased from about 2:1 to 3.5:1 between 1993 and 2002. This happened while absolute (1\$-day) poverty declined massively—by almost 200 million people.

The persistent concentration of (absolute and relative) poverty in agriculture and rural areas reflects, among other things, deep inertia in people's occupational characteristics. Migration out of agriculture to urban areas is often hampered by lack of information, costs, skill gaps, aging, and family and cultural ties. In some countries this slow transition of labor out of agriculture has been exacerbated by longstanding policy impediments to rural labor mobility, as in China, where the shares of agriculture in employment are still quite high (65 percent

²⁷ This holds definitely in relative terms and to the extent that the income gap is not compensated by off-farm incomes.

in 2003) compared with other countries at similar levels of development.

1.2. The pitfalls of agricultural protection and subsidies

Historically, there have been numerous attempts to reduce rural poverty and address the rising rural-urban income gap by increasing agricultural protection and subsidies. The regularity with which countries have shifted from taxing (especially export) agriculture to finance industrial development at low levels of development, to subsidizing and protecting agriculture as they grew richer, is striking. Agricultural policymaking in the EAP countries is following the same pattern (Figure 3).²⁸ While still taxing its agriculture heavily in the early 1980s, China abolished all direct taxation of agriculture in 2006 and provided US\$ 5.6 billion to subsidize farmers in

²⁸ The nominal rate of assistance to farmers is defined as the price of their product in the domestic market (plus any direct output subsidy) less its price at the border, expressed as a percentage of the border price (adjusting for transport costs, quality differences, etc.). Where important, further corrections are made to adjust for distortions on the input side (input subsidies and other interventions affecting the input price) and in the foreign exchange rate.

Figure 2: The transition of labor out of agriculture lags the restructuring of the economies away from agriculture, resulting in a widening rural-urban divide.

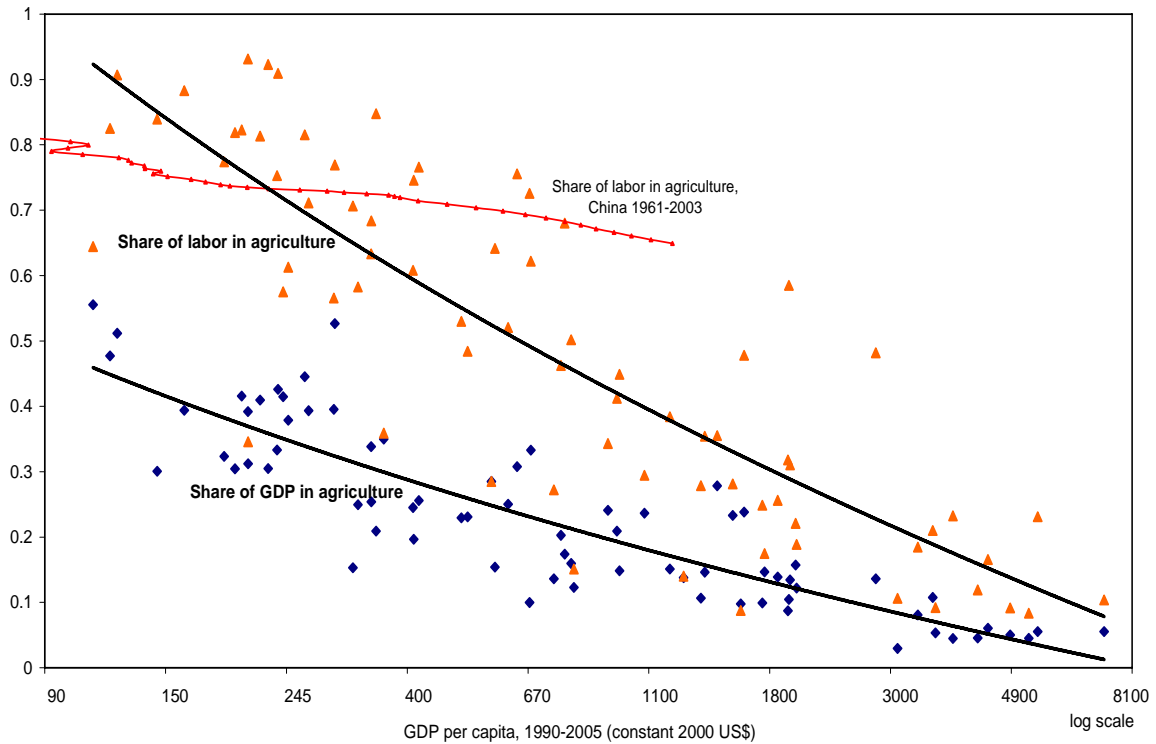
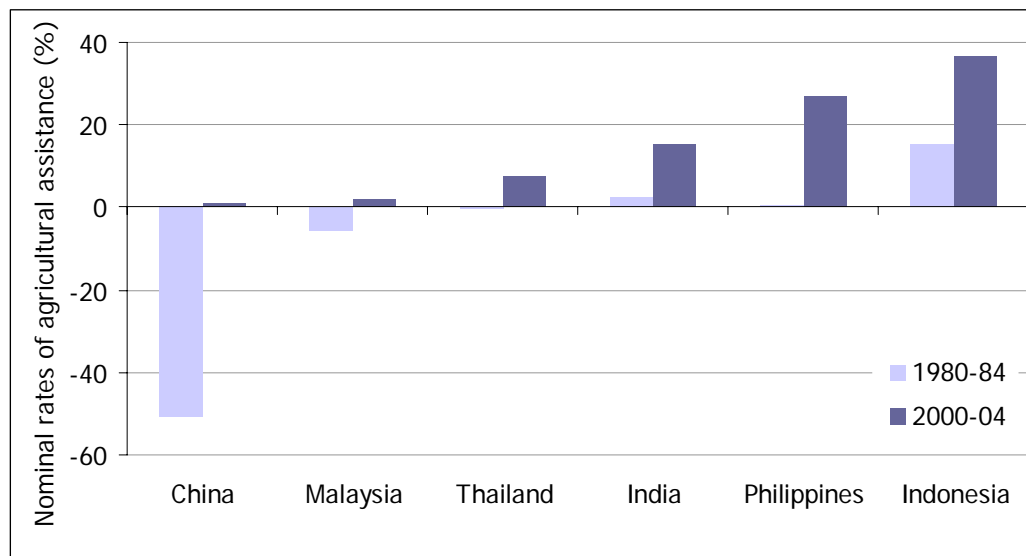


