WORLD BANK **EAST ASIA AND PACIFIC ECONOMIC UPDATE** OCTOBER 2013

Rebuilding Policy Buffers, Reinvigorating Growth

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Rebuilding Policy Buffers, Reinvigorating Growth

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ABBREVIATIONS

ADB Asian Development Bank
AMCs asset management companies
ASEAN Association of Southeast Asian Nations
BI Bank Indonesia
BIS Bank for International Settlements
BPO business processing outsourcing
BPM5 Balance of Payments Manual, 5th edition
BPM6 Balance of Payments Manual, 6th edition
cif cost, insurance and freight
CPI Consumer Price Index
EEZ exclusive economic zone
eop end of period
ETF Exchange Traded Fund
EU European Union
FAI fixed asset investment
FDI foreign direct investment
Fed U.S. Federal Reserve
fob free on board
FY fiscal year
g&s goods and services
GDP gross domestic product
GFCF gross fixed capital formation
GFS Government Finance Statistics
GNI gross national income
IMF International Monetary Fund
JETRO Japan External Trade Organization
LFPR labor force participation rate
LGFV local government financing vehicles
LNG liquefied natural gas
MIC middle-income country
MSCI Morgan Stanley Capital International
NCD noncommunicable disease
NIEs newly industrialized economies
OECD Organisation for Economic Co-operation and Development
p.a. per annum
PBC People's Bank of China
PMI Purchasing Manager Index
PPI producer price index
PPP purchasing power parity
QE quantitative easing
q-o-q quarter-on-quarter
qoq-sa quarter-on-quarter, seasonally adjusted
REER real effective exchange rate
SAR special administrative region
SDA special deposit account
SHIBOR Shanghai Interbank Offer Rate
SME small and medium-size enterprise
SOEs state-owned enterprises
TFR total fertility rate
TSF Total Social Financing
UMP unconventional monetary policy
VDS Vessel Day Scheme
WMPs Wealth Management Products
yoy year-on-year

Countries

CHN China
FJI Fiji
IDN Indonesia
KHM Cambodia
LAO Lao PDR
MMR Myanmar
MNG Mongolia
MYS Malaysia
PHL Philippines
PNG Papua New Guinea
SLB Solomon Islands
THA Thailand
VNM Vietnam

Regions, World Bank classification

EAP East Asia and Pacific
ECA Europoe and Central Asia
LAC Latin America and the Carribean
MENA Middle East and North Africa
SAS South Asia
SSA Sub-Saharan Africa

Currency Units

B Thai bhat
CR Cambodian riel
D Vietnamese dong
F$ Fiji dollar
K Myanmar kyat
K Papua New Guinea kina
Kip Lao PDR
₱ Philippine peso
RM Malaysian ringgit
RMB Chinese renminbi
Rp Indonesian rupiah
SI$ Solomon Islands dollar
Tog Mongolia
US$ Timor-Leste, United States
Y Chinese yuan

PREFACE AND ACKNOWLEDGMENTS

The *East Asia and Pacific Economic Update* is a joint report of the East Asia Pacific Chief Economist's Office and the East Asia Pacific Poverty Reduction and Economic Management Department. Part I was prepared by Antonio Ollero, Ekaterine Vashakmadze and Deepak Mishra. Part II was prepared by Antonio Ollero and Nikola Spatafora, with contributions from Roberto Rocha, Karlis Smits, Jun Wang and Sanket Mohapatra. Part III was prepared by Truman Packard, Tran Van Nguyen, Philip O'Keefe, Nithin Umapathi, and Aparnaa Somanathan. The work on Part I was supervised by Deepak Mishra. The work on Parts II and III was supervised by Nikola Spatafora. This report was prepared under the direction of Bert Hofman (Chief Economist, East Asia and Pacific Region), Sudhir Shetty (Director, Poverty Reduction and Economic Management, East Asia and Pacific Region), and Shubham Chaudhuri (Sector Manager, Poverty Reduction and Economic Management, East Asia and Pacific Region).

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Developing East Asia and Pacific as used in this report includes China, Indonesia, Malaysia, Philippines, Thailand, Vietnam, Cambodia, Lao People's Democratic Republic (PDR), Mongolia, Myanmar, Timor-Leste, Fiji, Papua New Guinea, Solomon Islands and other island economies in the Pacific. The Newly Industrialized Economies (NIEs) include Hong Kong SAR, China; the Republic of Korea; Singapore; and Taiwan, China. The ASEAN member countries are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. The ASEAN-4 are Indonesia, Malaysia, Philippines, and Thailand.

