EAST ASIA UPDATE

November 2006

Managing Through a Global Downturn

Special Focus: Investing in Young People

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CONTENTS

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EAST ASIA AND PACIFIC REGIONAL UPDATE

Summary

Growth in Emerging East Asia is expected to reach close to 8 percent in 2006, the second strongest pace in the five year long economic expansion underway in the region since 2001.[1] Among the developing economies of the region aggregate growth of 9.2 percent would indeed be the highest in the last five years.[2] (Table 1.) Poverty at the $2 a day level is estimated to have fallen by around 1 ½ percentage points to a little over 29 percent of the population. As in recent years, high aggregate GDP growth in the region is dominated by the fact that the region's largest economy, China, was also its fastest growing, reaching over 10 percent, while the other larger middle and high income economies of the region grew in a range of 4-6 percent. Strong export growth was a common factor sustaining growth throughout the region this year. But domestic demand performance was more varied, continuing strong in China and Vietnam, but easing in several of the South East Asian middle income economies and North Asian NIEs, reflecting adjustment to the impact of higher oil prices and higher domestic interest rates, among other factors.

Table 1. East Asia Economic Growth

	2004	2005	2006	2007
Emerging East Asia	8.0	7.5	7.8	7.3
Develop. E. Asia	9.1	9.0	9.2	8.7
S.E. Asia	6.0	5.1	5.2	5.6
Indonesia	5.1	5.6	5.5	6.2
Malaysia	7.2	5.2	5.5	5.5
Philippines	6.2	5.0	5.5	5.7
Thailand	6.2	4.5	4.5	4.6
Transition Econ.				
China	10.1	10.2	10.4	9.6
Vietnam	7.8	8.4	8.0	7.5
Small Economies	6.6	7.6	6.4	5.3
Newly Ind. Econ.	6.0	4.7	5.1	4.5
Korea	4.7	4.0	5.1	4.5
3 other NIEs	7.2	5.4	5.1	4.4
Japan	2.3	2.6	2.9	2.4

World Bank East Asia Region; October 2006. Consensus Forecasts for NIEs..

In some respects the forces expected to drive the outlook for 2007 are the converse of those that have driven outcomes in 2006, with exports expected to slow (rather than accelerating), and with domestic demand making a bigger contribution to growth than in 2006. Growth in Emerging East Asia is expected to slow by about half a percentage point in 2007 to a little over 7 percent, and in Developing East Asia to a little over 8½ percent, principally reflecting an expected weakening in US growth, and a consequent slowing in the region's export growth. It is true that intra-regional East Asian trade has grown strongly over the last decade (centered on exports by other East Asian economies to China). However, something like two thirds of intra-Asian exports are intermediate products used as inputs into exports whose final markets lie outside Asia. Thus the region remains intimately linked to extra-regional global markets. Nevertheless, the extent of the expected export slowdown should be limited if, as forecast, the US economy achieves a soft-landing, and slower US growth is accompanied by a rotation in relative growth momentum to other regions.

Even as exports slow, though, there are a number of factors that should support domestic consumption and investment. World oil prices have fallen substantially since their summer highs and are forecast to stabilize and then gradually decline over time, which should help bolster incomes in what is overall an oil importing region. Central banks in the region had tightened monetary policy since the middle of 2004 to curb a potential rise in inflation. With inflation stabilizing and turning lower during 2006, central banks in the region have stopped tightening or (as in Indonesia) started easing. By the second quarter average short term rates in East Asia were lower than in the US. Most central banks should have room to ease monetary policy in 2007, helping bolster domestic demand in case of a significant export led slowdown. In addition, fiscal balances have improved and government debt has generally declined over the course of the decade in most of the larger East Asian economies, thanks to fiscal consolidation efforts, relatively low interest rates and sustained economic growth since 2001. Except for the Philippines, central government debt levels are now generally less than 50 percent of GDP, leaving room for greater fiscal stimulus, should that be needed, particularly spending on needed infrastructure, which would also ease capacity bottlenecks and constraints. Stronger domestic demand growth is unlikely to face much of a balance of payments constraint in the larger economies of the region, given their current account surplus and strong foreign reserve positions. Improvements in the balance sheets and profitability of the region's corporations and banks, and lower levels of

[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).

[2] Regional and sub-regional GDPs are the sum of national GDPs measured in 2000 US dollars. The resulting growth rates are higher than those shown in earlier editions of the East Asia Update (which used fixed GDP weights), principally because of a higher weight given to China.

spare capacity after several years of sustained growth in many economies should provide a more favorable environment for new investment spending.

The rest of this summary provides further information on the main cross-country trends and policy issues discussed in this report. Developments at the country level are discussed in the "Country Sections" at the back of the report, while fuller Country Briefs are available at the website associated with this report.[3] The Special Focus in this report is on "Investing in Young People in East Asia and the Pacific", a study of the lessons for East Asia from the World Bank's recent World Development Report 2007: *Development and the Next Generation.*

East Asia Regional Outlook

- ***Growth***. Robust aggregate East Asian growth in 2006 has been underpinned by growth of over 10 percent in the region's largest economy, China, supported by strength in both exports and domestic demand. Growth has also been high in several low income transition countries, running at 7-9 percent in Vietnam, Cambodia, Lao PDR and Mongolia. The larger middle and high income economies of the region are however likely to see more modest growth in a 4-6 percent range. Robust export growth has been a common feature sustaining activity throughout the region, underpinned by above-trend growth of 3 percent in developed OECD economies, as well as by strong growth in China and continued expansion in global electronic and other high tech product markets. Domestic consumption and investment performance was much more varied, though. Both continued to run at strong rates in economies like China, Malaysia and Vietnam. On the other hand consumption growth was particularly weak in Taiwan, China, where, a credit card bust left over-indebted consumers cutting back spending, and was also slowing in Indonesia and Thailand in the first part of the year. Investment growth also slowed or became negative in the latter three economies, as well as in Korea and the Philippines. In addition to the adverse impact of higher oil prices and interest rates, domestic demand was affected by tightness in fiscal policies in some economies, as well as a series of country-specific factors such as political tensions and natural disasters.

- ***Poverty.*** Current estimates suggest that the number of East Asian poor at the $2 a day level is likely to have fallen to some 550 million (or 29.3 percent of the population) in 2006, a drop of some 25 million (or over 1 ½ percentage points) from 2005. The current estimates are a little higher than in the last (March 2006) East Asia Update, because of an unexpected up tick in poverty in Indonesia, the first since the financial crisis. Poverty at the national poverty line increased from 16 percent in February 2005 to 17.8 percent in March 2006. Most of the increase resulted from a sharp rise in domestic rice prices, partly due to shortages resulting from a ban on rice imports. In response the government reopened rice imports, helping stabilize prices. In much of the rest of the region, though, 2006 is likely to see further substantial declines in poverty. Poverty reduction has been occurring at exceptionally rapid rates in Vietnam. The current estimates now incorporate the results of Vietnam's 2004 Household Survey, which suggest a sharp acceleration in poverty reduction in 2002-04, almost all of it in rural areas, resulting from rapid productivity gains in agriculture, diversification to new crops and non-agricultural activities, hefty increases in international prices for key exported crops, more resources for targeted poverty reduction programs and a more pro-poor focus in public investment and other fiscal expenditure programs. With further buoyant growth, poverty rates in Vietnam are estimated to have now fallen below those in Indonesia and Philippines.

The international and regional environment

- ***Developed economies***. Growth in OECD developed economies is expected to have risen to 3 percent in 2006 from 2.6 percent in 2005, the result of an unexpectedly strong and broad based recovery in the Euro Area that should bring that region's growth up from 1.4 percent in 2005 to 2.3 percent in 2006. Second quarter Euro Area growth reached 3.8 percent, the strongest in six years. In the United States, on the other hand, growth decelerated from an exceptionally strong 5.6 percent in the first quarter of 2006 to 2.6 percent in the second and 1.6 percent in the third. Nine tenths of the slowdown in the third quarter reflected plunging residential investment and the ongoing slump in the housing sector. The sharp slowdown has led to consensus forecasts for US growth in 2007 being reduced by half a percentage point to around 2 ½ percent – still a 'soft-landing' scenario, although the likelihood of a 'hard-landing' or recession has undoubtedly increased, as has overall uncertainty about the outlook. Not all US data has been quite so negative as in housing. Employment and wage gains have been robust, as were consumption and business investment growth in the third quarter, adding some credibility to the consensus soft-landing view. In Japan an unexpected dip to only 1 percent GDP growth in the second quarter of 2006 has also raised concerns about the outlook for the recovery there. Worrying signs of weakness also emerged in Europe when French growth fell to zero in the third quarter. Overall OECD economy growth is expected to dip by over half a percentage point to under 2 ½ percent in 2007, with world trade growth expected to come down from 9.7 percent to 7.3 percent, one of the lower rates in recent years.

[3] http://www.worldbank.org/eapupdate/.

- ***China***. Growth in China accelerated to almost 11 percent in the first half of the year, reaching 11.3 percent in the second quarter, the highest in a decade, before decelerating modestly to 10.4 percent in the third quarter, following tightening measures aimed at reducing investment growth. Investment and export growth have been the principal drivers of growth in the year. The slowdown in investment growth in the third quarter was partly offset by rising export growth, which picked up from round 22 percent in US dollar terms in the last quarter of 2005 to 29 percent in the third quarter of 2006. With rising export growth outpacing imports by a growing margin, the contribution of net trade to GDP growth increased to almost 3 percentage points in the third quarter, after 1.2 percentage point in the first and 2.4 percentage points in the second. The trade surplus rose to US$110 billion in the first three quarters of the year from US$ 69 billion in the same 2005 period. China's current account surplus is forecast to rise to $223 billion in 2006 (8.5 percent of GDP) from $160 billion in 2005. From the perspective of its trading partners in Emerging East Asia, China's rapid growth continues to provide an important locomotive for the region as a whole. China's imports from the rest of emerging East Asia were up about 20 percent in the first three quarters of 2006, about the same pace as in 2005.

- ***'Decoupling', Intra and Extra-regional trade.*** The rapid growth of intra-East Asian trade over the last decade naturally raises the question how far such trade may protect East Asia from a downturn in exports to the US or other extra-regional markets. By 2005 32 percent of Emerging East Asian exports went to other economies in the region, while another 11 percent went to Japan. The first point to note is that it is East Asian economies other than China that have experienced the fastest growth in intra-regional exports, principally to China. China, on the other hand, has become the East Asian economy with the highest orientation to the US market, while its intra-Asian exports have remained steady at around 16 percent. The rising export-orientation of other East Asian economies towards China mainly reflects a changing regional division of labor over the last decade, with the emergence of China as a central assembler and exporter of finished manufactures to global markets outside Asia, and of other East Asian economies as suppliers of specialized capital goods, parts, components and other intermediates to China. China's demand for these inputs from the rest of East Asia is therefore driven to a large extent by demand for its exports to the major developed economy markets outside emerging East Asia. Something like two thirds of intra-Asian trade gets incorporated into exports shipped to extra-regional markets. As a result the growth on intra-Asian trade tends to be highly correlated with that of extra-regional trade. A rough calculation suggests that net of such intermediates trade East Asian intra-regional trade amounts to some 14 percent of the total, with Japan, the US and Europe respectively comprising 14, 25 and 22 percent of East Asian exports. A generalized decline in extra-regional markets would certainly have a strong impact on East Asian exports. The impact would however be considerably softened if there was a rotation of growth from the US towards Europe, Japan and East Asian domestic demand itself.

- ***Oil.*** Crude oil prices have been on a highly volatile path since our March 2006 East Asia Update, first running up to well over $70 in early August, before falling to below $60 in early October. This large retracement in prices bolsters confidence in the view that oil prices have seen their peak and are likely to decline further over the next several years, albeit at a gradual pace. Nevertheless the underlying demand and supply factors remain finely balanced, reflected in the unusually low level of spare production capacity in OPEC. Prices are currently projected to ease from $65 in 2006 to $60 in 2007, which would be higher than prices in early October 2006. On the supply side, high current prices are expected to induce further significant investments and gains in production, which are expected by the IEA to reach 1.8 mb/d in 2007, led by increases in the FSU, Africa and North America. On the other hand, continued world economic growth at relatively robust rates over 3 percent is expected to induce stronger demand gains than in the last two years. Thus the margin of spare production capacity is expected to widen only gradually, leaving prices vulnerable to unexpected supply disruptions and fears of disruptions.

- ***Balance of payments and financial market developments.*** Emerging East Asian foreign exchange reserves continue to accumulate at a solid pace, rising to $1938 billion by September 2006, of which $989 billion were held by China alone. As in 2005, much the greater part of the region's reserve accumulation continues to be financed by its rising current account surplus. Emerging East Asia's current account surplus in the year to the second quarter of 2006 rose to an estimated $302 billion - around 6 percent of GDP - up from $266 billion in 2005, headed by the sharp rise in China's surplus. Private capital inflows to and outflows from East Asia remain buoyant, reflecting the growing integration of the region into global financial markets. Net foreign direct investment inflows remain strong, totaling $101 billion in the year to the second quarter of 2006, compared to $112 billion in 2005. Gross financial capital inflows (mainly portfolio capital and bank lending) slackened somewhat during and after the global equity market correction in May-June of the year, but were reviving by September. East Asian equity prices also resumed moving higher in the third quarter. However, while gross financial capital inflows of portfolio capital and loans have remained healthy, one of the more notable balance

of payments developments in East Asia in the last 1-2 years has been that on a net basis the region is now supporting large net *outflows* of these kinds of capital – residents are acquiring net foreign assets of portfolio and other financial assets. Such net outflows are estimated at $110 billion in the year to the second quarter of 2006. Among the main factors underpinning this change in net financial capital flows is that there has been more monetary policy tightening in the US than in East Asia. US short term interest rates were lower than average East Asian rates till recently; now they are higher.

Domestic trends and policy issues

- ***Financial sector trends and issues***. Over the last 5-6 years banks in the previously crisis-affected East Asian countries have achieved substantial improvements in capital adequacy, asset quality and profitability. There was something of a pause or slowing in the process of clearing up bad debts during the first half of 2006, though. In Indonesia the rate of non-performing loan (NPL) rate at commercial banks picked up from 7.6 percent at the end of 2005 to 8.3 percent in June 2006 (and 8.4 percent in August), due in part to a change in rules for classification of assets at the two largest state owned banks. In Thailand the NPL rate at 8.2 percent in June 2006 was only slightly below the end-2005 rate. In both cases the authorities announced steps to further address NPL issues. Policy efforts to continue to address tasks of financial sector restructuring and consolidation left over from the financial crisis, as well as longer term financial sector strengthening and development remain important. NPL ratios in Emerging East Asia remain rather higher than in other developing regions such as Latin America and Emerging Europe.

- ***Towards a More Resilient, Diversified Financial Sector.*** [4] The importance of diversified financial systems is increasingly recognized in East Asia. Such systems can serve to enhance efficiency by providing specialized resource mobilization, allocation and risk management services. Although the region has traditionally had a bank-centered system, it has made much progress in developing securities markets in recent years. Equity markets in the region have tripled since the crisis—from a market capitalization of US$ 0.8 trillion in 1997 to almost US$ 2.9 trillion in 2005. The region's bond markets have also seen sizable growth over the past nine years, albeit with considerable variation across countries. For the region as a whole, bonds outstanding amounted to US$1.5 trillion in 2005—up from US$ 0.4 trillion in 1997. To foster further development of securities markets, a key constraint that needs to be addressed is limited liquidity. Investors are generally willing to invest in securities only if there is enough liquidity for them to sell and exit easily when needed. Three key factors affect liquidity and efficiency—and ultimately the role that securities markets play in the region: (i) the availability of good information to price securities accurately. East Asian economies have made good progress in establishing the legal framework for corporate governance, disclosure, accounting and auditing, but need to improve implementation; (ii) reducing transaction costs, in particular by fostering repo (repurchase) markets, securities lending, margin trading and derivatives, together with the strong regulatory and risk management frameworks needed for such markets; (iii) development of a more diversified and deeper institutional investor base, for example pension funds, insurance and mutual funds.

- ***Towards "An East Asian Renaissance".***[5] Healthy growth in the years since the financial crisis means that East Asia is increasingly a middle-income region. Once Vietnam reaches middle income country levels, which could happen as early as 2010, more than nine out of ten East Asians will inhabit a middle income country. Middle-income status poses new and quite specific development challenges. Research suggests that the sectoral pattern of growth changes as countries grow through middle-income. On the one hand, there is a demand for a greater variety of goods, many of which can be produced domestically, so there is a force towards sectoral diversification. On the other, countries only get richer if they specialize in what they do best. Although countries appear to initially diversify, at some point at middle income levels they begin to specialize, drawing on economies of large scale production and greater proficiency in innovation and knowledge based production. This is the challenge that confronts East Asian countries today, especially those in South East Asia. But this development strategy has distributional consequences at the country level which need to be managed. Inequality in much of developing East Asia has risen, not just in terms of income levels, but also in terms of schooling and access to basic services. Despite the huge differences in income per head between East Asian countries, more than three-quarters of the inequality of living standards of East Asian citizens comes from within-country inequality. In short, despite successful global integration and increasing regional integration, many East Asian countries are falling behind in domestic integration. Addressing the challenge of domestic integration must entail managing problems of rapid urbanization, service delivery, social cohesion and corruption.

[4] This section of the report draws on Ghosh: "East Asian Finance – the Road to Robust Markets." World Bank (2006).

[5] This section of the report draws on Gill and Kharas: "An East Asian Renaissance – Ideas for Economic Growth." World Bank (2006).

EAST ASIA AND PACIFIC REGIONAL UPDATE

East Asia Regional Outlook

Growth

Growth in Emerging East Asia is expected to reach close to 8 percent in 2006, the second strongest pace in the five year long economic expansion underway in the region since 2001. Among the developing economies of the region aggregate growth of 9.2 percent would indeed be the highest in the last five years. (Table 1, Exhibit 1). Although there is likely to be a fairly wide range of outcomes across individual economies, this range itself is solidly positive – the slowest growth rate among the larger economies is a projected 4 percent in Taiwan (China), a high income economy with a per capita income of over $15000. At the other end of the scale, growth is fastest in the region's largest economy, China, where it is expected to reach 10.4 percent, supported by strength in both exports and domestic demand. Growth has also been high in several low income countries that are making the transition to a market economy, running at 7-9 percent in Vietnam, Cambodia, Lao PDR and Mongolia. These four economies and China have also seen the most rapid growth in the region over the last five years. Growth in 2006 is projected to come in at somewhat more modest rates in the larger middle and high income economies of the region – 4 ½ - 5 ½ percent rates among South East Asian economies like Indonesia, Malaysia, Philippines and Thailand, and 4-5 percent in the larger Newly Industrialized Economies (NIEs) such as Korea and Taiwan (China). (Table 2).

Looking forward, East Asian growth is widely expected to slow in 2007, principally the result of a significant slowing in the US economy, where growth is expected to fall by almost one percentage point to about 2 ½ percent. Given this sort of 'soft-landing', most analyses look to a fairly modest deceleration in East Asia, in this report to a little over 7 percent. Indeed some slowing trends were already emerging over the course of 2006. Third quarter growth in China eased modestly to 10.4 percent from 11.3 percent in the second quarter. As Exhibit 2

Exhibit 1

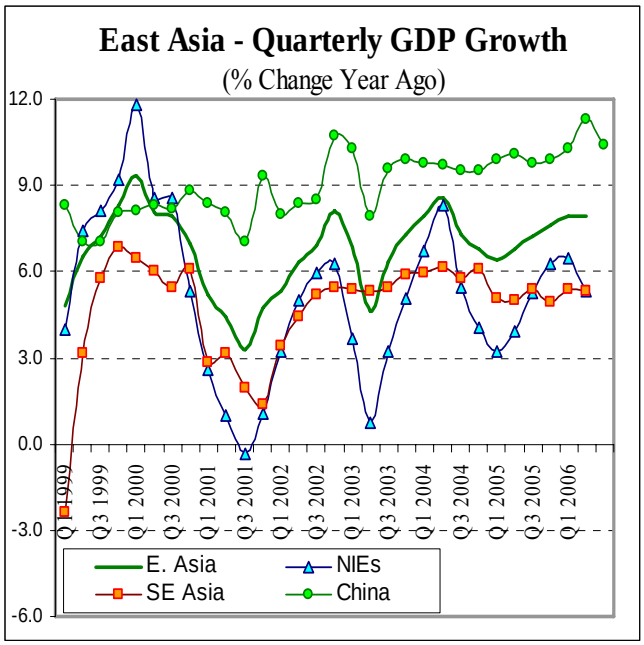


Table 2. Growth in Real GDP and Components of Aggregate Demand (% change year ago)

		Indonesia	Malaysia	Philippines	Thailand	Hong Kong	Korea	Singapore	Taiwan, China	S.E. Asia	NIEs
GDP	2004	5.1	7.2	6.2	6.2	8.6	4.7	8.7	6.1	6.0	6.0
	2005	5.6	5.2	5.0	4.5	7.3	4.0	6.4	4.0	5.1	4.7
	2005 H2	5.3	5.2	5.1	5.0	7.9	4.9	8.1	5.4	5.2	5.8
	2006 H1	5.0	5.7	5.6	5.5	6.6	5.7	9.4	4.6	5.4	5.8
Consumption	2004	5.0	10.5	5.8	5.9	7.3	-0.3	5.9	3.9	6.5	2.6
	2005	4.0	9.2	4.9	4.4	3.4	3.2	2.5	2.7	5.3	3.0
	2005 H2	4.3	9.6	5.0	4.3	3.5	4.1	2.6	2.9	5.5	3.5
	2006 H1	3.0	7.4	5.4	3.9	4.7	4.6	3.3	1.7	4.5	3.7
Investment	2004	14.6	3.1	1.3	13.8	3.0	2.1	10.2	17.5	9.9	7.4
	2005	9.9	4.7	-3.9	11.4	4.1	2.3	-1.9	1.2	7.0	1.9
	2005 H2	5.5	5.0	-2.4	8.3	5.5	3.1	3.4	-5.2	4.8	1.1
	2006 H1	-0.1	9.4	-2.7	5.2	5.9	2.2	10.6	-4.5	2.8	1.5
Exports	2004	13.5	16.3	14.4	9.6	15.8	19.6		15.0	13.2	17.5
	2005	8.6	8.6	4.2	4.3	10.7	8.5		7.3	6.7	8.5
	2005 H2	6.1	7.7	6.5	7.8	11.5	10.8		11.5	6.9	11.1
	2006 H1	11.1	5.4	17.5	11.3	9.8	13.7		13.0	11.1	12.8

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

Exhibit 2

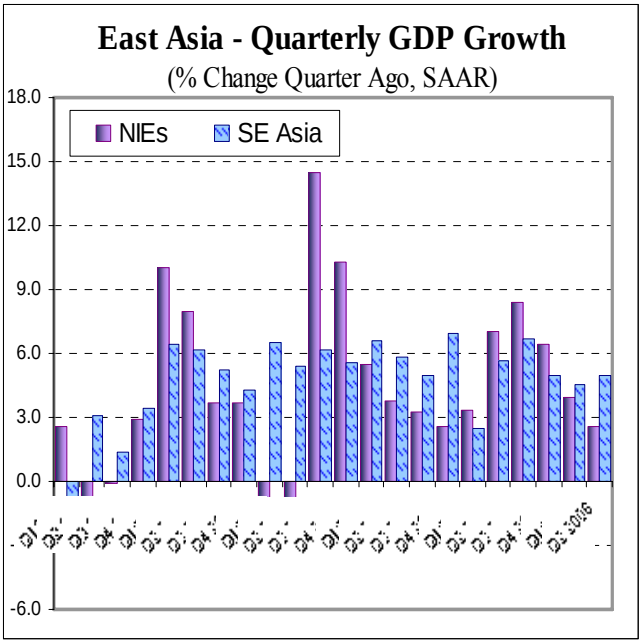
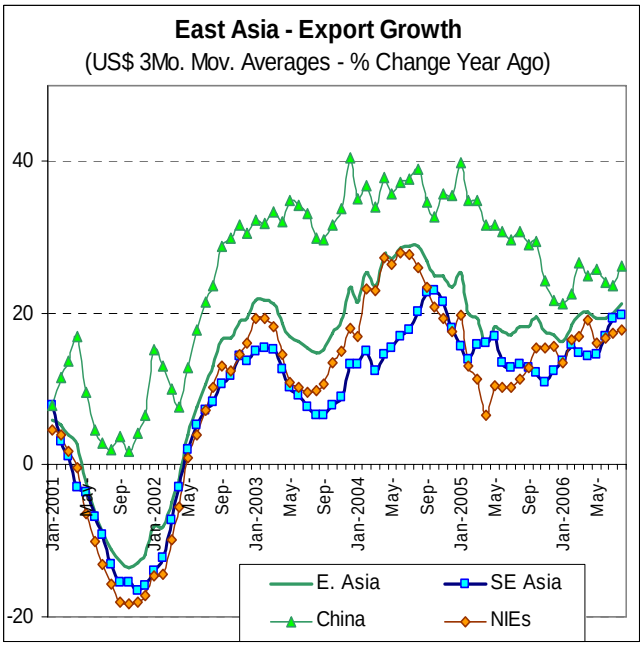


Exhibit 3



shows, annualized quarter on quarter growth in the NIEs dipped from a little over 6 percent in the fourth quarter of 2005 to a little under 3 percent in the second quarter of 2006, principally due to slower growth in Korea and Taiwan (China). Third quarter growth in Korea also ran at 3-4 percent in quarter on quarter terms (saar). But again, these signs of slower growth were not apparent everywhere. Monthly indicators suggested a significant strengthening in third quarter consumption and investment activity in Indonesia. Interestingly, exports were not the explanation for these occasional signs of third quarter slowing (or acceleration). Although there may be concerns about an export slowdown in 2007, there has been little sign of it in 2006.

Strong exports drive growth everywhere…

Robust export growth has been a common feature sustaining activity throughout the region, running at around 20 percent in US dollar terms and 10-15 percent in real terms. (Exhibit 3 and Table 2). The buoyant export scene was underpinned by above-trend growth of 3 percent in developed OECD economies, as well as continued expansion in global electronic and other high tech product markets. East Asian export growth was also underpinned by continued strong growth in China, drawing in imports from the rest of East Asia to meet domestic demand and, more importantly, imports of intermediates for use in China's export production, which continued to grow at around 30 percent in dollar terms. If anything, regional export growth was accelerating in the third quarter of the year, picking up to 21 percent year on year in the three months to August from 16-17 percent at the start of the year, supported by acceleration in East Asian high tech exports and industrial production growth.

…but domestic demand trends diverge

Given robust and relatively uniform export growth across the region, it is generally differences in domestic demand trends that have driven differences in economic growth outcomes across countries this year, as well as the recent signs of slowing in individual economies noted above. In particular, it is much more robust domestic demand growth in China and some of the smaller transition economies that principally explains their faster growth performance this year as compared to the middle income South East Asian economies and the large North Asian NIEs like Korea and Taiwan (China). Thus nominal fixed asset investment (FAI) growth in China reached 31 percent in the first half of 2006, while per-capita consumption grew 8-9 percent in real terms. Monetary policy and administrative tightening measures slowed FAI growth to 24 percent in the third quarter. Domestic consumption and investment growth also continue to grow rapidly in Vietnam. (Box 1 below on 'The Rise of Vietnam's Private Sector' outlines how policy reforms have unleashed a powerful surge of investment and output growth by the country's emerging private sector.)

On the other hand, as Table 2 indicates, household consumption growth eased in several of the middle and high income economies in the first half of 2006, including in Indonesia, Thailand and Taiwan, China. There was also a more widespread slowing of investment growth, which was running at year on year rates of only 1-3 percent in aggregate in the middle and high income economies in the first half of 2006. Exhibits 4 and 5 show indexes of the level of real fixed investment in South East Asia and the NIEs. These suggest that investment spending has also been erratic over the past year. Take the four quarters from mid-

Exhibit 4

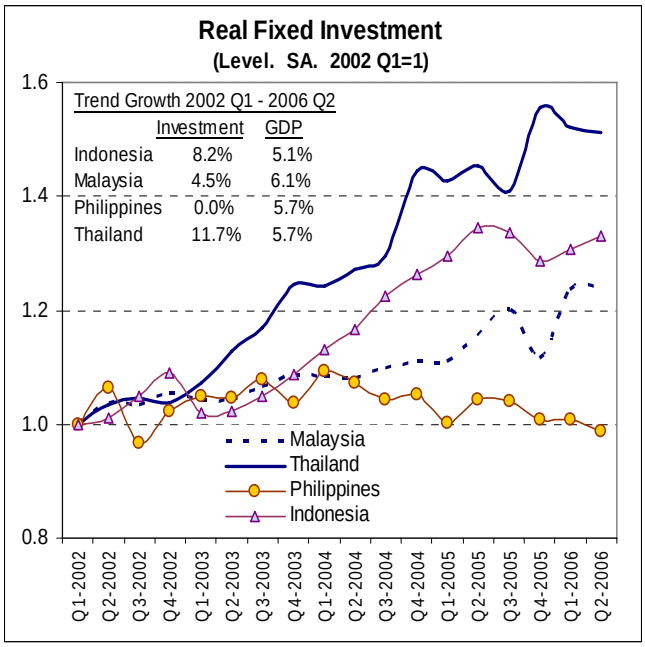
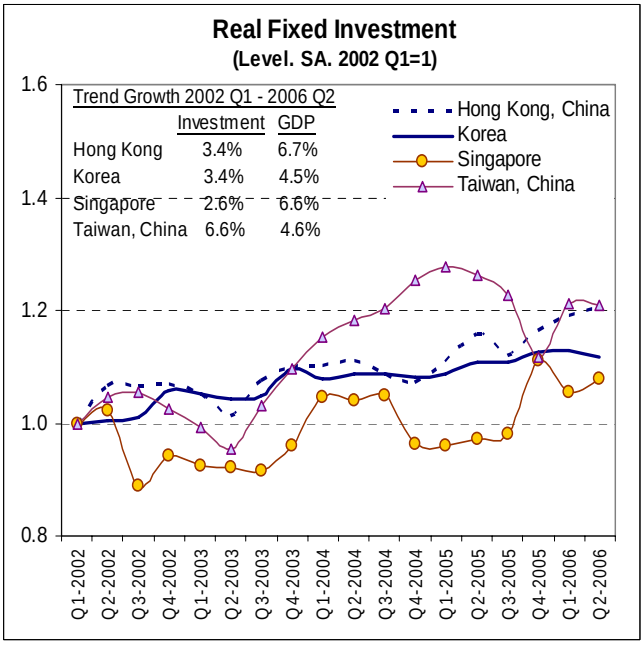


Exhibit 5



2005 through mid 2006: investment spending fell in three of those four quarters in the Philippines, Thailand and Taiwan (China), and in two out of four quarters in Indonesia.

The recent hesitation in domestic consumption and investment growth reflected a variety of factors. Consumers and businesses have had to adjust to the impact of sharply high oil prices and the reduction or removal of fuel subsidies in economies such as Indonesia and Thailand. Economies in the region have also tightened monetary policies beginning in mid 2004 in some economies and continuing through early 2006, to avert a sustained rise in inflation that could be sparked by rising oil prices and rising capacity utilization after several years of recovery and expansion. Short term interest rates around the region rose on average by nearly 200 basis points between the end of 2004 and the spring of 2006. A credit card bust has also left debt-constrained consumers cutting back spending in Taiwan, China.

In some economies fiscal policy also tightened, whether by design or inadvertently. The Philippines undertook a major fiscal consolidation, reducing its public sector deficit by 2 percentage points of GDP in 2005. The removal of fuel subsidies transferred some $10 billion from consumers and businesses to central and regional governments in Indonesia. In a number of countries fiscal policy was tighter than planned because of administrative bottlenecks in actually disbursing budgeted spending. Political instability and tensions have also sapped consumer and business confidence in economies such as Thailand and Taiwan, China. Uncertainty about the future course of oil prices and about the outlook for growth in the US and other developed economies may also have played a role in dampening domestic demand.

Box 1. The Rise of Vietnam's Private Sector

The last ten years have witnessed the rise of a dynamic private sector in Vietnam. Registrations of private firms have doubled since the Enterprise Law of 2000, from under-20,000 to nearly 40,000 in 2005. The share of the domestic private sector in investment rose from 23 percent to 32 percent. The turnover of domestic private firms in manufacturing rose at nearly 22 percent per year and their exports grew by 28 percent per year. The sector's share of manufacturing production rose from 27 percent in 2000 to 33 percent in 2005, while that in non-oil exports climbed from 21 percent to 32 percent.

Part of this impressive performance is due to radical simplification of bureaucratic procedures, The Enterprise Law of 2000 protects the right of citizens to establish and operate private businesses without needless official intervention. Even more, it results from the fostering of competition across the board, from the abolition of foreign trading monopolies in the early 1990s to reforms that have brought Vietnam to the doorstep of WTO accession.

Vietnam did not choose mass privatization of state-owned enterprises as the path to private sector development. It let the private sector grow "on the side". The government feared that mass privatization could disrupt economic activity. Without the right institutional framework, selling off state assets at bargain prices might well foster corruption.

Only now, after many years of experimentation with small-scale equitization (the preferred term for privatization), is the government turning to large enterprises. Equitization has itself undergone improvement, with appraisals being conducted by outside evaluators, and share

issues taking place at market values through auctions. The percentage of shares sold to non-employees or to outsiders, including foreigners, has increased. A recent survey shows that almost 90 percent of enterprises had improved financial performance after equitization. More than 2,300 enterprises were equitized in the last five years.

A further boost has come from new Enterprise and Investment laws in 2005. Domestic and foreign enterprises will now be governed by the same laws and investment regime. Over the next four years all SOEs will be equitized or transformed to other corporate forms, and will be governed by the new Enterprise Law. The ownership rights of the state will be transferred from line ministries and provinces to a profit-oriented State Capital Investment Corporation. This move is expected to eliminate the conflicting roles of ministries and provinces as owners and regulators of SOEs.

The rise of the domestic private sector has been accompanied by a boom in foreign direct investment. At first most investors were from East Asia and partnered with SOEs. Now, however, investors from Western countries are well represented too. An increasing share of projects takes the form of green-field investment. In 2006, Vietnam is expected to attract almost $7 billion in FDI, almost half as much as India in absolute terms, and more than China as a proportion of GDP. FDI now accounts for 16 percent of total investment and 46 percent of non-oil exports. Japanese investors now rank Vietnam as the third most attractive investment destination worldwide.

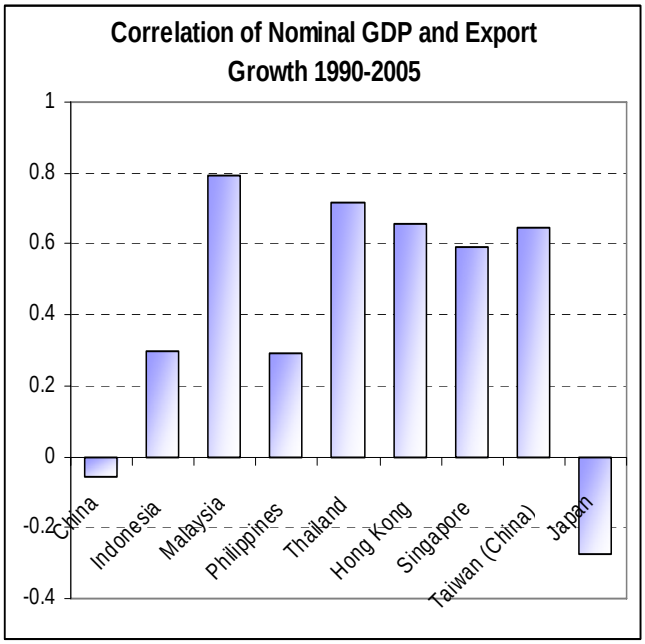
Despite these remarkable successes Vietnam gets apparently gloomy assessments in cross-country investment climate comparisons. Why? First, such international ratings tend to focus on the legal and regulatory framework for the conduct of business, where Vietnam undoubtedly has much to do. However entrepreneurs also value other aspects of the investment climate such as the diligence and low cost of labor, the predictability of economic policies, and low levels of crime. Second, there is sometimes a gap between the regulatory framework and the way it is implemented in practice. For example, laws and regulations may allow a long time for the authorities to register an enterprise, but competition between provinces may dramatically reduce the actual time required.

Box contributed by Vivek Suri and Viet Tuan Dinh.

Outlook for 2007

In some respects the forces expected to influence the outlook for 2007 are the converse of those that have driven outcomes in East Asia in 2005-06. Growth in Emerging East Asia is expected to slow by about half a percentage point in 2007 to a little over 7 percent, and in Developing Asia to a little over 8 ½ percent, principally reflecting an expected weakening in US and developed country growth, and in the region's export growth. On the other hand domestic demand is expected to play a more considerable role in supporting growth, supported by factors such as stabilization and gradual decline in world oil prices, easier domestic monetary policies, room for more expansive fiscal policies, the region's extremely strong balance of payments and foreign reserves position, improvements in the balance sheets and profitability of the region's corporations and banks, and running down of spare capacity after several years of sustained growth in many economies.