Figure 3: Countries go from agricultural taxation to protection as they get richer



Source: Anderson (forthcoming).

2007. The Philippines and Indonesia have evolved from relatively neutral agricultural price and trade regimes in the early 1980s to substantially protected ones today.

The frequent turn to protective agricultural policy instruments in fighting the rural-urban divide is politically rational. Price supports are often preferred by politicians over agricultural income supports because self-sufficiency sometimes appeals to voters, farmers fear a visible “welfare” stigma, and information on the cost of such policies is not readily available. The benefits from public investments in agricultural productivity, on the other hand, such as agricultural research and development (R&D) and rural infrastructure, are less immediate, less visible and thus less appealing to policy makers.

Yet, protective agricultural trade policies often impose high economic costs and are sometimes ineffective. In 2004 Indonesia placed a ban on rice imports as a way of supporting producer prices. But later the ban contributed to an increase in the poverty headcount from 16 percent in 2005 to 18 percent in 2006, at which point it had to be relaxed. The protection of food prices benefited the medium and larger farmers at the expense of the poor consumers, including most small farmers, who are typically net food buyers. Subsidizing private agricultural inputs such as water and fertilizer is usually also regressive, benefiting the larger farmers most. Tackling the growing rural-urban divide without imposing high economic costs that may impede economic growth remains one of the fundamental challenges facing East Asian economies today.

1.3. Urbanization and rural income growth: two pillars for growth with equity

One way to accelerate faster absorption of rural labor in the urban economy is by investing in urban infrastructure, human capital and labor market policies such as vocational training, transport services and job matching. The divergent patterns in urbanization and poverty reduction in the Philippines and Thailand (Box 1) suggest, however, that the pace and pattern of urbanization (mega cities versus secondary towns) are equally important and that urbanization efforts must be matched by investments in rural development for rapid poverty reduction. Urbanization by itself will only stimulate rural-urban migration and exacerbate problems of urban unemployment, congestion and urban poverty.

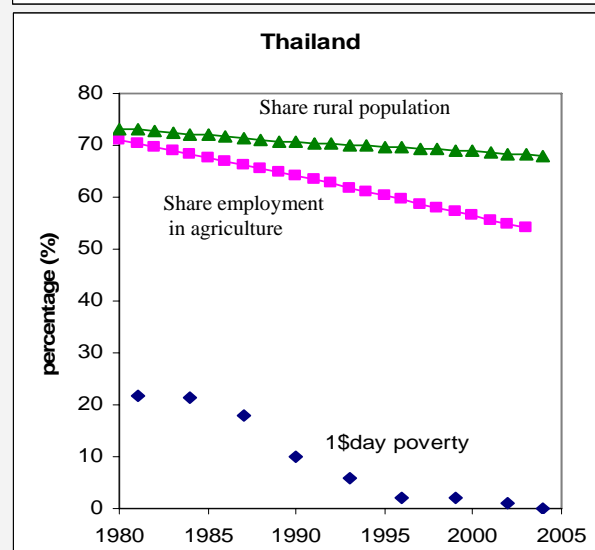
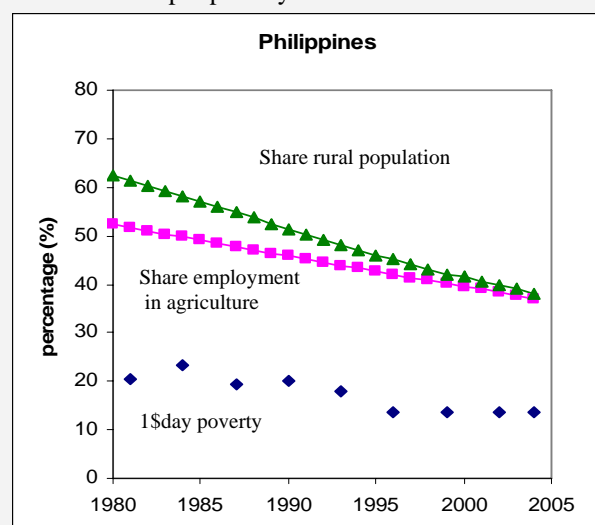
Box 1: Rapid urbanization and slower poverty reduction in the Philippines; rural diversification and rapid poverty reduction in Thailand.

