

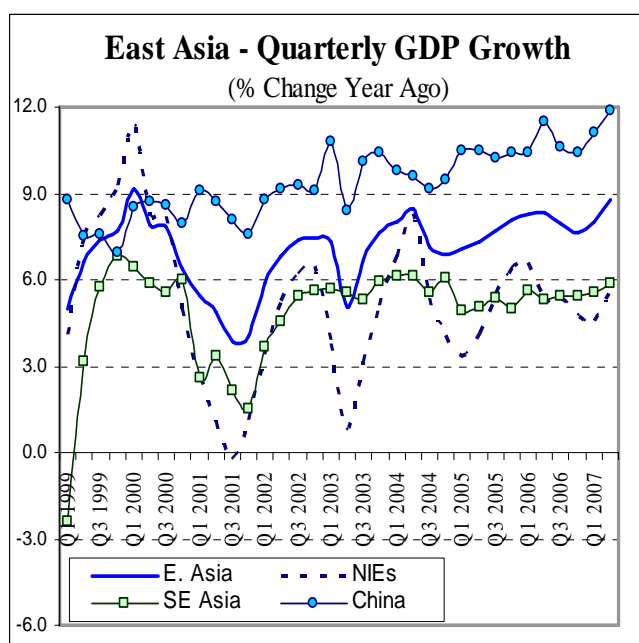
EAST ASIA AND PACIFIC UPDATE

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 2007, 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

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

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).

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.

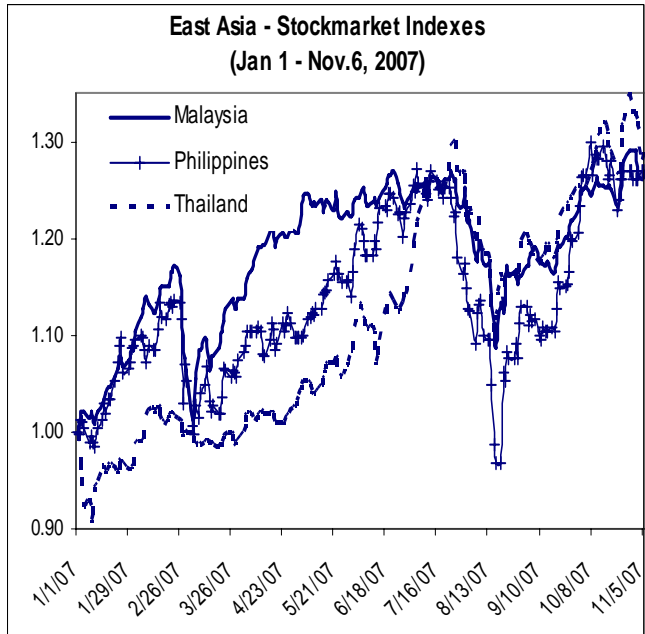
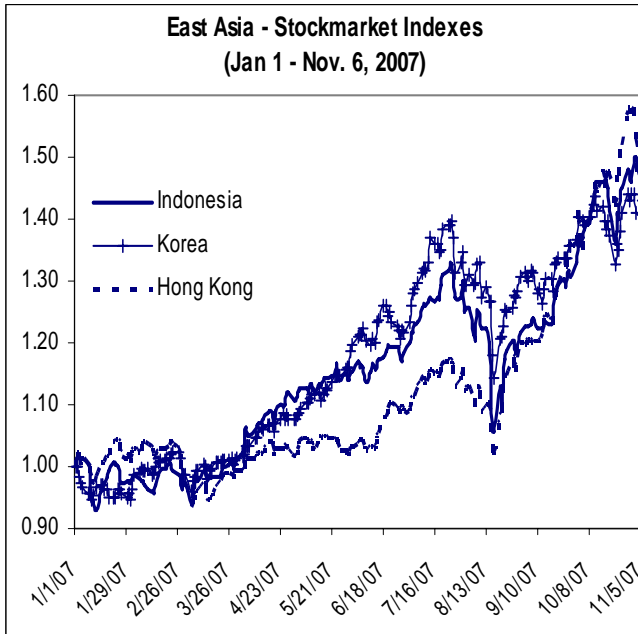
Among individual economies, *China* is the largest overseas holder of US mortgage backed securities - around \$260 billion - mostly through its international reserve holdings and also through holdings of commercial banks. However, nearly all of these holdings are backed by US government agencies such 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.