Exhibit 6



As later discussion in this report corroborates, the US remains a significant final export market for East Asia despite the large growth in the share of intra-regional trade in recent years. Some 20 percent of the region's exports go to the US, down mildly from 22 percent in 1995. Exports by other East Asian economies to China and to each other have grown strongly over the last decade, on the other hand, reaching some 44 percent by 2005 and raising the question whether strong domestic demand growth in China and the rest of Asia could offset a US downturn. Exhibit 6 shows that the correlation between export growth and GDP growth has been rather low – negative in fact - in large Asian economies like China, and Japan. This suggests that these larger East Asian economies may be better able to weather a US downturn despite a weakening in their export growth.

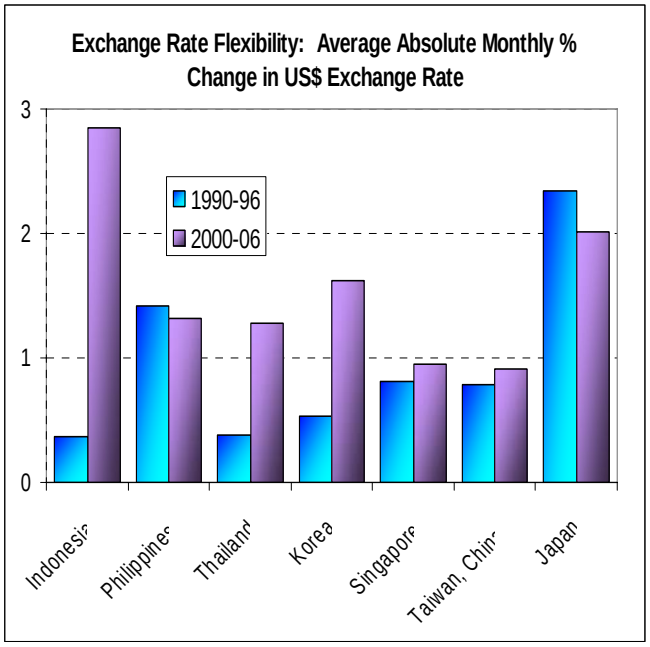
What about most other emerging East Asian economies? Could they also ride on coat-tails of continued robust growth in China? Here the key observation is that something like two thirds of intra-Asian exports are intermediate products used as inputs into exports whose final markets lie outside Asia. A slowdown in extra-regional markets would thus have an immediate and significant impact on intra-regional trade, a connection clearly seen during the 2001 global high-tech recession. At that time GDP growth in Emerging East Asia ex-China fell to only 1-2 percent, even though China continued to grow at

over 8 percent. Thus while strong continued domestic demand growth in China could provide some offset, and while consensus forecasts look for a slowing in US and other OECD economy growth to a 2-2 ½ percent range, a more severe 'hard landing' would, other things equal, undoubtedly have a severe impact on many economies in the region.

Nevertheless there are a number of factors that may help mitigate the impact of an unexpectedly severe export slowdown in the world outside East Asia. First, world oil prices had fallen by around $15 from their summer highs by the end of October. Oil prices are forecast to stabilize at around current levels and then gradually decline over time, which should help unwind some of the income losses caused by rising oil prices over the last three years in what is overall a net oil importing region.

As noted, East Asian central banks have generally tightened monetary policies, with policy interest rates rising from mid 2004 to the early part of 2006 to curb potential acceleration of inflation. Inflation rates have indeed been stabilizing and turning lower over the course of this year, allowing central banks to keep policy rates stable, and in the case of Indonesia, to begin easing. Central banks should have room to begin or continue easing monetary policy in 2007, which should help bolster domestic demand in case of a significant export led slowdown. The move towards greater exchange rate flexibility in the region in the years since the financial crisis (Exhibit 7) should also give central banks more freedom to use monetary policy in support of domestic policy targets rather than to maintain a given fixed exchange rate target.

Exhibit 7



Fiscal balances have improved and government debt has generally declined over the course of the decade in most of the larger East Asian economies, thanks to fiscal consolidation efforts, relatively low interest rates and sustained economic growth since 2001. Except for the Philippines, central government debt levels are now generally less than 50 percent of GDP, (Table 3), leaving room for short run fiscal stimulus, should global growth and exports slow to an unexpected degree in 2007. Indeed in a number of economies the greater difficulty seems to be lack of administrative capacity to spend budgeted resources rather than any lack of resources.

Table 3. Fiscal Balances and Debt

	2000	2001	2002	2003	2004	2005	2006
Fiscal Balance (a)							
China	-3.3	-2.7	-3.0	-2.5	-1.5	-1.3	-1.0
Indonesia	-1.8	-2.5	-0.9	-1.7	-1.0	-0.5	-1.1
Korea (b)	1.3	0.6	2.3	2.7	2.3	2.1	2.4
Malaysia	-5.7	-5.5	-5.6	-5.3	-4.3	-3.8	-3.5
Philippines	-4.0	-4.0	-5.3	-4.6	-3.8	-2.7	-1.5
Thailand	-2.2	-2.4	-1.4	0.4	0.1	-0.6	0.0
Government Debt (a)							
China (c)	16.4	17.7	18.9	19.2	18.5	17.9	16.9
Indonesia	80.0	76.4	70.8	61.1	54.6	46.8	37.0
Korea (d)	31.8	35.3	33.4	32.6	33.5	36.4	35.4
Malaysia	36.6	43.6	45.6	47.8	48.1	46.2	44.6
Philippines	64.6	65.7	71.0	77.7	78.5	71.8	65.4
Thailand (e)	57.0	56.5	53.8	48.7	48.0	46.4	41.0

Source: World Bank data and staff estimates. (a) Central government. (b) Including social security funds.(c) Includes local government (d)Includes KAMCO, KDIC bonds. (e) Includes SOEs and FIDF.

In *Indonesia*, for example, government debt has dropped from 80 percent of GDP at the end of 2000 to an estimated 37 percent at the end of 2006. Last year's administered fuel price increases totaling a cumulative 143 percent effectively transferred an estimated US$10 billion of disposable income from consumers to regional and central governments. This, together with under-spending of budgeted expenditures, resulted in fiscal tightening, with the fiscal deficit falling to only 0.5 percent of GDP. In 2006 fiscal policy has been put on a more expansionary track, although under-spending by regional governments means that the actual deficit will again be lower than planned. Looking forward, both central and regional governments have room to expand spending on public infrastructure in 2007 and beyond. In *Thailand* the budget is likely to be in balance this year, as it has been on average since 2003. Here too government spending has been coming in below budget, in particular as disbursements for public investment were delayed by the uncertain political conditions. Public investment spending is likely to pickup in 2007 as political conditions stabilize. In *Korea* the surplus on the overall balance (inclusive of social security funds) is likely to come in well above budget, also because of under-spending. In the *Philippines* the National Government deficit was cut by more than half through September 2006, as tax revenue increased sharply with implementation of a VAT reform.

This followed a major adjustment of the consolidated public sector deficit to 2 percent of GDP in 2005 (implying a primary surplus of over 4 percent). But, with national government debt still at over 70 percent of GDP at the end of 2005, the scope for counter-cyclical fiscal policy is more limited than in other East Asian economies.

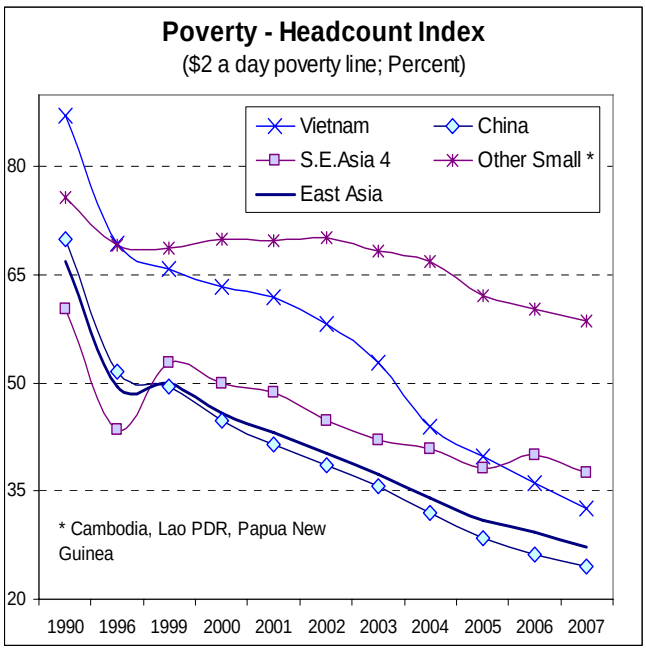
Poverty reduction and human development

In a year of strong economic growth for Developing East Asia – an aggregate 9.2 percent – further solid gains in poverty reduction are to be expected. Our current estimates suggest that the number of East Asian poor at the $2 a day level is likely to have fallen to some 550 million (or 29.3 percent of the population) in 2006, a drop of some 25 million (or over 1 ½ percentage points) from 2005. (Exhibit 8). More unusually, the current estimates are a little higher than in the last East Asia Update, accounted for by an unexpected up tick in poverty in Indonesia, the first since the financial crisis. Poverty at the national poverty line was estimated to have increased from 16 percent in February 2005 to 17.8 percent in March 2006. Most of the increase resulted from a sharp run-up in domestic rice prices, which in turn was partly due to shortages resulting from a ban on rice imports. Rice makes up about 25 percent of the consumption basket of the poor in Indonesia and three-fourths of the poor are net consumers of rice. In response the government reopened rice imports, helping stabilize prices. Current estimates also suggest that the pace of poverty reduction in Thailand may have eased in the last 2-3 years, in line with slowing economic growth in this period.

In much of the rest of the region, though, substantial gains in poverty reduction continue to occur. In China, where growth topped 10 percent this year, poverty at the $2 a day level is estimated to have been falling by 2 ½ - 3 ½ percentage points a year throughout this decade, falling to an estimated 26 percent in 2006. As the discussion of China below indicates, however, these findings come with a caveat about the accuracy with which household surveys cover the large itinerant migrant population, which may number as many as 150 million. While internal rural-urban migration has been one of the great engines of poverty reduction in China, more attention is now being paid to better protecting the interests of migrants and to easing the stresses in urban areas caused by high migration.

Poverty reduction is also occurring at rapid rates in Vietnam. The current estimates now incorporate the results of Vietnam's 2004 Household Survey, which suggest a sharp acceleration in poverty reduction in 2002-04, almost all of it in rural areas, resulting from rapid productivity gains in agriculture, diversification to new crops and non-agricultural activities, hefty increases in international prices for key exported crops, more resources for targeted poverty reduction programs and a more pro-poor focus in public investment and other fiscal expenditure programs. With further buoyant growth, poverty rates in Vietnam are estimated to have now fallen below those in Indonesia and Philippines. Poverty reduction has nevertheless been much slower among ethnic minorities than among the majority Kinh and Chinese populations in Vietnam, so that, as the later discussion in this section suggests, poverty is increasingly concentrated among minority communities, requiring more carefully designed and focused approaches to poverty alleviation. Poverty reduction and economic growth have also accelerated in low income economies like Cambodia and Lao PDR in recent years, although poverty levels still remain high – over 50 percent of the population at the $2 a day level.

Exhibit 8



China

Recent estimates for China indicate that the poverty rate and the number of poor continued to fall between 2005 and 2006. The World Bank estimates that in 2006, 8 percent of the population—about 106 million individuals—were below the dollar-a-day consumption poverty line, nearly all of whom were in (or from) rural areas. These findings come with a caveat: China has witnessed an unprecedented internal migration from rural to urban areas during the last 15 years and there are concerns about the accuracy with which household surveys cover the often itinerant migrant population, many of whom may be living in temporary and unregistered structures. (See Box 2.)

Nevertheless, three things are clear. First, internal migration and remittances play an important role in poverty reduction in rural areas: World Bank estimates indicate that in 2003, rural households with no migrant workers were nearly 50 percent more likely to be poor than those with migrant workers. Second, migration is a cause of rising

social inequities in urban areas: where migrant workers do bring their families to the cities, they are often denied access to government-funded health care facilities and priced out of local government schools—a recent survey indicated a premium of over 35 percent above what urban residents paid for tuition and school fees. Third, migration is likely to continue and even increase: while the 'floating population' of migrants is estimated at nearly 150 million, the number of remaining surplus workers in rural areas is estimated at about another 150 million.

Apart from new initiatives under the 11th Five Year Plan announced in March and described in the previous issue of the East Asia Update, the main recent poverty policy development was State Council Document No. 5 of 2006: "Opinions of the State Council on the Issue of Rural Migrant Workers." The document lays out an ambitious policy agenda to protect the rights and opportunities of rural migrant workers and their families and to ensure that they do not become a permanent urban underclass. It establishes a State Council Joint Conference on Rural Migrant Issues to implement this agenda. There are two key challenges: realizing the potential for rural poverty reduction, and addressing socioeconomic stresses in urban areas.

Realizing the poverty reduction potential of migration

Arguably, migration has played a foundational role in China's growth over the last two decades. In urban areas, the abundant supply of migrant workers has been an important element of China's competitive advantage. Migrant remittances are a major source of income for rural households—in the first nine months of 2005, RMB 85 billion in remittances were transferred through the postal system. However, not all the poor have been able to make use of this opportunity. And significant labor productivity differentials across sectors suggest that not enough people are moving: in 2004, value-added per worker in urban areas was 3.3 times that in rural areas. Thus the policy challenge includes addressing market failures and policy induced barriers in both factor and product markets that impede labor mobility, as well as fostering more investment in upgrading the skills of potential migrants in line with evolving labor demands.

Meeting challenges of migration in urban areas

Migrants remain a vulnerable segment of the urban labor market. Even controlling for occupation and skills, migrant workers earn less than registered urban workers and are more likely to experience wage arrears and to work without a contract. Few migrant workers participate in the main urban social insurance programs. Interestingly, preliminary estimates suggest that poverty rates are no higher among migrant households than among urban residents, despite urban residents having more access to social assistance programs. Several facts help explain this. Migrants are less likely to be out of the labor force or unemployed, work much longer hours and have fewer dependents (1.6 compared to 2.2). Migrants who cannot find work in cities are likely to return to rural areas, and the dependents of low income earners often remain in villages.

Box 2. The dimensions of internal migration in China

Internal migration in China since the late 1980s, and particularly in the last decade, has been described as the largest peacetime movement of people in history. Large numbers of rural workers have migrated to the cities to work, pulled by jobs in China's fast-growing manufacturing industries, and pushed by the growing pool of surplus labor resulting from reforms in agriculture. This movement has occurred despite longstanding policy impediments to labor mobility, notably, the "hukou" or household registration system. An individual's "hukou" status is assigned at birth and gives certain guarantees, for example an allocation of arable land in rural areas and rights to whatever social services are provided by local government in urban areas. But, except for college-educated white-collar workers, switching one's hukou from rural to urban and from one location to another is difficult.

The result has been a large "floating population" of people who live and work for many months of each year in places where they do not have hukou and thus have only limited, highly variable access to basic social services, potentially suffering discrimination in access to economic opportunities. Rough estimates of the size of the floating population—those who live for more than six months outside the township where they have their hukou—indicate that it constituted nearly 150 million people in recent years, nearly ten times the number in the late 1980s.

The Rural Household Survey of the National Bureau of Statistics indicates that in 2004 nearly two-thirds of migrants had left their families behind in rural areas. They were young, over two-thirds male, less educated than their urban counterparts—only 15 percent have completed senior high school—and concentrated in low-skilled industry, services and construction. Most work in the coastal provinces, often traveling long distances to do so. The scale of the phenomenon is suggested by the fact that in 2004 42 percent of rural households had at least one household member who worked as a migrant worker elsewhere. Less is known about the remaining third of the floating population. The presumption is that many are rural migrants who have moved with their families to urban areas and now permanently reside there without official recognition.

Box contributed by Shubham Chaudhuri.

Indonesia

Indonesia's Central Bureau of Statistics (BPS) announced that the poverty rate rose to 17.75 percent in March 2006 from 16 percent in February 2005, the first increase in poverty incidence since the economic crisis. An additional 4 million people fell into poverty during the period. Several events have likely affected poverty. A cut in fuel subsidies in October 2005 increased fuel prices by 114

percent, tripling the price of kerosene. Rice prices also rose 33 percent between February 2005 and March 2006.

World Bank analysis indicates that the fuel price increase is unlikely to have been the main driver behind the poverty increase. On its own the fuel price increase would have reduced the welfare of the poor and near poor by some 5 percent. However this effect was more than offset by the impact of the unconditional cash transfer (UCT) program introduced to soften the impact of the fuel subsidy cuts. The UCT program, which targets 19.2 million poor and near-poor households – some 34 percent of the population– is the world's largest ever cash transfer program, with beneficiary families each receiving about US$11 per month. Even assuming significant mistargeting of cash transfers, households in the lower deciles were on average more than compensated for the price increases[6].

Higher rice prices—partly due to shortages resulting from a ban on rice imports—are therefore likely the main factor behind the increase in poverty rates. Rice makes up about 25 percent of the consumption basket of the poor. Three-fourths of the poor are net consumers of rice. Thus rice price increases hurt far more people than they help. World Bank estimates suggest that 3.1 million people may have been pushed into poverty as a result of the rice price rise between February 2005 and March 2006, around 75 percent of the published increase in poverty. In response the government reopened rice imports before Idul Fitri, allowing in 210,000 ton, which has helped stabilize prices.

The planned CCT program scheduled to begin in May 2007 in 6 provinces will cover approximately 1 million households. Bappenas is working with relevant agencies to develop key elements of the program, including payment levels, the transfer system, institutional arrangements, training and communications, and monitoring and evaluation. The World Bank is providing technical assistance to Bappenas and DepSos. Cash transfers will be given to the female caregiver in each beneficiary family, and will be conditional on primary and junior secondary education enrollment and attendance, and on preventative care for children under 5 years and prenatal care.

In August 2006 the government announced its decision to implement the National Community Empowerment Program (*Program Nasional Pemberdayaan Masyarakat),* a nationwide community driven development program which will build upon the Kecamatan Development Program (KDP) and Urban Poverty Program (UPP). The Government plans to have the program in all 5,358 kecamatan (hamlets) by 2009. In recent years, the World Bank has channeled over $1 billion to CDD programs, with significant benefits for the communities involved. The new program will be scaled up to over US$1 billion per year.

6 Although on average the scenarios point to a positive net income gain, the actual impact depends on the level of expenditure of the recipients. Further studies to fully decompose the change in poverty incidence will be conducted when Susenas 2006 data become available.

Mongolia

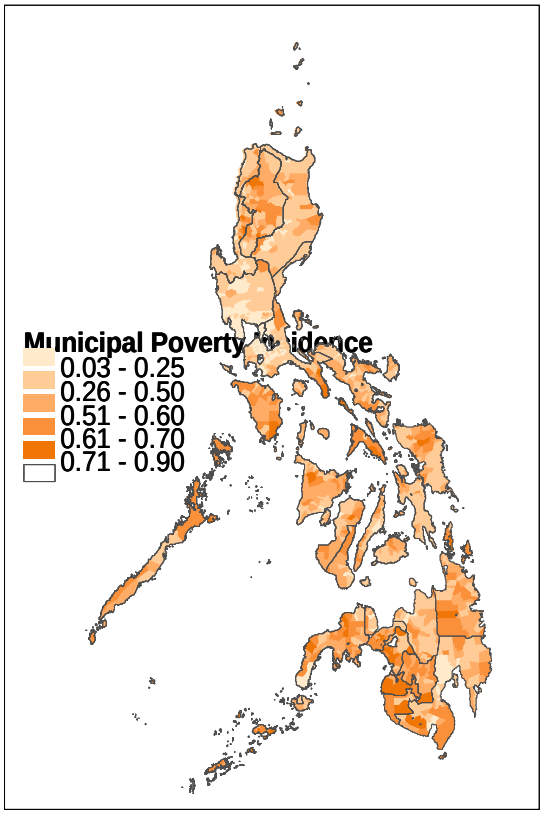
Mongolia's last available Household Survey in 2002 suggested a national poverty rate of around 36 percent. Estimates based on sectoral output and employment rates suggest it may have fallen to around 32 percent by 2005. Poverty is highest in rural areas and in the west of the country. The largest single group of poor comprises poor herder households. Poverty incidence among herders is 41 percent compared to the national rate of 36 percent.

Livestock are the main livelihood for 40 percent of the workforce, (or 386,000 out of a labor force of 968,000), though contributing only around 20 percent of national GDP. Goats, sheep, cattle, horses, yaks and camels are the main animals tended. Herder households are vulnerable to extreme climate events that cause high livestock mortality, in particular frequent droughts and the severe winters and springs known as *dzud.* One third of the national herd was lost in *dzud* between 1999 and 2002. Many households left the livestock sector and sought alternative livelihoods, including migration to cities, especially Ulaan Baatar, the capital, which now has a population approaching 1 million out of the national population of 2.5 million. Many rural Mongolians will nevertheless continue to depend on livestock for some time. Coping with the inherent risks of the livestock sector will be critical to their well-being. In part increased mobility has enabled households to diversify sources of income and so to mitigate risk. It is estimated that around 100,000 people are now engaged in small-scale informal mining.

Philippines

The Philippines' National Statistical Coordination Board (NSCB) and the World Bank recently released a national poverty map (Exhibit 9) for the period 2004-2005. The map is a response to the demand from policy makers for a more disaggregated level of poverty estimates. In particular, the country's anti-poverty flagship program, KALAHI, needs such information to allocate resources to the neediest areas. The NSCB-World Bank project is the first to produce a consistent set of poverty measures for all 1623 municipalities in the country, using the 2000 Census and the 2000 Family Income and Expenditure Survey.

Exhibit 9



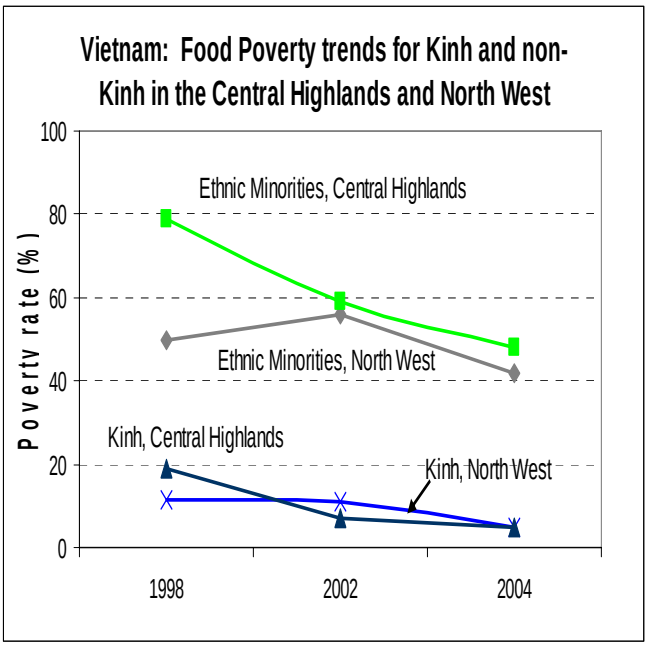
The results find high provincial poverty incidence in Mindanao Island, Bicol, Eastern Visaya, Cardillera Administrative Region, and Southern Tagalog. Over half the population in most provinces in these regions lived below the national poverty threshold in 2000. There is also a great variation of poverty incidences across municipalities within provinces. Some municipalities in the better-off provinces also experienced high poverty incidence, but the worst municipalities with the highest poverty incidence and poverty severity were mainly in Mindanao, Eastern Visaya and Southern Tagalog regions. The lowest poverty incidences were found in all the districts of the National Capital Region (i.e., Manila and surrounding areas).

Vietnam

The poverty estimates discussed here recently incorporated the results of the 2004 Vietnam Household Living Standard Survey (VHLSS). The Survey suggests that poverty reduction accelerated sharply in 2002-04, dropping from 29 percent in 2002 (the date of the previous Survey) to 21 percent in 2004, using the national poverty line. At the $2 a day level, poverty is estimated to have fallen from 58 percent to 44 percent. Virtually all of the fall was due to declines in rural poverty. Rural incomes benefited from productivity gains in agriculture and diversification to new crops and non-agricultural activities, as well from hefty increases in international prices for crops such as coffee and rice. Policy also played a part. There was a large increase in government resources for targeted poverty reduction programs. The 2001-2005 Public Investment Program raised infrastructure investment in remote, mountainous and border areas. The 2002 Budget Law decentralized public finance, with a clearly pro- poor impact. New rules for tax-revenue sharing allow poor provinces to retain more of the revenue collected in their territory.[7] Looking forward, Vietnam's Socio-Economic Development Plan for 2006-2010 has a stronger focus on poverty reduction and candidly analyzes the problems of disadvantaged groups and regions, including rural-urban migrants, people with disabilities and ethnic minorities.

The problem of poverty among ethnic minorities is especially pressing.[8] Because poverty reduction has been much slower among minorities than among the majority Kinh and Chinese populations, the proportion of the poor who are ethnic minorities doubled over the past 11 years to around 39 percent (although minorities are only 14 percent of the population). Despite government efforts, 61 percent of ethnic minorities were still poor in 2004, compared to 14 percent of Kinh. If current trends continue the problem of poverty in Vietnam will be overwhelmingly one of ethnic minorities within five years. Even more worryingly, over a third of ethnic minorities were unable to meet basic food needs in 2004. (Figure 10).

Exhibit 10



Ethnic minority poverty persists because minorities lack access to quality cropping and forest lands. While most minority households have annual cropland with sizes comparable to Kinh farmers, their land quality is lower.

[7] On a technical note, it is possible the 2002 Survey might have underestimated consumption expenditure and thus somewhat overestimated poverty, leading to some exaggeration in how quickly poverty fell in 2002-04.

[8] See Rob Swinkels and Carrie Turk: "Explaining Ethnic Minority Poverty in Vietnam: a summary of recent trends and current challenges." World Bank, September 2006.

Only 14 percent have access to gravity or pump irrigation, compared to 54 percent of Kinh farmers. Ethnic minorities are disadvantaged by isolation, limited market access and constrained access to agricultural and forestry extension services and to quality health and education services. The helpfulness of national target programs (NTPs) and extension services aimed at minorities has sometimes been limited, partly due to local officials limiting participation in decision making, reluctance to decentralize program management and lack of attention to market demand, affordability or local conditions. Ethnic minority adults have less education than their Kinh counterparts. Only 29 percent have completed at least lower secondary compared with 52 percent of Kinh adults. But there is evidence that the transfer of more resources to poorer areas is beginning to improve school quality standards, while mechanisms to exempt ethnic minorities from school contributions are expanding their outreach.

The international and regional environment

Global growth accelerated to near 4 percent in 2006 from 3.5 percent in 2005 (to around 5 percent in PPP terms), despite a further rise in average oil prices and widespread tightening of monetary policies aimed at keeping inflation in check. (Table 4). Developing country growth accelerated to 6.9 percent, more than twice the pace in OECD economies, with China alone contributing an estimated 0.5 percentage points to world growth. Evidence also mounted over the course of the year of a rotation in relative demand growth from the United States to Europe, where growth accelerated in the first half, and also to emerging Asia, in particular China, where growth also accelerated to over 10 percent. A continued rotation in global demand would help ensure that the expected slowing in world growth in 2007 in response to tighter monetary policies should be relatively modest, a 'soft landing' with world growth of about 3.3 percent. It was troubling, then, to see signs of greater weakness emerging in Japan in the second quarter and in the Euro area in the third quarter.

Developed country trends

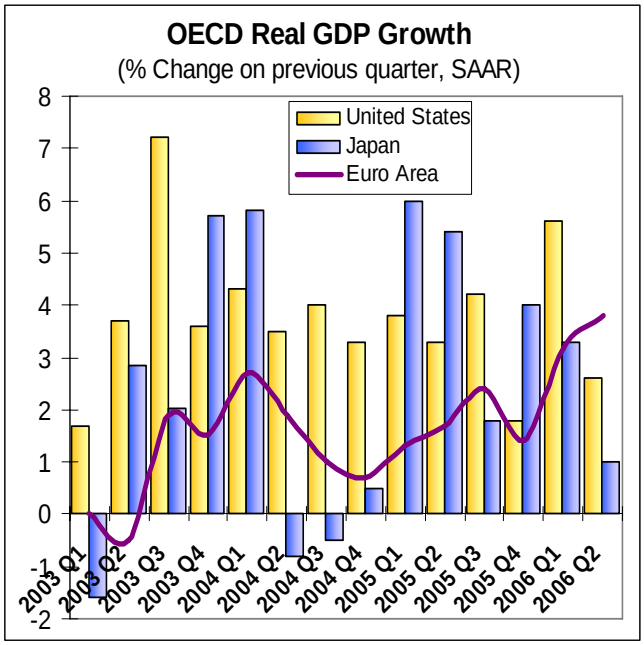
In the *United States* growth decelerated from an exceptionally strong 5.6 percent (saar) in the first quarter of 2006 to 2.6 percent in the second and 1.6 percent in the third. (Exhibit 11). All of the downturn in the second quarter resulted from slower domestic demand growth, notably weaker growth in spending on consumer durables, housing investment and business investment on equipment and software. Nine tenths of the slowdown in the third quarter reflected the ongoing slump in housing, with residential investment falling 17.4 percent, after an 11 percent fall in the second quarter. By the end of the third quarter existing home sales stood 12.7 percent below year-earlier levels; housing starts were down 20 percent; permits 28 percent. The median price for homes sold dropped in August and September for the first time since 1995. By September median prices were 2.2 percent below a year earlier. Other indicators suggest continued weakness in October. The Institute of Supply Management's headline index of activity in manufacturing dropped from 52.9 in September to 51.2, below most forecasts, and rapidly approaching the 50 mark which divides "expansion" from "contraction".

Table 4. International Economic Environment

	2004	2005	2006	2007
% Change from previous year, except interest rates				
GDP Growth				
World	4.1	3.5	3.9	3.3
World (PPP Weights)	5.2	4.7	5.1	4.5
OECD	3.2	2.6	3.0	2.4
United States	4.2	3.2	3.3	2.4
Euro Area	2.0	1.4	2.3	1.9
Japan	2.7	2.6	2.9	2.4
Australia	3.0	2.5	3.1	3.5
World Trade (Volume)	10.4	7.5	9.7	7.3
CPI Inflation - G7 [a/]	1.8	2.2	2.5	2.1
Oil Price - $/bbl	37.7	53.4	65.0	60.0
- % Change	30.6	41.5	21.7	-7.7
Non-oil Commodity Prices	17.5	13.4	20.6	-4.5
LIBOR (US$. 6 Mo.)	1.6	3.6	5.4	5.7

Source: World Bank DEC Prospects Group update 10/03/06. a/ In local currency, aggregated using 1995 weights.

Exhibit 11



Not all recent indicators were negative though, leading to some expectations of a stronger fourth quarter. The outlook in part depends on the extent of spillover effects from the housing recession, including possible negative wealth effect on consumption due to weaker house prices. The third quarter GDP data gave some cause for

cheer in this respect. Despite the plunge in residential investment, consumption spending growth accelerated to 3.1 percent (saar), while business investment growth doubled to 8.6 percent. Sharp declines in oil and gasoline prices underpinned some increases in consumer confidence in September and early October, after large declines earlier in the year. Consumer spending is also likely to be underpinned by continued strength in labor markets. Payroll numbers in the third quarter and October have been higher than expected and come on top of a big upward revision of 810,000 jobs in employment estimates for the year to March 2006. The unemployment rate fell to 4.4 percent in October from 4.6 percent in September. Worker compensation growth picked up to a hefty 5.5 percent in the third quarter. Housing starts and sales actually showed small month-to-month increases towards the end of the third quarter, leading to suggestions that the 'freefall' may be drawing to an end, although few would look for any sustained rebound for some time yet.

On balance the flow of data has led to consensus forecasts for US growth in 2007 being cut from a little over 3 percent last January to a little over 2 ½ percent in October, with a greater likelihood of a 'hard-landing', and with increased uncertainty about the outlook. Increased uncertainty could be one explanation for the divergence seen in US financial markets: stock market prices have risen strongly from August onwards, suggesting that equity investors were not looking for a further marked weakening in growth. On the other hand yields in the government bond market fell by over 50 basis points over the third quarter, suggesting expectations of a weakening economy.

In *Japan* solid GDP growth rates of 3-4 percent (saar) in the last quarter of 2005 and first of 2006 led to expectations of sustained robust growth of 2½-3 percent for the rest of 2006. These hopes took a knock when growth dipped to only 1 percent in the second quarter, pulled down by lower public investment (reflecting longer term efforts at fiscal consolidation), as well as lower housing investment and a slowing in export growth. On a more positive note, private consumption grew by about 2 percent, while business investment continued to expand at a double-digit rate, supported by buoyant business profits. Current indicators for factory orders, exports and retail sales also suggested that the weaker trend continued in the third quarter. On a more positive note, the Bank of Japan's September Tankan Survey was more upbeat than expected, with large manufacturing firms planning significant expansion in capital expenditures. Business confidence was bolstered by the new Prime Minister Shintaro Abe's appointment of what are perceived to be a strong cabinet and economic policy teams. Overall, the consensus expectation remains for the economy to achieve a 'soft landing' in 2007, with projected growth of 2.4 percent.

Countering the slower trend in the US and Japan, growth in the *Euro Area* has accelerated in 2006, with outcomes generally exceeding expectations. Second quarter GDP growth for the Euro Area was revised up by 0.2 points to an exceptional 3.8 percent (saar), up from an also strong 3.2 percent growth pace in the first quarter. This was also the most robust Euro Area growth pace in six years. Fixed investment—the pillar for Euro Area recovery in 2006—contributed about half of growth in the quarter while inventories contributed another 0.5 percentage points. More recent data show a firming of production trends across the big countries of the Area, drawing on both stronger domestic and foreign demand. These include solid gains in factory orders, industrial production, PMI surveys for manufacturing and services activity, employment and retail sales. Inflation pressures are waning running at below the below the ECB's 2 percent target in September. Euro Area business sentiment has climbed to its highest level in five years. Nevertheless, some worrying signs of weakness did emerge in Europe in the third quarter, for example a fall in French growth to zero from 4.9 percent in the second quarter.

China

Growth in China accelerated to almost 11 percent in the first half of the year, reaching 11.3 percent in the second quarter, the highest in a decade, before decelerating modestly to 10.4 percent in the third quarter, following tightening measures aimed at reducing investment growth, which together with exports, has been one of the principal drivers of growth in the year.

Growth in nominal urban fixed asset investment (FAI)[9] accelerated from a little over 25 percent in 2005 to about 31 percent in the first half of 2006. Concerns about excessive investment growth led to a new round of tightening starting in April. The measures include monetary tightening by absorbing liquidity in the interbank market; administrative measures to limit speculative investment in real estate, reinforcement of controls and regulations on investment projects, including a re-evaluation of all large investment projects under implementation; and loosening controls on capital outflows. As Box 3 below elaborates, rising internal profitability has made enterprise saving the principal source of financing for investment by Chinese enterprises. This development may make investment more pro-cyclical, as high profits in good times are ploughed back into more investment, and may also weaken the ability of monetary policy to control investment. The tightening measures did nevertheless succeed in easing FAI growth to 24 percent in the third quarter. Consumption growth also continued at robust rates, although lagging well behind investment. Real per capita urban consumption grew 8.4 percent in the first half, fuelled by rapid wage increases. Real per capita rural consumption rose an even more solid 9.3 percent in this period.

[9] FAI is an imperfect measure of fixed investment in the national accounts sense. It is, however, available in a monthly data series. The relation between the two is discussed further in the World Bank's China Quarterly Update, November 2006.

Box 3. Saving, Investment and Profits in China's Enterprises

A lively debate has emerged on how high enterprise profits are in China and what role they play in financing enterprise investment and the implications for policy. If it is internal enterprise saving that is the main source of investment finance rather than external bank financing, monetary policy may be less effective in slowing China's rapid investment growth, and other measures may be needed. A high share of profits in investment financing may also lead to more inefficient investment if corporate governance is weak, with little outside scrutiny by shareholders or banks.

China's investment reached over 40 percent of GDP in 2005, of which around 31 percentage points was undertaken by enterprises. Of this enterprise investment, just over 20 percentage points was financed internally from enterprise savings and the remainder, about one third, by outside sources such as banks. This level of enterprise saving is higher than household saving in China, and higher than enterprise saving in most other countries.[10]

There are three reasons why enterprise saving is relatively high in China. First, industry makes up a larger share of GDP in China than in most other countries. Industry is more capital intensive than other sectors, which means that a relatively large share of total income goes to capital in the form of interest and profits, instead of wages to labor. That is why there is a strong cross-country correlation between the importance of industry and saving. Second, China has a tradition of low dividend payments. This is so especially for state owned enterprises (SOEs), which still make up a significant share of the economy, especially in capital-intensive sectors like heavy industry. Third, since the mid-1990s, profitability has increased due to rapid industrial growth and restructuring of SOEs. Profit margins of Chinese enterprises have doubled since 1999. (Box Table 1). Since total profits equal profit margin on sales times sales volume, and rapid economic growth boosted sales volumes in recent years, profit volumes have also surged, averaging 36 percent growth in 1999-2005.

Of course there are still many loss-making enterprises in China, even if overall profits are up. But the trend in the share of such enterprises is clearly down. According to the NBS Yearbook, 18 percent of industrial enterprises (above a certain size) were making losses in 2005 compared to 28 percent in 1998. And whereas in 1998 such losses still outweighed total profits of profitable enterprises, by 2005 such profits were RMB 1.4 trillion, 14 times larger than the losses of loss-making enterprises.