In the early 1980s, Thailand and the Philippines were at similar levels of development (around US\$ 900 GDP per capita) and poverty (around 20 percent of people below the 1\$-day poverty line). The Philippines urbanized rapidly, with only 38 percent of the population in rural

areas by 2004, compared with 62 percent in 1984. Labor moved out of agriculture largely through urban migration. One-dollar-a-day poverty declined to 13.5 percent in 2004; the Gini coefficient of income inequality increased from 0.41 to 0.44.

In Thailand, urbanization was much slower—the rural share of the population declined only 5 percent points from 73 percent in 1984 to 68 percent in 2004. Labor moved more rapidly out of agriculture largely into the rural nonfarm economy. By 2004, 1\$-day poverty had virtually disappeared; the Gini coefficient decreased from 0.45 to 0.42. Throughout this period the share of government expenditures going to agriculture was 50 percent higher in Thailand than in the Philippines.

While many factors underpin these divergent patterns, the contrasting experience of Thailand and the Philippines illustrates that *rapid* urbanization is neither necessary nor sufficient for rapid poverty reduction.



Rural income growth in East Asia between 1992 and 2003 accounted for three quarters of the 13 percentage point decline in the \$1 a day poverty rate; rural-urban migration for one fifth, and urban income growth for about 5 percent. While this decomposition does not account for the indirect effects of urbanization on rural incomes through urban-rural remittances and tightening rural labor markets following urban migration, the share of rural income growth in explaining the poverty decline is so large that it is safe to assume that it overwhelms these indirect effects. Moreover, the decomposition assumes that migrants have the same characteristics as the rest of the population, while they are usually less poor and more entrepreneurial, resulting in an overly optimistic attribution of the poverty decline to migration.

Econometric decompositions from China (Ravallion and Chen, 2007) indicate that rural income growth accounts for all the poverty reduction over the past decades. This is consistent with econometric evidence from other transforming and urbanized countries (respectively India and Mexico). Complementing urbanization policies with those that foster rural income growth holds most promise.

1.4. Both agriculture and the rural non-farm sector drive rural poverty reduction

The potential of agriculture to contribute to rural poverty reduction differs across countries. In China, where land is relatively equally distributed, the reduction in poverty was 3.5 times higher from GDP growth originating in agriculture than from GDP growth originating in industry or services (Ravallion and Chen, 2007). Rapid agricultural development is likely to remain an important pathway out of poverty for many of Vietnam's poor as well (van de Walle and Cratty, 2004). Econometric evidence from the Philippines also shows that growth in agriculture is more poverty reducing than growth in industry (Balicasan and Fuwa, 2004).

But the rural nonfarm sector is also growing rapidly. Rural households in Vietnam and Indonesia obtained 57 percent of their income outside agriculture in 1998 and 2000 respectively. In Indonesia (as in India), growth in rural services was estimated to contribute at least as much to rural poverty reduction as growth in agriculture (Suryahadi, Suryadarma, and Sumarto, 2006; Ravallion and Datt, 1996). Rural nonfarm employment growth is often related to agricultural growth through forward linkages. Rural trading and transport, often of food, make up about 30 percent of rural nonfarm employment. As agriculture grows and diets diversify, it further generates employment in the agro-processing industry. Urban overcrowding and higher urban labor costs have also stimulated urban-to-rural subcontracting, as in China's rapidly developing town and village enterprises. Many of the public investments necessary to

foster the rural non-farm economy, such as a sound rural investment climate, rural infrastructure and education, also benefit agriculture and vice versa.