EXECUTIVE SUMMARY

PART I

Global growth momentum accelerated during the second and third quarters of 2013, while many downside risks lingered in the background. The second quarter of 2013 marked the first time in 30 months that the economies of the Euro area, Japan, and the United States all posted positive growth. The Euro area exited from its long recession in the second quarter, registering a growth rate of 1.2 percent (quarter-on-quarter in seasonally adjusted terms). Recovery intensified in the United States, with its economy growing at 2.5 percent, while Japan's economy expanded by a solid 3.8 percent. Similarly, growth accelerated in several emerging markets including in Brazil, China, Malaysia, South Africa, and Turkey. Leading indicators of economic activities also suggest that global production and trade cycles may have bottomed out in the third quarter. Yet the risks to the global recovery from the uncertainty surrounding the fiscal deadlock in the United States, the impact of the withdrawal of monetary stimulus from the advanced economies, an abrupt slowdown of investment in China, and unrests in the Middle-East remain prominent.

Strengthening of global growth momentum will help developing East Asia maintain a growth rate in excess of 7 percent, retaining its status as the global growth leader. Growth in China is expected to meet the official indicative target of 7.5 percent in 2013—0.8 percentage points lower than our projected rate in April. In the medium term, China's growth is expected to remain range bound between 7.5 and 7.7 percent as the authorities emphasize productivity and innovation, and rebalance demand from investment-led to consumption-based growth. Growth in developing East Asia (excluding China) is expected to decline from 6.2 percent in 2012 to 5.2 percent in 2013, before rebounding to 5.3 and 5.7 percent in 2014 and 2015, respectively. The recovery in ASEAN countries, which include a few high-income countries, will be more gradual, with expected growth of 5.1 percent (2013), 5.1 percent (2014), and 5.4 percent (2015). Notwithstanding the modest decline in growth in 2013, the East Asia Pacific (EAP) region will contribute nearly two-fifths of global growth and one-third of global trade—higher than any other region in the world.

Domestic demand, which has been the main driver of growth in the EAP region in the post-global financial crisis period, is slowing. Robust growth in private consumption and investment, supported by large stimulus programs, has contributed to more than 90 percent of growth in developing East Asia since 2009. But as stimulus programs are being phased out, domestic demand is weakening. Since mid-2012, the Indonesian economy has been affected by lower global commodity prices and a slowdown in private investment. Higher private sector debt has reduced the ability of Malaysia and Thailand to further reflate their economies, while Vietnam's economy has been restrained by persistent problems in the banking sector and state-owned enterprises. And China is likely to seek further rebalancing of its economy by slowing credit growth and investment, although the pacing is likely to depend on overall growth.

The decision by the U.S. Federal Reserve (Fed) to delay tapering of quantitative easing (QE) has restored capital flows to emerging markets, giving the authorities a second opportunity to take measures to lower risks from future volatility. The speculations about withdrawal of quantitative easing led to stock market sell-offs, depreciation of currencies, and a sharp rise in domestic bond yields. Indonesia was affected most, followed by Thailand, the Philippines, and Malaysia. Countries in the region that experienced comparatively larger fund withdrawals were the ones that had larger foreign participation in their financial markets, putting them at risk to further volatility. The financial markets have stabilized after the Fed decided to delay the withdrawal of QE—

giving EAP countries a much- needed respite and a second opportunity to better prepare for eventual tapering. Measures to lower risks from tapering include reducing excessive reliance on short-term and foreign-currency-denominated debt, accepting a weaker exchange rate when growth is below potential, and building policy buffers to respond to changing global liquidity conditions.

As the global growth cycle undergoes change, adjustments to fiscal and monetary policy are warranted in many EAP countries. Most EAP countries have eschewed large fiscal stimulus to support growth this year, and some have started addressing fiscal sustainability issues related to past expansive policies. Credit growth has moderated in several of the region's large economies, though credit-to-GDP ratios remain elevated in most countries compared to the 2008 levels. The authorities are also employing macro-prudential measures to contain risks arising from recent credit expansion. At the same time, several EAP countries are trying to rationalize subsidy regimes—including fuel subsidies in Indonesia and Malaysia and the rice subsidy in Thailand.