Box Table 1. Industrial Profits in China's industry (%)

	1999	2000	2001	2002	2003	2004	2005
Profit Margin	2.7	4.8	4.5	4.9	5.7	6.0	5.7
Sales Growth	10.2	20.4	11.4	16.7	28.3	31.4	27.0
Profit Growth	52.0	86.2	8.1	20.6	42.7	38.1	22.6

Source: National Bureau of Statistics.

SOEs are very much part of this profit story. Profits of all SOEs in 2005 amounted to RMB 905 billion, up 25 percent from the year before. Profits of state-controlled enterprises rose 20 percent in the first 3 quarters of 2006. The number of loss-making SOEs has been declining over time, and the ratio of profits of profit making enterprises to losses of loss making ones rose from over 1 in 1999 to over 6 in 2005. Subsidies to loss-making SOEs have fallen over time to now only RMB20 billion, or only 2 percent of total SOE profits. However, State Enterprises still use capital less efficiently than private enterprises.

Three issues stand out: First, given that such a large share of investment is financed by enterprise saving and government transfers, monetary policy may not be as effective in reining in investment as sometimes thought. Second, the important role of internally-generated funds in financing makes investment pro-cyclical: in good times, high profits, ploughed back into new investment, will further fuel activity, while in bad times subdued profits will hold back investment and activity. Third, the importance of retained earnings means that much of the financing of investment faces little outside scrutiny, since the decisions on financing projects are made by enterprise management rather than the financial sector. This may affect the efficiency of investment. That is why the continued investment boom warrants concerns about efficiency, making more moderate growth desirable.

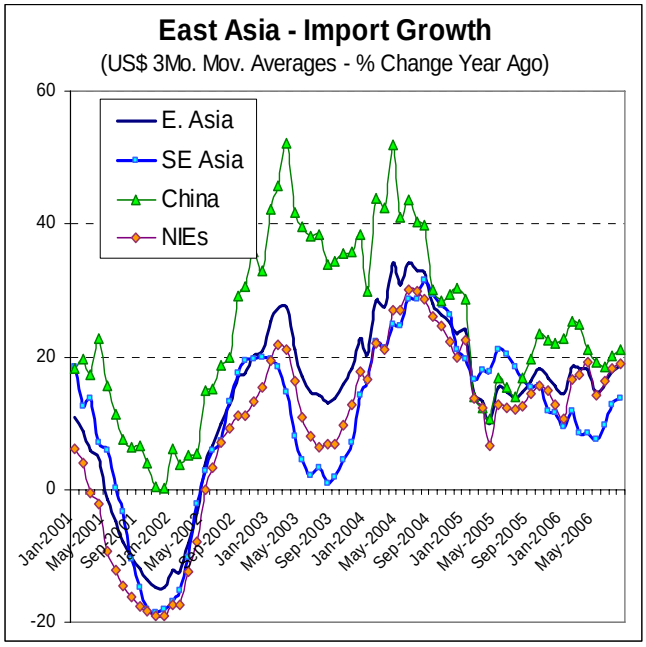
Introducing a dividend policy for SOEs is a reform that can help both with improving the efficiency of investment and with addressing macroeconomic concerns.

Box contributed by Louis Kuijs.

The slowdown in investment growth in the third quarter was partly offset by a further increase in the contribution of net trade to growth. Export growth has in fact been picking up over the course of the year, rising from around 22 percent in nominal US dollar terms in the last quarter of 2005 to 29 percent in the third quarter of 2006. Export strength partly reflects new production capacity put in place by the heavy investment of recent years, particularly in sectors such as steel and machinery, resulting, for example, in the country turning from a net steel importer into a net exporter. Import growth has been rather more stable, running at 21 percent in the first nine months and 22 percent in the third quarter. (Exhibit 12).

[10] See Louis Kuijs. "How will China's Saving-Investment Balance Evolve?", World Bank Policy Research Paper 3958 and "A Note on Profits and Investment of China's Enterprises", available on www.worldbank.org/cn.

Exhibit 12



With rising export growth outpacing imports by a growing margin, the contribution of net trade to GDP growth increased to almost 3 percentage points in the third quarter, after 1.2 percentage point in the first and 2.4 percentage points in the second. The trade surplus reached a record US$ 49 billion in the third quarter, up from US$ 29 billion in the third quarter of 2005. In the first three quarters the trade surplus rose to US$110 billion from US$ 69 billion in the same 2005 period.

The rapid increase in the trade and current account surpluses (discussed further in the later section on balance of payments issues) is now the principal short term macroeconomic imbalance of concern to the authorities. As noted, the authorities have aimed to cool the rapid growth in investment. The aim has been not so much to prevent generalized overheating, of which there is little sign in the inflation data, but rather to reduce the risk of overcapacity and resources being wasted in poorly chosen and inefficient investment projects (which could in time contribute to bad debt problems in the banking system). Nevertheless lower investment growth is likely to aggravate the rapid rise in the trade imbalance unless offset by stronger consumption growth and a greater switching of domestic demand growth towards imports. The circumstances therefore point towards a continued focus on the role of a stronger exchange rate in bringing about desirable expenditure switching, as well as structural measures to foster stronger consumption growth. Such measures can include, for example expansion of the social safety net, in particular expansion of rural health insurance and establishment of rural pensions, as well more public financing of education.

From the perspective of its trading partners in Emerging East Asia, China's rapid growth continues to provide an important locomotive for trade and growth in the region as a whole. China's imports from the rest of emerging East Asia were up about 20 percent in the first three quarters of 2006, about the same pace as in 2005. (Exhibit 13). Measured from the perspective of these trading partners, exports to China and Hong Kong contributed about a third of overall export growth in the first half of the year, while exports to other emerging East Asian economies contributed about a quarter. (Exhibit 14).

Exhibit 13

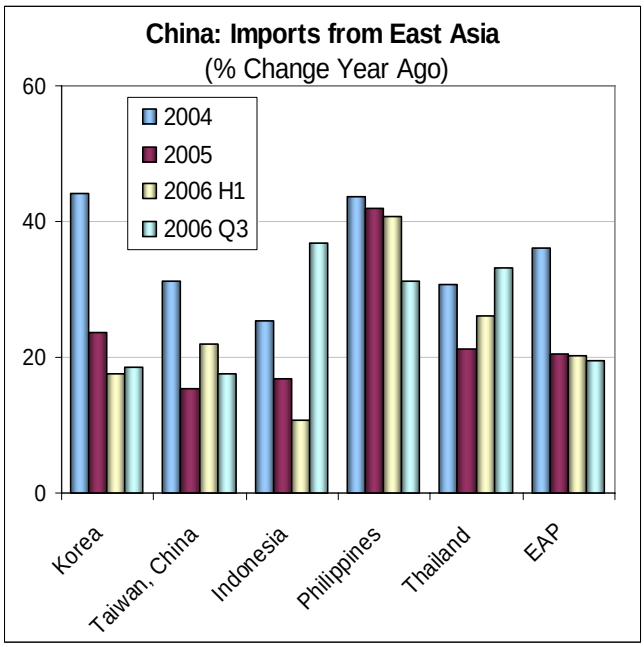
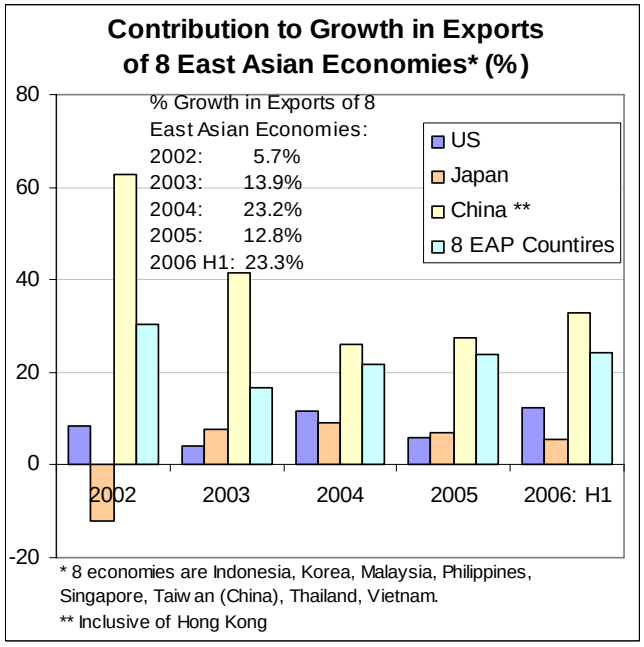


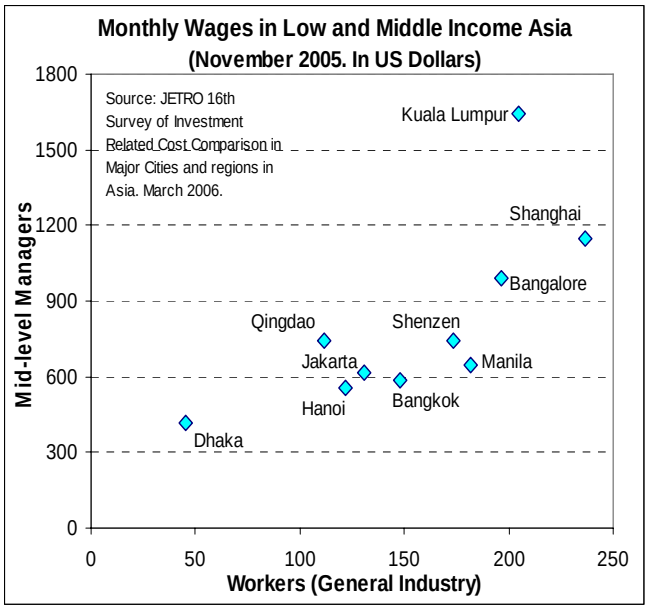
Exhibit 14



The rapid growth of China's imports from the rest of East Asia has in effect compensated those economies for their losses in world markets as a result of competitive pressure from China's exports. At the same time China is

rapidly moving up the value-added ladder in its export composition, in part because of the fast growth of wages that has accompanied economic growth. Average nominal wages in China have risen 145 percent since 1998, about 14 percent a year. Chinese workers and middle managers in many coastal cities are now more expensive than in many low and middle income economies in Asia. (Exhibit 15). The concerns of some that it would take many years before they could compete with cheap Chinese labor should be alleviated by the rapid structural changes taking place in China's product and labor markets.

Exhibit 15.



'Decoupling', Intra and Extra-Regional Trade

How seriously would a marked slowdown in the US economy affect the export-oriented Emerging East Asia region? Is it likely that - given the rapid momentum of growth in the region and the rise of intra-regional trade – East Asia could now rely mainly on intra-regional demand, that it might be only lightly scathed by a recession in the US or, more generally, in the world outside the region? The question has been widely debated among economic commentators of late. The answer appears to be that East Asian exports would still be significantly affected by a serious US slowdown or recession. Here we briefly review some of the issues underlying this question, referring where appropriate to several detailed studies already undertaken by other analysts.[11]

Table 5 indicates that the share of emerging East Asian exports going to the US fell modestly from 22 percent in 1995 to a still substantial 19.7 percent in 2005. (The table treats China and Hong Kong as a single economy, netting out their exports to each other.) Over the same period the share of intra-East Asian exports rose modestly from 30 percent in 1995 to just less than 32 percent in 2005. These seem rather small changes from which to argue that East Asia has become substantially less dependent on US markets in recent years.

The geographical pattern of China's exports (inclusive of Hong Kong) has also been remarkably stable. Exports to the US comprised 26 percent of the total in 2005, only slightly down from 27 percent in 1995, while exports to the rest of East Asia have been steady at 16 percent. China (inclusive of Hong Kong) is now the economy in the region with the highest export orientation towards the US..

It is only when one looks at Emerging East Asian economies other than China and Hong Kong that more dramatic changes emerge. Taking the seven main other economies together, Table 5 shows that their exports to the US fell from 20 percent to 15 percent of their total exports over this period, while exports to the rest of East Asia (including China and Hong Kong) jumped from 36 percent to 44 percent. Indeed it was precisely exports to China (inclusive of Hong Kong) that explained all of the increase in these countries' intra-Asian trade: exports to China jumped from 13 percent to 23 percent of the total, while the share of exports to other East Asian economies (not including China) was generally flat.

The key change in the geographical structure of trade in East Asia over the last decade, then, has been a shift in the export orientation of East Asian economies other than China from the USA to China. Does this mean these economies are now significantly more decoupled from the US than a decade ago? Given the strong growth of domestic demand in China, is it not likely that China could replace the US as the main locomotive of East Asian growth? There are at least two answers to this question. From a short run cyclical perspective, the short answer seems to be: not yet – it is unlikely that strong growth in China could offset the effects of a recession in the US. However, from a longer run, structural perspective, the deepening integration of East Asian economies is indeed a crucial source of productivity gains and growth for the region.

From the short run, cyclical perspective, there is reason to think that there has been rather less decoupling from extra-regional markets than would appear on the face of it. The change in export-orientation of other East Asian economies towards China mainly reflects the change in the regional division of labor within East Asia over the last decade, with the growth of China as a central assembler and exporter of finished manufactures to global markets outside Asia, and of other East Asian economies as suppliers of specialized capital goods, parts, components and other intermediates to China. China's demand for these inputs from the rest of East Asia is therefore driven to a large

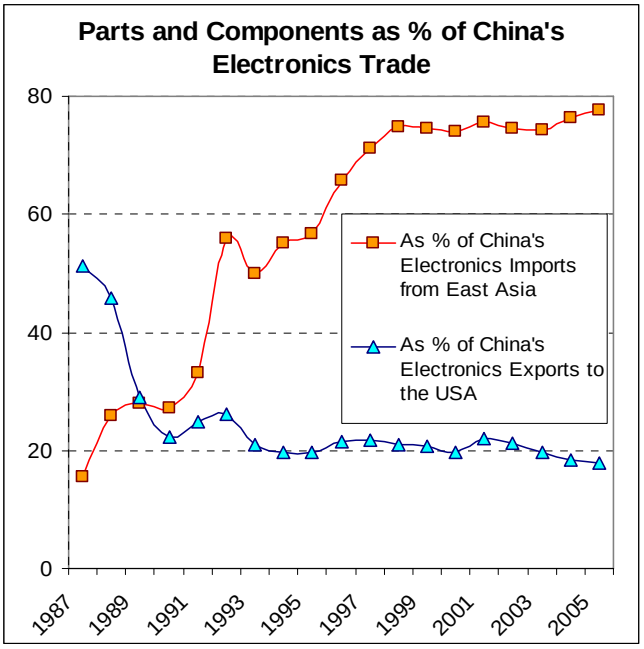
[11] See for example Jonathan Anderson: 'The Return of Asia (Part 3): Delinking? Or Just Recovering?' UBS Investment Research,. Asian Economic Perspectives October 24, 2006. See also Hak Bin Chua: 'A US Slowdown: Asia Decoupling or Vulnerable?' Citigroup. Asia Macro Views September 4, 2006.

Table 5. East Asia - Export Market Shares (% of Total Exports)

	Exports to:							
	USA		Emerging East Asia		China+HK		Other East Asia (7)	
	2005	1995	2005	1995	2005	1995	2005	1995
Emerg.East Asia	19.7	22.0	31.9	30.1	12.9	9.4	19.0	20.7
China+HK	26.3	27.4	16.0	16.3	..	..	16.0	16.3
Other E.Asia (7)	14.7	19.8	43.8	35.8	22.5	13.3	21.3	22.5
Indonesia	11.5	13.9	38.1	27.2	9.5	7.5	28.6	19.7
Malaysia	19.7	20.8	43.3	40.1	12.4	7.9	30.9	32.2
Philippines	18.0	35.8	42.5	24.6	18.0	5.9	24.5	18.7
Thailand	15.5	17.2	35.7	29.7	13.8	7.8	21.9	21.9
Korea	14.6	18.5	39.4	30.6	27.2	15.1	12.1	15.5
Singapore	11.5	18.3	49.4	44.3	19.9	10.9	29.4	33.4
Taiwan (China)	15.1	23.7	52.4	38.5	37.8	23.7	14.6	14.8

extent by demand for its exports to the major developed economy markets outside emerging East Asia – the United States in the first place, but also Europe and Japan. A downturn in China's exports to these global markets is swiftly felt in the exports of the rest of East Asia to China. The rest of this section presents evidence that supports this view.

Exhibit 16



China's emerging role as a processor and workshop for global markets and the role of other East Asian economies as suppliers of inputs to China are especially clear in electronics and 'high tech' products. Such high tech products (defined here as the SITC 75, 76 and 77 categories) have become ever more important in both China's exports and imports, increasing from 7 percent of exports in 1990 to 37 percent in 2005, and from 10 to 31 percent of imports over the same period. The composition of China's high tech imports is rather different from that of its exports, though. In particular, as Exhibit 16 indicates, parts and components are almost [80] percent of China's high tech imports from the rest of East Asia, a proportion that has increased dramatically over the last 15 years. On the other hand, they are less than 20 percent of China's high tech exports to the US, a proportion that has fallen substantially over the years, implying a growing share of finished products in exports to the US.

Exhibit 17.
China: Processing Exports (As % of Total)

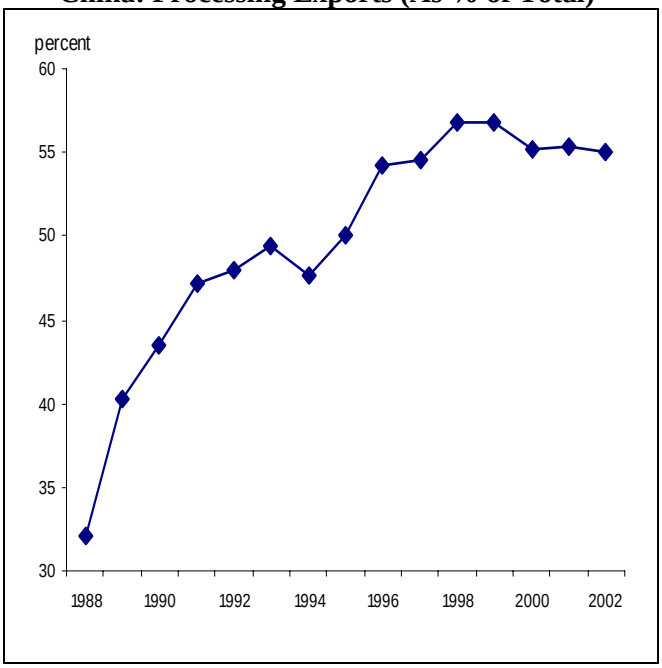
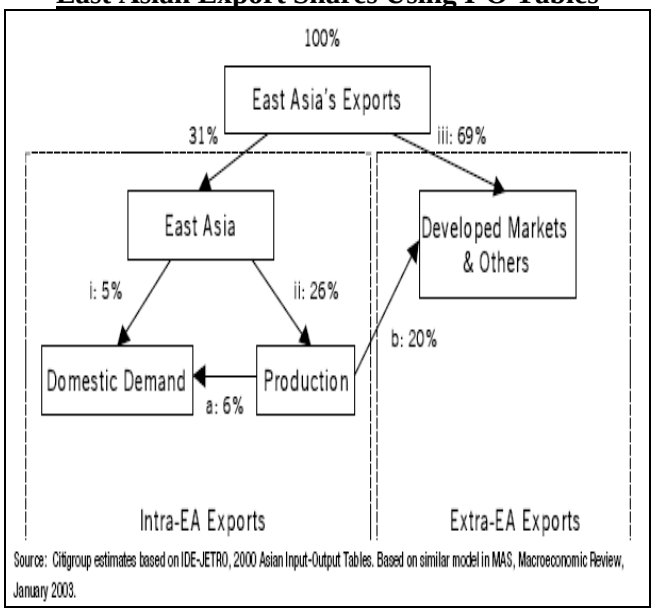


Exhibit 17 documents the importance of assembly and processing for China's export economy more generally. Some 55 percent of China's exports now are goods that have been imported into China by foreign enterprises for processing and re-export back into global markets. Such processing exports have almost doubled over the last

decade, rising from 29 percent of the total in 1994. The corresponding imports for processing have risen from 46 to 56 percent over this period. Anderson (2006) calculates that if such processing shipments are stripped out and "re-assigned" to their final destinations, then the share of China in the exports of the other main East Asian economies falls from 27 percent to only 13 percent.[12] The share of the US, Japan and the EU increases from 36 percent to 45 percent.

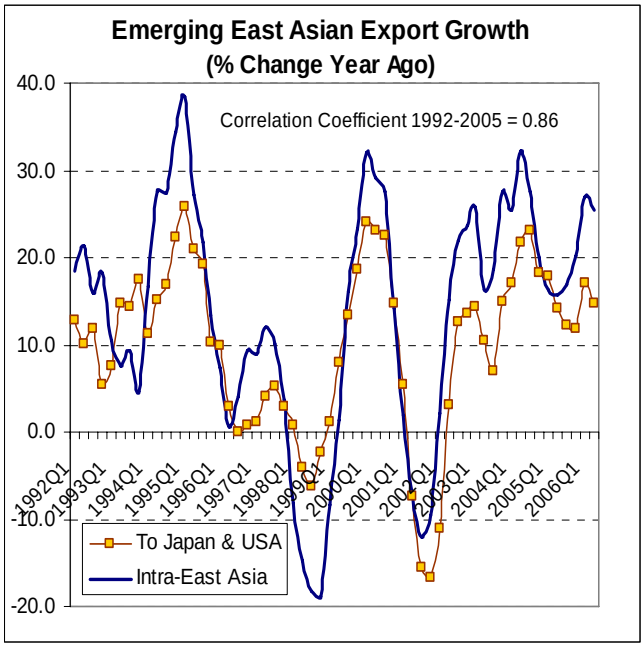
Exhibit 18.
East Asian Export Shares Using I-O Tables



Source: Citigroup Asia Macro Views. September 4, 2006.

Exhibit 18 presents the results of a recent study (Bin Chua, 2006) that provides a more systematic analysis of the final destination of East Asian exports using recently published international input-output tables for East Asia.[13] Exhibit 18 notes that some 31 percent of East Asian exports (including China and Hong Kong) are intra-Asian exports, while 69 percent go outside the region. There is a significant element of double-counting in this calculation, however, because a large part of intra-Asian exports are intermediates that end up incorporated in extra-Asian exports. The exhibit suggests that of the 31 percent of intra-Asian exports, only 5 percentage points directly satisfy Asian domestic demand. The remaining 26 percentage points are intermediates that go into Asian production processes. Of these, 6 percentage points also finally go to satisfying Asian domestic demand (making a total 11 percentage points devoted to Asian domestic demand), while the remaining 20 percentage points are exports outside the region (but which have already been counted in the initial 69 percent allocated to extra-Asian exports). A more accurate measurement would then be that about 14 percent of East Asian exports are intra-regional (=11/(11+69)), while 86 percent are extra-regional (=69/(11+69)).[14] Within the latter figure, exports to the USA would represent 25 percentage points, while those to Japan, Europe and all other markets would comprise 14, 22 and 25 percentage points respectively.

Exhibit 19



These calculations also suggest that it is premature to expect a decoupling of East Asian export prospects from developments in the US or other major extra-regional markets. As Exhibit 19 indicates, growth in intra-Asian exports over the last two decades has been closely correlated with that in extra-regional markets, in this case with exports to the US and Japan. Exhibit 20 shows a similar close correlation between growth in China's imports of high tech parts and components from East Asia and its exports of high tech goods to the US. As recently as 2001, the end of the global high tech bubble and sharp declines in high tech demand in the developed economies resulted in an equally sharp fall in intra-Asian exports. Growth in China's imports from the rest of Asia fell from 36 percent in 2000 to almost zero in 2001, despite GDP growth in China of over 8 percent. Real GDP growth in the rest of Asia fell to only 1-2 percent in 2001.

The broadly diversified geographical structure of East Asian export markets does however suggest that the impact of a US slowdown could be mitigated to some extent by stronger growth in other major markets even after netting out the impact of intra-regional intermediate trade. As the

[12] These figures include Hong Kong in the group of other East Asian economies, and so differ from the figures in Table 5, which include Hong Kong with China.

[13] IDE JETRO. Asian International Input Output Tables 2000. March, 2006.

[14] This calculation of course makes the somewhat unrealistic assumption that extra-regional exports do not also need to be adjusted for input-output relationships.

earlier adjusted calculations show, intra-Emerging East Asian exports and exports to Japan together comprise 28 percent of exports, while Europe and the rest of the world comprise 22 and 25 percent respectively, each broadly similar to the 25 percent US share of East Asian exports. Such a switch towards non-US markets may be facilitated by the fact that the commodity composition of East Asian exports to different major extra-regional markets is quite similar.

Exhibit 20

Table 6. Export Similarity Indexes for Emerging East Asian Exports to Various Markets (2005) *

	USA-Europe	USA-Japan	Japan-Europe
Export Similarity Index [15]	83.6	66.3	67.2
Spearman Rank Correlation	91.4	82.5	80.3

* Calculated with exports at the 3 digit SITC level.

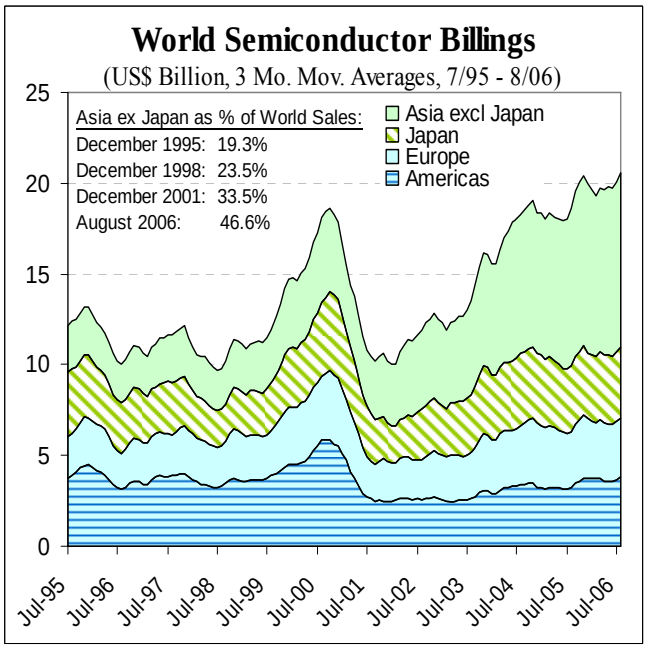
Table 6 shows several measures of export similarity for Emerging East Asian exports to the US compared to exports to Europe, together with exports to the US versus Japan, and exports to Japan versus those to Europe. These indexes can range in theory from 0 (no similarity) to 100 (perfect similarity). The indexes suggest quite high similarity between East Asian exports to the US and Europe, and, to a somewhat lesser extent, between exports to the US and Japan. (To provide some comparison, the similarity index between Korean and Indonesian exports to the world - i.e. between a capital goods and manufactures exporter and a more primary commodity oriented exporter - is only 33).

Commodity markets

High tech cycle

Robust exports of electronics and high tech products have been one of the more positive sustaining forces in many East Asian economies this year. On balance recent data seem to confirm that global demand for these products is continuing to expand at healthy rates. Worldwide semiconductor sales in the three months to August 2006 averaged a record $20.5 billion, rising 10.5 percent from a year earlier. (Exhibit 21). The Semiconductor Industry Association (SIA) reports that sales growth was spread across a wide range of semiconductor products, reflecting good growth in end-markets. Consumer electronics end-markets, which now account for over 50 percent of semiconductor sales, continue to perform well, with an upturn in September US retail sales mildly alleviating concerns about severe downturn in US consumer spending in the rest of 2006 or in 2007.

Exhibit 21



Not all indicators are entirely rosy though. The SIA noted that inventories have been rising in recent months, though they remain in line with requirements for the upcoming peak holiday sales period. Worldwide sales

[15] The export similarity (XS) index provides useful information on distinctive export patterns from country to country. It is defined as:

$XS_{j,k} = \sum_i [\min (X_{ij}, X_{ik}) * 100]$

Where X_{ij} and X_{ik} are industry i's export shares in country j's and country k's exports, which usually include a group of countries or competitors. The index varies between zero and 100, with zero indicating complete dissimilarity and 100 representing identical export composition. This measure is subject to aggregation bias (as the data are more finely disaggregated, the index will tend to fall) and hence embodies a certain arbitrariness due to product choice.

bookings by the North American semiconductor equipment machinery industry have moved a little lower in recent months, causing the book-to-bill ratio to fall from 1.14 in June to 0.99-1 in August September. (Exhibit 22). Taken in conjunction with the SIA's report that capacity utilization in the semiconductor industry is expected to remain at a high 95 percent level for the rest of year, the weakening in semiconductor machinery orders may suggest that semiconductor manufacturers are expecting a downturn in final demand for their products and therefore do not think it worthwhile to invest in additional capacity.

Exhibit 22

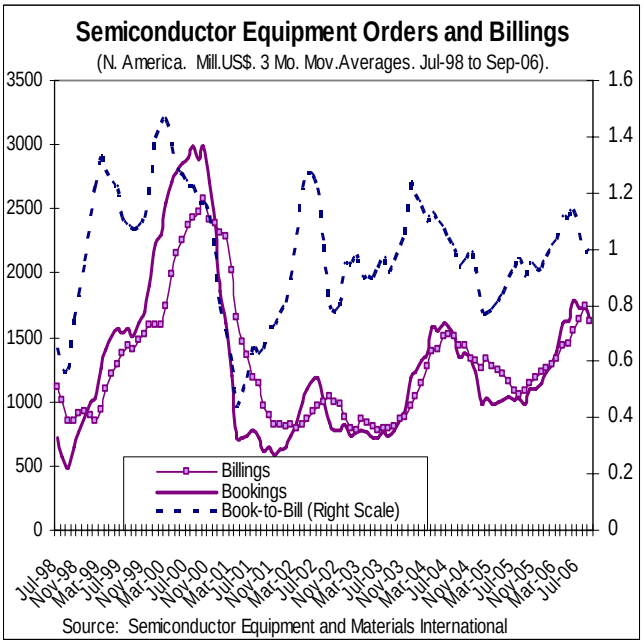
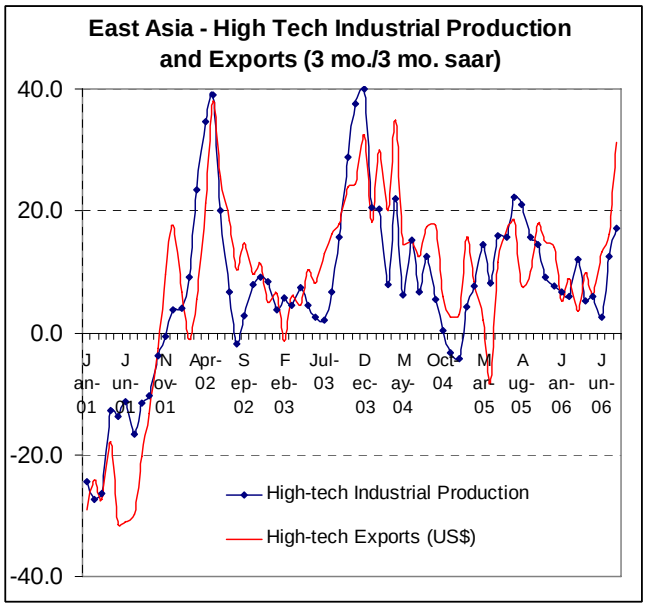


Exhibit 23

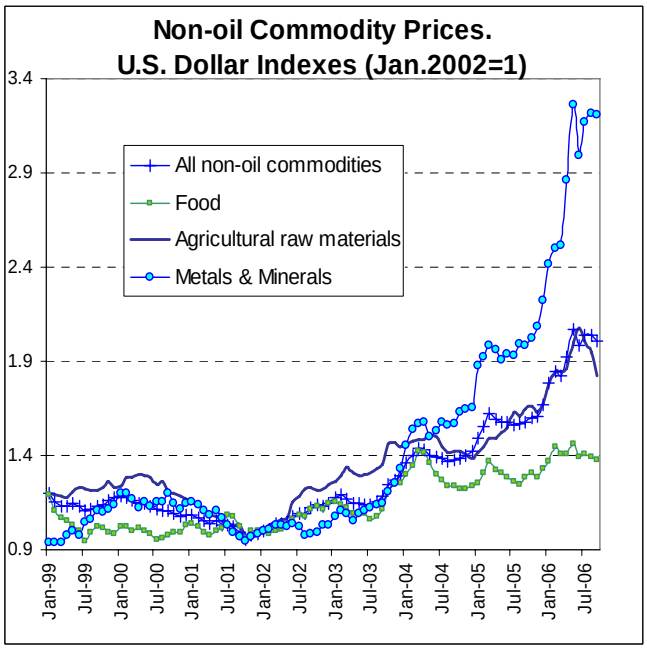


Be that as it may, East Asian high tech exports and industrial production are clearly benefiting from the current strength in world high tech final product markets (particularly for sales of cell phones, MP3 players and similar consumer electronics products). And after a slow period in the early months of 2006, aggregate high tech production and exports from selected East Asian economies accelerated in the middle part of the year. The three month on three month seasonally adjusted annual rate (saar) of growth of industrial production jumped to 17.2 percent in August from 2.5 percent during the second quarter, while export growth more-than doubled from 13.3% to 31.2% by August. (Exhibit 23).

Non oil commodity markets

Strong world economic growth in 2006 has been reflected in another leg upward for the boom in many non-oil primary commodity prices that began in early 2002, along with the present global economic expansion. The Bank's index of non-oil commodity prices surged 31 percent between September 2005 and May 2006 in US dollar terms. (Exhibit 24). Dollar prices have shown modest declines or held flat since May, perhaps reflecting such factors as expectations of slowing world demand growth going forward, tighter monetary policies around the world and the modest strengthening of the dollar against other major currencies in recent months.

Exhibit 24



Metals and minerals have been especially buoyant, rising 64 percent between last September and this May, with especially large gains for copper, nickel and zinc, metals where, in addition to robust industrial demand growth, prices have also been boosted by labor and other supply problems, and by very low inventory levels. Prices have been volatile since May, but have generally remained close

to the highs attained in the first half. While US demand is slowing because of the downturn in US housing construction, demand from China has been strengthening after a period of de-stocking. Sentiment remains quite bullish, with metals like zinc and nickel making new nominal highs in September. In East Asia, an exporter of both minerals and oil like Papua New Guinea has enjoyed multiple terms of trade gains from both higher minerals and oil prices. A mineral exporting oil importer like Mongolia has had a more mixed experience, with high copper export prices offsetting by more costly oil imports.

Of note for agricultural raw materials exporters such as Indonesia, Malaysia, Thailand and Vietnam, rubber prices have fallen by about 25 percent since May, after rising nearly 50 percent since last September, reflecting the fall in world oil prices, and hence in the cost of synthetic rubber. Prices for food commodities exported by East Asian economies have also been rising, though at generally modest rates. An exception is robusta coffee, exported from Indonesia and Vietnam, prices for which are up 65 percent over the past year following weather related supply problems in Brazil, and Vietnam. Rice, a significant export in Thailand and Vietnam, saw a close-to 10 percent increase in its price over the past year, and close to 60 percent since the end of 2003, supported by rising prices for wheat (a close substitute for rice in many countries), and a government price stabilization program and rising currency in Thailand, a major world exporter. As noted in the discussion of poverty, though, higher rice prices were the main reason for a small increase in poverty in Indonesia, a n occasional rice importer.

Oil markets

Crude oil prices have been on a highly volatile path since our March 2006 East Asia Update, first running up to well over $70 in early August, before falling to below $60 in early October.[16] (Exhibit 25). In both nominal and real terms, the recent price declines are the largest retracement since prices began their medium term run-up in early 2003. (Exhibit 26). These developments bolster confidence in the view put forward in March, that oil prices have seen their peak and are likely to decline further over the next several years, albeit at a gradual pace. Nevertheless the underlying demand and supply factors remain finely balanced, reflected in the unusually low level of spare production capacity in OPEC. Although OPEC spare capacity has recently trended higher to reach about 3 mb/d, that remains only half the levels as recently as early 2002. Renewed fears of war and oil supply disruptions in the Middle East, for example, could easily send prices well above their recent August peaks.