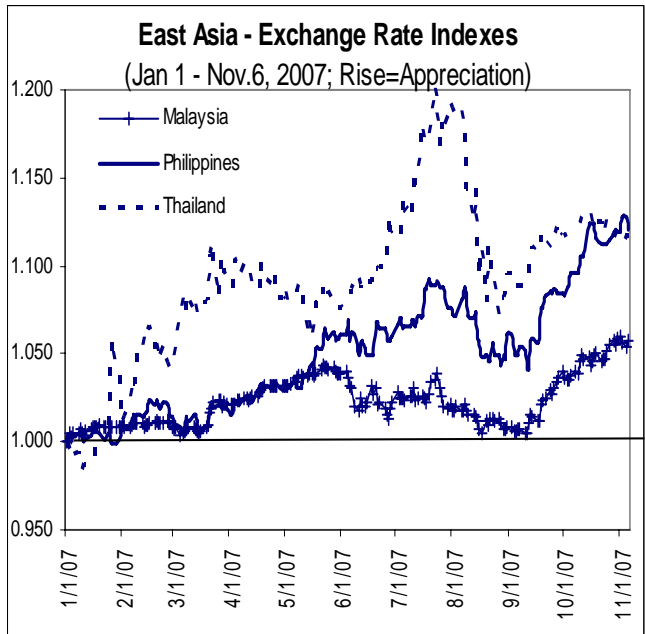
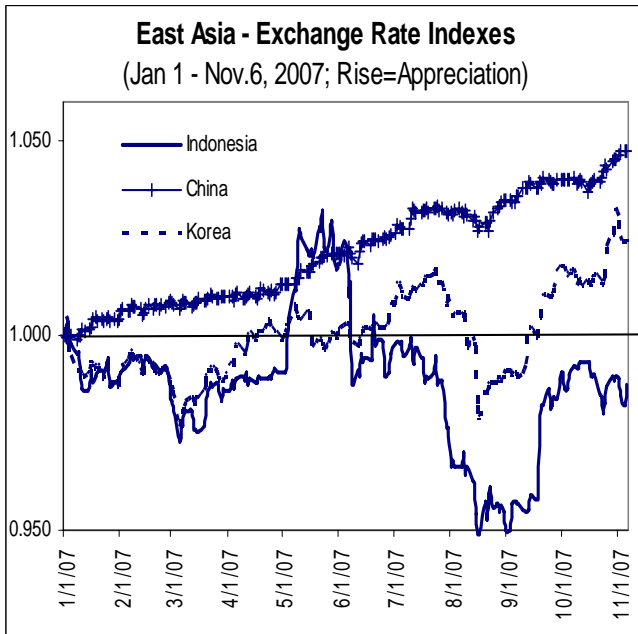
³ Fitch Ratings Press Release 8/22/07: Limited Direct Impact on Asia-Pacific Banks from Subprime Exposure.

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.

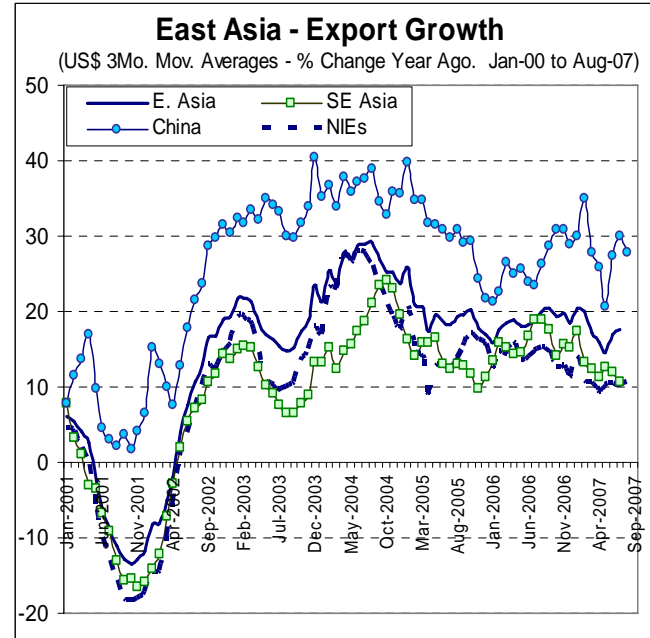
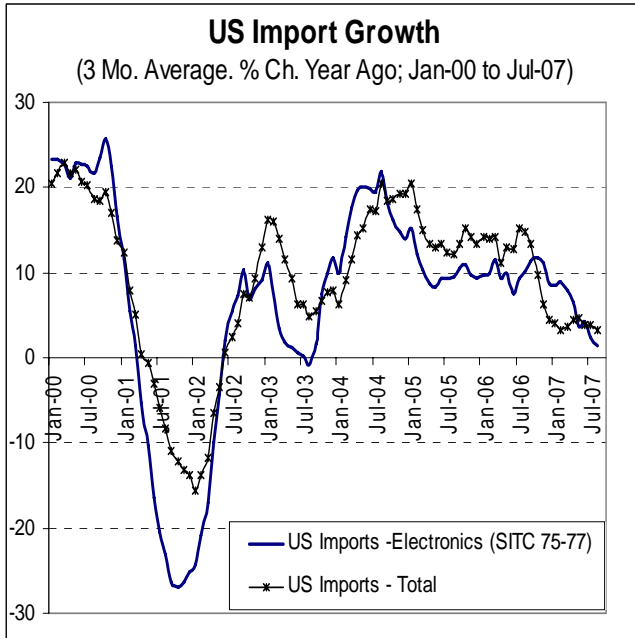
The export slowdown is already here (and gone?)