1.5. Changing food habits open up exciting new growth opportunities for agriculture

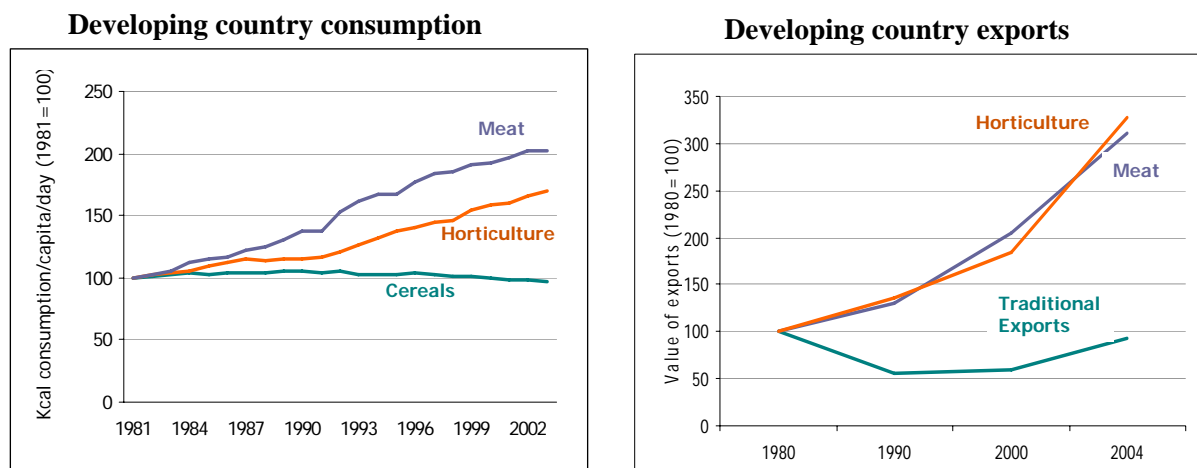
Rising incomes and urbanization are shifting the composition of domestic food expenditure from basic and unprocessed staple foods to meat, horticulture and processed foods (Figure 4). In 2005, Indonesians spent on average about as much on rice (and other cereals/tubers) as on prepared foods—one fifth, down from 39 percent in 1980. Fruits and vegetables are one of the fastest growing agricultural markets in East Asia, with fruit and vegetable production increasing respectively by 7.3 and 6.1 percent a year during 1980-2004. Relative to cereals, horticulture increases the returns to land about 10-fold and requires twice as much labor input per hectare. It generates more off-farm jobs in processing, packaging, and marketing. The EAP countries are also undergoing a livestock and aquaculture revolution. Production of meat (especially pork and chicken, which make up almost 80 percent of total meat production) increased by 6.7 per cent per year during 1980-2004. Aquaculture increased at an annual rate of 10 percent since the mid 1980s.

Globalization and changing consumer tastes for specialty products and year-round supplies of fresh produce in industrial countries have also opened up new export opportunities (Figure 4). In 2005, China emerged as the fourth largest world exporter of apples (in US\$) in the world. The rising demand for feed grains reinforced by the shift to intensive (stall fed) livestock production provides opportunities for countries with abundant land resources (Laos and Cambodia). Biofuels based on oil palm are being actively explored by Indonesia and Malaysia (although the profitability of some current production methods, environmental issues, limited employment generation, and the prospect of alternative technologies based on cellulose rich materials such as crop residues and wood chips, make biofuels' future growth quite uncertain).

1.6. But new (and old) agriculture also face new challenges

Economies of scale in processing and marketing, and consumer demands for quality are spurring the vertical integration of supply chains led by specialized agribusinesses and supermarkets. Helping poorer farmers connect to these new markets poses an important policy challenge. In Indonesia, the share of fresh fruit and vegetables retailed in supermarkets is still low (10-15 percent), but up from almost zero a decade ago. A rapid penetration by supermarkets is likely at the doorstep of the EAP countries, as in Latin America where supermarkets exceed 50 percent of retail food sales in many countries. Poorer smallholders also face challenges

Figure 4: Diet diversification out of staples provides new growth opportunities for agriculture in developing countries, at home and abroad.



Source: World Development Report 2008.

in connecting to the growing market for meat and dairy because of economies of scale in intensive chicken and pork production and quality concerns. Horticulture and intensive animal husbandry bring new environmental challenges. Horticulture already accounts for 28 percent of global pesticide consumption and the growing concentration of animals near urban and peri-urban areas increases waste pollution and the incidence of diseases such as tuberculosis and avian flu.

There are also rising uncertainties regarding future world food supplies and prices. For the first time in decades, projection models predict a slight annual increase in world food prices till 2030. Most recently, maize, wheat, and rice prices have gone up by 35 to 53 percent compared to 2004, in part due to biofuel policies in the United States and the European Union. In most EAP countries (except Lao and Cambodia) the land frontier has been closed, while population growth and urbanization continue to reduce the area available for agriculture. Cereal yield gains from the Green Revolution package of modern varieties, fertilizers and irrigation have been largely materialized. Improved varieties of cereals are already planted on more than 80 percent of the cultivated area. The experimental rice yield potential has been growing by less than 1 percent a year over the last decade, down from 2-3 percent during 1960-1985. With an estimated 500 million people in EAP living in absolute water scarcity, maintaining irrigated food production through large extractions of water from rivers or the ground is unsustainable. Climate change, high energy prices and the related expansion of biofuels using agricultural feedstocks, further add to the uncertainties. Increased investment in technological innovations and environmentally sustainable soil and water management

practices will be necessary to sustain EAP's historically stellar cereal yield growth.