Exhibit 25

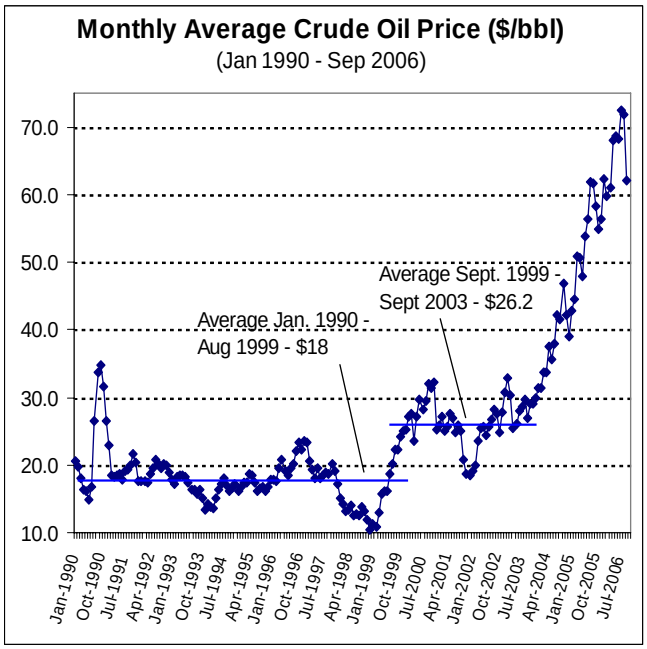
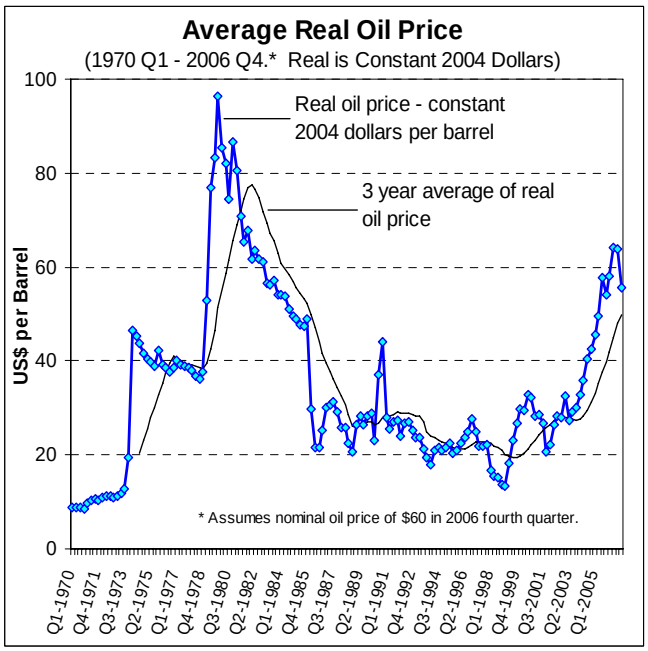


Exhibit 26

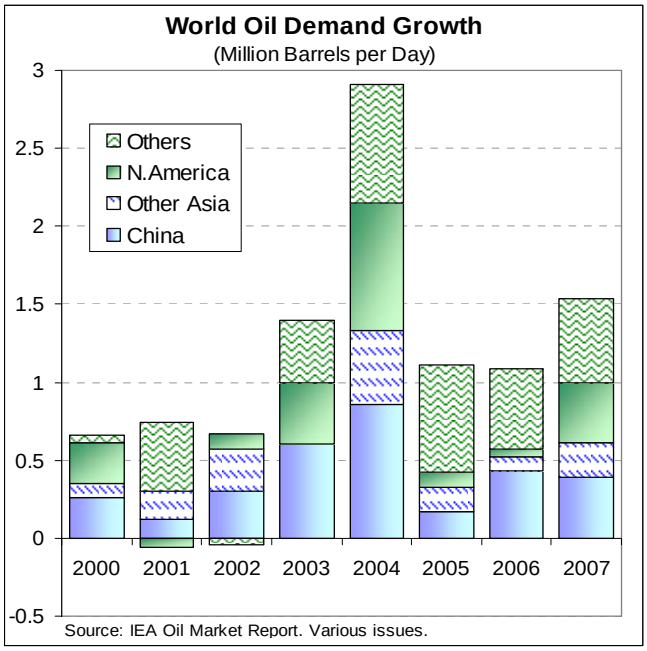


For the moment, though, it is a dissipation in fears of supply disruptions that have played their part in pushing prices lower – for example, the ceasefire in Lebanon, perceptions that the nuclear crisis with Iran will not lead to war just yet and the passing of a hurricane season in the Gulf of Mexico without major storm-related disruption of US production. Although actual supply increases have tended to disappoint and to undershoot planned increases, non-OPEC supply is now starting to grow, rising 1.1mb/d in the third quarter, with largest gains in the United States, Russia, Azerbaijan, Canada, Angola, Sudan and Brazil.

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

On the demand side, the high and rising level of oil prices has also begun curbing demand. Oil demand in OECD countries declined in each of the first three quarters of 2006. Adjustment to high prices also crimped demand growth in developing Asia (other than China) and Latin America. Demand growth was more robust in China, driven by strong demand for transport fuels and unusually warm weather, although remaining well below demand increases seen in 2003 and 2004. Taken together, the International Energy Agency estimates that world oil demand will increase 1.1 mb/d in 2006, the same as in 2005 and well below demand increases in 2003 and 2004, despite the strong growth of the world economy this year. (Exhibit 27). The combination of reviving supply growth and weak demand growth was reflected in rising inventories. OECD inventories at end-August were 89 million barrels or 3.4 percent higher than a year earlier, and days of forward supply stood at 55 days, the highest since 2002. In the United States, crude and product stocks are well above the last 5-year range.

Exhibit 27

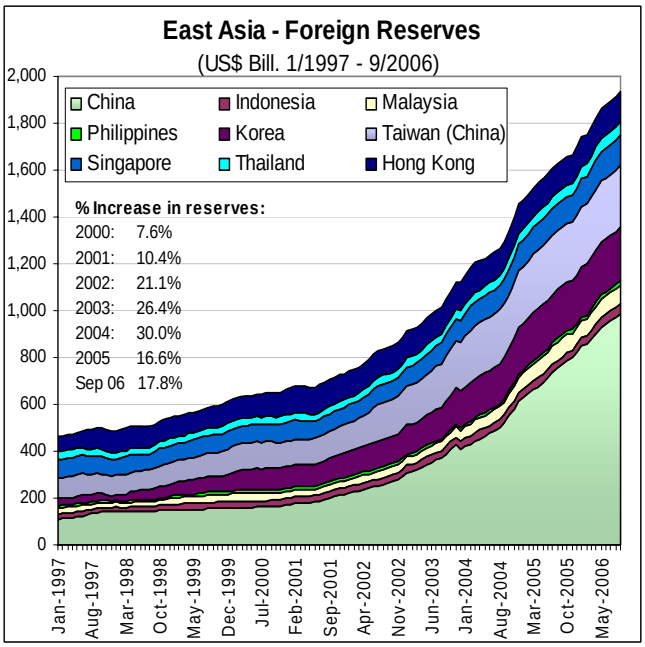


Looking forward, supply and demand forces are likely to remain finely balanced, resulting in an only gradual decline in prices. Prices are currently projected to ease from $65 in 2006 to $60 in 2007, which would be higher than prices in early October 2006. On the supply side, high current prices are expected to induce further significant investments and gains in production, which are expected by the IEA to reach 1.8 mb/d in 2007, led by increases in the FSU, Africa and North America. On the other hand, continued world economic growth at relatively robust rates over 3 percent is expected to induce stronger demand gains than in the last two years. Thus the margin of spare production capacity is expected to widen only gradually, leaving prices vulnerable to unexpected supply disruptions and fears of disruptions.

Balance of payments and financial markets

Emerging East Asian foreign exchange reserves continue to accumulate at a solid pace, rising to $1938 billion by September 2006, of which $989 billion were held by China alone. Regional reserves were up $242 billion compared to the end of 2005, the pace of accumulation having picked up from $190 billion in the same period of 2005. (Exhibit 27). As Table 7 indicates, about two thirds of the reserve accumulation in the region was contributed by China, although reserve accumulation also accelerated in most of the South East Asian middle income economies and in the NIEs as compared to 2005.

Exhibit 27



As in 2005, much the greater part of the region's reserve accumulation continues to be financed by its current account surplus, which is likely to reach another record in nominal dollar terms in 2006. Table 8 shows that the regional current account surplus in the year to the second quarter of 2006 rose to an estimated $302 billion, up from $266 billion in 2005. The regional surplus is likely to rise further in the second half of 2006, mainly due to strong export growth and a surge in China's trade surplus. For the year as a whole China's trade surplus is expected to rise to $170 billion (from $134 billion in 2005), while its current account surplus is forecast to rise to $223 billion (8.5 percent of GDP) from $160 billion in 2005. Elsewhere in the region current account surpluses have also been rising among the main South East Asian economies, due to a combination of strong export growth and only modest growth in domestic demand leading to less rapid growth in imports. These trends should begin reversing as domestic demand strengthens in late 2006 and into 2007, in Thailand, for example, as public investment on proposed 'mega-projects' revives.

Table 7. Change in Reserves (US$ Bill.)

	2002	2003	2004	2005	2006 1-9
East Asia	154.3	234.1	335.7	241.2	241.6
China	75.5	117	206.3	207	166.4
S.E. Asia	13.3	18	28.9	7	29.2
Indonesia	4	4.3	0	-1.6	7.6
Malaysia	3.7	10.4	21.8	3.8	9.3
Philippines	-0.1	0.3	-0.5	2.8	2.9
Thailand	5.7	3	7.6	2	9.3
NIEs	65.4	99.1	100.5	27.1	46.1
Hong Kong	0.7	6.5	5.2	0.7	6.1
Korea	18.6	33.9	43.7	11.3	17.8
Singapore	6.6	13.7	16.5	3.6	13.9
Taiwan, China	39.4	45	35.1	11.6	8.3

Table 8. Current Account Balances (US$ Bill.)

	2002	2003	2004	2005	2006*
East Asia	118.0	165.9	182.9	265.6	301.7
China	35.4	45.9	68.7	160.8	185.1
S.E. Asia	27.2	40.0	25.5	18.6	30.8
Indonesia	7.8	17.3	1.6	0.3	4.1
Malaysia	8.0	13.3	14.9	20.0	19.9
Philippines	4.4	1.4	2.2	2.0	4.2
Thailand	7.0	7.9	6.9	-3.7	2.7
NIEs	55.4	80.0	88.7	86.2	85.8
Hong Kong	12.4	16.5	15.7	20.3	18.6
Korea	5.4	11.9	28.2	16.6	7.7
Singapore	11.9	22.3	26.3	33.2	38.3
Taiwan, China	25.6	29.3	18.5	16.1	21.2

* 4-quarter total, as of 2006 Q2.

Private capital inflows to and outflows from East Asia remain buoyant, reflecting the growing integration of the region into global financial markets. Net foreign direct investment inflows remain strong, totaling $101 billion in the year to the second quarter of 2006, compared to $112 billion in 2005. The equivalent figures for China were $76.3 billion, down mildly from $86.1 billion in 2005. A few years ago it was common to hear concerns that the popularity of FDI in China was diverting FDI from the middle income South East Asian economies, among others. Exhibit 28 should ease such concerns, showing that gross FDI inflows to South East Asia revived strongly in 2005 to reach $15 billion. FDI inflows continued to increase in the first half of 2006 in Malaysia, Philippines and Thailand, although there was some pullback in Indonesia. FDI outflows from South East Asian economies have also grown quickly in the last 2-3 years, principally from Indonesia and Malaysia, reflecting the emergence of South East Asian multinational corporations undertaking their own cross-border investment and production strategies.

Exhibit 28

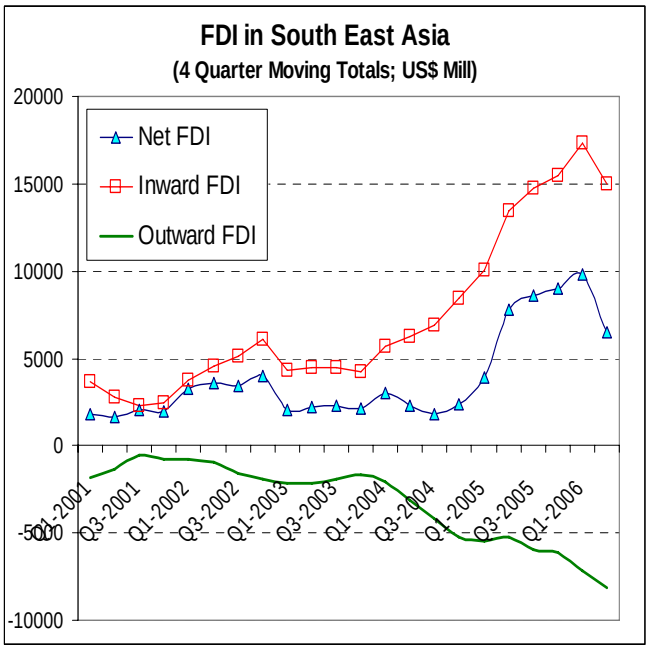
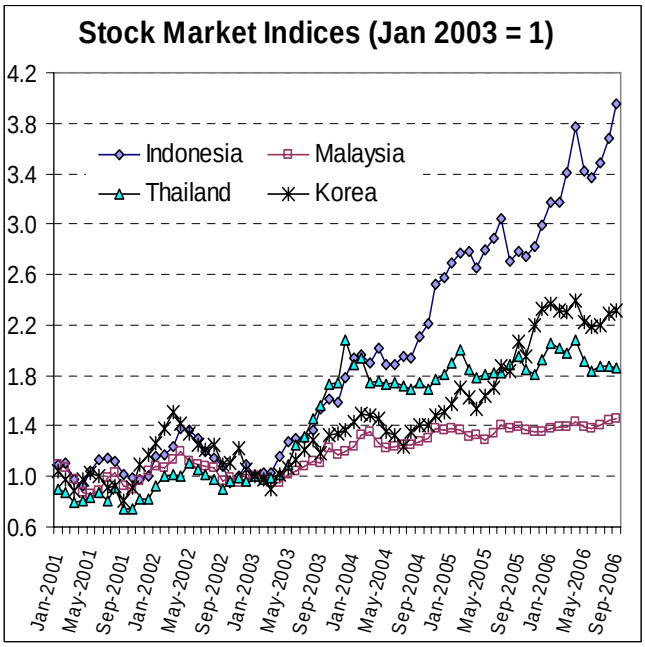


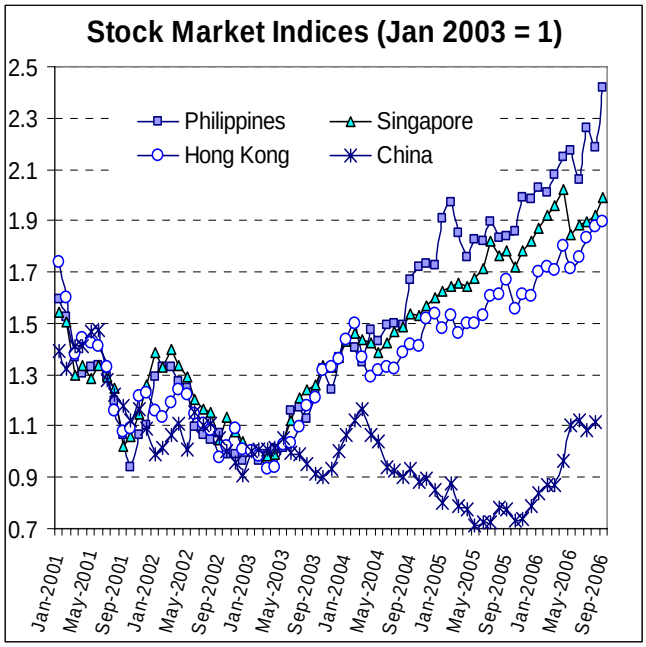
Exhibit 29



Gross financial capital inflows to East Asia (mainly comprising portfolio capital and bank lending) rose substantially in 2005 and the first part of 2006 – part of the broader revival of flows to emerging markets over the last 2-3 years. In May and June of 2006, however, signs of rising inflationary pressure, tightening of monetary policies in advanced countries and an increase in international

investor risk perceptions led to some weakening in advanced country equity markets and more significant corrections in emerging equity markets – including East Asian equity markets - and other risky asset classes. Net equity portfolio sales by international investors contributed to equity market declines of 9-12 percent in Indonesia, Korea and Thailand and 6-7 percent in Singapore and Taiwan (China). (Exhibits 29 and 30). Gross financial capital inflows to the region also slackened in July and August.

Exhibit 30



As Exhibits 29 and 30 suggest however, the May-June equity market corrections did not signify a more negative re-evaluation of fundamentals in the East Asia region by international and domestic investors. On the contrary, the region's strong fundamentals appear to have prevailed in investor perceptions quite quickly. These fundamentals include the region's large and growing foreign exchange reserves, declining external debt, surplus current account positions, strong export growth, improved balance sheets and profitability in the corporate and financial sectors, strengthening fiscal positions, and, finally, greater exchange rate flexibility, which is allowing central banks more room to pursue independent and effective monetary policies to control inflation. The equity price declines in East Asia were generally smaller than those in Latin America and Emerging Europe, and prices resumed moving higher in the third quarter. In most cases external spreads on sovereign debt was little affected (Exhibit 31). Exchange rates versus the dollar either appreciated or were broadly flat between the end of 2005 and the end of the third quarter of 2006. (Exhibit 32). Monthly data suggest gross financial capital inflows revived strongly in September.

Exhibit 31

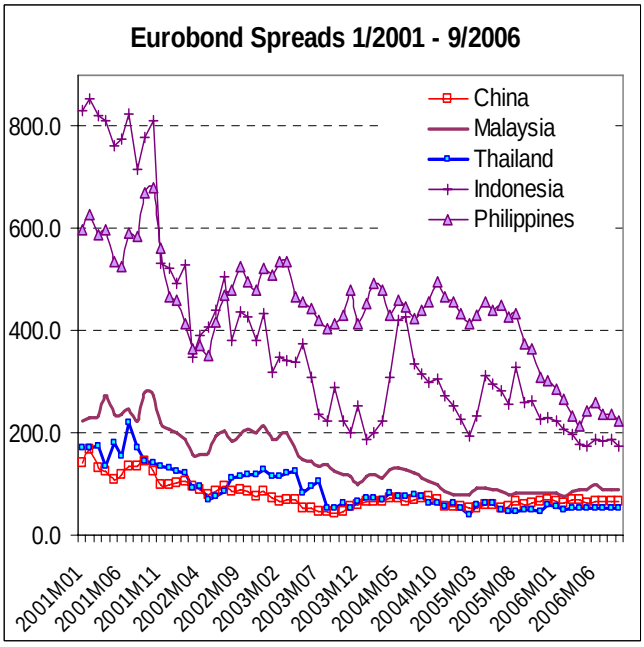
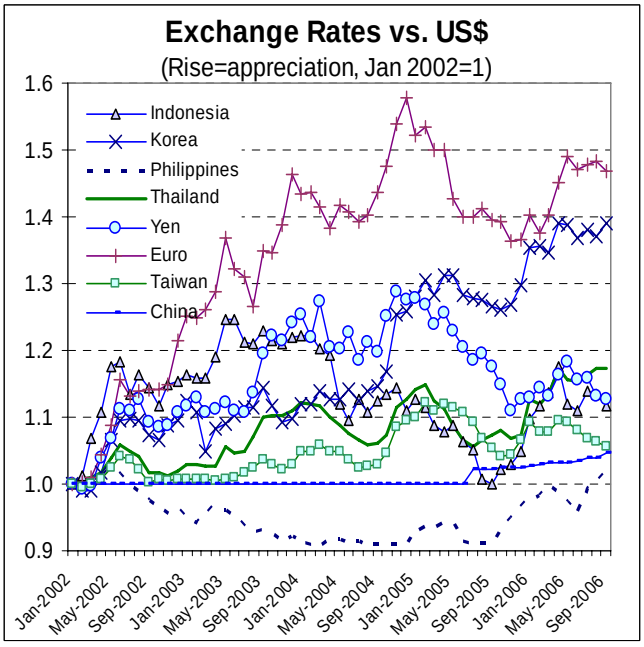


Exhibit 32

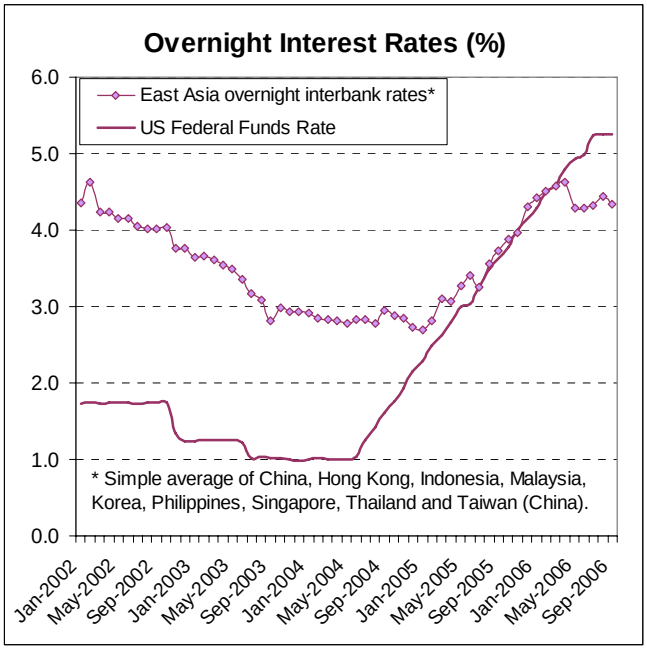


However, while gross financial capital inflows of portfolio capital and loans have remained healthy, one of the more notable balance of payments developments in East Asia in the last 1-2 years has been that on a net basis the region is now supporting large net *outflows* of these kinds of capital. As a matter of definition the region's net flow of portfolio and other financial capital (inclusive of net errors and omissions) must equal the change in its foreign exchange reserves less the region's current account surplus and its net FDI flows. This calculation suggests that in the year to the second quarter of 2006 East Asia had net financial capital outflows of around $110 billion (a change

in foreign exchange reserves of $293 billion over this period, less a current account surplus of $302 billion and less net FDI inflows of $101 billion). The emergence of these net outflows during 2005 and 2006 represents a large swing from 2004, when the region was still a recipient of over $100 billion in net inflows of portfolio and other financial capital.

The main factors underpinning this change in net financial capital flows include both shifts in the relative macroeconomic policy stance and cyclical position of East Asia relative to other major regions, as well as policy changes in the direction of greater exchange rate flexibility and capital account openness.

Exhibit 33



At the level of the relative macroeconomic policy stance there has been a closing of the gap and then a reversal of the differential between US and East Asian interest rates. As Exhibit 33 shows, East Asian short term interest rates averaged 200-300 basis points higher than US rates through the middle of 2004. The tightening of US monetary policy from mid 2004 through mid 2006 then eliminated that entire gap, despite a turn to monetary tightening in East Asia as well. A number of countries such as Hong Kong, Singapore and Thailand began tightening at around the same time as the US, while other economies joined in over the course of 2005, to avert the impact of rising oil prices becoming embedded in a more sustained rise in inflation rates. Indonesia began tightening in the third quarter of 2005, after a narrowing spread with U.S. rates contributed to capital outflows, a fall in reserves and a significant weakening of the currency. The Bank Indonesia policy rate was raised in a number of steps to 12.75 percent by year end, which successfully stabilized the exchange rate and staunched capital outflows.

Table 9. Inflation (% change year ago)

	2004 Year	2005 Year	2006 Q1	2006 Q2	Latest Month
"Headline" Consumer Price Inflation					
China	3.9	1.8	1.5	1.8	1.3
Indonesia	6.1	10.5	16.9	15.5	14.6
Korea	3.6	2.8	2.4	2.3	2.4
Malaysia	1.5	3.1	3.8	4.1	3.3
Philippines	6.0	7.6	7.3	6.9	5.7
Thailand	2.8	4.5	5.7	6.0	2.7
"Core" Inflation					
China	0.0	0.5	0.0	0.4	0.7
Indonesia		4.2	10.0	9.6	9.2
Korea	2.9	2.4	1.6	1.9	2.2
Philippines	4.9	7.0	6.1	6.1	5.0
Thailand	0.4	4.6	2.6	2.8	1.9

Recent data suggest that inflation in the region has begun to ease at both the headline and core levels, (Table 9), allowing central banks to put the tightening cycle on hold and hold interest rates steady for the moment, or, as in the case of Indonesia, to begin lowering rates. As inflation and inflation expectations have fallen Bank Indonesia has reduced interest rates by two and a half percentage points from a high of 12.75 percent, with single digits (or close to) expected by year end. In other economies it is generally expected that policy rates will remain stable through the year end and that the next moves will likely be lower, especially if the world economy weakens more than currently expected. As Exhibit 33 above shows, with the current stabilization or easing, East Asian short term rates are now average lower than US rates, providing one key reason for the swing towards greater net outflows of financial capital from the region noted above.

Changes in exchange rate policy are also likely to have had some impact on the direction of net capital flows. A large volume of speculative short term capital flows were attracted to East Asia in 2004 by the prospect of capital gains to be made from exchange rate revaluation in countries with pegged exchange rates, such as China and Malaysia. However both China and Malaysia undertook small revaluations of their currencies in mid 2005, followed by a gradual or 'crawling' appreciation at variable rates. This has introduced a modicum of uncertainty about the future course of these exchange rates, tending to dissipate earlier speculative pressures.

Finally, China has been looking at means to give residents more options for portfolio and other types of financial investments abroad, in part as a means of easing the inflationary pressure on domestic money supply created by continued large increases in China's foreign exchange reserves. Non-FDI financial capital flows from China (including "errors and omissions") ran a net outflow of $0.5 billion in the first half of 2006 compared to a net inflow of $10.7 billion in the same period of last year. Much of this turn-around in non-FDI flows appears to have been led by

domestic financial institutions, which some argue was done at the request of the monetary authorities, as well as the second Qualified Domestic Investor Initiative (QDII) introduced in April 2006, which granted banks more leeway in investing in international capital markets on their own account. The fact that the monthly increase in banks' net foreign assets jumped to RMB 400 billion in June from an average RMB 150 billion previously suggests that banks are using this leeway. The authorities also made some progress in liberalizing individuals' overseas investment under the QDII mechanism.

Domestic trends and policy challenges

Financial sector trends and issues

Over the last 5-6 years banks in the previously crisis-affected East Asian countries have achieved substantial improvements in capital adequacy, asset quality and profitability. (Exhibit 34, Table 10). Exhibit 34 suggests there was something of a pause or slowing in the process of clearing up bad debts during the first half of 2006. In Indonesia the rate of non-performing loan (NPL) rate at commercial banks picked up from 7.6 percent at the end of 2005 to 8.3 percent in June 2006 (and 8.4 percent in August), due in part to a change in rules about loan classification at the two largest state owned banks. In Thailand the NPL rate at 8.2 percent in June 2006 was only slightly below the end-2005 rate. In both cases the authorities announced steps to further address NPL issues. Policy efforts to continue to address tasks of financial sector restructuring and consolidation left over from the financial crisis, as well as longer term financial sector strengthening and development remain important. As Exhibit 35 indicates, NPL ratios in Emerging East Asia remain rather higher than in other developing regions such as Latin America and Emerging Europe.

Among developments at the country level:

In ***China*** the carving out of non-performing loans from the "Big Four" State Commercial Banks (SCBs) is largely complete, for now. By the end of 2005 more than $400 Billion of loans was written off or transferred to Asset Management Companies. According to statistics from the China Banking Regulatory Commission (CBRC), the ratio of Non-Performing Loans (NPLs) to total loans at SCBs fell to 9.8 percent in June 2006 from 10.9 percent at the end of 2005. The NPL ratio for all banks (including joint stock and other commercial banks) also fell from 8.6 percent at the end of 2005 and to 7.5 percent at the end of June 2006. Private sector estimates of NPL levels vary widely but are generally higher. Despite the comprehensive 'carve-out' of previously reported NPLs, increased pressure on bank managers to avoid poor quality lending and much progress on reforming and recapitalizing China's banks, there remains concern that the current high level of lending growth and cyclical investment will encourage unproductive and will create a new generation of Non-Performing Loans in the event of an economic downturn.

Exhibit 34

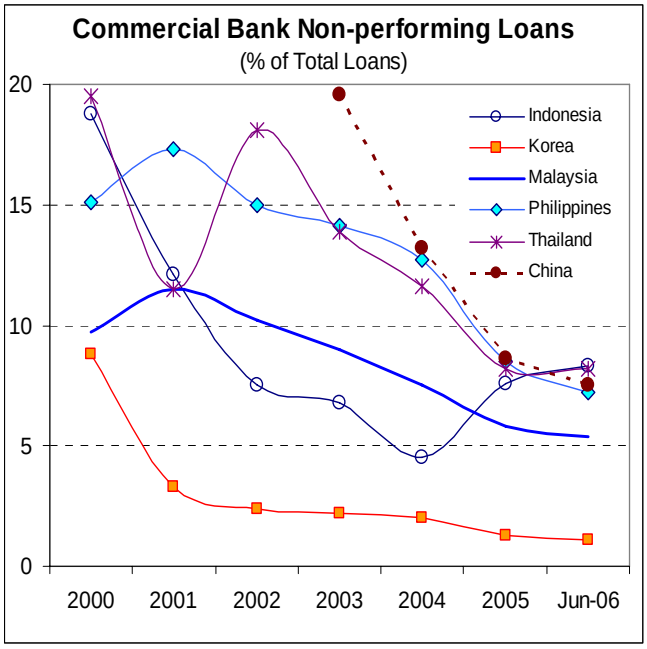


Exhibit 35

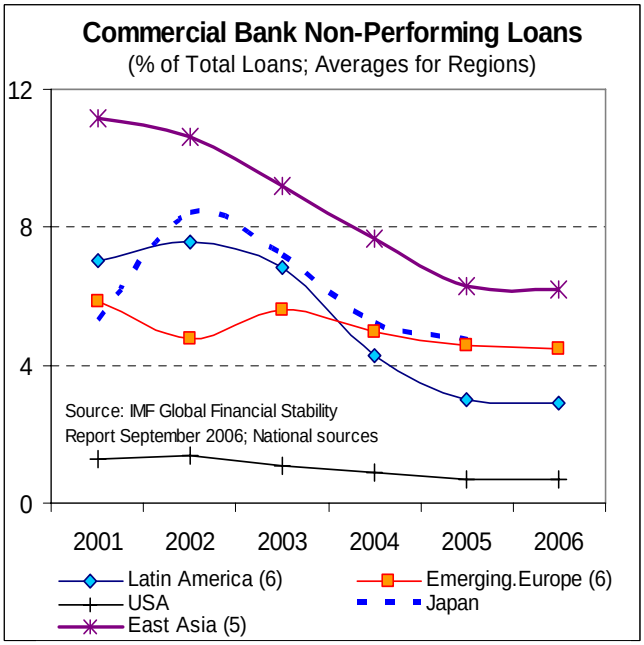


Table 10. Commercial Banks – Financial Ratios

	1998	2003	2004	2005	2006*
Interest Margin					
East Asia**	0.5	3.2	3.7	3.9	3.8
Indonesia	-8.3	4.6	5.9	5.6	5.9
Korea	1.5	2.8	2.8	3.1	2.9
Malaysia	4	3.1	3	3.1	3.3
Philippines	5.7	3.7	4.2	4.6	4.1
Thailand	-0.3	2	2.5	2.9	3.2
Return on Assets					
East Asia	-5.7	1.2	1.6	1.5	
Indonesia	-18.8	2.6	3.5	2.6	2.5
Korea	-3	0.1	0.9	1.2	
Malaysia	-1.3	1.3	1.4	1.4	1.2
Philippines	0.8	1.1	0.9	1.1	1.1
Thailand	-6.1	0.7	1.2	1.4	1.3
Capital Adequacy Ratio					
East Asia	6.4	14.6	15.0	15.0	15.6
Indonesia	-15.7	19.4	19.4	19.3	20.5
Korea	8.2	10.4	11.3	12.4	12.7
Malaysia	11.8	13.8	14.4	13.1	13.2
Philippines	17.5	16	17.4	16.7	16.7
Thailand	10.2	13.4	12.4	13.2	13.5

National Sources. *June 2006. ** Simple average.

The Chinese banking sector continues to diversify its ownership. Three out of 4 state-owned commercial banks - Bank of China (BOC), China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC) - have been recapitalized by the government to the tune of US $75 billion. All three have made headway in ownership transformation by signing agreements with foreign strategic investors and all three have now made initial public offerings and have listed on the Hong Kong and Shanghai stock exchanges:

- ICBC launched simultaneous IPOs on the Hong Kong and Shanghai Stock Exchanges on October 16, raising US $19.1 billion by Oct. 20. ICBC ranks as China's largest lender by assets and is so far the biggest IPO in the world.
- In June 2006 the Bank of China listed on the Hong Kong Stock Exchange raising US$11.2 billion. In July it was listed on the Shanghai Stock Exchange where it raised nearly 20 billion yuan (US$2.5 billion).
- At the end of October 2005, China Construction Bank made an initial public offering on the Hong Kong Stock Exchange, raising over US$8 billion.

Foreign listings are expected to bring higher standards of oversight, particularly in areas such as corporate governance and the appointment of senior managers that have traditionally been state-directed. Nevertheless, the government has declared that it will remain a dominant shareholder in the SCBs even after recapitalization and restructuring, for the sake of maintaining financial stability. It continues to appoint top managers in these banks, which has been criticized as direct interference in the internal corporate governance of the post-restructuring SCBs.

In ***Indonesia*** bank interest margins and overall profitability remain at healthy levels (Table 9), indicating the ability of the banking sector to mitigate adverse impacts from the sudden monetary policy tightening in late 2005. Capital adequacy ratios also remain at high levels. There was a modest increase in the ratio of commercial bank NPLs in the first part of 2006, however, due in part to a change in rules for loan classification which did not reflect a fundamental change in the State Banks current circumstances. A measure allowing State Banks to provision and write-down loans as private banks are allowed to do is expected shortly. The government's financial sector reform package issued in early July 2006 however strengthened regulatory powers to resolve problem debts at state banks more speedily. More broadly, the July reform package covers key areas such as financial stability, the banking sector, non bank financial institutions (NBFI), capital market development, export financing and privatization of SOEs. Whilst most of the areas covered are not new, the reform package should facilitate better coordination amongst stakeholders and sharpen the focus of work, while assigning clear time-bound results and responsibilities for each area. Implementation has started and thus far the results have been encouraging.

Korea's banks have continued to strengthen their financial position. The average non-performing loan ratio fell to 1.0 percent at the end of June 2006 from 1.2 percent at the end of 2005. The non-performing loan ratio hit record lows for all main categories of loans, corporate, household and credit card receivables. As a result of increased net income, the average capital adequacy ratio rose slightly to a record 13.1 percent at the end of June 2006 from 13.0 percent at the end of 2005. All banks reported capital adequacy ratios higher than 10 percent at the end of June 2006. Continued loan growth and a drop in provisioning for non-performing loans drove up banks' net income in the first half of 2006 by 23.4 percent over the previous year. The six credit card companies have also been improving in financial health. After registering combined positive net profits in 2005 for the first time in three years, they increased profits to Won 526.4 billion in the first quarter of 2006, up from Won 344.2 in the previous quarter, due to a drop in bad debt expenses.

Philippines has seen some improvements in bank asset quality and profitability over the last 18 months, together with a pick-up in reforms affecting banking sector operation and regulation. The NPL ratio at commercial banks edged down to 8.2 percent at the end of the first quarter of 2006 from 8.5 percent at the end of 2005 and 12.7 percent at the end of 2004. A broader measure of non-performing assets (NPAs) that includes "real and other properties owned or acquired"(ROPOA) also edged down to

a little over 18 percent. The take-out of non-performing assets from commercial bank balance sheets has picked up. After a slow start, the Special Purpose Vehicle (SPV) Act enacted in 2002 has facilitated the sale of about Peso 97 billion worth of non-performing assets by the end of 2005, reducing the stock of non-performing assets in the banking system by about 19 percent. The life of the SPV Act has been extended for two years. BSP estimates this would facilitate resolution of an additional NPAs with a face value of about Peso 100bn during the next six months or so.

Recent reforms implemented by the central bank have focused on strengthening corporate governance, risk management, and capital adequacy in commercial banks. Higher risk weightings were introduced for NPLS, as a step towards introducing the Basel II framework, which is due to take effect in 2007. The application of international accounting standards (IFRS) also became mandatory for commercial banks starting with 2005 financial accounts. These measures are causing banks to raise additional capital. Commercial banks including state-owned banks raised more than US$200 million in the first half of 2006 by way of bonds that qualify as Tier-2 capital. At least another US$100 million worth of hybrid capital debt instruments are planned to be issued during the remainder of this year. These changes are also leading to revival of consolidation and merger activity in the banking system with two commercial banks being put into play in the first half of 2006.

Non-performing loans in ***Thailand's*** commercial banks have been reduced from a high of 47 percent of loans in mid 1999, in the aftermath of the financial crisis to 8.3 percent at the end of 2005. The NPL ratio has remained relatively flat since then, touching 8.2 percent in June 2006. Viewed by sectors, the highest NPL ratios are in construction, real estate and agriculture, all over 15 percent, while the lowest are to financial institutions, public utilities and loans for personal consumption (the latter about 6 percent). The Government has announced a plan to further reduce NPLs to around 5 percent by year end by transferring NPLs to the Government owned asset management company BAM. As in other countries, there are NPLs in the system that have been transferred to private or public asset management companies (AMCs). The NPL ratio inclusive of NPLs transferred to AMCs was estimated at 24 percent in December 2005. Calculation of this series was discontinued at the start of this year however. Bank profitability continued to improve in 2006, as indeed it has done throughout this decade, primarily because of increasing net interest margins. In the current phase of monetary policy tightening, both lending and deposit rates have risen, but the former more than the latter: the average interest yield on assets picked up to 5.2 percent in the second quarter of 2006 from 4 percent at the end of 2005, while average funding costs rose to 2 percent from 1.2 percent over the same period.

Towards a More Resilient, Diversified Financial Sector

The importance of diversified financial systems is increasingly recognized in the East Asia region. Promotion of deeper, more diversified financial systems through cross-border integration has been a major thrust of regional cooperation efforts since the financial crisis of 1997. As long as financial systems are sufficiently deep[17], a diversified financial system can serve to enhance efficiency—since financial intermediaries and markets perform the core functions of resource mobilization, resource allocation and risk management in different ways and each may be better at certain aspects of these functions. By offering a wider array of risk-sharing mechanisms, diversification can also increase the overall risk-bearing capacity of the economy. This section reviews progress towards more robust and diversified East Asian financial markets in recent years, key constraints and the main areas where further policy reforms are needed.[18]

The region has made considerable progress in developing the securities markets. Equity markets in the region have tripled since the crisis—from a market capitalization of US 0.8 trillion in 1997 to almost US$ 2.9 trillion in 2005 (Exhibit 36). Although stock markets are still considerably smaller than in the US, UK or Germany, and in aggregate still account for only 6 percent of world stock market capitalization, in relation to the size of domestic economies, they compare favorably to those of advanced industrialized countries. Indeed, stock market capitalization in Hong Kong (China), Singapore or Malaysia is proportionally larger than in the US, UK or Germany. The region's bond markets have also seen sizable growth over the past nine years, albeit with considerable variation across countries. For the region as a whole, bonds outstanding amounted to US$1.5 trillion in 2005—up from US$ 0.4 trillion in 1997.