With growth running at or above potential for most countries in the region, progress at upgrading growth and reducing poverty depends crucially on structural reforms. China seems to be on the cusp of announcing significant reforms involving the country's urbanization policy, land management system, residency (*hukuo*) system, financial systems, and fiscal decentralization. In Malaysia, the authorities continue to implement an "economic transformation program" aimed at raising Malaysia to high-income status by 2020. On the other hand, Indonesia needs a more open trade and investment regime and greater regulatory certainty, and the Philippines needs to enhance domestic competition and relax limits on foreign ownership. In Thailand, an appropriate medium-term fiscal framework should further strengthen investor confidence. Investment in infrastructure is crucial in all of these economies, which includes making public investment more efficient through better project selection, innovative financing, and effective implementation.

While the balance of risks to our base case regional forecast lies on the downside, several upside risks have recently emerged. The three immediate headline risks include a less orderly tapering of the U.S.'s unconventional monetary policies, prolonged fiscal deadlock in the U.S., and a sharper than expected slowdown of the Chinese economy. However, not all risks are on the downside. First, stronger global growth will provide considerable tailwinds to EAP countries through expansion of global trade. This will enable them to wind down stimulus measures without losing much growth. Second, the impact of QE tapering on EAP capital inflows may to some degree be offset more depreciated currencies and by Japan's new strategy to exit deflation and revive growth, which could spill over to EAP countries through expanded bank lending, portfolio rebalancing, and increased outward foreign direct investment. In short, countries that can minimize the risks of rising interest rates while maximizing the benefits from improved trade prospects will perform better.

PART II

This report includes a special section focusing on two emerging regional issues: the sustainability of China's investment- and credit-intensive growth model, and the regional implications of any future tapering of quantitative easing in the United States.

China's credit boom may have run its course. China responded to the global financial crisis with a massive, investment-heavy stimulus program, supported by a vast credit expansion. The growth it triggered does not appear sustainable over the long term. Massive new lending in recent years has raised debt in all sectors of the economy, posing some risks to financial stability. The rapid expansion of shadow banking poses serious

challenges, since shadow banking is closely linked to the banking system, is less regulated, and operates with implicit guarantees from banks and local governments. The rise in local government debt is also a concern, given the complexity and opacity of municipal finances. Policy action should focus on three key areas: containing the rapid growth of credit in the economy and tightening financial supervision; rationalizing municipal finance; and broadening and deepening financial sector reforms.

The end of quantitative easing. Quantitative easing, particularly in its early stages, had a positive impact on capital flows to EAP and on regional financial markets. That said, quantitative easing accounted for only part of the total variation in capital inflows and asset prices. Conversely, any scaling back of quantitative easing in the United States will result in higher borrowing costs, lower capital inflows, and a decline in asset prices in EAP. This will affect investment and potential output, and raises concerns about potentially overextended domestic financial sectors. Estimates of the impact vary widely, but it is likely to prove larger in economies characterized by greater financial openness, significant current-account deficits, rapid credit growth in recent years, or large increases in debt. Countries may be able to reduce the cost of their borrowing by strengthening their own domestic institutions and further improving the investment climate.

PART III

This report also includes a special section focusing on two medium-term regional development issues: labor-market challenges, and the implications of population aging.

At Work in East Asia Pacific. Labor markets and their contribution to growth and household well-being are a growing concern in EAP. Problems include high youth inactivity, rising inequality, and binding skills shortages. A key underlying issue is widespread economic informality, which increases household vulnerability to shocks, limits the tax base, and constrains innovation and productivity. Informality is both a consequence of relatively stringent labor regulations, and a reason for their widespread evasion. Key components of the appropriate policy response include macroeconomic stability, and a regulatory framework that encourages, in particular, the small and medium-size enterprises where most people in EAP work. It is also critical to "formalize" more work, so as to increase the coverage of essential work-risk and social protection, and to sustain growth. To this end, policies should encourage mobility of labor and human capital, and not favor some forms of employment (for instance, full-time wage employment in manufacturing) over others. Among the more specific challenges, mainly agrarian countries should focus on raising agricultural productivity. In urbanizing countries, good urban planning becomes critical. The Pacific Island Countries should provide youth with the human capital needed to succeed abroad.