2. East Asia's emerging agriculture-for-development agenda

The objective of East Asian policy makers is to reduce rural poverty and overcome rural-urban income disparities through policies that are feasible, effective and environmentally sustainable. Three important policy entry points include: 1) increasing agricultural productivity by going beyond the Green (staple crop) Revolution towards more sustainable and high value agriculture, 2) promoting off-farm employment and urban migration, and 3) better assisting subsistence farmers and populations in lagging areas. Avoiding pressures to introduce new agricultural protection and input subsidies and properly align the price of environmental inputs such as water with their real costs remain a challenge.

2.1. Moving beyond the Green Revolution to more sustainable and high value agriculture

Four challenges in increasing agricultural productivity are: 1) expanding the share of high value agriculture, which yields higher returns per area than cereals, while continuing to increase the absolute output of staple crops; 2) increasing staple crop yields especially through more investment in demand driven agricultural R&D and extension systems; 3) strengthening farmers' risk management capacity, especially given concerns about climate change; 4) making agricultural production systems environmentally sustainable.

Table 1: Public and private options for strengthening farmer links to the market

Issue	Public sector		Private sector
	Public investments	Policy environment	
Lack of access to markets	<ul style="list-style-type: none"> Invest in education, rural infrastructure (roads, electricity, irrigation); support formation of producer organizations 	<ul style="list-style-type: none"> Liberalize domestic trade; foster development of input and credit markets 	<ul style="list-style-type: none"> Assist farmers in forming producer organizations
Weak technical capacity	<ul style="list-style-type: none"> Support market-oriented extension 	<ul style="list-style-type: none"> Foster the environment for private extension participation 	<ul style="list-style-type: none"> Provide extension and key inputs to farmers
Meeting quality standards	<ul style="list-style-type: none"> Support farmer training on good agricultural practices for quality enhancement and food safety 	<ul style="list-style-type: none"> Establish grades and standards 	<ul style="list-style-type: none"> Supply inputs and train farmers on quality management and food safety
Meeting contract conditions	<ul style="list-style-type: none"> Train firms in contract design and management; train farmers on their rights and obligations 	<ul style="list-style-type: none"> Foster institutions for dispute resolution; strengthen producer organizations 	<ul style="list-style-type: none"> Foster trust; develop contracts that are self-enforcing
Farmer exposure to risk	<ul style="list-style-type: none"> Development of commodity and futures exchanges; train firms on use of market instruments to hedge risk 	<ul style="list-style-type: none"> Create enabling environment for insurance market 	<ul style="list-style-type: none"> Use contracts that share risk equally among parties; assist farmers to access insurance

Source: World Development Report 2008.

Expanding high value agriculture and opportunities for smallholders

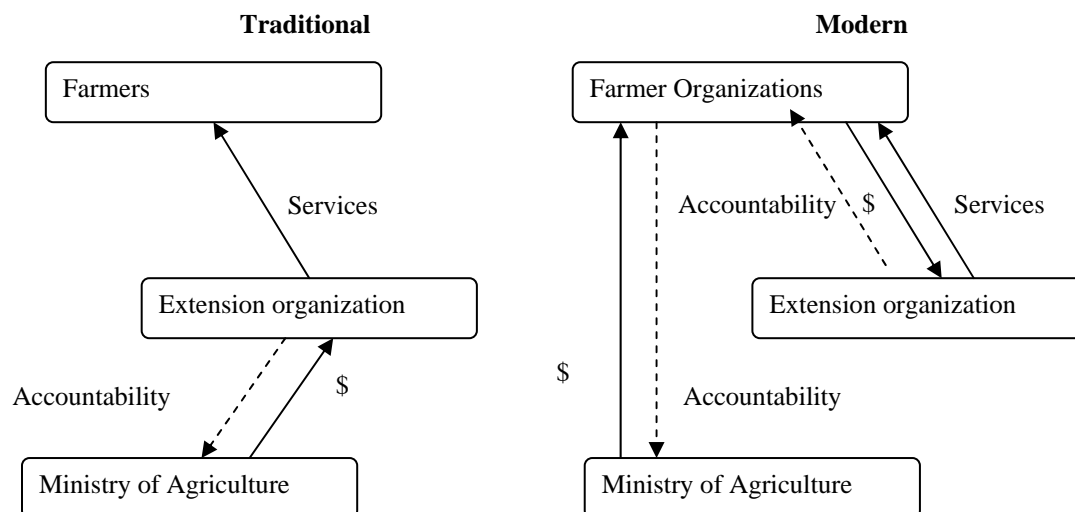
Success in high value agricultural markets requires a good investment climate as well as good regulatory institutions to ensure compliance with international sanitary and phytosanitary (SPS) standards (an issue driven home by China's recent problems with food safety standards). This is an issue of great concern to East Asian economies. Several studies and projects have been initiated (as in Vietnam and Laos) to achieve SPS compliance through joint public and private efforts, with the public sector focusing on standards, food safety legislation and disease surveillance and the private sector looking at training and monitoring compliance. Despite worries that the cost of compliance disadvantages developing countries studies suggest they tend to be small, with fixed costs 0.5 to 5 percent of three-to-five year exports and variable costs only 1 to 3 percent of annual exports. Developing countries can also draw support from the Standards and Trade Development Facility to strengthen local capacity to meet the SPS standards.