Despite the impressive (300 percent) growth in the securities markets over the past nine years, the banking sector, with US$5.5 trillion in assets, still dominates. On average the banking sector accounts for almost 60 percent of total financial sector assets. Indeed, given the depth of the financial sector overall,[19] the region lags in the relative importance of the securities markets and in particular, the corporate bond markets.

The key constraint that needs to be addressed in East Asian securities markets is limited liquidity. Investors are generally willing to invest in securities only if there is enough liquidity for them to sell and exit easily when needed. And, if liquidity is low and price discovery does not function well, the investors that do participate will generally demand a higher interest rate or return to compensate for the

[17] Otherwise the markets are likely to be too thin, i.e. there is a size threshold for sustaining liquid (secondary) markets.

[18] This discussion draws on Swati Ghosh: "East Asian Finance: The Road to Robust Markets." World Bank (2006).

[19] Total financial sector assets amounted to US$9.6 trillion.

low liquidity, and this in turn may further deter companies from listing on the stock exchange or issuing bonds.

Exhibit 36. Equity Markets

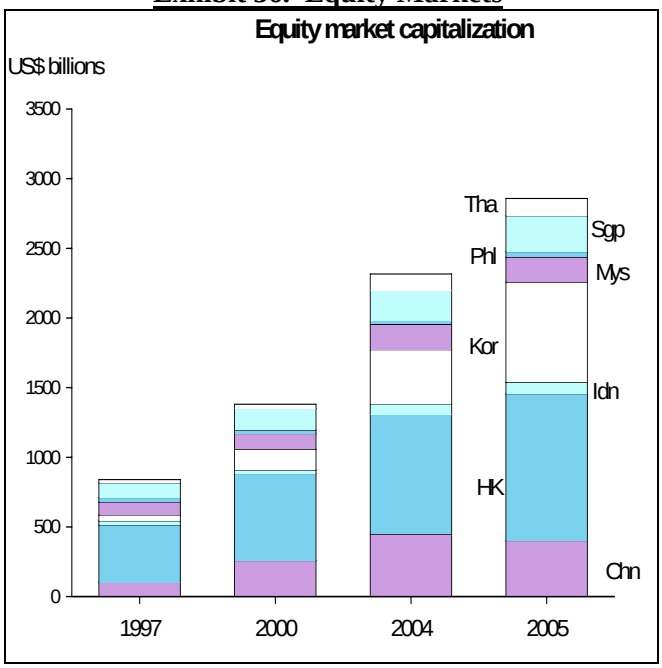
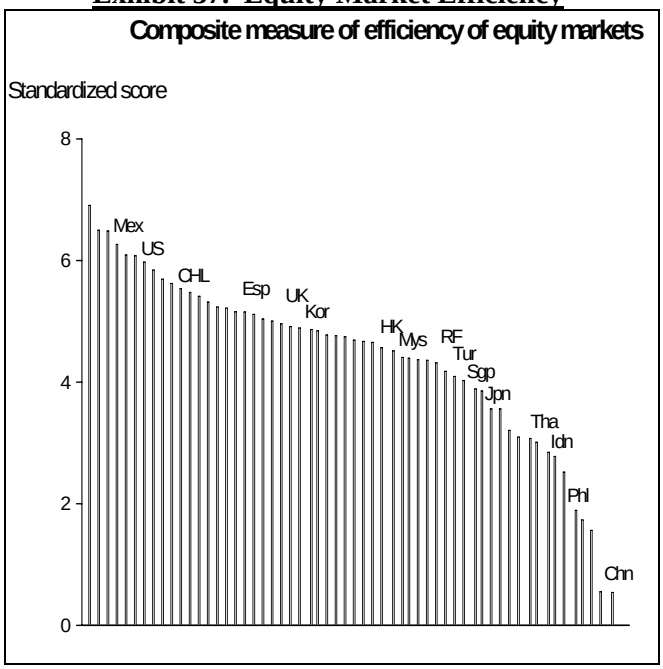
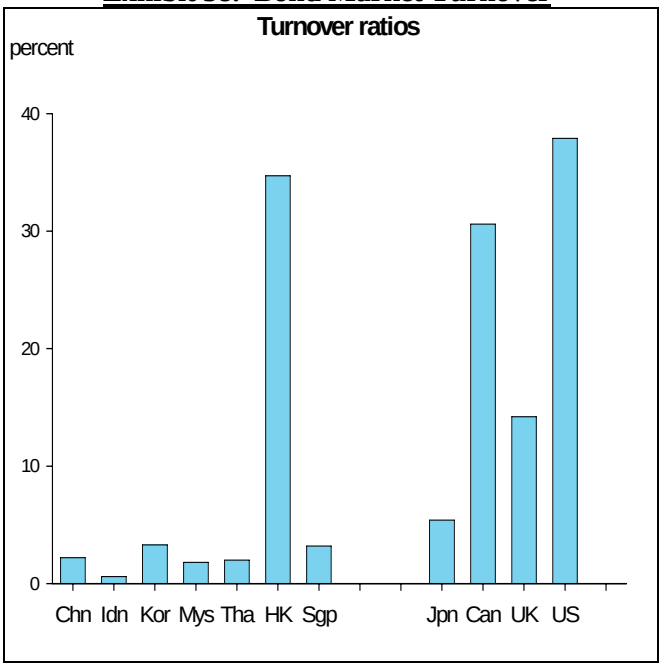


Exhibit 37. Equity Market Efficiency



Based on a measure of efficiency that captures transactions costs and the quality information disclosure, Korea, Hong Kong, Singapore and Malaysia have the most efficient markets in the region. However, among a sample of 124 economies, Korea falls in the third highest quartile, the others in the median. The remaining countries—Indonesia, Thailand Philippines and China fall in the bottom quartile in terms of efficiency[20] (Exhibit 37). The lack of liquidity in bond markets—measured by turnover ratios and bid ask spreads—is a greater issue in most countries but especially so in countries such as Indonesia and the Philippines.[21]

Exhibit 38. Bond Market Turnover



Three key factors affect liquidity and efficiency—and ultimately the role that securities markets play in the region, namely: the availability of information to price securities accurately, transactions costs, and the size and heterogeneity of the investor base. To enhance efficiency, each of these elements will need to be addressed.

The availability of good **information** to price securities accurately is clearly affected by corporate governance and the degree and quality of disclosure. Countries in the region have made considerable progress in strengthening the legal and regulatory framework with respect to corporate governance and disclosure requirements, and in strengthening accounting and auditing

[20] This is a composite measure of efficiency that captures transactions costs and the quality of information disclosure. Transactions costs are measured by the proportion of zero return days in a trading year. Since informed traders only trade when the benefits of doing so exceed the costs, a market with higher trading costs (both explicit and implicit) will exhibit more days without trading—hence zero return. The quality of information disclosure is measured by stock market synchronicity which captures the co-movement between individual stocks. A high level of co-movement indicates that there is not much firm specific information.

[21] Turnover ratios are value of bonds traded/average amount of bonds outstanding.

standards. But assessments indicate that a stronger focus on implementation and enforcement are needed.[22]

Transactions costs comprise explicit trading costs—such as commissions, settlement fees and taxes—as well as implicit costs—which represent the opportunity costs of delaying or not executing a trade. The factors that affect explicit and implicit transactions costs include withholding taxes and fees, the efficiency of intermediaries, market infrastructure and institutional arrangements and "complementary" infrastructure.

The region's securities market infrastructure is relatively well developed, with almost all countries possessing advanced clearing and settlement systems. There is more variation in the "complementary" infrastructure—repo (repurchase) markets, securities lending, margin trading and derivatives. These instruments can foster greater liquidity, reduce transactions costs and allow market participants to manage and transfer risks to those better able and willing to bear them. They can however also facilitate inappropriate risk transfers to institutions with weak risk management capacity and to more weakly regulated segments of the financial markets This calls for an appropriate framework of good corporate governance and sound risk management within financial institutions, as well as proactive measures by regulators and supervisors to monitor and contain such risks.

At present, the bulk of the derivatives activity is limited to a few economies in the region, notably Hong Kong (China), Korea and Singapore. To further develop derivatives markets, cross country experience suggests the following needs: efficient, liquid and integrated cash markets (for bonds, equities, commodities and other assets) that are broadly determined by market forces rather than administered prices; a suitable legal and regulatory framework, and key elements of institutional infrastructure (accounting and auditing and disclosure standards) as well as market infrastructure.

Finally, developing **a broader and more diversified investor base** is key for liquidity: the participation of investors with different risk preferences and appetites contributes to greater trading and to more efficient markets. This will require further developing the domestic institutional investor base—pension funds, insurance and mutual funds—as well as fostering greater regional financial integration. The assets of East Asia's institutional investors in these three categories have grown over the past few years and now amount to 45 percent of GDP for the region as a whole. There is much variation across countries, however, with the institutional investor base still a very small percentage of GDP in China, Indonesia and the Philippines.

Pension schemes of the region differ widely in their institutional design, coverage, maturity, benefit provision, value of assets under management, and asset allocation—all of which bear on the actual and potential impact on pension funds on the development of capital markets. Pension assets in the region are still relatively small; amounting to less than 25 percent of GDP in most countries, with the exception of Malaysia and Singapore, where they exceed 50 percent.. Even at their current size, though, the region's pension funds could contribute more to capital market development if they were to invest in a greater share of their assets in securities. The World Bank East Asia Region's recent report on "East Asian Finance: The Road to Robust Markets" outlines a range of reforms that would both advance the goals of pension funds and simultaneously encourage a greater use of capital markets.

Assets of life insurance have grown quite rapidly, although they are still relatively small. Insurance premiums as a percentage of GDP and premiums per capita show substantial scope for further growth, particularly in China, Indonesia, the Philippines and Thailand. In countries such as Indonesia, Malaysia, the Philippines and Thailand, the industry consists of many small players which are unable to play a significant role in capital market development. Greater consolidation in the insurance sector could therefore play a role in capital market development. Several jurisdictions are moving to introduce risk-based capital requirements in the insurance sector, which is likely to enhance insurance companies' risk management skills and allow countries to move to more liberal investment regimes. A focus on more stringent minimum capital regulations can also help foster more consolidation.

The regional financial cooperation measures that are being undertaken under the Executives Meeting of East Asia and Pacific Central Banks, (such as the Asian Bond Fund Initiatives), ASEAN + 3 and APEC, are also helping to identify the impediments to cross-border investments and to facilitate issuance by private sector participants. Together with measures taken at the domestic level, these initiatives should help promote deeper and more diversified markets.

Towards an "An East Asian Renaissance"

East Asia is vastly different today than the place described in a 1993 World Bank report *The East Asian Miracle.* That report summarized its success as 'growth with equity' powered by global integration and good government. Since then, China has emerged as the biggest development story of the nineties, while the region was also wracked by the most severe economic crisis in many decades. East Asia has been transformed by these developments, from a set of countries rapidly integrating with the world to one that is also aggressively exploiting the sources of dynamism that lie within the region. Just as the region was earlier drawn to the developed world by prospects of a mutually beneficial exchange of goods, capital, and ideas, so now different parts of the region are now being pulled towards each other for the same reasons. But countries in East Asia now face potential pitfalls associated with congestion, conflict, and corruption, the

[22] See CLSA, 2005.

domestic side-effects of rapid growth driven by successful international integration. In addition to global and regional integration, East Asian countries need a third integration, this time at home. A new report of the World Bank assesses the steps needed for ensuring that this "third integration" is as potent as the first two.[23]

Regional integration accelerates

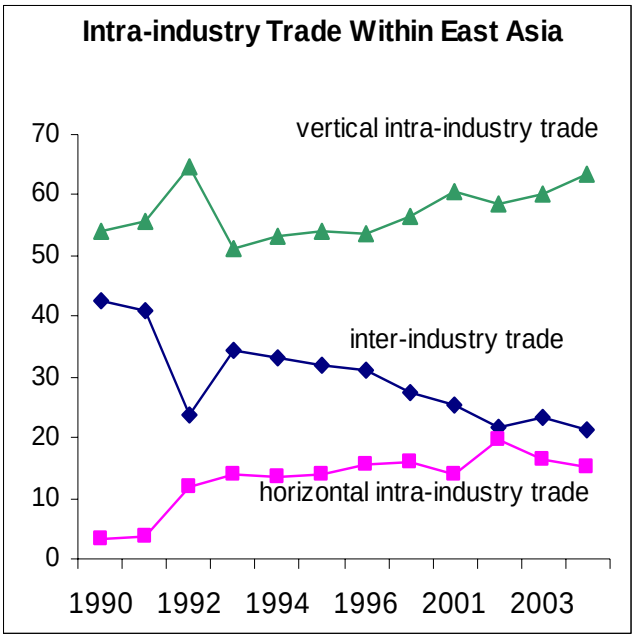
East Asia's first integration was with global trade markets and is today very advanced. East Asian economies have been built on trade and their success with global integration continues to grow. Excluding Japan, other countries in the region—known collectively as emerging East Asia—have increased their world export market share to 20 percent, double their GDP share. Emerging East Asia is now one of the most open regions in the world with total merchandise trade reaching the same size as total GDP. This has been achieved in large part because of open trade policies. Although tariffs for selected items like rice and other agricultural products are high, the weighted average import tariff rate in East Asia is just over 5 percent.

East Asia's second integration has been within the region. Regional integration has accelerated since China's accession to the World Trade Organization in 2001. Regional trade has been growing at about 10 percent over the last decade, despite the crisis of 1997-98. East Asian economies now source over half their imports from within the region. But this trade is complementary to, not a substitute for, global trade. Regional trade is dominated by intermediate imports of parts and components, moving between countries in complex production networks. (Exhibit 39). Outside the region, trade is dominated by final goods. The two go hand-in-hand: intra-regional trade provides a low-cost high-quality supply chain; inter-regional trade provides a mass market in which economies of scale can be exploited.

Regional technology flows are becoming important. While the US and Japan are still the most important sources of know-how, Korea, Taiwan, China, and China have been increasing their R&D efforts. As a result, intra-regional creation of knowledge and associated technology flows have joined global flows in spurring innovation in East Asian enterprises.

Finance has followed trade and technology. The major global multinationals which have long made direct investments in East Asia have now been joined by emerging multinationals from within the region. Investors from Korea, Taiwan (China), Singapore and Hong Kong are active in the developing East Asia. In fact, they now have larger equity and bond investments in the developing markets of the region than do Americans, Japanese or Europeans, a radical reversal from ten years ago. A more diversified supply of finance which includes knowledgeable investors from within the region will provide more stability to financial flows in East Asia.

Exhibit 39



Growth challenges in a middle income region

The result of growth spurred by global and regional integration has been unprecedented progress. 250 million East Asians left the ranks of the poor in the last five years alone. In 1990, emerging East Asia had a GDP of $1.2 trillion; today it is over $4 trillion. With Japan, Australia and New Zealand added, the region has a combined GDP of over $10 trillion, close to one-quarter of the world's output. With this growth, the region has become more middle income. Once Vietnam reaches middle income country levels, which could happen as early as 2010, more than nine out of ten East Asians will inhabit a middle income country. This transition of spending power is changing the pattern of economic growth, with more demand for consumer durables, non-tradable services, and housing, fuelled by growing consumer credit.

East Asia is increasingly a middle-income region with more countries looking for strategies to move to rich country status. Research suggests that the sectoral pattern of growth changes as countries grow through middle-income. On the one hand, there is a demand for a greater variety of goods, many of which can be produced domestically, so there is a force towards sectoral diversification. On the other, countries only get richer if they specialize in what they do best. Which tendency dominates is an empirical question—researchers speculate that it depends on the extent of scale economies in production compared with the desire for variety in consumption. Countries appear to initially diversify, meaning that value added and employment is spread out more and more through the

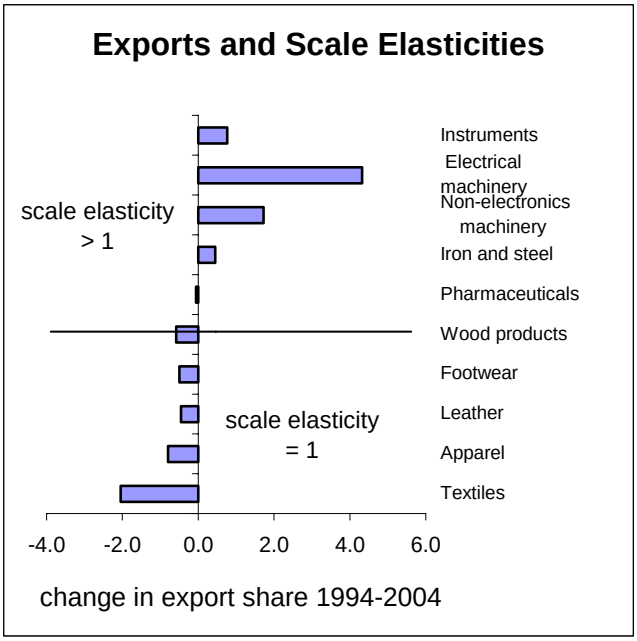
[23] Indermit Gill and Homi Kharas. "An East Asian Renaissance: Ideas for Economic Growth", The World Bank, forthcoming.

economy. But at a turning point that differs across countries but which *systematically* happens at middle-income levels, countries start to specialize in production and employment again. Scale economies in production appear to win out. This suggests that new strategies must be adopted at some point in time by middle income countries if they are to successfully become rich.

The idea that middle income countries have to do something different if they are to prosper is consistent with the fact that middle income countries have grown less rapidly than either rich or poor countries, and this accounts for the lack of economic convergence in the world. Middle income countries, it is argued, are squeezed between low-wage competitors in poor countries who dominate mature industries, and innovators in rich countries, who dominate industries undergoing rapid technological change.

This is the challenge that confronts East Asian countries today, especially those in South East Asia. There is reason for optimism. The Newly Industrialized Economies (NIEs) in East Asia successfully made this transition from middle income to rich, showing that it can be done given the right circumstances. And within East Asia, experience suggests that there is not such a sharp distinction between low-income domination of manufacturing and rich country domination of the knowledge economy. For middle-income countries, it seems the answer lies in straddling both strategies: remaining successful manufacturers while seeking success in the knowledge economy. Indeed, developing East Asia has been expanding exports in sectors that exhibit increasing returns to scale, such as electronics and electrical machinery. (Exhibit 40).

Exhibit 40

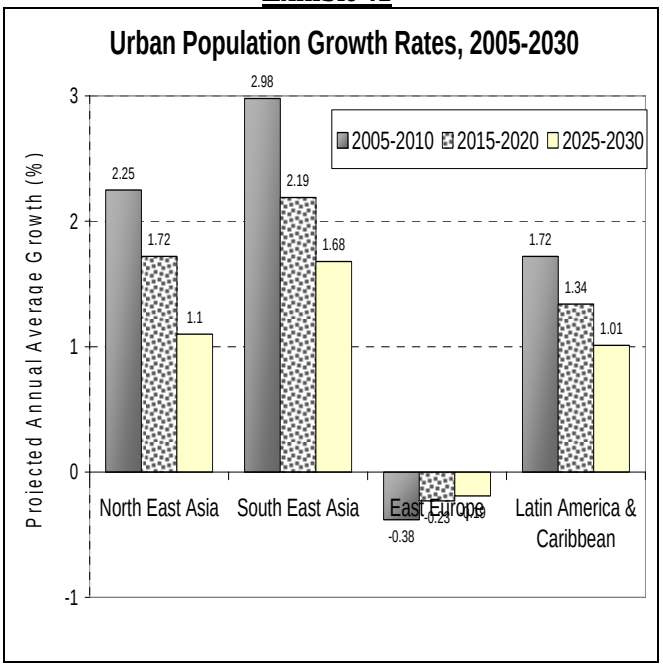


Distributional effects of scale-centered growth

Scale-centered growth powered by international integration and innovation will help middle-income countries reduce the gap in living standards relative to industrialized countries. But this development strategy has distributional consequences at the country level which need to be managed. Inequality in much of developing East Asia has risen, not just in terms of income levels, but also in terms of schooling and access to basic services. Poorer regions and rural areas are falling further behind their urban counterparts. In some cases ethnic minorities are not participating in growth. Despite the huge differences in income per head between East Asian countries, more than three-quarters of the inequality of living standards of East Asian citizens comes from within-country inequality.

In short, despite successful global integration and increasing regional integration, many East Asian countries are falling behind in domestic integration.

Exhibit 41



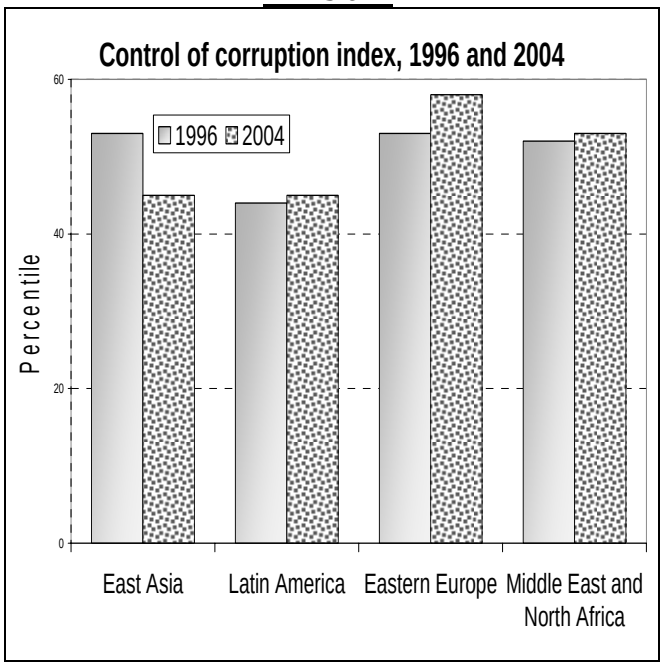
Addressing the challenge of domestic integration must start with cities. East Asia is witnessing one of the largest rural-to-urban shifts of population in history: two million new city-dwellers are expected every month for the next twenty years. (Exhibit 41). This massive movement will put pressure on the mega-cities of the region, those with more than 10 million inhabitants, especially on their ability to provide clean air, sanitary water, green spaces, easy commutes and low crime. In other words, mega-city livability must improve dramatically. But the bulk of urban population growth will happen in small cities, those with fewer than 500,000 people. These cities are generally less well-managed. A poor business environment also translates into a smaller tax base and these cities spend less per capita

on key social services and on environmental clean-up, making them even less attractive places for investment.

The gap between income levels in smaller interior cities and large coastal cities is also related to the poor level of domestic infrastructure connecting most cities to major ports. While East Asia has some of the world's most efficient seaports and air transport facilities, the internal logistics within countries fall far short of what is needed. Better road and rail links and improved multi-modal logistics are necessary to link interior cities to trading centers and so reduce the income gap between workers in different cities.

Growing inequality is pressuring East Asia's social cohesion. Governments have to come up with solutions to the problems of national distribution and local economic management and service delivery. But governments in turn are being sharply questioned by civil society groups because of a perception of widespread corruption in some countries. Centralized corruption has been a target of organized civil society. Countries like Korea and Malaysia are trying to join Singapore, Japan and Hong Kong as places where corruption is severely sanctioned and opportunities for corruption are minimized by a rules-based government. Indonesia, China and Vietnam have also launched aggressive anti-corruption programs at the national level and moved to prosecute high ranking officials.

Exhibit 42



Much of the problem is now at the local level. East Asia has moved swiftly to decentralize public expenditures on social services and infrastructure. In the long run, this should lead to greater transparency and accountability of local public officials, helping promote a fair and just society. But in the interim, while institutional checks and balances are maturing, there is a risk that decentralization will make control of corruption harder to achieve, threatening economic efficiency, aggravating social tensions, and worsening gaps in sub-national economic performance. These changes may explain the deterioration in perception-based anti-corruption indicators. These suggest that East Asia is falling behind in its efforts to fight corruption; what they may be signaling is the greater emphasis needed to ensure clean governments as these economies grapple with the middle-income development challenge.

East Asia needs a 'third integration'

The region has successfully integrated with global markets, and East Asian goods are found in every country of the world. It has also integrated regionally, developing a complex structure of production networks to provide a low cost, high quality manufacturing base. The challenge now is to complement global and regional integration with domestic integration. This requires ensuring vibrant cities that are well-linked to the outside world but which remain linked domestically; strengthening social cohesion so that societies stay as strong as economies; and providing clean governments which efficiently reinvest the economic returns that accompany fast growth. The global trade and technology flows and regional networks that are powering East Asia's growth provide adequate resources for meeting the challenge of domestic integration. If East Asian policymakers succeed in making this third integration as successful as the first two, they can, within a generation, eliminate poverty and lead their countries into the ranks of rich, developed nations of the world.

COUNTRY SECTIONS

Major Economies [24]

China

Rapid growth continues. China's economy expanded by 10.7 percent in the first nine months of 2006. GDP growth slowed to 10.4 percent in the third quarter, after 11.3 percent in the second quarter, when China registered its highest growth in over a decade. Boosted by a rapidly rising trade surplus, China's international reserves topped that of Japan and totaled $988 billion at end-September.

On the supply side, industry continued to power ahead, up 13 percent in the third quarter of 2006 (yoy), while services continued to lag.. Investment and exports remained the main drivers of demand. Export growth was up to over 30 percent (yoy) in dollar terms in August-September, outpacing that of imports by a growing margin. As a result, the contribution of net trade to GDP growth increased to almost 3 percentage points in the third quarter, and the current account surplus has continued to increase. The sharply rising trade surplus also continued to boost a buildup of international reserves despite a mild slowdown in FDI, and rising portfolio outflows from China abroad in the third quarter. At the end of the third quarter, reserves stood at $988 billion, the largest in the world, and are set to surpass the $1 trillion mark in October. The increase in reserves has sparked a debate as to whether better use of them could be made. Meanwhile, monetary aggregates expanded beyond targets, although more recently M2 has slowed down somewhat.

The authorities implemented a series of measures to cool down the economy. Continued rapid economic growth in the first half of 2006, especially of investment, raised concerns with the authorities. Around mid-year they implemented several tightening measures, including monetary tightening by absorbing liquidity in the interbank market and raising reserve requirements; administrative measures to limit investment in real estate; reinforcement of controls and regulations on investment projects, including a re-evaluation of all large investment projects; and loosening controls on capital outflows. The measures seem to have taken some effect on investment: urban fixed asset investment slowed down considerably, from around 30 percent (yoy) in the first half to 24 percent in the third quarter, although fixed asset investment rebounded in September with respect to August.

The outlook for China's economy remains favorable. Although growth is clearly very rapid, even by Chinese standards, there are no strong signs of economy-wide overheating. Production capacity continues to expand in line with demand, inflation remains low, and the current account is in surplus. However, high investment could cause overcapacity in specific sectors, and may affect the banks because loans may turn bad in the future. The authorities can take some comfort from the fact that most investment is financed from enterprise saving rather than by banks, and that the highest investment growth is taking place in largely commercialized sectors. But the continued investment boom warrants concerns about efficiency, making more moderate growth desirable. On the external side, key risks are a sharper than expected slowdown in the US economy and a disorderly resolution of global imbalances.

In deciding on macroeconomic policies, the authorities may stay the course on current measures, and await further evidence of their effects before initiating additional demand-reducing measures. A drastic slowdown alone would further lower imports and boost the current account, creating more problems for monetary policy and trade relations. Continuing the recent strengthening of the Renminbi against the dollar may ameliorate part of this dilemma, as it would raise imports, reduce capital inflows, and switch investment to the non-tradables sector. Also, the latest data suggest that the recent measures have started to have some effect on monetary aggregates and investment. Internationally, if the slowdown in the US starts to affect China's growth prospects, the authorities may need to reconsider the macroeconomic stance.

China's government has included social and environmental considerations more firmly among the key economic policy objectives. This was confirmed by the communiqué of the sixth Plenum of the 16th CPC Central Committee held during October 8-11. While the communiqué stated that rapid economic growth remains a key objective, it also confirmed the objective of improving the quality of economic growth, rebalancing the economic growth pattern, and striving to achieve a harmonious society.

More policy focus can be put on rebalancing the economy away from industry, investment and export led growth towards growth more driven by domestic consumption and growth in services. Although this is a medium term objective of the authorities, there are reasons to give it more prominence. First, many of the measures that can help rebalance the economy also support desirable macroeconomic adjustment. Second, the current investment boom may give rise to a capital stock that would no longer be viable once relative prices and standards better reflect the government's new priorities. The package of policies that would promote rebalancing include: (i) measures to stimulate domestic consumption (for example expansion of the social safety net, in particular expansion of rural health

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

insurance and establishment of a rural pension, as well more public financing of education), and to increase the efficiency of investment (for example introducing a dividend policy for SOEs and further financial sector reform); (ii) measures to increase the relative attractiveness of producing services (non tradables) over manufacturing production (tradables); and (iii) institutional reforms to give local decision makers stronger incentives and better tools to pursue rebalancing.

Indonesia

Following dramatic fiscal and monetary policy adjustments in late 2005, growth in the Indonesian economy slowed significantly in the first half of 2006, although recovery was underway by the third quarter. This year's economic slowdown was also aggravated by new natural disasters. Another devastating earthquake struck Yogyakarta and Central Java, there was another tsunami in West Java and now a mud volcano in East Java, all adding to the toll of destroyed property and displaced people. On the plus side, reconstruction and recovery from the December 2004 tsunami in Aceh and Nias is now well underway, with thousands of houses built and more under construction. The key economic challenge involves turning the cyclical upturn in the latter part of this year into sustained longer term growth while addressing poverty and improving disaster preparedness and response.

Last year's cuts in fuel subsidies (leading to administered fuel price increases totaling a cumulative 143 percent) effectively transferred an estimated US$10 billion dollars of disposable income from consumers to regional and central governments. This shock, combined with interest rate increases of 400bps between August and December, brought Indonesian growth to below 5 percent in H1 2006. These adjustments were designed to put Indonesian fiscal and monetary policy on solid footing and were well received in financial markets. The exchange rate strengthened, the stock market increased over 40 percent in the year to this September. Rating upgrades were announced by Moody's from B2 to B1 in May and by S&P from B+ to BB- in July. Monetary policy was eased and policy interest rates lowered from May, as inflation also began receding.

The short-run negative impacts of last year's policy tightening on the economy in 2006 were partly offset by growth in exports, which reached 17.2 percent in the first eight months of this year. There was also a pick up in government spending (up 38 percent over relatively low levels in 2005), including cash transfers of approximately US$30 per household per quarter to over 19 million households (which transferred approximately US$ 2 billion in disposable income back to the poor over the course of the year). Increases in central spending were offset to some extent by an accumulation of fiscal reserves at regional governments, which were unable to program or spend increased resource transfers to regions that averaged over 50 percent. The slowdown in private consumption in the first half was milder than expected (growth of 3.0 percent) although investment contracted (-0.1 percent) as businesses appeared to take a wait-and-see attitude. Higher exports and slowing growth in imports raised the current account balance to US$4.6 billion in the first half, up from US$0.8 billion a year earlier. Exports clearly benefited from higher international commodity prices with agriculture commodities up 12 percent and mining 46 percent, although industrial exports lagged).

Unfortunately, despite increased spending on poverty programs, poverty rose from 16 percent to 17.75 percent between 2005 and 2006. While the government's Unconditional Cash Transfer program more than compensated the poor for higher fuel prices, a ban on rice imports contributed to a 30 percent rise in domestic rice prices by the time of the poverty survey in 2006. As the poor spend close to a quarter of their income on rice, poverty rose. In response the government reopened rice imports, allowing in some 210,000 tons, which helped stabilize domestic rice prices.

The higher current account surplus and balance on the capital account[25] allowed Bank Indonesia to add substantial international reserves, which reached US$41 billion in September, despite prepayments of almost US $8 billion to the IMF. Reserves had fallen to a low of US$30 billion in September 2005. In October, as the impact of last year's fuel price increase was removed from year-on-year comparisons, inflation fell to 6.3 percent, down from 17.1 percent at year end 2005. Annual inflation in 2006 is now expected to come in below Bank Indonesia's target of 7-9 percent. As inflation and inflation expectations have fallen the Central Bank has reduced interest rates by two percentage points from a high of 12.75 percent, with single digits (or close to) expected by year end. The central government budget deficit is estimated to be around 1 percent of GDP, which will reduce the government debt to GDP ratio to less than 40 percent by year end.

Recent data is beginning to confirm a sharp upturn in growth. By August/September most real indicators (cars, motorcycles, cement, etc.) were turning sharply upward. Import of capital goods, which had turned down, reflecting low investment, began to recover in the third quarter. August saw the highest single month's capital imports since September 1997 (US$855 million).

The government recognizes the need to reinforce this improving macroeconomic position with investment climate reforms. Three key policy packages are being implemented:

Investment climate reforms are divided into five categories: (i) general investment policies; (ii) customs; (iii) tax; (iv) labor; and (v) SMEs. Among the many measures included are completion of an investment law with new regulations designed to increase transparency and reduce red tape; cuts

[25] The capital account went from a deficit of US$2.3 billion in H1 2005 to one of US$0.4 billion in H1 2006. Although net FDI was almost balanced, strong portfolio investment contributed to the improvement.

in corporate and personal income tax rates; business friendly revisions to tax administration; and improved procedures in customs.

Infrastructure includes: (i) establishing an effective framework for policy, regulation, and new institutions; (ii) sector specific reforms; (iii) facilitating increased local government participation in infrastructure; and (iv) improved project preparation. One of the key framework measures has been the creation of a Risk Management Unit at the Ministry of Finance which can offer guarantees to private sector infrastructure providers on behalf of the Government, and specific budget allocations for the contingent liabilities taken on.

The *financial reform* package was formulated with three broad objectives (i) increasing access to finance (ii) reducing the cost of finance and (iii) diversifying the financial sector and reducing its vulnerability to shocks. This latest package has provisions that allow State Banks to provision and write down bad debts and begins the long sought after clean-up of the insurance sector among other things.

Each of these packages includes important reform measures but there have been implementation problems in some areas. Measures have sometimes slipped or been dropped and the quality of the reforms enacted has not been consistent. Revisions to Labor Law 13/2003 designed to foster increased employment met a negative reaction from organized labor and were put on hold, although there is now discussion of changes to improve severance provisions. The investment law is on this year's Parliamentary agenda but implementing decrees needed to improve transparency and reduce red tape are awaiting final enactment; the submission of business friendly tax measures was held up in Parliament and are now expected to take effect in 2008. Lack of capacity has slowed the development of model infrastructure projects.

Both fiscal and monetary polices are now supportive of higher growth. Bank Indonesia should have room for further easing into 2007 as inflation continues to fall. This should spur demand for corporate investment and recovery in consumer durables. Both central and regional governments are increasing spending and have fiscal space to expand public investment into 2007 and beyond. The current policy momentum will increase investment and bring the economy to into the 6 percent growth range by early 2007 and growth for the year as a whole should be 6 to 6.5 percent. The key economic challenge is to maintain this growth through 2007 and into the longer term. This will require investment and financial sector reforms that trigger business confidence and ramping up public and private infrastructure spending to overcome binding energy and transport constraints.

Korea

After accelerating throughout the course of 2005, Korea's economy slowed down this year, principally due to weaker domestic demand. Real GDP growth moderated to a 4.6 percent year-on-year pace in the third quarter of 2006 from 6.1 percent in the first. Consumer spending, which has exceeded household income growth for the past two years, started to moderate. Gross fixed investment remained sluggish, in large part due to government measures to restrain speculative investment in real estate. On the other hand, export growth has been robust despite the hefty 20 percent won appreciation over the last 2-3 years, reflecting strong productivity gains and the high non-price competitiveness of Korean IT-related products.

Inflation has continued subdued, aided by the strengthening of won. Core inflation has remained below the lower range of the central bank's medium term target of 2.5-3.5 percent. Given an expected moderation in economic growth and the recent decline in oil prices, inflation is likely to be kept in check though the next year. On the other hand, housing prices have been rebounding since last November, after government measures had stabilized the real estate market between last August and October.

The central bank kept its target for the benchmark call rate (uncollateralized call rate) steady in the last two months after it raised rates by a cumulative 125 basis points. The monetary tightening cycle might come to an end in response to subdued inflation and moderation in growth, although signs of acceleration in real estate prices still remain a concern. Korea's government will maintain a neutral stance in drafting the budget for 2007, with a greater focus on redistributive and social welfare functions. The fiscal balance excluding the social security fund will continue to be a deficit of less than 1 percent in 2007.

On the external front, the current account slipped into a slight deficit for the first eight months in 2006, on the back of a larger oil import bill. On the other hand, the capital account surplus widened substantially during the same period, as banks increased borrowing from overseas on the back of their improved credit worthiness and low Japanese yen interest rates, which helped drive up the country's short-term debts to a record high. With the small current account deficit more than offset by capital account surpluses, the country's foreign exchange reserves continued to rise to US$ 228.2 billion as of September, which is more than enough to cover the short-term external debts.