Aging in East Asia Pacific. EAP is in the midst of the most rapid population-aging process ever seen. Aging is driven by declining fertility and increasing life expectancy, and is occurring at relatively low income levels. It will have major effects on the labor force and aggregate growth, although with significant differences across countries. The effects may be compounded by urbanization, as a result of lower labor-force participation rates among the urban elderly. There are also growing concerns about the elderly poor, as family support networks become stretched. Aging raises several critical policy challenges. First, extending productive working lives, sustaining the skills of aging workers, and increasing labor-force participation rates. Second, reforming pension systems to increase coverage and financial protection, taking into account administrative capacity and fiscal sustainability. Third, reforming health-care systems, including in particular care for the aged and long-term care, also through changes in how healthcare providers are paid.

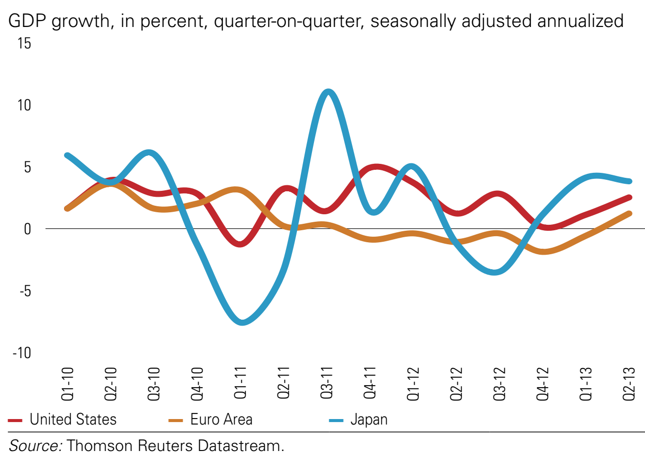
Part I. Recent Developments and Outlook

I.A. Recent Developments

Global growth prospects have become more promising as recovery is picking up momentum in the major advanced economies. For the first time since mid-2010, the Euro area, Japan, and the United States have all reported positive growth (quarter-on-quarter in seasonally adjusted terms [qoq-sa]) during the second quarter of 2013 (Figure 1). After a record 18 months in economic contraction, the Euro area emerged from recession in July 2013. Japan's economy has expanded at a higher than expected rate for the third straight quarter after its government decided to forcefully pursue more accommodative monetary and fiscal policies. And the U.S. economy, which slowed during the second half of 2012 and earlier this year, appears to have bounced back in the second quarter of 2013.

Figure 1. Recovery is gaining momentum in the major advanced economies…

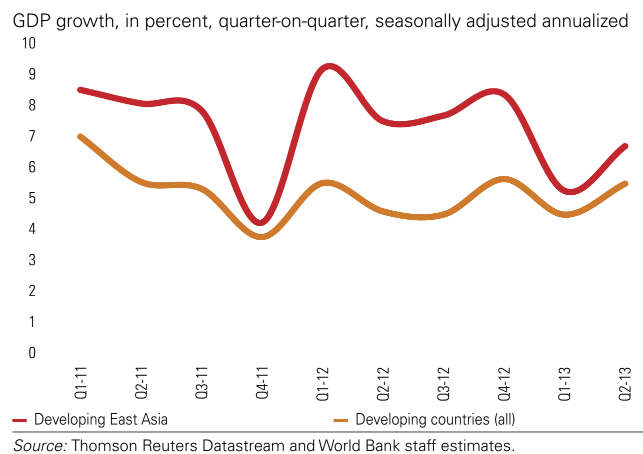
GDP growth, in percent, quarter-on-quarter, seasonally adjusted annualized



Source: Thomson Reuters Datastream.

Figure 2. …as well as in developing countries

GDP growth, in percent, quarter-on-quarter, seasonally adjusted annualized



Source: Thomson Reuters Datastream and World Bank staff estimates.

Growth momentum is strengthening in some of the large developing countries, as well. China's annualized quarterly growth rate picked up to 7.5 percent in the second quarter from 6.3 percent in the first quarter, and most recent industrial production and trade data suggest further strengthening of output in the third quarter of 2013. Similarly, growth accelerated in several major developing economies including Brazil (6 percent annualized), South Africa (3 percent), and Turkey (8 percent) among others (Figure 2). Other leading indicators of economic activities, for example, the Purchasing Manager Index (PMI), and the Baltic Dry Index, an indicator of global freight costs, seem to suggest that global production and trade cycles are bottoming out. However, not all large developing countries are experiencing a growth rebound (for example, India, the Russian Federation) and there are significant risks to the pace of global recovery.