Poorer farmers often find it hard to exploit opportunities in high value agriculture because of lack of education, inadequate access to irrigation water free of contaminants, and poor access to key infrastructure and capital goods, such as cold chains, greenhouses, packing

sheds, roads, and vehicles, all things that pose important threshold investments. There are a number of things that the government and the private sector can do to help smallholders meet the requirements of supermarkets and other coordinated supply chains, mainly by fostering institutional innovations such as contract farming, the promotion of producer organizations, and public-private partnerships (Table 1). Government extension agents can for example join forces with supermarket field staff to strengthen the technical capacity of farmers to acquire inputs, obtain certification, and improve quality and food safety. Normincorp, a marketing company in the Philippines, links farmers directly to buyers for a 6 percent facilitation fee. It procures vegetables for the fast-food industry, supermarkets and vegetable processors from production clusters of 10 small farmers allied with a commercial lead farmer responsible for overall quality control. The clusters commit themselves to undertake a common production and marketing plan.

Increasing staple crop yields through investment in agricultural R&D and extension

Despite high estimated returns to agricultural R&D—on average 50 percent in Asia across 222 studies—agricultural research remains largely underfunded. Public spending on agricultural R&D averaged 0.4 percent of agricultural GDP in Asian

Figure 5: Financing for extension services, the traditional and the new approach

Source: Chipeta, 2006.

countries in 2000—42 percent coming from China. This compares with 0.53 percent in developing countries and 2.36 percent in high income countries. With the exception of Brazil, China and India that doubled or tripled their public spending on agricultural R&D between 1981 and 2000, most countries reduced public spending on agricultural R&D. Regional and global partnerships to enable small and medium size countries and research organizations to capture the economies of scale in research can be very powerful. In addition to the Consultative Group on International Agricultural Research (CGIAR), one of agriculture's global success stories, other regional initiatives such as FONTAGRO, the Regional Fund for Agricultural Technology for Latin America and the Caribbean are also proving successful. Farmer organizations can play an important role in promoting more demand-driven R&D, as demonstrated by the PRODUCE foundations, created by farmer NGOs in Mexico, that leveraged funds for cash-strapped national agricultural research stations. Above all, it will require political will to invest more in economically effective, but risky and less visible instruments with a long term pay-off (10 years or more).

More demand driven extension systems through the decentralization of extension services and by making extension service providers directly accountable to the farmers can facilitate faster adoption of new technologies (Figure 5). The active involvement of farmers at district and subdistrict levels in setting priorities for extension activities by the Agricultural Technology Management Agencies in India since 2000 increased farmers' incomes by an estimated 25 percent. The declining costs of and increased access to information technologies also provide fascinating new avenues. Increasingly, extension services

are also provided through mixed public-private systems, involving farmer organizations, NGOs, and public agencies contracting out extension services, as in Uganda.

Strengthening farmers' risk management capacity

Farming is a risky business, with climate change further exacerbating uncertainty. Weather-indexed insurance schemes can help farmers better manage weather related risks with payouts triggered if a specified weather event passes a given threshold (e.g. rainfall falls below a certain level). Indexing to events that cannot be influenced by individuals helps overcome moral hazard and adverse selection issues that have plagued the implementation of agricultural insurance everywhere. In a private livestock insurance scheme, currently being tested in Mongolia, herders pay a premium for the base insurance product, which pays an indemnity to individual herders whenever the livestock mortality rate in a local region exceeds a threshold. Private insurance companies are reinsured by the government.

Such indexed insurance programs are promising, but it is not yet possible to draw definite conclusions about their sustainability or impact on farmers' technology and portfolio choices. Governments should also watch the distributional implications of these schemes. The poorest households may not be willing to pay the premiums because they are credit or liquidity constrained, as observed in studies from India and Tanzania, as well as other insurance markets. Targeted subsidies may be considered for variable costs, especially when insurance premiums are less costly than ex post assistance. Subsidies can also offset the fixed costs of establishing a market. Other adaptation measures include

development of flood-, heat-, and drought-resistant crops, and better climate information.

Improving the environmental sustainability of agricultural systems

More crop per drop. Present patterns of water use in many areas are not sustainable. Irrigation currently uses an average of 70-80 percent of the available fresh water, with an efficiency rate of only 50-60 percent, while demand for water for urban, industrial and environmental needs is rising. In South-East Asia, better integrated river basin management is currently pursued under the Mekong River Basin Water Partnership Program (MWARP) to better allocate water across sectors. More efficient water use in irrigation requires setting charges for water and power that reflect their actual cost. Recent experience in China in the Tarim Basin demonstrated that a shift from area based to volume based charges for irrigation water resulted in a 17 percent decrease in water use. Nonetheless, better cost recovery remains a challenge everywhere because of vested interests and measurement problems. It usually works better when the governance of irrigation systems is decentralized. Farmers are also more willing to share the cost of services when it is accompanied by modernization of irrigation schemes to facilitate the more flexible water management needed for production of vegetables for urban markets. New technologies for better measurement are also becoming available such as automated channel control of irrigation as applied in Australia and remote sensing to measure soil moisture content and evapo-transpiration of crops in the field.