Korean banks have continued to strengthen their financial position. The average non-performing loan ratio of commercial banks fell to 1.0 percent at the end of June 2006. The non-performing loan ratio hit record lows for all categories of loans including corporate loans, household loans and credit card receivables. As a result of a 20 percent increase in net income, the average capital adequacy ratio rose slightly to a record 13.1 percent at the end of June 2006. In addition, the six credit card companies have been improving in financial health. Their average capital adequacy ratio continued to rise sharply, reaching 22.4 percent at the end of March 2006 as a result of increased

profit and an additional capital injection. Meanwhile, large Korean commercial banks are moving further into universal banking by acquiring non-bank financial institutions. Shinhan Financial Group is set to acquire LG card, the country's largest card issuer.

A moderation of consumption and export growth is expected to result in overall GDP growth of 4.5 percent in 2007, compared to 5.1 percent in 2006. Private consumption is like to slow moderately, reflecting low consumer confidence and sluggish stock prices. While the firm labor market will help soften this slowdown, still high household debts could weigh on consumer spending in case consumer sentiment deteriorates further. Export growth is also expected to moderate in line with a slowdown in industrial countries. Geopolitical risks associated with North Korea, a sharper-than expected slowdown in the U.S. economy and still volatile oil prices could pose a substantial downside risk to the Korean economy.

Malaysia

The Malaysian economy has done remarkably in the first half (H1) of 2006 with real GDP growing at 5.5 and 5.9 percent in the first and second quarters respectively. Looking forward, medium-term prospects remain broadly positive. Malaysia is expected to grow by 5.5 percent in 2006 and 2007, and 5.5-6 percent through 2008. Among factors contributing to growth next year are likely to be public investment, spurred by implementation of 20 high-impact projects, and continued strong demand for commodity products. Growth of real GDP reached 5.7 percent in H1 2006, from 4.9 percent in H1 2005, mainly driven by the strong growth in manufacturing output, spurred by recovery in the production of electronic and electrical products. Economic growth for 2006, currently expected to be 5.5 percent could actually be higher as more recent numbers suggest, in part due to increased government disbursements in the second half of this year and the resulting boost in domestic consumption.

Spurred by higher prices, exports of commodities have seen healthy growth in 2006. Rubber exports grew by 56 percent in January-July 2006, compared to 0.1 percent in the first seven months of 2005. This is due mainly to the surge of rubber export prices by almost 50 percent in 2006 combined with a supply constraint in major exporters like Thailand and Malaysia. Palm oil exports also grew by 2 percent in RM value terms in the first seven months of 2006, compared to -3 percent in the first seven months of 2005, driven by a 4 percent increase in export prices between January and July 2006. Going forward, although, palm oil prices are expected to stabilize, exports will continue to grow as a result of the stronger food consumption demand from China and India as well as industrial demand for the bio-fuel programs in EU-25 and China. Malaysian rubber export growth depends mainly on the global demand for automobile, in particular China's.

As in other economies around the region, inflation has picked up and is expected to reach 4 percent in 2006, the highest in eight years. Consumer price inflation rose to 4.1 percent at the end of the second quarter of 2006 from 3.7 percent in the first quarter. The increase was driven mainly by reductions in fuel subsidies in February and the resulting 23 percent jump in fuel prices. Higher duties on cigarettes and liquor, steeper highway toll charges, and a 12 percent rise in electricity tariffs in June also contributed to higher inflation.

To curb inflation, Bank Negara Malaysia (BNM) raised the benchmark overnight policy rate (OPR) by 80 basis points to 3.5 percent between November 2005 and April 2006. However, the OPR is expected to remain at 3.5 percent the rest of the year, given concerns over the global economic slowdown. In addition, headline inflation seems to have peaked in H1 2006, as the rate has declined to 3.87 percent for the first eight months of the year from 3.94 percent for H1. While core inflation doubled in 2005, it remained relatively low, averaging less than 2 percent. As of October 31, 2006, the international reserves of BNM amounted to RM293.4 billion (USD79.6 billion), equivalent to about 8.1 months of retained imports and 6.7 times short term debt.

Private investment has been relatively weak in Malaysia since the 1997 crisis. There are several reasons explaining the lack of investment recovery in Malaysia. Several studies including World Bank (2005), UBS (2006) have identified the regulatory burden, especially for services, and skills shortages as the two most binding constraints to private investment recovery. These two constraints have increased the cost of doing business and reduced expected profitability of future investments. The Malaysian government is aware of the situation and is initiating measures to tackle these issues.

In addition, the budget for 2007 announced on September 1, 2006 increased federal government development expenditures by 24.3 percent in 2007 compared to 17.3 percent in 2006 and the budget deficit will be around 3.5 percent of GDP. More than RM 100 billion is earmarked for "high-impact" projects aimed at encouraging private investment and reducing regional inequality. The budget has also lowered the corporate income tax by one percentage point. The Ninth Malaysia Plan (2006-2010) and the third Industrial Master Plan target the development of higher value-added manufacturing and expansion of the services sector such that services account for 60 percent of GDP in 2020 compared to 50 percent currently; this will also involve higher investments in infrastructure projects.

Philippines

Philippine economic performance has strengthened in 2006, aided by a recovery of agriculture and exports and continued rapid growth of remittances. Following a major adjustment of the consolidated public sector deficit (CPSD) to 2 percent of GDP in 2005 (implying a primary surplus of

over 4 percent), the National Government deficit was cut by more than half through September 2006, as tax revenue increased sharply with implementation of the VAT reform. Progress with fiscal consolidation objectives has contributed to buoyancy in the financial markets, which have bounced back following the worldwide correction in the second quarter that impacted the Philippines significantly.

GDP growth increased to 5.6 percent in the first half of 2006, while GNP growth reached 6.5 percent, aided by double-digit expansion of remittances. Favorable weather helped increase farm output by over 5 percent while a rebound in electronics exports pushed overall export growth to 17.5 percent. The service sector which contributes about half of total output continued to lead overall growth. Back office activities such as business process outsourcing have become a dominant driver of service sector growth, although manufacturing growth also rose above 6 percent in the first half of 2006. Investment, however, contracted by nearly 4 percent, while government spending was constrained by the non-passage of the 2006 budget.

Average inflation in the first three quarters slowed to 6.8 percent from 7.9 percent, while the 12-month CPI decelerated to 5.7 percent in September, as farm prices stabilized and the stronger peso countered the impact on prices of the VAT adjustment. As a result of a lower than programmed inflation rate, the BSP was able to keep its policy rates unchanged despite increases in US rates in the second and third quarters.

The pace of formal employment increased in parallel to the stronger economic activity in the year ending July. The number of wage and salary workers increased by about 1.2 million (7.5 percent) with the service sector accounting for the majority of the increase. Overall employment growth, however, was more modest, and unemployment increased from 7.7 percent to 8 percent, reflecting the growth of new entrants into the labor force and the fact that wage and salary workers account for less than half of the labor force. In particular, employment in agriculture decreased in the same period. About 8½ million Filipino workers, a quarter of the domestic labor force, work abroad.

A sharp increase in tax revenue collection thus far in 2006 has strengthened the credibility of the Government's fiscal consolidation objectives for the medium term as tax reforms have achieved high initial returns. In the first nine months, the national government deficit fell to P50.4 billion from P108.5 billion through September 2005. Strong revenue collection and depressed spending generated budget surpluses in four out of the nine months. In particular, VAT revenue was 6 percent above target in the first eight months (after netting out revenue losses due to mitigating measures). Over all, revenue grew by nearly 20 percent through September, while tax revenue including non-cash collection grew by 24 percent. The Bureau of Internal Revenue has recently created a Tax Reform Administration Group headed by a deputy commissioner to manage the reform program of the bureau. Task forces have been created for each of the seven critical reform areas identified, including registration cleanup, enhanced audit, and performance-based management. The non-passage of the 2006 budget restrained spending through September although the recent passage of a P47 billion supplemental budget mainly to finance obligatory expenses such as salaries and internal revenue allotment (to local governments), spending in the last quarter is expected to increase.

The consolidated public sector posted a deficit of P33.2 billion in the first quarter of 2006, down from P51.1 billion in the first quarter of 2005. The deficit was trimmed by improvements in the balances of government corporations and savings from local government units. The second quarter national government surplus is expected to further bring down the deficit but delays in the disposition of major generation assets of the National Power Corporation could reverse these gains in the second half of the year.

Until the tightening of global liquidity conditions led to the May-June 2006 correction, financial markets in the Philippines displayed an extended period of improvement, reflected in reduced spreads for global bond issues, falling interest rates for local currency government borrowing, a strengthening currency, and a buoyant stock market which reached a seven-year high in mid-May. Bond spreads have fallen significantly in the past two years, reflecting both the liquidity in emerging market spreads and improving Philippine spreads vis-à-vis the EMBI. In common with other emerging markets, these positive trends were reversed during mid-May to early July, but financial markets have since stabilized and in fact have been relatively quick to regain lost ground in comparison to other emerging markets. For example, the Philippine peso was trading at a four-year high against the US dollar in October, gaining some 14 percent since a year ago. Ample domestic liquidity pushed down short-term treasury rates well below inflation, but rates have risen relative to mid-May. FDI and portfolio flows grew rapidly in 2005 and early 2006 but these flows remain small in relation to the economy and its neighbors.

Rapid growth of remittances and transfers from overseas workers, amounting to about 14 percent of GDP in 2005, has converted large trade deficits into modest current account surpluses, and helped to boost consumption and reduce its volatility. The strong performance of remittances and exports has helped to insulate the current account from higher imported oil prices, allowing the central bank to increase gross reserves by $3.1 billion in 2006 through September, notwithstanding the prior market correction.

Thailand

Thailand's economic growth this year has been mainly driven by high export growth. Domestic demand, on

the other hand, continued to be depressed by high oil prices, higher inflation, rising interest rates, and declining terms of trade. Political uncertainties since the beginning of the year also lowered consumer and private investor confidence and delayed public investment. Real GDP growth this year is projected at 4.5 percent, the, same as last year. Net exports surged as exports grew strongly, reflecting robust global demand, while imports slowed in line with depressed domestic demand.

Growth in 2007 is expected to be similar to this year. A forecast decline in fuel costs, lower inflation, and interest rates and improved confidence next year should help encourage household consumption and private investment. Public investment growth will also be higher next year as Government budget disbursements, which were delayed in the last quarter of 2006, will resume in January 2007. Export growth, on the other hand, will likely decelerate with the lower growth expected in several of Thailand's major markets, namely the US, Japan, and the EU, and the expiration of the US GSP for Thailand at the end of 2006.

Thailand's external situation remains robust. Because of a much lower trade deficit and a rebound in the services account the current account is expected to swing to a surplus of around 1.5 percent of GDP in 2006 from a deficit of 2.1 percent last year. The current account surplus would decline to roughly 0.2 percent of GDP next year as exports of goods decelerate while those of imports accelerate. . At the end of August, foreign reserves stood at US$59.4 billion or 3.2 times short term external debt. Total external debt is 28 percent of GDP.

The fiscal situation remains strong. The government budget is balanced this year, and will be in deficit by about 1.2 percent of GDP in 2007. Public debt as a share of GDP as of August is 41 percent and is projected to remain below 50 percent over the next 5 years.

Headline inflation and interest rate peaked this year and are expected to decline in 2007. The sharp rise in inflation this year mainly reflects a rise in domestic retail petrol prices, especially in the first half of the year, following the floating of retail prices since July 2005. Headline inflation this year will be around 5 percent, up from 4.5 percent in 2005. Core inflation has also risen. Inflation in 2007 is expected to ease to around 3-3.5 percent.

Political uncertainty has diminished after the interim government was established in October. Consumer and investor confidence indices had been declining since the beginning of the year but improved after the coup in September as political uncertainties have somewhat cleared up. Nevertheless, sentiment has not risen back to in the levels of 2004 or 2005. Both consumers and investors are still waiting to see the policy direction of the interim government, which will be presented to the Legislative Assembly on October 27th, 2006.

Private investment growth should strengthen modestly in 2007. This year, the sharp rise in energy prices, rising interest rates, real appreciation of the baht, delays in public spending, political uncertainties, and the uncertain outlook for global demand in coming years have taken a large toll on private investment growth. Private investment will grow at around 4.6 percent this year, the lowest since 2002, although overall manufacturing capacity utilization is very close to pre-crisis levels, with many industries running at more than 90 percent utilization. Next year, private investment growth should pick up slightly as energy prices fall, public investment resumes, political uncertainties are reduced and investor sentiments improve. Foreign direct investment was quite robust this year, expanding in the first 7 months of the year by more than 20 percent from the same period last year, but may be less so next year. Foreign investors will likely remain cautious and wait for greater clarity in policies, especially those related to foreign share holdings.

Public investment should speed up in 2007 as disbursements delayed this year start in the beginning of next year. Public investment this year has been delayed, particularly that from the central government budget, refelcting cash flow management problems at the start of the year and delays in disbursing the investment budget due to political uncertainties. The FY2007[26] investment budget will be disbursed in January next year. Thus, next year, public investment is expected to rise further. However, there may be delays in the large infrastructure projects (known as mega-projects) which will be mostly undertaken by state-owned enterprises, because they will be revised by the interim government. Thus, public investment growth in 2007 should pick up modestly from this year, which should help strengthen investor sentiment and crowd-in private investment.

Goods exports in 2006 have risen about 9 percent in volume terms and by around 18 percent in value terms. The top three Thai exports remain non-electrical machinery and parts (HS84), electrical machinery and equipment (HS85), and vehicle and parts (HS87). The main export markets continue to be the US, Japan, and EU. Services exports growth reflects the rebound of tourism from the tsunami disaster at the end of 2004. As the global environment is quite uncertain next year with world trade volumes and growth in the economies of Thailand's key trading partners expected to slow, export growth is also expected to decelerate in 2007. Moreover, Thailand's exports to the US will be affected by the expiration of the US GSP for Thailand at the end of this year, while the Thailand-US bilateral free trade agreement (FTA) negotiations have been delayed.

Private consumption will unlikely be a major driver in 2007. Farm incomes next year will not support household consumption growth as much as they did in 2006, as world prices of Thailand's key crops, which have increased by 13

[26] FY2007 is from October 2006 to September 2007.

percent this year, are projected to rise by only 0.5 percent in 2007. Household borrowing will tend to be limited due to substantial increases in the ratio of household debt to income since 2000. Lending rates, while expected to trend lower next year, will also remain higher than the low levels prevailing before the recent tightening of monetary policy.

Thailand needs to focus on supply-side reforms to remain competitive in the coming years. Firms in the Thailand Investment Climate Survey[27] indicated that regulatory burden, shortage of skilled labor and infrastructure inadequacies were constraining business operations and investment. Streamlining regulations (in respect of investment, labor, tax, customs, etc) will be an important step for raising rates of return for firms. Similarly, improvements in secondary education, vocational education, English skills and IT skills will contribute much to removing the constraint of skill-availability and to expansion of ICT-use by firms. Expansion of infrastructure and infrastructure services will lower logistic costs. Moreover, price controls have been put in place since last year on over 170 consumer products and could limit firm profitability and expansion. These need to be carefully re-considered.

The interim government will continue policies to strengthen the quality of growth and has confirmed its commitment to elections in September next year. The interim government had indicated its commitment to pursue policies that promote the quality of growth, whereby the growth is underpinned by good governance practices and gains from growth are more fairly distributed to all sectors and groups in the country. . The Government will also focus on political reforms, including revising the 1997 Constitution as well as reducing the problems and violence in the southern part of the country. The details of the policy platform for the up coming year will be presented by the Prime Minister to the Legislative Assembly on October 27th, 2006. Broadly, it will be consistent with the targets in five areas laid out in 10th National Economic and Social Development Plan (2007-2011): (a) Improving social capital, (b) improving economic capital, (c) increasing community development and participation, (d) sustaining natural resources, and (e) promoting good governance.

Vietnam

GDP grew by 7.8 percent in the first nine months of the year, compared with 8.1 percent in the same period of 2005. With growth expected to remain strong in the fourth quarter, the government's target of 8 percent is likely to be met. In the first nine months, industrial value added grew nearly 10 percent year-on-year, followed by services at 8 percent and agriculture at 3.3 percent. Within the industrial sector, the turnover of the domestic private sector expanded 22 percent while that of state-owned enterprises (SOEs) grew 9.4 percent year-on-year.

Retail sales, an indicator of consumption, grew by 20.4 percent in the first nine months of 2006, about the same as in the equivalent 2005 period. Implemented investment, which is different from the standard measure of gross capital formation, was estimated to reach 76 percent of its annual forecast of 377 trillion dong (or 38.6 percent of GDP). FDI commitments have surged 26 percent year-on-year in the first nine months of the year to reach 5.1 billion dollars. FDI disbursements, including domestic borrowing of foreign enterprises, rose 8.8 percent to reach 2.87 billion dollars.

Export growth in the first nine months of the year stood at 24.2 percent year-on-year, supported by strong garment and footwear export growth, the latter despite an antidumping suit in the EU, their largest market. Exports of crude oil benefited from higher prices, even though there was some fall in volumes. Rice and coffee also experienced volume declines owing to weather related shocks. However, with Vietnam being a key coffee producer, a sharp rise in prices more than compensated the volume decline. Imports grew by 19.3 percent in the first nine months. Capital goods imports recovered strongly to record a growth of 22.1 percent compared with less than 2 percent in first nine months of 2005. Fabric imports also rose by a sharp 25 percent, reflecting the input requirements of garment exports. The trade balance swung from deficit to a small surplus in the first nine months of 2006. Helped by strong remittance flows, the current account recorded a surplus of 0.4 percent of GDP in 2005, and a similar surplus is anticipated in 2006 as well. Inflows of FDI and ODA have been robust, leading to a rapid rise in foreign reserves. By end-June reserves reached nearly 11 billion dollars (11 weeks of imports) compared with 8.6 billion dollars at end-2005.

Vietnam has concluded all the bilateral agreements needed for WTO accession. According to trade minister Truong Dinh Tuyen, Vietnam's entry to the WTO will then be approved at a general meeting of the WTO Secretariat on November 6-8. Vietnam also requires a vote on Permanent Normal Trade Relations in the US congress. This vote is expected to be concluded in Vietnam's favor prior to the APEC summit meeting in Hanoi in late November.

Fiscal revenues and expenditures look on track to meet budget targets. The target for the budget deficit in 2006 is 2.6 percent of GDP, and on-lending of ODA is projected to add another 1.3 percent. Revenues were buoyed by high oil prices in the first half, but will be dampened by lower prices in the third quarter. To partially compensate, the government reintroduced tariffs on certain oil products which had earlier been eliminated to stabilize domestic prices. On the expenditure side, a pay rise for state employees is expected to cost the government 6.2 trillion in the final quarter of 2006, and 26.6 trillion dong in 2007. This pay hike is related to an increase in the minimum wage

[27] The survey was conducted as a part of the *Thailand Productivity and Investment Climate Study (2006)*, a joint report of the World Bank and the National Economic & Social Development Board (NESDB).

in state owned and private enterprises from 350,000 dong (22 dollars) per month to 450,000 dong (28 dollars). The adjustments will further narrow the minimum wage gap between domestic and foreign invested sectors. The gap is to be reduced to zero by 2010 as part of WTO commitments. The minimum wage hike will also be a basis for adjustment of government pensions and other social security payments.

In an effort to enhance transparency, the Ministry of Finance has begun to post quarterly budget execution reports on its website. Off-budget expenditures have been reported for 2004 and 2005. Regulations to publish local budgets have also been issued. The State Audit of Vietnam became an independent body reporting to the National Assembly in 2005, and has made its audit of the state budget public for the first time. The report, which has been widely quoted in the press, sheds light on loss making SOEs, tax arrears, and funds that had hitherto been "secret."

Inflation fell to 6.9 percent in September 2006, its lowest level since April 2004, and down from 7.7 percent year-on-year in the first eight months. Poor weather conditions have continued to exert upward pressure on food prices. Domestic oil price adjustments have lagged behind international price movements, but the lags have become smaller in recent months. With the recent softening in international prices, the domestic price for gasoline has been reduced, although the price of diesel, which is currently below international levels, has not been adjusted downwards.

The stock market has grown rapidly during 2006. The number of listed companies increased from 36 at the end of 2005 to 67 in early October 2006. Fifty of these are listed on the Ho Chi Minh City securities trading center (HSTC), and the other 17 on the organized over-the-counter market in Hanoi. Market capitalization of the HSTC has increased from under-500 million dollars in December 2005 to nearly 3.3 billion (5.5 percent of annualized GDP) in October 2006. The stock price index has increased by over 70 percent since December 2005. Foreign investors have been net buyers and have accounted for around 13 percent of trading activity in 2006. Enterprises are keen to list before January 2007, when tax incentives available to listed companies will be removed.

Credit growth slowed to 21 percent at the end of June, compared with nearly 32 percent in December 2005. The decline was mainly due to slower lending by State Owned Commercial Banks (SOCBs). The sharper slow down in SOCBs credit may be related to their efforts to conform to stricter prudential standards that were introduced in 2005. However, deposit growth at both the SOCBs and JSBs has remained high at 40 percent. Deposit rates have been rising especially as joint stock banks have competed for funds and currently stand at 8.4 percent for a one year deposit. With deposit growth far exceeding lending growth, SOCBs have experienced a build-up of excess liquidity. On the policy front, the government recently announced that SOCBs will now conduct their equitizations by 2008, two years earlier than previously stated. The state is expected to retain a 51 percent stake, with foreign ownership restricted to 30 percent. The limit on a single foreign investor is likely to be raised from 10 to 20 percent.

In coming months Vietnam may issue international bonds to finance projects that are deemed strategic. The proceeds are likely to be on-lent to state owned corporations executing the projects. These corporations have not yet established their own creditworthiness in international markets, and the financing requirements are likely too large to be met through domestic commercial banks. Last year the government raised 750 million dollars to on-lend to a shipbuilder. The bond currently trades at a spread of 160 basis points over US treasuries. In September, Standard and Poor's upgraded Vietnam's foreign currency rating by one notch to BB, its local currency rating to BB+ from BB, and assessed the outlook as stable.

Smaller Economies

Cambodia

Cambodia's real GDP grew by an unprecedented 13.4 percent in 2005.[28] The stellar performance was driven by solid garment exports, strong tourism receipts, significant growth in FDI, the continuing construction boom, and record crops in agriculture. Agriculture remained a crucial sector for the economy, accounting for 38 percent of GDP growth and some 60 percent of total employment in 2005. Growth in 2006 is expected to moderate to a projected 8.9 percent owing to slower expansion in construction and agriculture. Consumer price inflation is projected to fall to around 5 percent in 2006, down from 6.7 percent in 2005. A sound macroeconomic framework has helped underpin success in 2006. However, Cambodia's narrow growth base remains a concern. Recent and ongoing work—including the National Export Strategy, 2007–2010, the Small and Medium Enterprise Development Framework, 2005–2010, and the second phase of the Integrated Framework (IF) for trade—aim to tackle this challenge.

The external sector maintained its dynamism in 2005 with an 11 percent increase in apparel exports. The apparel industry benefited from protective measures against Chinese apparel imports introduced by the US and the European Union in mid-2005. The signing of the Trade and Investment Framework Agreement (TIFA) between Cambodia and the U.S. in July 2006 is expected to further spur bilateral trade. The external sector also saw 44 percent

[28] The official growth figure is not strictly comparable to earlier years since it also reflects some changes in national accounts methodology, including revised statistical coverage and compilation methods. A comparable figure taking these adjustments into account would put 2005 growth at about 9.8 percent.

growth in tourism receipts and a more than doubling of FDI. The external sector remains strong, with exports expected to grow by 15 percent in 2006 and FDI continuing to expand. Despite projected strong export growth, the trade deficit is forecast to reach 20 percent of GDP in 2006, up from 16 percent in 2005, due to faster import growth. Gross foreign reserves are projected to reach US$ 1.1 billion (from US$ 0.9 billion in 2005) and the exchange rate is projected to depreciate slightly (0.8 percent) against the US dollar.

The fiscal front saw modest improvement in 2005 with total revenue rising slightly from 10.4 percent of GDP in 2004 to 10.5 percent in 2005. Revenue is expected to jump to 12 percent of GDP in 2006, due to growth in both domestic and international tax collections, while non-tax revenue is expected to remain steady as a share of GDP. Expenditure contracted to 13.8 percent of GDP in 2005, but is expected to increase slightly to 14.4 percent in 2006, reflecting growth in current spending. The net impact of both revenue and expenditure measures is expected to reduce the overall deficit (excluding grants) from -3.4 to -2.6 percent of GDP in 2006, with the deficit inclusive of grants falling to 0.9 percent in 2006.

Growth in broad money is expected to increase by about 27 percent in 2006, significantly higher than in 2005. Private sector credit is expected to continue to accelerate in 2006 with growth of about 35 percent. Commercial interest rates, however, remain relatively high at about 15 percent p.a.

On the structural reform agenda the Public Financial Management (PFM) Reform Program, launched by the Prime Minister in December 2004, is beginning to yield results. The amount of customs revenue collected through the banking system has increased from zero in 2004 to 36 percent of the total in 2005, and is scheduled to increase further in 2006; 86 percent of all Tax Department revenue is now collected through the banking system; a growing share of Treasury payments to suppliers are made by check instead of cash; a new annual budget process that incorporates program budgeting has been adopted; the stock of old expenditure arrears has been reduced by over 40 percent; the procurement process has been streamlined, tightened, and made more competitive; the Government has set up internal audit departments in a dozen line ministries, and, for the first time in Cambodia, a pilot program has been launched to pay civil servants through commercial banks instead of by cash. The PFM Reform Program is supported by 11 donors, most recently the World Bank, which approved a US$ 14 million grant project in June 2006.

Financial sector reform, guided by the ten-year sector blueprint adopted in 2001, has also progressed. A Credit Information Sharing System has been introduced, providing commercial banks with credit-related information on prospective customers, thus lowering delinquency rates and loan defaults. The development of a national payment system and a comprehensive information technology system for banking functions has become a pressing sectoral challenge.

Another major challenge for the Government is the passage of several laws necessary for WTO compliance, including: the Secured Transactions Law, the Commercial Leasing Law, the Law on the Issuance and Trade of Non-Governmental Securities, the Insolvency Law, and the Law on Establishment of Commercial Court, among others.

Fiji

The National Elections in May 2006 saw a historic event for the country with the installation of its first multi-party cabinet, led by the incumbent Prime Minister. The military has also welcomed this move. Fiji also hosted the 37th Pacific Islands Forum Leaders Meeting in October this year.

Fiji's economy is projected to recover from its low growth of 0.7 percent in 2005 to 3.1 percent in 2006. The stronger growth is driven by robust economic activity in the agriculture, forestry, fishing, and services sectors. The government forecasts real GDP growth of around 2.5 percent over the medium term.

The fiscal deficit for 2006 is projected to narrow slightly from its 2005 level to meet the government's target deficit of 4 percent of GDP. The government aims to reduce the budget deficit over the medium term to contain rising public sector debt, which remains above 50 percent of GDP. Inflation at end-2006 is projected to remain under 4 percent. Inflationary pressures from high global oil prices and a weaker local currency is expected to be partially offset by lower domestic prices and the tightening of monetary policy.

The boom in the tourism industry (Fiji's main foreign exchange earner) is expected to resume after a slight slowdown in the first quarter of 2006, associated with uncertainties surrounding the national elections. Tourist arrivals in 2006 are projected to increase by 5 percent over the previous year.

The current account balance deteriorated cumulative to April 2006. Merchandise exports fell by 9 percent mainly due to lower earnings from garments and sugar, while imports climbed by 18 percent owing to stronger consumption demand and the higher cost of oil. This has led to a worrying decline in foreign reserves, to cover less than 3 months of imports of goods at end-June 2006.

The performance of the garment industry continues to weaken following the expiry of US preferential trade agreement in early-2005. Export earnings fell by 43 percent in 2005 and are projected to further decline in 2006. Sugar production in the season to June 2006 declined by 14 percent over the comparable period last season, largely due to mill-related issues and unfavorable weather conditions.

Government efforts to cushion some of these adverse impacts on the economy include issuing a FJD$300 million (US$173 million) bond on the international market to raise gross reserves, negotiating with Australia to review the SPARTECA (South Pacific Regional Trade and Economic Cooperation Agreement) Rules of Origin for garments, restructuring the sugar industry and upgrading the four sugar mills, as well as initiatives to diversify export production.

Lao PDR

Lao PDR has maintained relatively stable macroeconomic conditions and robust economic growth. Monetary and fiscal discipline has improved. The momentum of structural reforms in trade, private sector development and public financial management has been sustained. Strong growth and relatively low inflation continues to reduce poverty in both rural and urban areas.

Growth is estimated to exceed 7 percent in 2006, after reaching 7 percent in 2005, largely due to continuing investments in mining and hydro-power. This rate of growth is expected to continue in 2007 as investment and exports continue to grow. Foreign investment inflows into mining and hydro-power remain buoyant. Tourism receipts continue to perform well (with tourist visits growing over 20 percent a year), as are some non-traditional exports. Gold and copper exports have been rising rapidly over the last two years. However, garments, coffee, and wood exports are doing less well.

Headline inflation fell to 7 percent in August 2006 from a high of 9 percent earlier in the year. The government's efforts to control the budget deficit, despite pressures on the wage-bill and slow growth in revenue, have helped keep inflation in check. Core inflation remains subdued at 5 percent. Nevertheless, there are a number of fiscal risks that will have to be managed to sustain macro-economic stability. On the expenditure side, budget consolidation efforts have generated arrears and lowered non-wage recurrent spending. On the revenue side, if the mining royalties collected are not remitted by provinces to the central budget or if non-resource tax administration slackens or if greater central control over customs and taxes is not restored, the fiscal situation could deteriorate. A secular decline in aid inflows as a share of GDP has made faster growth in revenue and higher efficiency in public spending imperative if delivery of basic services is to improve without undermining fiscal stability.

The external position of Lao PDR has strengthened. A surge in mining exports, combined with buoyant tourism receipts and substantial foreign direct investment inflows, helped raise external reserves to more than 3 months of imports. The kip/baht exchange rate has been stable and the current account deficit has increased significantly to accommodate the foreign investment inflows to the mining and hydropower sectors. External debt is down from 83.4 percent of GDP in 2004 to 77.4 percent of GDP in 2005 (or 166 percent of exports in NPV terms), but it remains a concern. If reforms continue to be implemented as planned, new borrowing is mainly on concessional terms, and growth continues to be robust in the medium term, the debt-burden ratios are projected to fall further.

Implementation of structural reforms has continued, even if slowly. Actions to open trade and private investment continue to be taken. The SOE sector is borrowing less from banks and receiving lower subsidy from the government. Large SOEs are undergoing restructuring and tariff adjustments. But the restructuring of state-owned commercial banks is not going that well. There is an urgent need to implement the modified 'Governance Agreements' and make better use of International Banking Advisors. More importantly there is a need to obtain private strategic partners. To improve banking services in the country, there is also a need to 'level the playing field' for all state-owned and private banks, though progress in this direction is very slow. Public expenditure management reform has gained considerable momentum over the last six months, including expanded internal Government dialogue on key aspects of center-local fiscal relations i.e. greater central control and administration of customs and taxes; more consolidated treasury management and increased use of budget norms to ensure that provinces' choices reflect national priorities.

The final version of the sixth National Socioeconomic Development Plan (2006-11) is expected to be issued in late October 2006. Its preparation followed a consultative and participatory process for the first time, with donors providing formal comments in January 2006. This sixth Plan draft emphasizes the objective of poverty-reduction and of the Millennium Development Goals (MDGs), as well as directions for policies and public investments necessary to achieve them.

Mongolia

Mongolia's high economic growth continues. Between January and August 2006, real gross industrial output increased by 32 percent compared to the corresponding period last year. Main drivers of industrial growth were manufacturing products, in particular beverages (32 percent), textiles (31 percent) and basic metals (36 percent). Despite remarkably high international prices, mining sector production contracted by 7.5 percent in real terms, as a result of the stagnation of copper extraction and a decrease in recorded gold production. (The mining sector is however attracting foreign direct investment which is expected to reach $319 millions in 2006.) In the tertiary sector, the volume of railway transport services decreased by 2.7 percent over the period, despite strong growth in freight forwarding (40.3 percent). Overall GDP growth is projected to be around 7 percent in 2006, with the main contributions coming from the manufacturing, livestock and services sectors.

High prices for copper and gold have sustained export revenue growth in 2006. In the January-August 2006 period, exports in US dollar terms increased by 60 percent and imports by 32 percent from the year earlier period. Copper concentrate and gold contributed 43 percent and 13 percent of total export value respectively. The floating exchange rate appreciated slightly, reaching 1168 togrog per USD by September. Inflation was brought down from 9.2 percent in 2005 to 5.3 percent in 2006 as of August, although monetary growth remains strong, suggesting that monetization of the economy is still at work. As of June 2006, broad money increased by 46 percent and credit to the private sector by 40 percent.

The fiscal balance is expected to remain in surplus in 2006, for the second consecutive year. As of August 2006, budget revenue collection reported an increase of 47 percent compared to the same period last year, while total government expenditure was up 21 percent. As a result, the government budget recorded a surplus of 181bln togrog through August 2006. The main factors contributing to the surplus were the exceptionally high level of copper and gold prices leading to an increase in foreign trade tax collection and dividend earnings, an overall increase in tax collection due to a higher level of economic activity.

Significant changes to fiscal policy have been implemented since the beginning of the year including on the revenue side, the introduction of a large "windfall" tax on the copper and gold sectors, and an increase in mining royalties from 2.5 percent to 5 percent. On the spending side, civil service wages were increased by over 30 percent, means testing for the child allowance was eliminated, and universal lump-sum allowances for newlyweds and newborns were introduced. A development fund was created into which revenues from the windfall tax are paid. Two third of the development fund is aimed at financing social programs and capital spending while the remaining should be saved for future uses. In addition, new tax laws were adopted and are expected to come into effect on January 2007. The main reforms include (i) a cut in the corporate income tax by 5 percent, combined with a thirty-fold increase in the threshold for the higher CIT rate, the abolition of tax holidays, the introduction of loss carry forward and (iii) a cut in the VAT by 5 percentage points, combined with the abolition of numerous exemptions.

The recently adopted fiscal policy measures accentuate the dependence of public finances on the mining economy and, as a result, increase Mongolia's vulnerability to a reversal of the upward trend in metals prices. On the revenue side, the reduction of VAT rate, and the cut in CIT will narrow the revenue base. Meanwhile, the increase in mining royalties rates and the introduction of the windfall tax would skew the revenue structure towards mining. On the expenditure side, the increase in civil service wages, the elimination of means testing for child allowances and introduction of new universal allowances will imply a continuing call on resources for the government to meet these recurrent expenditures even in times when the current revenue boom subsides. This would make needed fiscal adjustments in the future more difficult and crowd out capital expenditures, typically in key items such as maintenance of existing capital and infrastructure.

Mongolia is at moderate risk of debt distress over the medium term. The outstanding stock of external debt is equivalent to 70.5 percent of GDP as of end-2005, and 44 percent in Net Present Value terms (NPV). The debt burden looks sustainable assuming no major negative terms of trade shock and only concessional borrowing. International commodity prices are volatile however, and significant declines from current high levels cannot be ruled out. The Government is working on a debt management strategy which will articulate the medium-term priorities for domestic and external borrowing.

Finally, an Anti-Corruption Law as well as an Anti Money Laundering Law were adopted by Parliament last Spring. These 2 laws, together with the ratification by Mongolia of the UN Convention against corruption last year, will form the backbone of Mongolia's legal framework to fight corruption.

Papua New Guinea

Economic performance in 2006 is expected to be good with GDP growth expected to be nearly 4 percent, marking the third consecutive year of expansion. The strength of economic performance has been due mainly to the mineral sector which has benefited from historically high international commodity prices—principally for oil, copper and gold—that have prevailed over the first three quarters of the year. Non-mineral GDP is expected to increase by over 3 percent due to continued robust agricultural production and an expansion in construction for both commercial and residential real estate. Fiscal management has remained the cornerstone of the recovery while stable monetary conditions have played an important supporting role.

A budgetary surplus of 2.3 percent of GDP was registered in the first half of the year due to higher than budgeted mineral tax receipts. Underlying tax collections across all other categories also remained strong, reflecting the strength of the economy. Expenditure control measures implemented in the recent past continued to bear fruit with overall spending remaining on track, relative to the budget. Lower than expected yields on Treasury bills and sales of government bonds at unexpected premiums resulted in further savings over the first half of the year. An overall surplus of about 1.8 percent of GDP is expected for the full year.

Due to the exceptionally high global commodity prices the trade balance remained in surplus over the first half of the year, a situation expected to be maintained through the full year and reflected in a current account surplus. The kina has remained stable over the first three quarters of the year, appreciating slightly against both the U.S. dollar (about $2^1/_2$ percent) and the Australian dollar

(about $3^1/_2$ percent) consistent with the country's improving terms of trade.

Although inflation picked up during the second quarter of 2006 compared to the first, it remains modest running at an annualized rate of 2.3 percent at mid-year. Treasury bill yields declined slightly to the 3-4 percent range as the government ceased to issue Treasury bills after May, on account of the continuing cash surplus. Both deposit and lending rates at commercial banks have continued the trend of 2005, declining slightly in the year to date. The build up of external reserves has been maintained with reserves at the end of the third quarter standing at about US$1,300 million, equivalent to over nine months of non-mineral imports.