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.

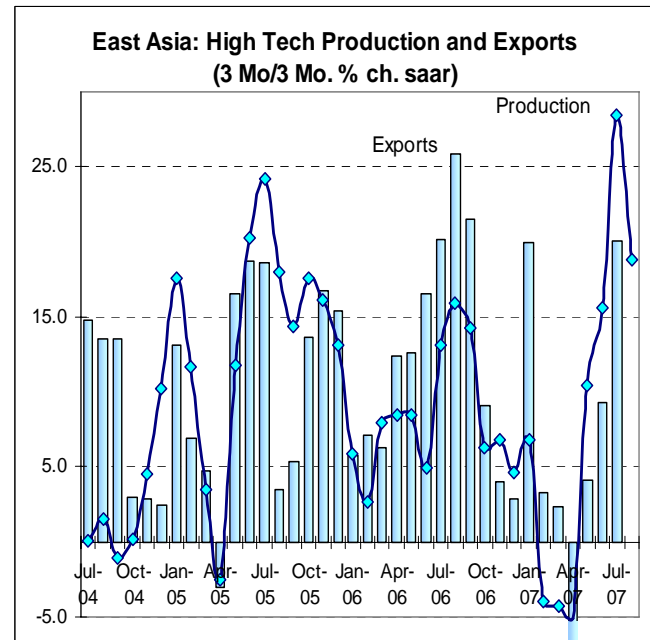
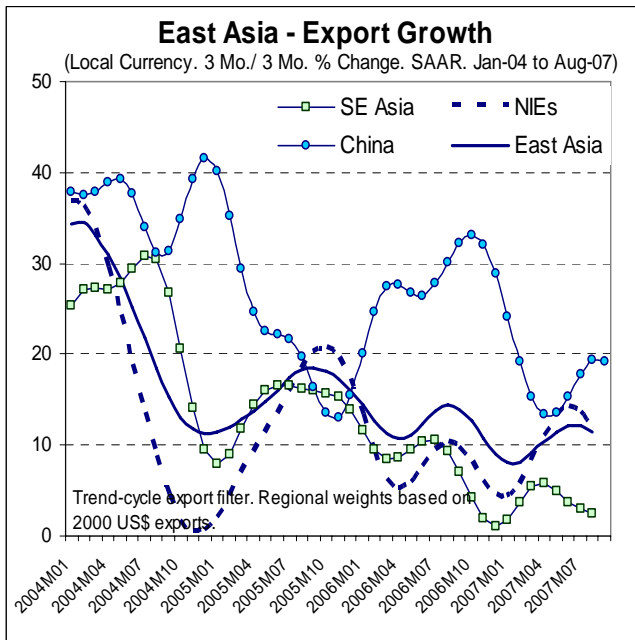
The slowdown in the US economy has already affected East Asian export growth, but is still permitting regional export growth in local currency terms of around 10-15 percent, and in dollar terms of 15-20 percent. Export growth in dollar terms slowed to around a 10 percent pace in the second quarter in 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.

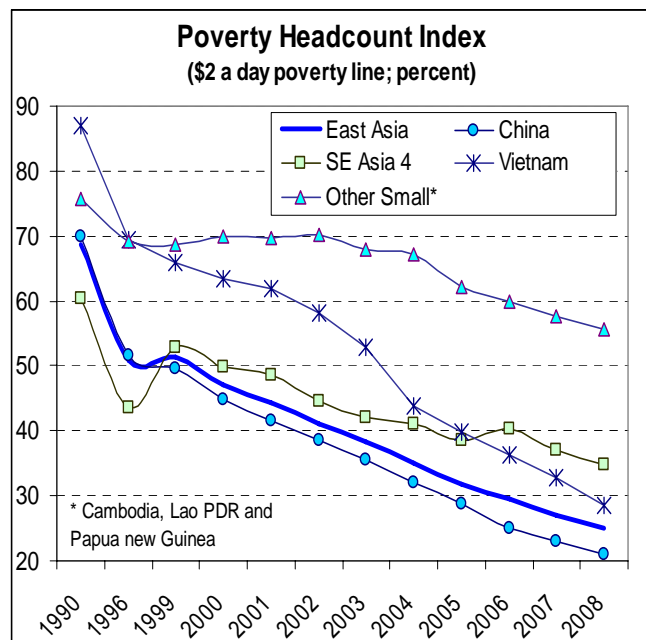
Strong economic growth – reaching an estimated 10.1 percent for developing East Asia in 2007 – is providing the underpinning for poverty reduction. But, as the review of individual country experiences below indicates, poverty in East Asia is now overwhelmingly a rural problem, with poverty declining 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.