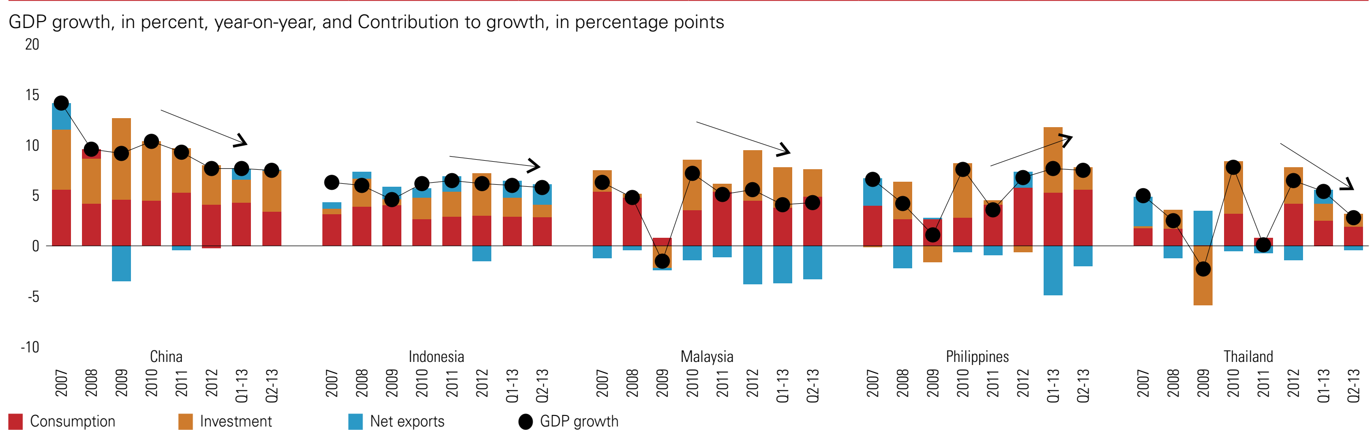
Real Sector: Is Domestic Demand Weakening?

While growth momentum accelerated in the second and third quarters in many EAP countries, year-on-year (y-o-y) changes continue to show a decline. China's growth rate is expected to be lower as the

economy transitions from a credit-fueled and investment-led boom to a more sustainable consumer- and services-oriented growth path (Figure 3). Lower global commodity prices have dampened export receipts and slowed private investment in the capital-intensive resource sectors of the Indonesian economy, depressing overall growth. Thailand's growth sharply decelerated in the second quarter of 2013, as post-flood reconstruction drew to a close and some of the stimulus measures were removed. Malaysia's economy expanded less than expected in the second quarter, and lower growth of exports dragged down growth. Vietnam extended its slow growth rate of last year, the lowest in 12 years, into the first half of this year. Problems at banks and state-owned enterprises (SOEs) continue to weigh down on domestic demand. Only the Philippines bucked the trend among the region's larger middle-income economies, posting a growth rate of 7.6 percent in the first half, more than 1 percentage point higher from a year ago. Consumption contributed three-fourths to growth in the second quarter, supported by resilient remittances.

Figure 3. Growth continues to be largely driven by domestic demand in large EAP countries

GDP growth, in percent, year-on-year, and Contribution to growth, in percentage points



Source: Haver Analytics and World Bank staff estimates.

Growth in the region's smaller economies has been encouraging. In Cambodia, garment exports and tourist arrivals expanded by double digits in the first six months from a year ago. An increase in acreage and better irrigation kept rice production high into the fifth year. In Lao PDR, the hydropower sector has generated positive spillover effects in construction and services. Two major projects are commencing operations this year, providing further impetus to economic activity. In Mongolia, growth rebounded in the second quarter of 2013. Agriculture led the double-digit growth thanks to favorable weather conditions. Construction, focused on infrastructure projects funded by last year's massive global bond offering (US$1.5 billion of *Chinggis* bonds, equivalent to one-fifth the size of the economy), expanded strongly in the second quarter. This helped to offset modest growth in mining, the latter bogged down by a weak global coal market. Robust gas production and exports drove growth in Myanmar higher than the year before. In Timor-Leste, public sector spending was a drag on growth: budget execution was at 20 percent of plan in July, compared to 36 percent a year ago. In contrast, data on private sector activity in the first quarter was positive: electricity consumption and vehicle sales grew strongly over a year ago.