The long awaited PNG-Australia gas pipeline project suffered a setback in September 2006 when a partner in the Australian section of the pipeline decided to cut back on design work due to rising costs and questions about demand. This is not expected to pose a long term impediment to the project.

Solomon Islands

Notwithstanding a violent two-day outbreak of civil unrest in the capital city during the National Elections in April 2006, a new four-party Coalition for Change government has been formed. The new government has released its *Policy Framework Translation and Implementation Document* which outlines the government's vision and mission for the nation. The document also identifies government's commitment toward several issues which include Constitutional reform (a new Constitution is expected to be completed by January 2007). The political situation however, remains fluid.

Macroeconomic conditions remain stable. Real GDP growth is expected to reach 5 percent in 2006, the same as in 2005, supported by palm oil production and the demand for services due to the Regional Assistance Mission to Solomon Islands (RAMSI).. However, growth is projected to slow to around 4 percent in 2007, reflecting lower timber logging. Inflation is projected to exceed 8 percent in 2006, largely due to higher oil prices, rapid growth in private credit, and stronger demand from the expatriate community.

The external position continues to weaken as oil prices soar and non-oil imports are boosted by investment projects. The current account deficit is projected to widen from 11 percent of GDP in 2005 to 16 percent in 2006 and 2007. Foreign reserves are projected to stand at US$98 million at end-2006, just over 5 months of import cover. Despite the prospective current account deficit, gross reserves are expected to remain relatively stable, aided by strong official development assistance and an increase in FDI linked to palm oil and gold mine projects.

A small budget surplus is projected for 2006 as higher revenue from improved tax compliance and reduced logging duty exemptions outpaces higher public spending on some relatively low-priority areas (public wage bill, tertiary scholarships and embassies). The medium term outlook presents several medium term fiscal risks, including public service wage increases, declining logging tax receipts, lower import duties and aid flows, recurrent expenditure needs, and the fragile financial situation of SOEs and provincial governments, the latter linked to problems of fiscal decentralization.

Total public debt has fallen from 122 percent of GDP in 2003 to 80 percent of GDP in 2005, and external debt has also declined from 70 to 54 percent of GDP in the same period. Public debt is projected to fall further to 70 percent of GDP in 2006 (with external debt falling to 50 percent of GDP). While debt forgiveness received through the Honiara Club negotiations and the agreement to settle interest arrears and outstanding advances with the Central Bank of Solomon Islands have helped to reduce public debt, the levels are still high and the debt position remains vulnerable.

Timor Leste

Timor-Leste slid into a complex crisis in April 2006, triggered by over a third of the army going on strike to protest alleged discrimination and their subsequent dismissal by the Government. The ensuing violence was centered in Dili, (although the rest of the country remained comparatively peaceful), and left about 160,000 internally displaced, 35 dead and about 1,200 houses burnt in Dili. The violence has exposed tensions within the military, between the military and police, and between eastern and western parts of the country. The country was forced to call for international forces to restore order. The unrest subsided after the arrival of troops from Australia, Malaysia, New Zealand and Portugal, but underlying tensions remain and sporadic incidents of violence have continued.

The security crisis led to a political crisis, forcing the resignation of former Prime Minister Alkatiri, and the arrest of the former interior minister on charges of distributing arms. In mid-July, former Foreign Minister Ramos-Horta was appointed as the new Prime Minister. A UN Commission of Inquiry is expected to release its findings on the events leading up to the crisis. Previously scheduled parliamentary and presidential elections are now due to take place in the spring of 2007.

The crisis paralyzed the government and the Dili economy. Between May and June, with the exception of the Ministry for Labor and Social Reintegration, Ministry of Health and a few departments in the Ministry of Planning and Finance, all public offices and private business in Dili were closed. The districts were less affected, but suffered from supply disruptions, decreased demand for their products, and the need to accommodate an influx of refugees. The offshore oil and gas sector was undisturbed, however, as was most family farming. Overall, non-oil GDP growth may be close to zero in 2006, notwithstanding

an expected end-year boost from higher public spending and international aid. CPI inflation spiked to nearly 7 percent in the year to June 2006, driven by higher transportation costs.

Until April 2006, Timor-Leste had made considerable progress in nation-building, maintaining peace, converting its petroleum wealth into a sustainable source of revenue for future generations, and restoring public services. Fiscal and current account surpluses have increased sharply on account of rapidly growing offshore revenue from oil and gas, and the Petroleum Fund had accumulated deposits amounting to $650 million by June 2006.

While petroleum GDP has grown rapidly, developments in the non-petroleum sector have been much weaker. After declining by about 6 percent per year during 2002-03, non-petroleum GDP is estimated to have grown modestly during 2004-05. But with population growth of around 3.9 percent, non-petroleum GDP per capita likely declined even in the recent period, and is estimated at about $350 in 2005. Non-petroleum exports, consisting largely of coffee, are estimated at $8 million in 2005.

The country has encountered difficulty and delay in executing its capital budget, and private investment and job creation have also been disappointing. Unemployment in Dili, where about a quarter of the formal labor force resides, is estimated at 27 percent, and youth unemployment is a particular problem that appears to have exacerbated the intensity of the recent conflict. Unemployment rates in the rest of the country are much lower, with the national rate estimated at 8.5 percent, reflecting the prevalence of self-employed and subsistence workers, and a relatively small formal labor force.

The country now faces the challenge of rebuilding trust and addressing the security situation and the rule of law. At the same time it needs to jump-start the economy and respond to basic humanitarian needs and development requirements.

A large increase in spending for FY06/07 has been approved by Parliament, in particular for emergency assistance, wage bonuses for civil servants, and an increased subsidy to the state-owned electricity company (offsetting a reduction in electricity prices). The budget directs more spending to development expenditure (44 percent) than had originally been planned. Although more than double the previous fiscal year levels, the new spending remains within the "sustainable" levels allowed under the country's savings policy.

A critical challenge is to improve budget execution so that spending priorities can be better realized. The government has revised its procurement law, allowing delegation of procurement up to $100,000 to those line ministries with the capacity to assume this responsibility. The first phase of the process covers the ministries of education, health, agriculture and finance, to be followed by 4-5 other ministries and agencies before June 2007. The core objective is to revamp the delivery of basic services and generate some 4-5,000 sustained jobs.

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 2000	8.6	12.5	5.3	8.2	8.4	7.2	10.9	6.5	2.4	7.8
Q4 2000	7.9	9.3	7.5	4.3	7.1	5.3	10.1	3.6	4.0	6.8
Q1 2001	9.1	2.4	4.4	3.5	2.9	1.3	4.7	0.6	1.7	4.8
Q2 2001	8.7	1.6	6.1	3.7	0.2	2.0	-0.6	-3.1	2.2	4.1
Q3 2001	8.1	-0.3	3.9	3.4	-1.2	1.4	-6.5	-4.6	2.1	2.9
Q4 2001	7.6	-1.0	1.0	4.6	-0.5	2.3	-6.1	-1.5	2.7	4.2
Q1 2002	8.8	-1.0	3.4	6.5	1.3	4.2	-0.6	1.3	4.5	5.0
Q2 2002	9.2	0.4	4.1	7.0	4.2	4.6	4.7	4.2	5.0	6.1
Q3 2002	9.3	2.9	5.2	6.8	6.0	3.3	6.4	6.1	5.8	6.7
Q4 2002	9.1	4.8	4.7	7.5	5.8	5.5	5.8	5.3	6.0	7.8
Q1 2003	10.3	4.4	4.9	3.8	5.0	4.8	2.9	3.4	6.8	6.5
Q2 2003	7.9	-0.7	5.2	2.2	4.7	4.3	-2.4	0.1	6.6	4.4
Q3 2003	9.6	4.0	4.6	2.3	5.3	5.4	3.6	4.2	6.7	6.1
Q4 2003	9.9	4.8	4.2	4.1	6.8	5.1	7.6	5.9	8.0	7.1
Q1 2004	9.8	8.1	4.1	5.4	7.9	6.5	8.5	7.6	6.7	7.7
Q2 2004	9.7	12.4	4.4	5.7	8.5	6.9	12.3	9.0	6.4	8.4
Q3 2004	9.5	6.8	4.6	4.7	6.8	6.0	7.5	5.5	6.3	7.1
Q4 2004	9.5	7.5	7.1	3.3	5.9	5.5	6.9	2.5	5.3	6.5
Q1 2005	9.9	6.0	6.3	2.7	6.1	4.2	3.4	2.5	3.2	6.1
Q2 2005	10.1	7.2	5.6	3.2	4.1	5.4	5.7	2.9	4.6	6.5
Q3 2005	9.8	8.2	5.6	4.5	5.3	4.8	7.6	4.2	5.4	7.0
Q4 2005	9.9	7.5	4.9	5.3	5.2	5.3	8.6	6.4	4.7	7.4
Q1 2006	10.3	8.0	4.7	6.1	5.5	5.7	10.8	4.9	6.1	7.7
Q2 2006	11.3	5.2	5.2	5.3	5.9	5.5	8.1	4.6	4.9	7.6

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

Appendix Table 2: East Asia: Merchandise Export Growth

(US $; % change form a year ago)

	2004	2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Jun-06	Jul-06	Aug-06	Sep-06	Oct-06
East Asia (9)	25.6	18.1	17.6	18.3	17.3	20.0	19.4	20.3	20.0	23.1		
SE Asia	17.6	13.6	13.4	12.9	12.5	14.9	17.2	19.6	20.4	18.3		
Indonesia	13.8	21.8	25.7	11.8	20.2	12.3	18.0	26.1	26.2	22.2	16.8	
Malaysia	20.8	11.4	10.8	8.4	13.3	13.7	14.5	14.6	19.8	17.5		
Philippines	9.5	4.0	3.6	5.0	3.5	14.0	19.5	20.6	12.9	21.3		
Thailand	19.9	14.5	12.3	23.1	9.7	18.7	19.2	20.7	19.6	15.7	15.4	
China	35.4	28.4	30.9	29.1	21.7	26.6	24.1	23.3	22.6	32.7	30.6	
NIEs	22.8	12.7	10.3	12.8	15.8	17.3	16.6	18.2	17.9	17.2	18.2	
Hong Kong	15.8	11.6	12.6	13.0	10.4	12.8	5.6	6.9	10.7	9.8	4.4	
Korea	12.1	24.6	9.0	15.4	11.6	11.4	16.3	15.2	12.4	17.0	21.3	11.5
Singapore	24.6	18.8	13.4	14.7	31.0	36.7	36.7	40.4	33.6	28.9	35.3	
Taiwan (China)	20.7	8.8	6.0	7.1	14.2	11.9	13.7	16.2	20.6	16.1	17.3	

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

	1999	2000	2001	2002	2003	2004	2005	Forecast 2006	Forecast 2007
East Asia	6.7	8.0	4.6	6.9	6.8	8.0	7.5	7.8	7.3
Developing East Asia	6.4	7.7	6.7	7.9	8.9	9.1	9.0	9.2	8.7
South East Asia	3.3	6.0	2.4	4.6	5.6	6.0	5.1	5.2	5.6
Indonesia	0.8	5.4	3.8	4.4	4.7	5.1	5.6	5.5	6.2
Malaysia	6.1	8.9	0.3	4.4	5.5	7.2	5.2	5.5	5.5
Philippines	3.4	6.0	1.8	4.3	5.0	6.2	5.0	5.5	5.7
Thailand	4.4	4.8	2.2	5.3	7.0	6.2	4.5	4.5	4.6
Transition									
China	7.6	8.4	8.3	9.1	10.0	10.1	10.2	10.4	9.6
Vietnam	4.8	6.8	6.9	7.1	7.3	7.8	8.4	8.0	7.5
Small Economies	9.1	3.2	3.9	3.6	5.3	6.6	7.6	6.4	5.3
Cambodia	12.6	8.4	7.7	6.2	8.6	10.0	13.4	8.9	6.5
Timor-Leste		15.4	16.6	-6.7	-6.2	0.4	2.3	0.3	8.0
Lao PDR	7.3	5.8	5.8	5.9	6.1	6.4	7.0	7.3	6.6
Mongolia	3.2	1.1	1.0	4.0	5.6	10.7	6.2	7.0	7.0
Fiji	8.8	-1.7	2.0	3.2	1.0	5.3	0.7	3.1	2.2
Kiribati	5.6	1.9	1.8	-4.3	2.3	-1.4	0.3	0.8	0.8
Marshall Islands	0.6	0.9	5.5	4.0	1.8	0.4	3.5	4.0	3.5
Micronesia, Fed. Sts.	-3.1	8.4	0.3	1.1	5.1	-3.8	0.3	1.0	1.0
Palau	-5.4	0.3	1.3	-3.5	-1.3	4.9	5.5	5.7	5.5
Papua New Guinea	7.5	-1.2	-0.1	-0.2	2.9	2.9	3.0	3.8	4.0
Samoa	2.3	7.0	7.1	4.4	1.6	3.2	5.4	4.3	3.1
Solomon Islands	-0.5	-14.3	-9.0	-1.6	6.4	8.0	5.0	5.3	4.3
Tonga	3.1	5.2	1.8	3.0	3.2	1.4	2.3	1.9	0.6
Vanuatu	-2.7	2.7	-2.7	-4.9	2.4	4.0	2.8	3.0	3.0
East Asia NIEs	7.3	8.4	1.1	5.2	3.2	6.0	4.7	5.1	4.5
Hong Kong (SAR)	3.4	12.4	0.6	1.8	3.2	8.6	7.3	5.9	4.9
Korea	9.5	8.5	3.8	7.0	3.1	4.7	4.0	5.1	4.5
Singapore	7.2	10.0	-2.3	4.0	2.9	8.7	6.4	7.4	5.0
Taiwan (China)	5.7	5.8	-2.2	4.2	3.4	6.1	4.0	4.0	4.0
Japan	0.2	2.8	0.2	0.1	1.8	2.7	2.6	2.9	2.4

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

Appendix Table 4: Primary Commodity Prices

(US Dollars - % change from a year ago)

			Actual							Projections	
Commodity	**1980-90**	**1991-98**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Crude oil average	0.0	-5.7	38.3	56.2	-13.7	2.4	15.9	30.6	41.5	27.3	-1.3
Non-Energy Commodities	-0.8	0.4	-11.2	-1.4	-9.1	5.3	10.2	17.5	13.4	20.9	-4.6
Agriculture	-1.9	0.8	-13.9	-5.7	-9.1	8.6	9.6	10.5	7.9	10.9	-1.6
Cocoa	-7.3	4.0	-32.3	-20.2	18.0	66.4	-1.5	-11.5	-0.8	0.8	3.2
Coffee, arabica	-3.6	12.6	-23.2	-16.2	-28.5	-1.2	4.3	25.3	42.7	-2.5	-5.1
Coconut oil	-1.4	10.6	12.0	-38.9	-29.4	32.4	11.0	41.4	-6.6	-2.8	-4.5
Palm oil	-3.0	12.3	-35.0	-28.8	-7.9	36.6	13.6	6.3	-10.4	4.2	0.2
Rice, Thai, 5%	0.8	2.1	-18.3	-18.5	-14.6	11.0	3.0	20.3	20.4	6.5	3.3
Sugar, world	16.4	-2.8	-29.8	30.6	5.6	-20.3	3.0	1.1	37.8	60.6	-14.3
Logs, Malaysia	1.9	3.4	15.2	1.5	-16.3	2.7	14.5	5.4	3.0	18.2	8.3
Sawnwood, Malaysia	4.1	-0.1	24.1	-1.0	-19.1	9.4	4.6	5.5	13.2	13.0	2.7
Rubber, RSS1, Singapore	-1.7	0.5	-12.9	6.2	-13.8	33.0	41.5	20.4	15.2	49.8	-6.9
Metals and minerals	2.9	-2.6	-2.3	12.6	-9.6	-3.1	12.7	37.1	26.7	41.6	-9.2
Tin	-6.7	-0.7	-2.5	0.6	-17.5	-9.5	20.5	73.9	-13.3	8.4	-12.5
Copper	4.3	-4.1	-4.9	15.3	-13.0	-1.2	14.1	61.1	28.4	71.2	-12.7

Source: World Bank DEC Prospects Group.

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

	China	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan, China	Thailand	Yen
Nov -2005	8.08	10035.00	1036.30	3.78	54.00	1.69	33.52	41.22	119.63
Dec -2005	8.07	9830.00	1013.00	3.78	53.07	1.66	32.85	41.07	117.97
Jan -2006	8.06	9395.00	971.00	3.75	52.34	1.62	31.99	39.08	117.71
Feb -2006	8.04	9230.00	969.00	3.71	52.09	1.62	32.46	39.31	116.25
Mar -2006	8.02	9075.00	975.90	3.69	51.28	1.62	32.46	38.83	117.40
Apr -2006	8.02	8775.00	945.70	3.63	51.83	1.58	31.91	37.52	114.30
May-2006	8.02	9220.00	947.40	3.63	52.65	1.58	32.02	38.13	112.24
Jun -2006	8.00	9300.00	960.30	3.68	53.59	1.59	32.40	38.22	114.95
Jul -2006	7.97	9070.00	953.10	3.65	51.62	1.58	32.76	37.85	114.80
Aug -2006	7.96	9100.00	959.60	3.68	50.94	1.57	32.91	37.58	117.32
Sep -2006	7.91	9235.00	945.20	3.69	50.39	1.59	33.10	37.54	118.03
Oct -2006	7.88	9110.00	944.20	3.65	49.81	1.56	33.26	36.75	116.88

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

	China	Indonesia	Malaysia	Philippines	Thailand	Hong Kong (SAR)	Korea	Singapore	Taiwan, China	Total
Dec-1996	107.039	19.281	27.009	9.905	37.810	63.808	33.201	76.847	88.038	462.938
Dec-1997	142.762	17.396	20.788	7.178	26.254	92.804	20.369	71.289	83.502	482.341
Dec-1998	149.188	23.516	25.559	9.273	28.825	89.650	51.975	74.928	90.341	543.255
Dec-1999	157.728	27.257	30.588	13.282	34.063	96.236	73.987	76.843	106.200	616.185
Dec-2000	168.278	29.394	29.523	13.090	32.016	107.542	96.131	80.132	106.742	662.848
Dec-2001	215.605	28.016	30.474	13.476	32.363	111.155	102.753	75.375	122.211	731.428
Dec-2002	291.128	32.039	34.222	13.329	38.055	111.896	121.343	82.021	161.656	885.689
Dec-2003	408.151	36.296	44.607	13.655	41.077	118.360	155.282	95.746	206.632	1119.806
Dec-2004	614.500	36.320	66.418	13.116	48.665	123.540	198.994	112.232	241.738	1455.523
Dec-2005	821.514	34.724	70.203	15.927	50.692	124.246	210.317	115.794	253.290	1696.707
Jul- 2006	957.070	41.126	79.059	18.333	57.112	127.383	225.642	129.003	260.370	1895.098
Aug-2006	974.584	41.995	79.000	18.672	57.695	128.900	226.951	129.908	261.020	1918.725
Sep-2006	987.928	42.353	79.539	18.810	59.997	130.300	228.150	129.719	261.550	1938.346

Source: Haver Analytics, Datastream

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

	$1 –a-day			$2-a-day		
	Mean Consumption (1993 PPP$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)	Population (mill.)
EAP						
1990	68.03	28.8	456.9	66.9	1,060.8	1585.4
1996	99.84	14.7	252.1	49.6	851.2	1716.0
1999	101.93	15.5	274.8	49.9	884.8	1772.4
2000	113.40	13.9	247.9	45.8	820.0	1789.6
2001	121.48	12.9	233.7	43.2	780.1	1805.6
2002	131.81	11.7	212.5	40.1	731.7	1822.5
2003	139.57	10.5	193.1	37.3	685.7	1838.0
2004	149.61	9.4	173.3	34.1	630.9	1850.8
2005	162.22	8.1	151.2	30.9	575.6	1865.5
2006	174.78	7.6	143.2	29.3	550.5	1880.7
2007	188.30	6.8	129.5	27.3	516.8	1896.2
EAP less China						
1990	96.44	21.8	96.3	59.1	261.2	442.1
1996	136.25	10.4	51.3	44.6	219.6	492.1
1999	123.58	11.0	56.4	50.8	261.2	514.5
2000	132.13	10.2	53.1	48.4	252.6	522.2
2001	135.55	9.6	50.8	47.3	250.5	529.3
2002	143.80	8.4	45.1	44.0	236.5	538.0
2003	145.44	7.5	40.9	41.2	225.0	545.7
2004	149.55	7.3	40.0	38.9	214.5	550.9
2005	155.29	6.1	34.2	36.2	202.1	557.8
2006	157.95	6.7	37.6	36.9	208.8	565.4
2007	163.80	5.9	33.6	34.6	198.1	573.1
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
2001	104.27	8.6	32.4	48.7	183.7	377.2
2002	111.40	7.0	26.9	44.7	171.3	383.4
2003	114.13	6.7	26.2	42.1	163.7	389.2
2004	118.76	6.9	27.4	40.8	161.4	395.3
2005	123.68	5.9	23.7	38.2	152.9	400.4
2006	123.69	7.0	28.6	40.0	162.3	406.1
2007	128.60	6.2	25.5	37.5	154.3	411.8
Lower Income EA (Cambodia, Laos, PNG, Vietnam)						
1990	45.21	47.7	40.3	84.6	71.6	84.6
1996	64.62	24.6	23.7	69.4	66.9	96.4
1999	68.68	19.1	19.5	66.5	67.6	101.6
2001	74.40	17.5	18.3	63.7	66.7	104.8
2002	75.77	16.9	18.1	60.9	65.2	107.0
2003	81.58	13.5	14.6	56.4	61.3	108.7
2004	89.42	11.7	12.6	49.3	53.0	107.5
2005	94.86	9.6	10.4	45.1	49.2	109.1
2006	99.89	8.1	9.0	41.9	46.4	110.8
2007	104.49	7.1	8.0	38.9	43.8	112.5

Appendix Table 8: Poverty in East Asia - Country Estimates

		$1 –a-day		$2-a-day			
	Mean Consumption (1993 PPP$/month)	**Headcount Index (%)**	**Number of Poor (mill.)**	**Headcount Index (%)**	**Number of Poor (mill.)**	**Gini Coefficient**	**Population (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	76.50	19.0	2.6	63.9	8.8	41.7	13.8
2005	85.99	12.4	1.7	56.2	7.9	--	14.1
2006	90.65	11.0	1.6	53.8	7.7	--	14.4
2007	94.00	10.0	1.5	52.0	7.6	--	14.6
China							
1990	57.05	31.5	360.6	69.9	799.6	36.0	1,143
1996	85.20	16.4	200.8	51.6	631.6	39.3	1,224
1999	93.07	17.4	218.4	49.6	623.6	42.6	1,258
2000	105.69	15.4	194.8	44.8	567.4	43.9	1,267
2001	115.65	14.3	183.0	41.5	529.6	44.9	1,276
2002	126.79	13.0	167.4	38.5	495.2	45.7	1,285
2003	137.09	11.8	152.2	35.7	460.7	--	1,292
2004	149.63	10.3	133.2	32.0	416.4	--	1,300
2005	165.18	8.9	117.0	28.6	373.5	--	1,308
2006	182.02	8.0	105.6	26.0	341.7	--	1,315
2007	198.91	7.2	95.9	24.1	318.7	--	1,323
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	89.47	7.5	17.5	46.4	108.2	--	232.9
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	57.06	27.9	1.6	74.9	4.3	--	5.8
2004	61.40	22.9	1.4	71.1	4.2	--	5.9
2005	64.23	20.0	1.2	68.6	4.2	--	6.1
2006	67.39	17.5	1.1	65.9	4.1	--	6.2
2007	70.24	15.1	1.0	63.4	4.0	--	6.4

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

		$1 –a-day		$2-a-day			
	Mean Consumption (1993 PPP$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)	Gini Coefficient	Population (mill.)
Malaysia							
1990	195.32	2.0	0.4	18.5	3.4	--	18.2
1996	261.87	0.8	0.2	13.1	2.8	--	21.1
1999	271.70	< 0.5	--	12.6	2.9	--	22.7
2000	304.27	< 0.5	--	9.7	2.3	--	23.3
2001	304.09	< 0.5	--	9.7	2.3	--	23.8
2002	310.00	< 0.5	--	9.2	2.2	--	24.3
2003	326.10	< 0.5	--	8.0	2.0	--	24.7
2004	354.20	< 0.5	--	6.2	1.6	--	25.1
2005	367.57	< 0.5	--	5.4	1.4	--	25.5
2006	382.53	< 0.5	--	4.6	1.2	--	25.9
2007	398.10	< 0.5	--	3.9	1.0	--	26.2
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	63.83	39.5	2.2	70.5	3.9	--	5.6
2004	64.39	38.6	2.2	70.0	4.0	--	5.7
2005	64.01	38.9	2.3	70.0	4.1	--	5.9
2006	64.77	38.6	2.3	69.9	4.2	--	6.0
2007	65.63	38.3	2.4	69.0	4.3	--	6.2
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	44.8	36.3	44.5	81.1
2004	110.72	11.7	9.6	42.8	35.2	--	82.4
2005	114.26	10.8	9.0	41.2	34.5	--	83.7
2006	118.49	9.6	8.1	39.3	33.4	--	85.1
2007	123.15	8.4	7.3	37.4	32.3	--	86.5
Korea							
1990	301.09	< 0.5	--	< 0.5	--	29.88	42.87
1996	480.46	< 0.5	--	< 0.5	--	29.71	45.52
1999	450.06	< 0.5	--	< 0.5	--	30.00	46.62
2001	496.18	< 0.5	--	< 0.5	--	--	47.01
2002	519.96	< 0.5	--	< 0.5	--	--	47.35
2003	557.51	< 0.5	--	< 0.5	--	--	47.62
2004	545.12	< 0.5	--	< 0.5	--	--	47.85
2005	537.13	< 0.5	--	< 0.5	--	--	48.08
2006	553.91	< 0.5	--	< 0.5	--	--	48.29
2007	577.51	< 0.5	--	< 0.5	--	--	48.50

Appendix Table 8: Poverty in East Asia - Country Estimates

		$1 –a-day		$2-a-day			
	Mean Consumption (1993 PPP$/month)	Headcount Index (%)	Number of Poor (mill.)	Headcount Index (%)	Number of Poor (mill.)	Gini Coefficient	Population (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	15.5	42.5	65.1
2005	156.47	1.7	1.1	22.9	14.9	--	65.1
2006	161.45	1.4	0.9	21.1	13.9	--	65.7
2007	166.57	1.2	0.8	19.2	12.7	--	66.2
Vietnam							
1990	41.73	50.8	33.6	87.0	57.6	--	66.2
1996	63.66	23.6	17.7	69.4	52.2	--	75.2
1999	68.90	16.9	13.4	65.9	52.0	--	78.9
2000	73.16	15.2	12.1	63.5	50.7	--	79.9
2001	76.62	14.6	11.8	61.8	50.1	--	81.0
2003	78.67	13.6	11.3	58.2	48.1	37.5	82.6
2004	85.63	9.9	8.3	52.9	44.3	--	83.8
2005	95.36	7.8	6.4	43.9	36.0	37.0	82.0
2006	100.77	6.2	5.2	39.7	33.0	--	83.1
2007	106.37	4.7	4.0	36.1	30.4	--	84.2

Notes for Appendix Tables 7 and 8

The poverty lines in Tables 7 and 8 are set at $1.08 and $2.15 per person per day (in 1993 PPP$) for all countries. For most countries, 1993 World Bank PPP estimates are used. The PPP for the Philippines is from the Penn World Tables, while that for PNG is the 1996 World Bank PPP. PPPs for Vietnam, Lao PDR and Cambodia have been further adjusted using a calorie price ratio between Indonesia and Vietnam. Projections are based on World Bank growth rate forecasts for 2003-2004. Wherever possible, the projections utilize information on sectoral GDP growth rates, changes in the food CPI relative to the general CPI, changes in the GDP deflator relative to the CPI, and changes in the consumption-income ratio. The projections assume that there is no change in relative inequalities *within* sectors. For China, the projections are done separately for rural and urban China, and then aggregated using population shares. Estimates for all countries except Malaysia and China are based on surveys of household consumption. The estimates for Malaysia and China use income surveys. For China, a survey-based estimate of mean consumption is used in conjunction with the income Lorenz curves to derive poverty estimates. These poverty estimates differ from those commonly found in national poverty assessments for two main reasons. First, country assessments use national poverty lines that differ from the uniform international poverty lines used here. Second, national poverty lines also typically allow for spatial cost of living differentials within countries, but such adjustments are omitted here to maintain a consistent methodology across countries. For instance, in the case of Thailand, these differences explain why the above estimates indicate a small increase in poverty between 1998 and 2000 (in spite of adjusting the CPI by the change in the national poverty lines over this period), while national poverty line-based estimates indicate a decline. Also for Thailand, the 2002 estimate is based on a longer consumption module, which could lead to a small overestimation of consumption relative to 2000. Poverty estimates for the Philippines for the years 2001 and 2002 are an average of a “forward” projection using survey data for 2000 and a “backward” projection using survey data for 2003.

Appendix Table 9: NPLs in the Commercial Banking System of the Crisis-Affected Countries
(% of total loans)

	1997	1998	1999	2000	2001	2002	2003	2004	2005				2006		
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Indonesia a/	7.2	48.6	32.9	18.8	12.1	7.5	6.8	4.5	4.4	7.0	7.9	7.6	8.2	8.3	8.4
Korea b/	6.0	7.3	13.6	8.8	3.3	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.2	1.1	
Malaysia c/		10.6	11.0	9.7	11.5	10.2	9.0	7.5	7.2	6.7	6.1	5.8	5.7	5.4	5.1
Philippines d/	4.7	10.4	12.3	15.1	17.3	15.0	14.1	12.7	11.3	9.2	9.5	8.5	8.0	7.2	
Thailand e/	..	45.0	39.9	19.5	11.5	18.1	13.9	11.6	11.1	10.6	10.2	8.3	8.0	8.2	

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

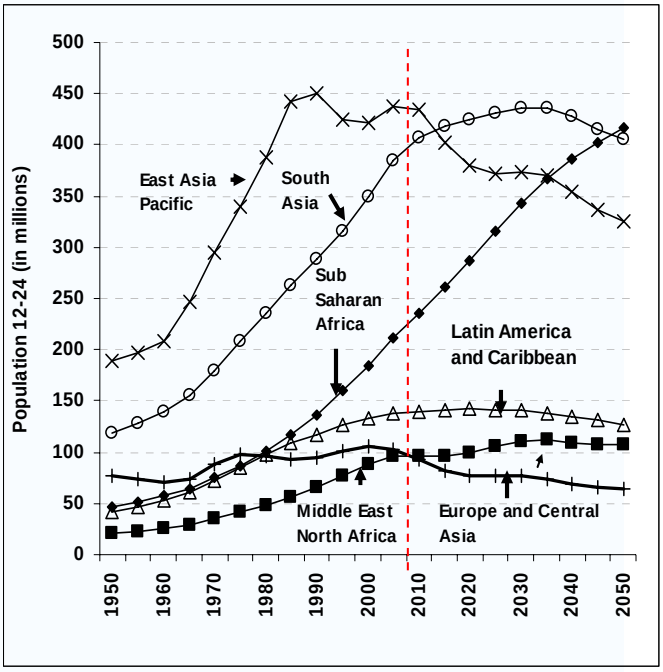
Special Focus

Investing in Young People in East Asia and the Pacific

World Development Report 2007: Development and the Next Generation

There are more young East Asians and Pacific Islanders aged 12 to 24 than ever before. The number of young people in the region is at a historical peak of 450 million. They account for one-third of the developing world's 1.3 billion youth population, largely because of the large youth populations in China, Indonesia, the Philippines, and Vietnam. These numbers will decline in the near future because the region's fertility rates began to decrease earlier than those of other regions (see Figure 1). Within this overall picture, trends differ across countries within the region. In China and Thailand, the youth population peaked over 15 years ago, but everywhere else the numbers of young people are at historical highs or will continue to grow in the foreseeable future.

Figure 1: The number of young people in East Asia and the Pacific is near it's historical peak



Source: UN Population Division, 2005

These large numbers could cause problems for the countries in question because of the need to employ all of these young people and to maintain social stability.[29] However, high youth populations also present these countries with unprecedented opportunities to grow and to make further progress in reducing poverty if the right policies and institutions are in place. There are at least two reasons for this.

First, this generation of young people is more educated and healthier than previous generations, which is a strong base for countries to build on in a global economy that demands more than basic skills. Thanks to the success of past policies, more young people are surviving childhood diseases and completing primary school. For the region as a whole, primary completion rates are close to universal, which is the highest rate of all the developing regions. Even in countries where primary completion rates are still far from universal (such as Cambodia, Lao PDR, and Myanmar), recent progress has been dramatic, particularly in Cambodia where these rates increased from less than 30 percent in the late 1990s to over 80 percent by the early 2000s.

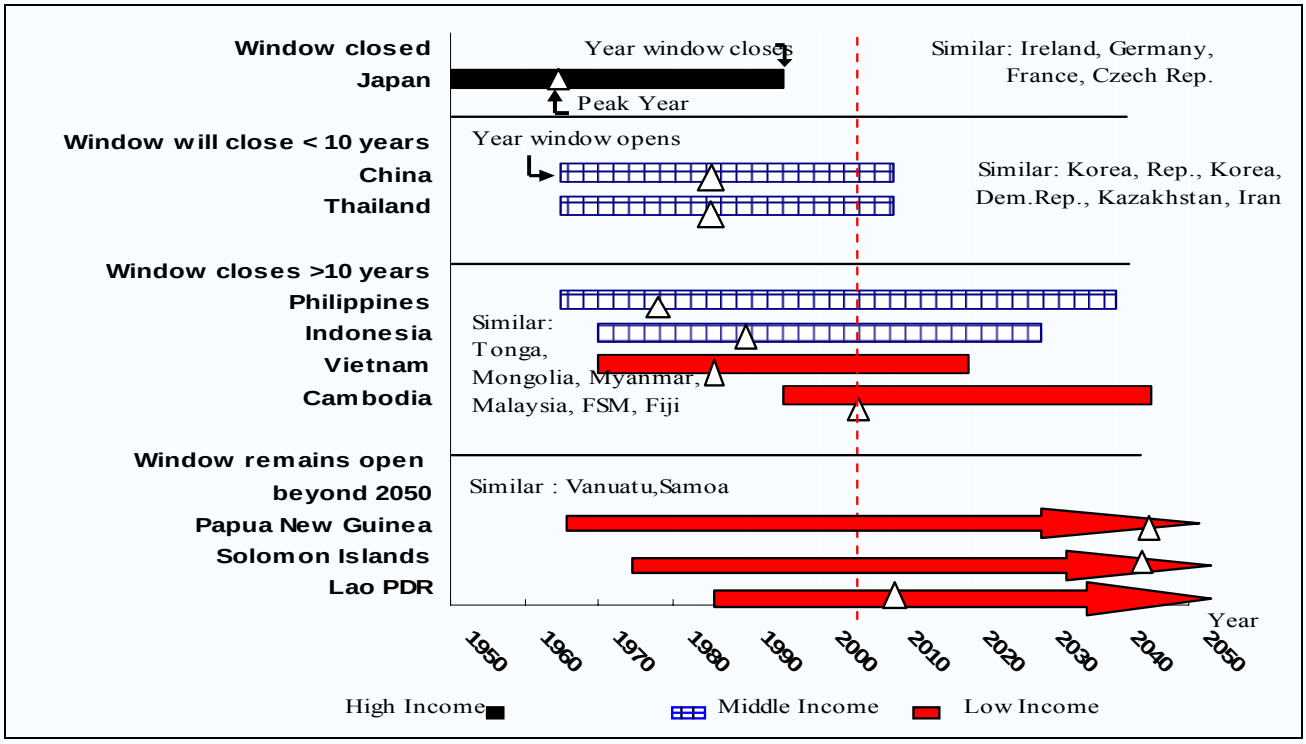
Second, because of falling fertility, the large numbers of young people today will translate into higher proportions of people of working age than of those of non-working age (chiefly children and the elderly), meaning that more income will be available per dependent. This demographic dividend can boost economic growth. One study attributes more than 40 percent of the high growth rates in the countries known as the East Asian "tigers" from 1965 to 1990 to their ability to take advantage of this dividend.[30]

This dividend will not be available forever because this "demographic window of opportunity" will eventually close as this cohort ages. Happily, it is still open for most of the countries in Eat Asia and the Pacific (see Figure 2). For middle-income countries such as China and Thailand, the window of opportunity will close within 10 years, which means that these countries need to invest in their young people urgently if they are to take advantage of this

[29] Unemployment is not only costly to individuals in terms of foregone learning while on the job, but it is also costly to societies as high open unemployment also generates social unrest, potentially hurting the climate for investment.

[30] Bloom and Canning (2004).

Figure 2: Demographic windows of opportunity in East Asia and the Pacific



Source: UN Population Division, 2005

opportunity. For other countries in the region, especially the poorest, the window will remain open for much longer.

The dividend is also not automatic. For example, in Latin America, the fertility rate in some countries declined early, and these countries failed to reap the growth dividend because they did not have the appropriate policies and institutions in place to develop and deploy human capital effectively. So what are those policies and institutions?