Greening the Green Revolution. The environmental damage from fertilizers through runoff can be reduced through better timed application of fertilizer, precision farming (using geographic information systems), introduction of nitrogen fixing legumes in the farming system, and low-tillage farming, as in the Indo-Gangetic Plain in India where wheat is immediately planted after rice without tilling, taking maximal advantage of the left over moisture. In China use of insect resistant Bt-cotton reduced pesticide application by two thirds and raised net incomes by US\$ 470 per hectare (or 340 percent). Nonetheless, the adoption of integrated management practices (including integrated pest management) has been slow. Subsidies for water and electricity distort the real cost. Integrated management also requires adaptive, knowledge intensive extension services that capture the complex interactions characterizing eco-systems.

Animal waste management. Poultry and pork producers have an incentive to concentrate in urban and peri-urban areas so as to reduce transport costs. This is causing pollution of water and soil with animal wastes, especially nitrogen and phosphorous, but also highly toxic heavy metals such as cadmium, copper, and zinc from animal feed additives. Thailand, a major player in the

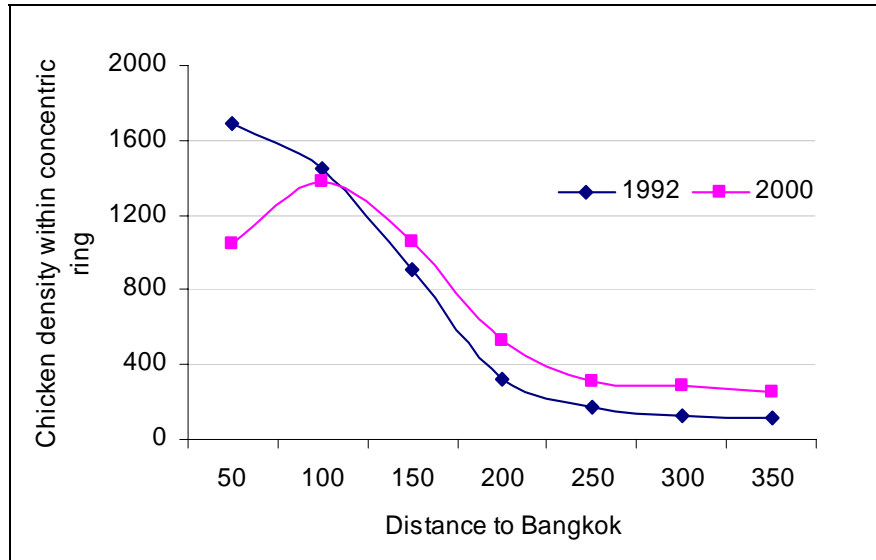
global poultry market—more than 500 million tons of exports in 2003—managed to drastically reduce the concentration of poultry around Bangkok (Figure 6) through taxation. Poultry farmers close to Bangkok had to pay high taxes; those outside the zone enjoyed tax-free status. Regulations such as a minimum distance between farms (Spain) or between farms and the nearest waterway (Brazil) have also been used to manage animal waste. Dense livestock populations increase the risks of spreading animal diseases, some of which may cross-over to humans. The rapid creation of disease-free zones, in response to an avian flu outbreak in 2003 in Thailand, with strictly enforced movement control and thousands of inspectors going door to door to search for diseased animals has been critical in stemming its spread.

2.2. Moving beyond the farm

A buoyant rural non-farm sector is equally critical to facilitate the transition out of agriculture and reduce the rural urban divide. In Indonesia, migrants to jobs in urban areas tend to be better-off rural non-farm workers who were already doing non-farm jobs in rural areas. Less-well-off rural people tend to have stronger income growth when moving relatively small distances (within a sub-district). Given such constraints, one of the best prospects for reducing rural poverty is the potential for rural residents to commute to jobs in nearby towns, while retaining their rural residence and their foothold in farming. In northeast Thailand, the greater availability of non-farm jobs in nearby rural towns led to significant improvements in income.

Studies of the rural investment climate reveal as major constraints in generating off-farm employment lack of well-functioning institutions, poor access to and high cost of credit, inadequate supply of electricity and poor quality roads. In addition rural firms often face low market demand for their goods, the major constraint in Indonesia and Vietnam. The dependence of the rural non-farm economy on local markets links their profitability to local incomes and thus to the factors constraining local agricultural productivity. The establishment of local aggro-based clusters around rural towns can help capture economies of agglomeration and could be fostered through public private partnerships. Indeed, small and intermediate rural towns often act as engines of non farm employment growth further away from large urban centers, including through jobs in sectors that provide services for local agriculture. Market demand can also be expanded by better roads and communications that link rural areas to the urban economy, facilitating subcontracting of labor intensive manufacturing to rural areas close to the cities.