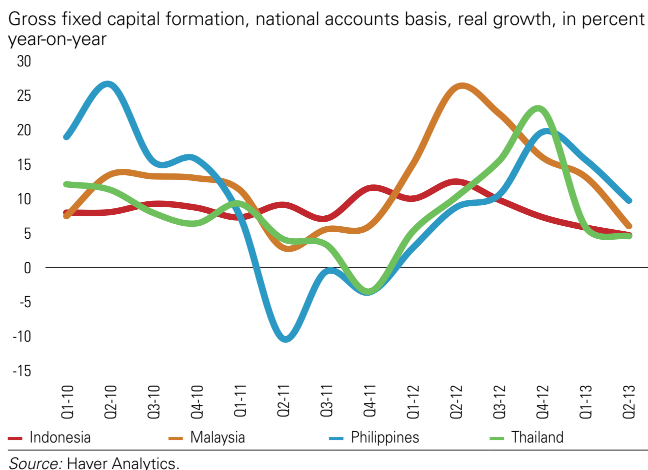
Economic performance has been mixed in the Pacific Islands. In the absence of current and higher-frequency indicators, assessments can only be made from available data—mostly last year's results. Papua New Guinea reported lower growth in 2012 than the year before. On a more positive note, the country's large US$19 billion liquefied natural gas (LNG) project (GDP was US$15.1 billion last year) is close to completion this year. Growth halved from the previous year in the Solomon Islands, where weak commodity prices hurt agricultural and

mineral production and investment, although government spending and bank lending supported consumption. In Fiji, Cyclone Evan, which struck in late 2012, damaged infrastructure and slowed tourism, a key driver of economic growth. Among the smaller islands, Kiribati and Vanuatu posted growth rates slightly higher than the historical average 2.0 percent. In Kiribati, growth was helped by major donor-funded infrastructure projects. Strong fishing license revenues enabled the fiscal deficit to narrow from double to single digits. Vanuatu performed better than in the last two years, supported by increased tourist arrivals. Growth in Samoa, Tonga, and Tuvalu came in under 2.0 percent. Remittances from seafarers continued to decline in Tuvalu. Significant increase in expenditure on recovery and rebuilding following Cyclone Evan has put Samoa at a high risk of debt distress. Tonga barely grew last year on low remittances, subdued tourism, and the winding down of fiscal stimulus following the completion of infrastructure projects financed by China.

Domestic demand continues to drive growth, but investment is slowing, especially in the ASEAN-4 countries (Indonesia, Malaysia, Philippines, and Thailand). Investment growth in Indonesia reached a three-year low in the second quarter. Investment is likely to face more headwinds: from interest rate hikes in response to rising inflation and capital outflows; from a slowdown in foreign direct investment (FDI), and from regulatory uncertainties. In Thailand, the end of large-scale government investment in response to the devastating floods in 2011 reduced investment growth in the second quarter. Major public transportation and water management projects were delayed, while private corporate investment in manufacturing equipment failed to provide any offset. Only private residential investment remained robust, against otherwise slowing growth. Malaysia reported significantly lower investment growth in the second quarter compared to the breakneck pace of the previous five quarters (Figure 4) and may slow further as global interest rates rise and the government considers sequencing investments with large import content. In the Philippines, in the first quarter, investment's contribution to quarterly growth was the greatest in 10 years. Private construction expanded 26 percent on the back of strong demand for residential and office space, and public construction, 46 percent, on better infrastructure project implementation and election-related spending. But investment growth returned to trend in the second quarter. Investment became the main driver of growth again in China, contributing to over half of GDP growth in the second quarter. (Figure 5).