The World Development Report (WDR) 2007, *Development and the Next Generation* (World Bank, 2006b) argues that key policies and institutions are those that develop young people's skills as they undergo five life transitions. These transitions are: (i) continuing education beyond primary-school age, (ii) going to work for the first time, (iii) growing up healthy, (iv) forming families, and (v) exercising citizenship. The WDR outlines three lenses through which to assess the adequacy of a country's existing policies for addressing these transitions. Do they offer **opportunities** for young people to develop their human capital and use it productively? Do they help young people develop their decisionmaking **capabilities** to choose wisely among available opportunities? Do they provide **second chances** when choices are either unavailable or missed?

This article summarizes some lessons from the WDR 2007 as they apply to the East Asia and Pacific region. The following sections discuss each policy lens in turn, focusing on three of the five transitions discussed in WDR 2007: transitions to learning, going to work, and growing up healthy. Each section begins by illustrating the current youth status in the region.

1. Broadening Opportunities for Young People

The growth of East Asian economies has been remarkably resilient. The rebound from the tumultuous financial crisis of 1997-98 has recently been described as a "renaissance."[31] This growth has created many opportunities for young people to develop and use their skills, but they continue to face several challenges in terms of their transitions through education and into work.

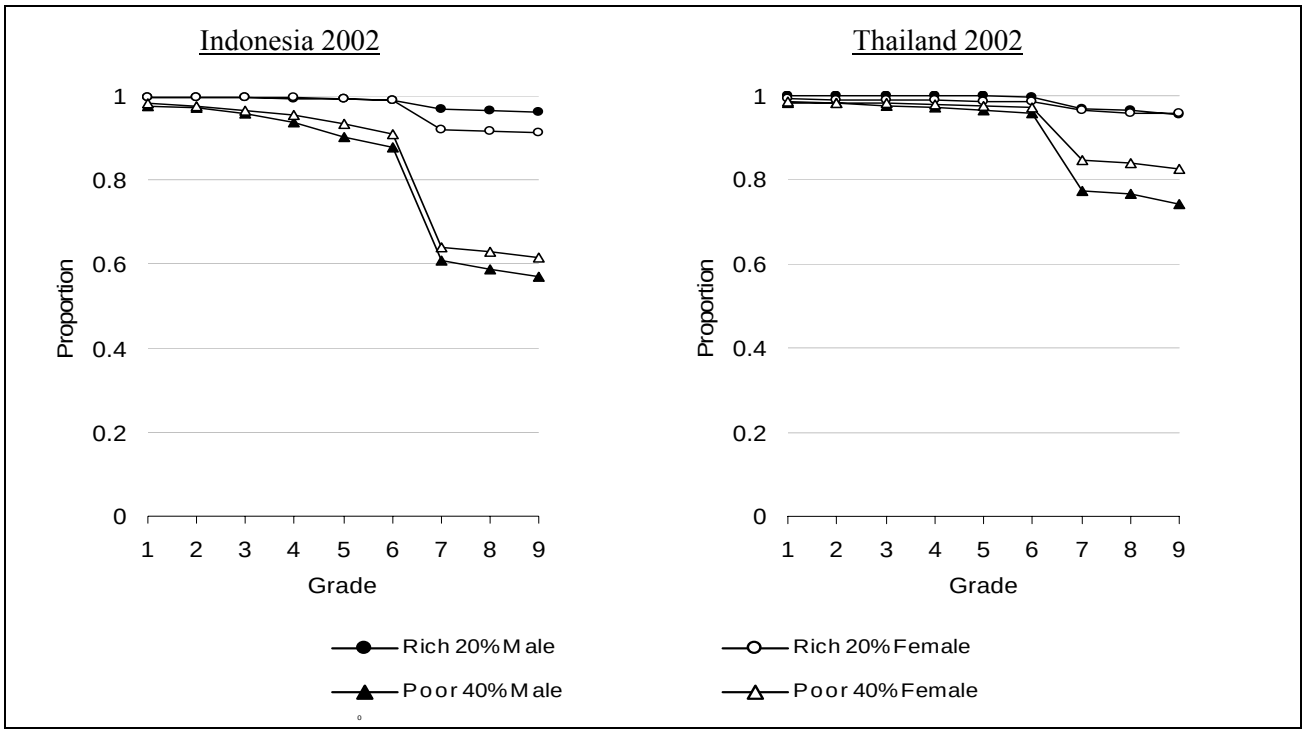
1.1 Broadening Opportunities: Challenges

Most EAP countries have almost universal primary completion rates. Yet many children in Cambodia, Lao PDR, and Myanmar drop out before completing primary school, and too many children never even start school. Also, for many, particularly the poor,

[31] Gill and Kharas (2006).

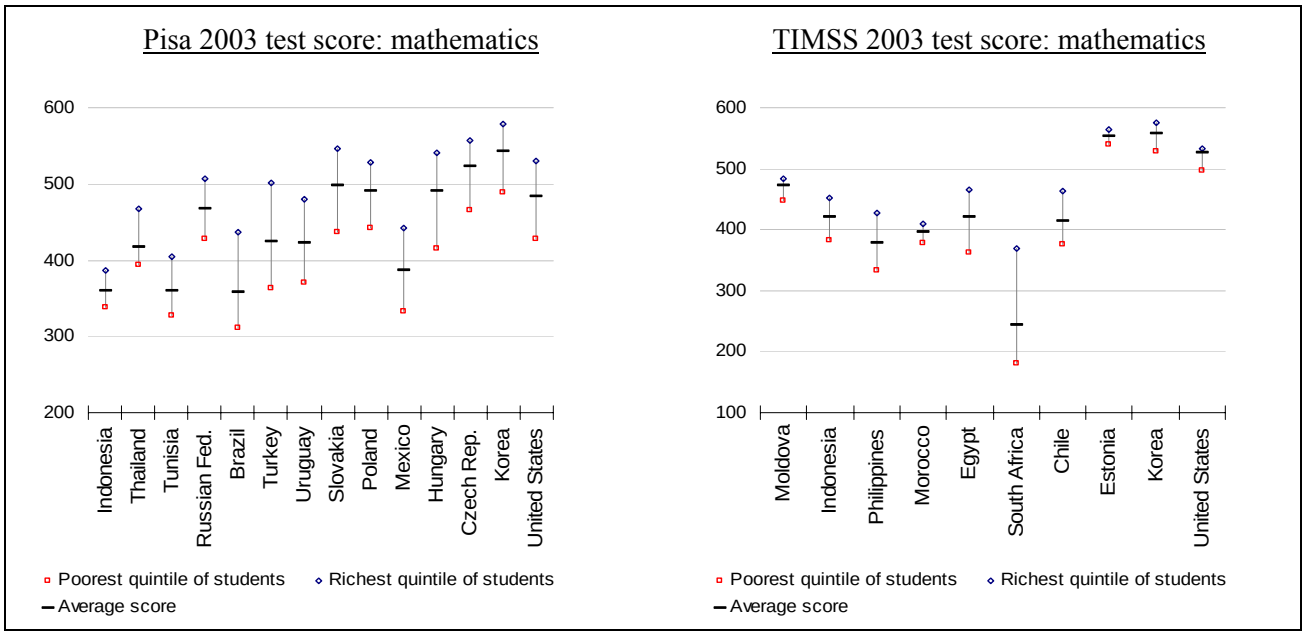
Figure 3: The transition to secondary school is a stumbling block for many students

Proportion completing each grade



Note: The richest 20 percent and poorest 40 percent are derived from an index of assets and housing characteristics. Figures are Kaplan-Meier estimates based on nationally representative samples of 10-19 year olds: http://econ.worldbank.org/projects/edattain.

Figure 4: Learning achievement in EAP middle-income countries is low



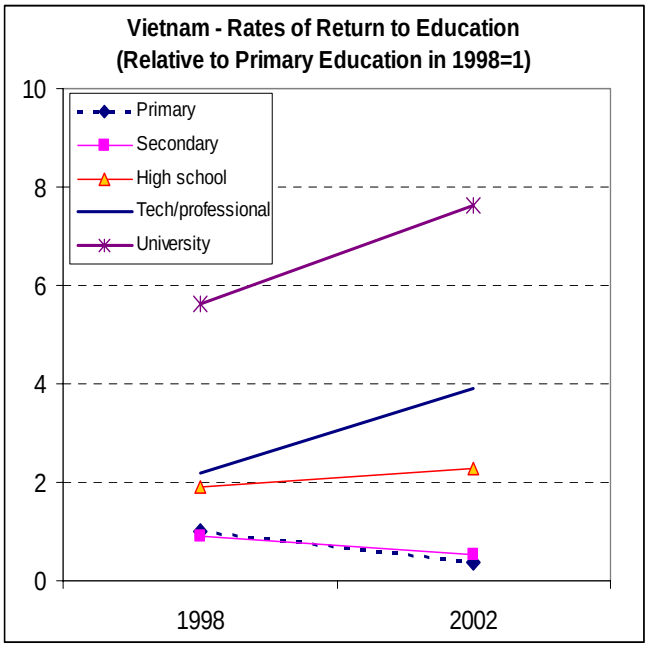
Source: World Development Report 2007. TIMSS 2003 test scores refer to grade 8.

there are barriers to making the transition to secondary school, even in countries with high primary completion rates such as Indonesia and Thailand (see Figure 3).

And the educational preparation of those who do get access to secondary school is low, particularly among the poor. The average performance of adolescents from three middle-income EAP countries (Thailand, Indonesia, and the Philippines) on standardized tests is well below the OECD average of 500 (see Figure 4). These numbers are all the more worrisome because these assessments do not include students who have already dropped out of school, who are likely to be the poorest and worst performing students.[32]

Low learning achievement has knock-on effects as the economies of East Asia are increasingly in need of workers with high skills and knowledge. This is reflected in the increase of the returns to upper secondary and, particularly, higher education relative to primary and lower secondary education despite the increase in their relative supplies (see Figure 5 and Table 1).

Figure 5: High and rising returns to higher skills (annualized returns to schooling)

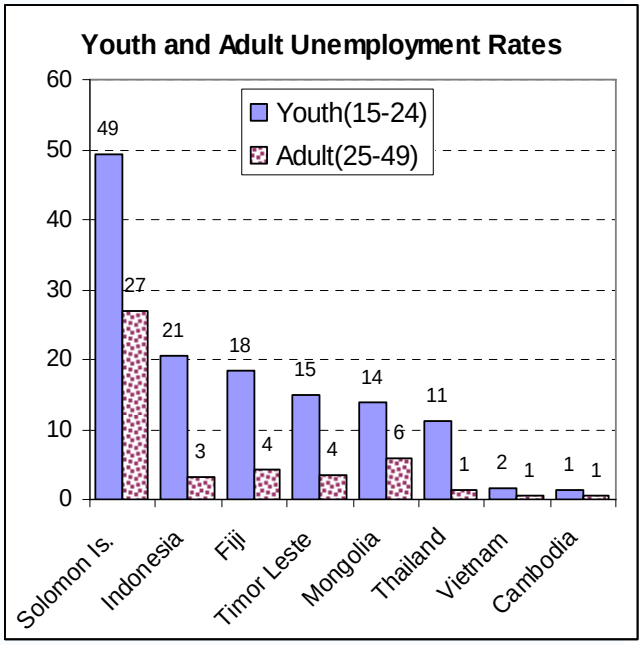


Another challenge is the rising youth unemployment rate in many countries in East Asia, which may have a negative effect on social cohesion.[33] Young people everywhere tend to have higher unemployment rates than adults (twice as high in rich countries). However, in countries like the Solomon Islands, FSM and Tonga, even where such ratios are not so high, there are so few employment opportunities that open youth unemployment exceeds 35 percent. In countries such as Indonesia and Thailand, adult unemployment rates are low but youth unemployment is six to nine times that of adults (see Figure 6).

Table 1: High returns to higher skills (annualized returns to schooling) [34]

	Primary	Lower Second.	General Second.	Tech. Second.	Tertiary
Singapore	5.7		7.6	8.4	23.7
Thailand	5.2	14.3	11.5	13.4	22.1
Philippines	10.7		7.6		19.8
Indonesia	5.6	8.6	10.7	11.7	13.6

Figure 6: Unemployment is higher among young people than among adults



Source: *World Development Report 2007*

Many of those who do find work are employed in dead-end jobs, which make it difficult for them to escape poverty. Many young people start working in the informal sector, which can be an important stepping

[32] In Thailand and Indonesia, the proportion of 15 year olds in school in Grades 7 and above is 84 and 73 percent respectively, while 85 percent of Philippino young people are enrolled in Grade 8.

[33] Gill and Kharas, 2006.

[34] Note: Estimates are based on log wage regressions for male workers whose primary employment was in the wage sector aged 18-65. Source: Vietnam (Living Standards Survey, 2002), Indonesia (Susenas, 2003), Thailand (Socioeconomic Survey, 2002), Philippines (Annual Poverty Indicator Survey, 1999), Singapore (Labor Force Survey, 1998).

stone, as in Latin America where the vast majority of apprenticeships occur in this sector. However, a study suggests that growing informality may be fueling growing inequality between the rich and the poor in urban areas in countries such as China.[35] In Indonesia, new jobs for young people are increasingly being created in the informal sector while at the same time employment in the formal sector is in decline, indicating that young people may be getting stuck in jobs that do not enhance their human capital.[36] Such poor opportunities can lead to discouragement. The proportion of young people aged between 15 and 25 who are neither working (in formal or informal sector) nor in school is large in countries like Indonesia (21 percent) and FSM (28.3 percent).

1.2 Broadening Opportunities: What is to be Done?

Those countries in East Asia that have successfully increased the opportunities available to young people to develop and deploy their human capital have focused on ensuring:

- The quality of basic education
- The relevance of post-basic education for work and life
- That economic growth fuels the demand for young workers
- Labor market mobility
- Opportunities for migration.

1.2.1. Improving the Quality of Basic Education

Large numbers of young people in EAP still do not acquire the basic skills needed for further study, work, and life.[37] Because learning is cumulative, early investments in children can increase their subsequent learning achievement and yield larger returns than later investments. For example, a program in the Philippines that combines education in preschools, health stations, and homes (parenting classes) has yielded significant gains in children's cognitive, motor, language, and social development, especially among children under the age of four.[38] So there is clear evidence that these early investments, complemented with subsequent learning investments in school, pay off.

A critical step towards ensuring that all young people have the basic skills necessary for work and life is to defer selection and specialization of students until after the lower secondary level and to make lower secondary school part of the basic and compulsory education cycle. While all EAP countries have moved admission tests and vocational specialization to upper secondary or beyond, thus giving students enough time to build a solid academic base before having to choose an occupational specialization, lower secondary education is still not compulsory in low-income countries like Cambodia and Lao PDR, and even in the Philippines.

However, the universalization of lower secondary education should not come at the expense of quality. In Korea, the government's strong commitment to quality education and partnership with the private sector allowed the secondary education sector to expand without compromising its quality. Vietnam has increased secondary enrollment substantially since the early 1990s while also improving quality by introducing an effective cost-sharing system.[39] To ensure that basic education equips children with key basic skills, standards need to be set and evaluation systems need to be set up to monitor schools' performance. The success of these measures ultimately depends on having well-prepared and motivated teachers and schools that are accountable for their performance.

1.2.2. Increasing the Relevance of Post-basic Education for Work and Life

Middle-income EAP countries are challenged by the growing demand for higher levels of skills. Labor markets are increasingly demanding workers who are capable of creative and critical thinking. Surveys of the investment climate in Malaysia, Thailand, and Mongolia have also indicated that there is an increasing demand for workers with communication skills as well. Entrepreneurship also requires thinking skills and such behavioral skills as self-confidence and leadership.[40]

The rising demand for these skills is largely unmet by the current education systems in EAP countries. The curricula remain too theoretical and fact-centered and provide little variety and flexibility.

The mismatch between the demand and supply of skills and its negative impact on growth are already being felt in a number of EAP countries. In a recent survey of the investment climate in Malaysia, about 50 percent of firms believed inadequate worker skills were

[35] Gill and Kharas (2006).
[36] World Bank (2004b).
[37] Basic skills denote the minimal set of abilities needed for further learning, work, and life, including numeracy and literacy and basic behavioral skills such as perseverance, self-discipline, and self-confidence.
[38] Armecina et al (2006).

[39] The new system included the creation of semi-public and private schools and the introduction of fees and, more recently, steps towards eliminating basic education fees for poor children. The additional resources were used to enhance quality (notably for effective textbook and teacher training policies) and to improve further the governance of the education sector (World Bank, 2006a: LAC-EAP secondary education book).
[40] Lee and Wong (2005).

the "top obstacle to business." In Vietnam, about 50 percent of firms in the textiles and chemical sectors consider the supply of skilled labor to be inadequate for their needs. Software companies also report that local IT training institutions fail to churn out qualified graduates and that they have to spend at least one year retraining them.

Countries that have succeeded in meeting the growing demand for post-basic skills[41] have taken a number of identifiable steps that have contributed to their success.

Providing Diverse and Flexible Post-basic Learning Options. Upper secondary education is still heavily directed towards preparing students for academic university degrees, except in China, Indonesia, and Thailand where vocational education accounts for between 30 and 40 percent of total enrollment in upper secondary schools. Students who chose vocational tracks should also be given the opportunity to enter higher education. Higher education is also heavily biased towards academic university degrees except in China and Malaysia, where half or more of all students are enrolled in shorter, more occupationally oriented programs. Governments can greatly facilitate the expansion and diversification of post-primary education by encouraging the private sector to become involved in financing and providing schools, while the governments themselves ensure quality standards throughout the education system. The private sector is small but rapidly growing in most EAP countries, except in the Philippines where it accounts for two-thirds of higher education enrollment. Private schools in the Philippines need to go through a probationary period after which they can ask to be accredited, which would enable them to receive government funds.[42] Educational accreditation system is, however, rare in EAP countries.

Making School Curricula More Relevant to the Skills Needed in the Economy. School curricula can be made more relevant to producing the skills needed by the modern economy by teaching practical subjects, thinking skills, and higher order behavioral skills (such as decision-making skills, teamwork, the ability to negotiate conflict and manage risks), as well as blending the academic and vocational curricula at the upper secondary level. These were the goals of the recent reform of the secondary education curriculum in Malaysia. The new curriculum includes health and civic education as core subjects in upper secondary schools and has introduced such practical subjects such as science and technology, English language, and economics. It has also integrated the general and vocational curricula by introducing vocational content into the academic curriculum as electives.

Connecting School and Work. School and work also need to be more connected. The German "dual system," which combines schooling with work, has been tried in several EAP countries, but success has been limited mainly because of the inability of these countries to create jobs for apprentices and to ensure sustainable employment for them thereafter.[43] In Japan, full-time schooling is followed by full-time employment in enterprises closely connected with the school. The transition from school to work can also be eased by linking educational institutions with prospective employers so that the employers can provide feedback on the relevance and effectiveness of the curriculum. Formal university-industry partnerships are rare in EAP countries. In China, universities and research institutes (URI) have contributed a great deal to the growth of local industry. Some of the largest Chinese high-tech firms (such as Lenovo and Tongfang) are spin-offs established to make and market URI's inventions.

Strengthening Educational Finance. Expanding and improving post-primary education can be costly. EAP countries should be able to raise the additional resources needed through a combination of cost-sharing, public-private partnerships, and efficiency enhancements, and some will also need help from donors. Vietnam and Korea managed to finance the expansion and improvement of secondary education by a combination of contributions from the families of students and working with the private sector. Soliciting contributions from those parents who are able and willing to pay prompts parents to become more engaged in the school's management and therefore to hold it accountable. Free tuition is neither fiscally sustainable nor pro-poor, particularly at the higher education level. To ensure equitable access, cost-sharing needs to be accompanied by grants, loans and learning accounts (see below). In the Philippines, the private sector has played a key role in the expansion of tertiary enrollment. Private universities in the Philippines can receive government funding (including subsidies for students) provided they are accredited.

Efficiency can be increased by applying formula funding (which uses indicators such as enrollment rates) to channel funding to education institutions, particularly in countries where the institutions have considerable autonomy over how to use the funds. Secondary school autonomy over the design and allocation of their budgets has been associated with efficiency gains in Indonesia, Thailand, and Korea. Formula funding can also be combined with competitive funding. In Indonesia, about

[41] Post-basic skills include thinking skills, higher order behavioral skills, specific knowledge applied to real-life situations, and vocational skills.
[42] World Bank (2004b).
[43] Johanson and Adams (2004).

25 percent of the recurrent budget to public universities is allocated through competitive funding.

1.2.3. Increasing Job Opportunities for Young People

Economy-wide growth tends to be a rising tide that lifts all boats, including those of young people. Growing intra-regional trade and the rising importance of intra-industry trade in EAP are together creating diverse new job opportunities. Because the young are most able to meet new and growing demand for labor, these shifts favor young workers — not only because of the large numbers, but also because youth are typically more mobile and may be more adaptable than older workers to new production methods. In Indonesia, the industries with the highest shares of young workers (more than twice the national average) are electronics and textile manufacturing, both of which are heavily engaged in exporting.

Young workers in these youth-intensive exporting sectors are disproportionately well-educated; 47 percent have completed secondary schooling compared with only 11 percent of other young workers. In Vietnam, the comparable percentages are 20 percent and 8 percent.[44] As wages in these firms tend to be high, growth in export-oriented sectors can also give young people an incentive to acquire the skills required to get a job in these sectors. In Indonesia, young workers in the youth-intensive exporting sector were paid 30 percent more than young workers in other sectors and 20 percent more than young workers in other manufacturing firms.

More Flexible Labor Markets. In many countries, labor market institutions penalize new entrants. According to the *2007 Doing Business Report* (World Bank, 2006c),[45] labor market regulations in EAP as a whole tend to be relatively flexible, but there is wide variation among countries. For example, Malaysia and Thailand have little employment rigidity, while the labor markets in Cambodia and Indonesia are more rigid.[46]

Job Training. Many young people who start out in the informal sector need to learn new skills while working in these jobs. If they are given practical on-the-job training in occupational and general behavioral skills in these informal sector jobs, then this will increase their employability for the future. Leaving training to firms, either in formal or informal sector, does not ensure that all young people can get access to training,[47] which calls for public intervention. But the track record of public training institutions in providing training to young people is very poor. These public training programs are more effective when they include employment services, counseling, and training in life skills (see below).[48] China, Korea, Malaysia, and Singapore have launched on public-private partnerships to diversify the financing of these programs**,** to make them more sustainable and relevant, and to increase access to them.

Entrepreneurship. Another option for the young is self-employment, but young people face many more constraints to starting a business than their elders because of their lack of access to capital and networks of potential clients and suppliers. As shown by the *Doing Business* indicators, EAP countries could do more to reduce the bureaucratic and legal hurdles to starting a business, though some countries such as China and Indonesia have already made efforts in this direction. Programs that promote youth entrepreneurship specifically may be an effective way to increase youth employment, but this is an area in which there is little solid evidence of what works.[49]

1.2.4. Generating Job Opportunities through Migration

Geographic mobility broadens opportunities. In this respect, the young are well positioned because they represent a disproportionately large share of all migrants both to urban areas and to other countries. However, there is a need for governments to help young migrants to assimilate into their new communities and to minimize potential stress on the host populations. Rural to urban migrants often face poor working conditions and limited access to social services**.** Migrants also lack information on required skills in the labor market. Recognizing the mismatch between the skills of these migrants and the demands of urban labor markets, the Chinese government has recently introduced a Rural Migrant Labor Training Plan (2003-2010).

International migration to larger economies is crucial for expanding the employment opportunities for young people, especially for young people from the Pacific Islands. However, this international migration is currently an option just for skilled workers**.** Governments can expand these international opportunities to a wider

[44] Authors' calculation using Investment Climate Surveys for Indonesia and Vietnam.

[45] Compared with other regions and the OECD, EAP has the lowest indices for difficulty in hiring and firing as well as rigidity of hours (with South Asia), hiring costs (second lowest after South Asia), and firing costs (third lowest after ECA and OECD).

[46] More research is, however, needed to assess the degree of labor market rigidity (beyond the assessment of labor legislation) and its impact in EAP countries.

[47] Large exporting firms with foreign ownership that tend to demand higher skilled labor are the most likely to provide training to their employees (Johanson and Adam, 2004).

[48] Betcherman, Olivas, and Dar (2004).

[49] World Bank (2006b).

group of workers, for example, by developing bilateral work arrangements with other countries**,** by recognizing the skills gained by migrants while abroad, and by lowering remittance costs. They can mitigate some of the risks associated with migration by providing job counseling and better information (for example, to reduce the risk of trafficking especially of women) and working with receiving countries to enable families to join migrants.

2. Developing the Decision-making Capabilities of Young People

Expanding opportunities is critical, but it is not enough. It is also important to help young people to choose among those opportunities.

2.1 Developing Capabilities: Challenges

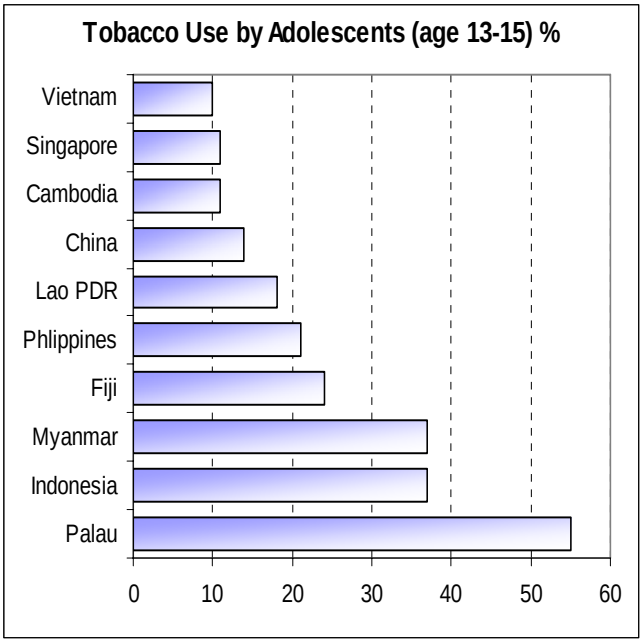
As young people grow up (broadly between the ages of 12 and 24), they gradually take over from their parents the power to make decisions about their lives.

Yet many young people must make these decisions without the information, financial resources, or decision-making skills needed to make good choices among life's opportunities. Take, for example, the question of safeguarding one's health. Youth is a time for experimentation when many people begin smoking, consuming alcohol and drugs, engaging in sex, and having more control over their diet and physical activity. The chances of young people making the wrong choices are heightened by the fact that they may not be aware of the costs of such risky behavior until they are older. This is dangerous for those who are less risk averse and discount the future too heavily.

Although per capita consumption of tobacco is declining in developed countries, it is rising in many developing countries. Between 1970 and 1990, tobacco consumption rose by about 3.4 percent a year in low- and middle-income countries. Also, people are beginning to smoke at younger ages. In East Asia, smoking among very young people (aged 13-15) is especially prevalent in countries like Palau, Indonesia and Myanmar. (See Figure 7).

The major ways in which HIV is spread are unprotected sex and sharing infected injecting equipment. Although the average prevalence rate of HIV is low in the region, it has been a major health concern in countries such as Cambodia and Thailand where the prevalence exceeded 1 percent among the population aged between 15 and 49. Knowing how to prevent transmission is crucial for avoiding the infection, yet misconceptions about HIV/AIDS are widespread among young people in EAP. More than half of all young women in Cambodia, Mongolia, and Vietnam and more than 80 percent in Indonesia and the Philippines think that HIV can be transmitted through witchcraft or mosquito bites or that a healthy-looking person cannot have the AIDS virus.[50]

Figure 7: Many young people, especially young men, consume tobacco



Note: *Data for males only from WDR 2007. Others are taken from World Bank (2004a) *Youth in Numbers*.

2.2 Developing Capabilities: What is to be Done?

Risky health behavior during youth can deplete the economy of productive human capital for many years into the future. The best way to avoid the future loss of productive human capital and steep increases in future health care expenditure is to modify people's health behavior during their youth when habits are still being learned. Changing people's behavior is one of the most difficult goals to achieve, but three critical ways to do so are discussed in this section – informing young people, helping them to command resources, and enhancing their capacity to make good decisions.

2.2.1. Informing Young People

Use schools. Young people can be provided with the necessary information about good health practices in several different ways. First, this information can be transmitted via the schools, which is where young people pick up much of what they know about the practicalities of daily living. Health education programs and school

[50] UNICEF, Joint United Nations Program on HIV/AIDS, and WHO (2002)

health policies have been effective in increasing young people's knowledge and adoption of safe health behavior. While some countries in East Asia offer students information on HIV prevention, on reproductive health, and on the dangers of tobacco, alcohol, and substance abuse, evidence suggests that most school curricula in the region need to be improved. For example, Vietnam introduces HIV/AIDS education in schools to students from the age of 8, but a recent report[51] showed that, among primary graduates aged 15 to 24, only 17.3 percent of women and 19.0 percent of men had comprehensive knowledge about HIV/AIDS.[52] The percentages were 44.4 for women and 53.5 for men aged 15 to 24 among secondary graduates.

One way to improve this situation is to provide specific rather than general information. It is also important that messages delivered through campaigns are accurate and tailored to different targets.

Those who deliver information to young people must also be skilled at communicating with them. This requires that they receive better training and that better incentives are provided to attract people to become school-based counselors. School-based career guidance services, a fairly new initiative, have shown promising results in many countries. One consistent finding is that their success depends on the quantity and quality of information available to counselors.

Use options outside schools. It is not enough just to intervene in schools because so many young people drop out, often because of poverty but also because young people can be poorly informed about the benefits of continuing their education. Simple and relatively cheap interventions that inform young people of the payoffs from further schooling can help them to make better decisions.[53]

In countries where many young people are not in school, it is important to go beyond the school-based approach. Both Cambodia and Thailand have contained the spread of HIV/AIDS partly through nationwide information campaigns that broadcast health information through the media, NGOs, and other information providers. For example, in Thailand, NGOs were used to outreach to commercial sex workers (CSWs), which has been crucial to Thailand's success in reducing the HIV transmission through unprotected commercial sex.

Use new technology. Given that a very high proportion of young people tends to use the Internet, this can be an important conduit of information to young people, not just on matters of health but also education and work opportunities. A study in China showed that, among young people aged between 16 and 25, 35 percent use the Internet for online study, 31 percent use it for work, and 20 percent use it to search for medical information. More reliable information and greater guidance on how to access this information can be helpful to young people. Other new technologies that can be used to provide information include SMS (text messaging). New Zealand succeeded in using this means to help young people to quit smoking.

2.2.2. Helping Young People to Command Resources

Because young people are only beginning to be financially independent, they are more constrained in their consumption and investment choices than adults. Investing in secondary and higher education tends to be beyond the means of poor young people. The opportunity costs from foregoing work to stay in school are highest in poor countries like Cambodia where 43 percent of boys are already working by the ages of 10 to 12. In Vietnam, a study has found that when children aged between 8 and 13 work while also being in school, this reduced their school enrollment and educational attainment rates five years later.[54] However, even in Thailand and Indonesia where most children complete primary school, large numbers of poor young people do not make it into lower secondary school or beyond.

A combination of grants, loans and savings schemes can help to ease the credit constraints on the demand for education at the secondary and tertiary levels. Need-based grants are more appropriate for lower secondary education, while loans and savings schemes are more suitable for upper secondary and higher education.

Conditional cash transfers (CCT), which provide cash to poor young people conditional on them attending school, have proven to be effective in raising school enrollment in Latin America and are quickly becoming popular in other parts of the world. In Cambodia, a

[51] General Statistical Office, National Institute of Hygiene and Epidemiology [Vietnam] and ORC Macro (2006).

[52] Comprehensive knowledge here refers to knowing that people can reduce their chances of getting the AIDS virus by having sex with only one uninfected, faithful partner and by using condoms consistently; knowing that a healthy-looking person can have the AIDS virus; and knowing that HIV cannot be transmitted by mosquito bites or by sharing food with a person who has AIDS.

[53] In the Dominican Republic, a survey of boys in the final year of primary school showed that they underestimated the returns to completing secondary school by up to a factor of ten. Boys at randomly selected schools were then told about the "true" earnings premium to secondary education. Four years later they were found to have completed more years of secondary school than those who had not been told (Jensen 2006).

[54] Beegle, Dehejia, and Gatti (2004).

secondary school scholarship program for girls has had a significant positive effect on girls' attendance in the first grade of secondary school.[55]

Income-contingent loans are superior to conventional loans because, by deferring payments until individuals start working and reach a certain income, they have lower default rates and promote more equitable access and loan repayment. They also increase efficiency by addressing uncertainty about future earnings and by facilitating consumption smoothing. They are often collected alongside income tax or social security contributions and thus have in-built-in insurance against borrowers' inability to repay since the loan repayment falls if a borrower's income falls. However, they are hard to implement and may be a realistic option only in some middle-income countries.[56] Developing countries with well-developed tax systems such as Thailand are only now starting to try such schemes. For countries with poorly developed income tax systems, alternative mechanisms such as targeted vouchers and individual learning accounts that encourage saving for education may be better options.[57]

3. Providing Second Chances

Invariably, bad choices will be made. Young people may drop out of school, begin working too early, or end up with jobs that lead nowhere. This can result in an enormous missed opportunity not just for the young but also for society as a whole. Policies that help young people to recover from bad choices or to escape poor circumstances can provide a safety net that benefits society well into the future. However, because remediation is costly, these programs must be targeted to those most in need, must be well coordinated with the mainstream programs and must provide the right incentives to beneficiaries.

3.1 HIV/AIDS

Thailand's experience in combating HIV/AIDS highlights the essential element needed for the success of second-chance interventions – the need to align these programs with interventions that provide opportunities and enhance capabilities. This is necessary to give the right incentives to beneficiaries, to avoid moral hazard, and to achieve high payoffs from the investment. In Thailand, many people living with HIV/AIDS (known as PHA) have been given treatment through the auspices of government-led programs. Many PHAs who received treatment through these programs are now helping to plan and implement a wide range of HIV/AIDS programs using the extensive network of more than 300 PHA organizations. PHA peer educators play an essential role in providing health information and in promoting healthy behavior when the availability of doctors and nurses is limited. Experience over the past few years indicates that PHAs can make a large contribution to helping others to adhere to treatment by sharing experiences and providing basic information in easy-to-understand language. The increased role of PHAs not only increased acceptance of and support for PHAs within the health care system, but it also helped PHAs to regain self confidence and dignity.[58] Providing remediation programs may trigger moral hazard, which is a primary concern for policymakers, but, as Thailand's case illustrates, when people are given incentives to safeguard their health, then this risk can be mitigated.

3.2. Education

Many young people drop out of school without the basic skills needed to find productive employment. This is a particular problem in low-income countries like Papua New Guinea, Myanmar, Lao PDR, and Cambodia where many children drop out before completing primary school (or never start) and where literacy rates among 15 to 25 year olds are low (for example, 67 percent in Papua New Guinea and 79 percent in Lao PDR). But many young people, particularly the poor, in middle-income countries like Thailand and Indonesia also drop out of school after completing basic education. A coherent system of second-chance programs, such as equivalency education programs, literacy programs, and job training, is needed to meet the diverse needs of these young people. Involving the private sector and NGOs in providing these programs can increase both diversity and enrollments.

The Philippines has a good example of an equivalence education program. This program has three levels – basic literacy, primary, and secondary. Learners are pre-tested to determine at which level they should begin. The program is designed to be client-oriented and flexible, with the curriculum and material being divided into short, self-paced modules. When ready for testing, the learner can register for national tests and, if successful, will receive certificates equivalent to the completion of primary or secondary education. The program is supported by a strong private-public partnership that is key to its success – while the government develops the curriculum, materials, and tests, accredited private sector institutions and NGOs deliver the training

[55] Filmer, Deon and Norbert Schady. 2006.
[56] See Chapman (forthcoming).
[57] *Oportunidades* in Mexico introduced *Jovenes con Oportunidades*, through which conditional cash transfer beneficiaries accumulate points from the last year of lower secondary until the end of secondary school, which beneficiaries can tap for further study or to start a business if they complete high school before turning 22.

[58] World Bank (2006a).

Evidence from *Entra 21* and *Jovennes* in Latin America shows that job training programs need to be part of a larger package of services to maximize their impact. Both of these programs target disadvantaged young people on a massive scale to provide them with technical training combined with life-skills training. They also cooperate with both the public and private sectors to providing internship opportunities to young people that may facilitate their later employment. The keys to the success of these programs are the high quality of the training providers, frequent feedback from employers, and strong institutions managing the programs**.**

Because of the high cost of second-chance programs, it is important to direct them to those young people who are most in need, and design them in ways that meet their needs. Geographical targeting may be a better option wherever poverty is clustered in specific poor regions and in remote rural areas.[59]

4. Footing the Bill

Some of the policy directions recommended here require a reallocation of resources. The biggest bill may be needed to underwrite increasing access to and improving the quality of basic education, while expanding the definition of basic education to include at least some secondary education. However as their economies grow, these sums of money are not beyond the capabilities of most countries in EAP.

Other measures that have been mentioned here may require less financial capital than political capital. Increasing the accountability of schools to students and their families or directing education subsidies towards those who need it the most are not easy to do. Neither is reforming employment protection legislation**,** which may threaten the entitlements of older workers. Similarly, providing young people with more and better information and developing their capability for making decisions may be controversial. At the same time, there are many ways to move forward that would allow young people, supported by good policies and institutions, to flourish and thereby contribute not only to their own futures but also to the future prosperity of the societies in which they live.

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[59] School attainment in urban areas is between 33 percent (the Philippines) and 50 percent (China, Indonesia and Thailand) higher than in rural areas.

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