Continued investment in rural education is critical to help poor households find good jobs outside agriculture. Skills remain the principal dividing line between higher paying non-farm jobs and lower paying agricultural ones. In the EAP region (exclusive of China),

Figure 6: Thailand is shifting the concentration of poultry away from Bangkok

Source: Steinfeld and others, 2006.

young male rural workers between 18 and 25 years old have about 2.1 years less education than their urban counterparts; for women the average gap is 2.4 years. Active labor market programs can also assist households migrate out of poverty. A job-matching program for migrants in China provided off-farm employment to about 200,000 upland laborers over six years. The program provided on-the-job training by enterprises. A computerized, demand-driven job placement system emphasized local markets, monitored worker safety and living conditions, and reported abuses and grievances. Migrant women's outlook on life greatly improved.

2.3 Assisting subsistence farmers and populations in lagging areas

Despite rapid overall growth, some populations are being left behind, especially in less-favored areas. East Asian countries are therefore ramping up special poor area development programs. These include Vietnam's P-135 projects aimed at reducing poverty among ethnic minorities and in mountainous areas where poverty rates are much higher, and the Mindanao project in the Philippines. Such interventions prove not only to be politically effective, but also economically efficient. Econometric studies from China, Thailand, India and Uganda show that public investments in certain types of agricultural R&D, rural roads and education can produce competitive returns in lagging areas (Fan, forthcoming). Successful programs combine local agricultural development, better use of environmental services, investment in skills for migration and wide safety nets.

Experience of projects in two of China's poorer provinces, Gansu and Inner Mongolia, indicates the

continued importance of agriculture in developing lagging rural areas. Per capita grain output rose by almost 50 percent following adoption of better agronomic practices and contributed to the increase in net income per capita of more than 50 percent between 1999 and 2004.²⁹ Most of the incremental output was sold in the market. Successful programs put local communities in the driver's seat as in Vietnam and focus on improving technologies for sustainable management of land, water and biodiversity. Water harvesting and small scale irrigation schemes, and agro-forestry, sometimes integrated with livestock, are also promising. In Latin America, payments for environmental services (PES) such as carbon sequestration, harboring biodiversity, and retaining forests are increasingly popular, providing additional sources of revenue. Secure long term property rights and effective land rental markets are necessary for investment in sustainable resource management. They also facilitate occupational transformation and help transfer land to the more productive producers, as in China where decentralized rentals have by now mostly replaced administrative reallocations. While almost 60 percent of those renting out land in China relied on agriculture as main source of income before entering rental markets, only 17 percent continued to do so afterwards; 55 percent migrated, and 29 percent went into local non-farm

²⁹ Two thirds of this increase came from yield increases, the rest from land expansion. The household income structure did not change, with about 70 percent still coming from agriculture (with 60 percent from crop planting, and a quarter from animal husbandry). Better agricultural technology (rather than migration) underpinned the dramatic improvement in living conditions among these rural households. The poverty headcount declined by more than 10 percentage points.

activity. Net revenue on rented plots rose by about 60 percent.

Public investment in rural education and vocational training helps younger farmers migrate out of agriculture, another pathway out of poverty for subsistence farmers in lagging areas. Successful programs include conditional cash transfers such as Mexico's Oportunidades and Brazil's Bolsa Familia that transfer cash conditional on regular school attendance. This helps children stay in school, breaking the vicious circle of intergenerational poverty. Remittances from migrants often provide an important source of income for those staying behind and policies that reduce the transaction costs on remittances and encourage investment in the local economy should be pursued.

Other safety nets can help reduce vulnerability and assist the many households unable to migrate (the elderly and less educated) or those without migrant household members. Flexible, countercyclical public employment and relief programs such as India's Maharashtra Employment Guarantee Scheme and Argentina's Trabajar program have been successful in helping households cope with income shocks. Rural noncontributory pensions have been introduced in countries in Latin America and Europe and Central Asia.

3. Agriculture for development in the 21st Century

Even though poverty has fallen dramatically, the rural-urban income divide in East Asia has increased. More than 90 percent of the poor in EAP live in rural areas now, the vast majority earning their living in agriculture. More rapid growth in the rural economy both on and off the farm provides good prospects for accelerating poverty reduction and tackling the rising rural-urban divide. A three-pronged "agriculture for development" approach is emerging. This approach focuses on increasing agricultural productivity by expanding beyond the Green Revolution towards more sustainable and high value agriculture, drawing on institutional and technological innovations. It fosters rural employment off the farm through a better investment climate and regional and secondary town development. And, it bolsters poor area development programs through a combination of agricultural development and environmental services, education for migration, and wide safety nets for those remaining behind.

Successful implementers of this agenda are pursuing multi-sector, decentralized, and participatory approaches that redefine the role of the state, the private sector and civil society. A major challenge is to avoid the pitfalls of increasing agricultural protection and subsidies, something currently observed in many EAP countries. These are not only economically detrimental in the short run but also difficult to remove once established. Instead, a focus on the provision of public goods such as a better

investment climate, more demand driven agricultural R&D and extension, increasing rural infrastructure and rural education holds most promise in accelerating poverty reduction and addressing the rural-urban divide.

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