Figure 4. Investment growth has moderated in the ASEAN-4…

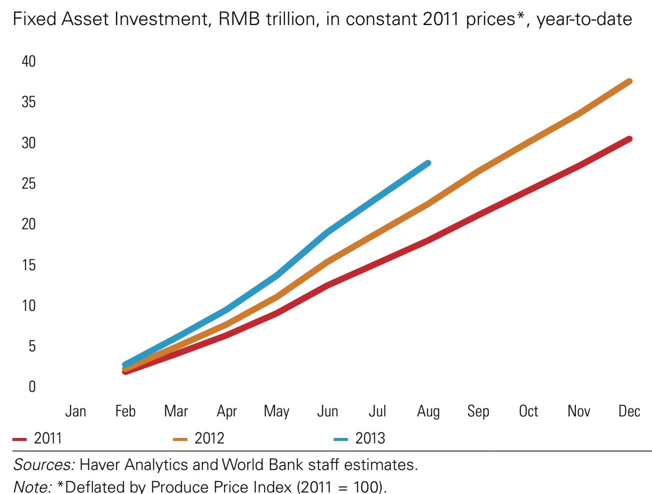
Gross fixed capital formation, national accounts basis, real growth, in percent year-on-year



Source: Haver Analytics.

Figure 5. …while urban FAI accelerated in China, helped by manufacturing investment and railway construction

Fixed Asset Investment, RMB trillion, in constant 2011 prices*, year-to-date

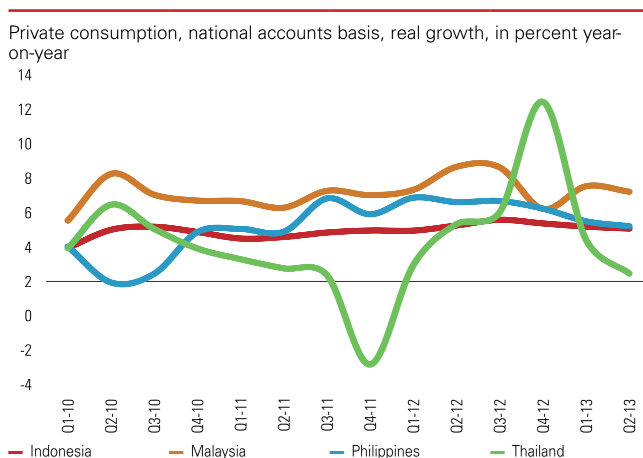


Sources: Haver Analytics and World Bank staff estimates.
Note: *Deflated by Produce Price Index (2011 = 100).

Consumption growth remains generally robust, but some of its drivers are softening. Consumption managed to hold up well in the first half of the year in Indonesia, although higher prices following an increase

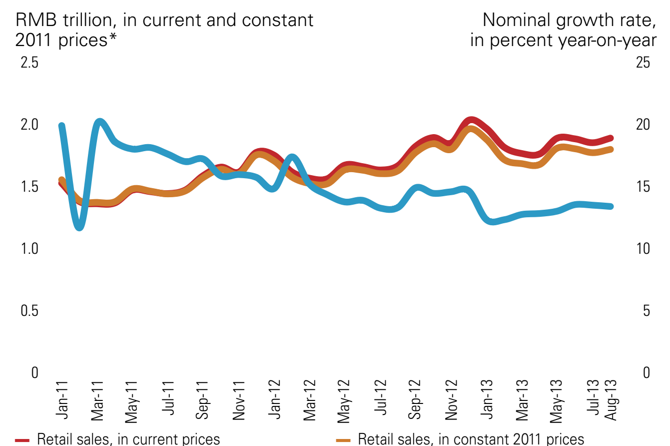
in subsidized fuel prices in June are weighing on consumer sentiment. Private consumption grew at a healthy pace in Malaysia in the second quarter, and public consumption accelerated, but mainly due to bonuses to civil servants and spending ahead of the general elections in May. Private consumption contributed half of GDP growth in the first half of the year in the Philippines, as remittances posted solid growth through midyear and a weaker peso boosted the purchasing power of remittance flows. In Thailand, rapid expansion of credit to households has weakened after some of the stimulus measures were withdrawn during the year (Figure 6). The contributions from various forms of government support have waned: households are more indebted now than they were four years ago, the tax rebate scheme on first car purchases expired at the end of last year, and the lift to consumer spending from post-flood investment has faded with the completion of reconstruction projects. In China, there has been some progress in rebalancing toward consumption: consumption contributed more to quarterly growth than investment in the last two years up to the first quarter, the share of labor in national income has been growing, and the share of services in output has risen. Still, the economy has yet to make the decisive turn toward consumer-based growth. Recent data show some recovery in consumption growth numbers at midyear (Figure 7).

Figure 6. Consumption growth has held up relatively well in ASEAN-4



Source: Haver Analytics.

Figure 7. Retail sales improved modestly in China in August, on more spending for construction materials and home appliances



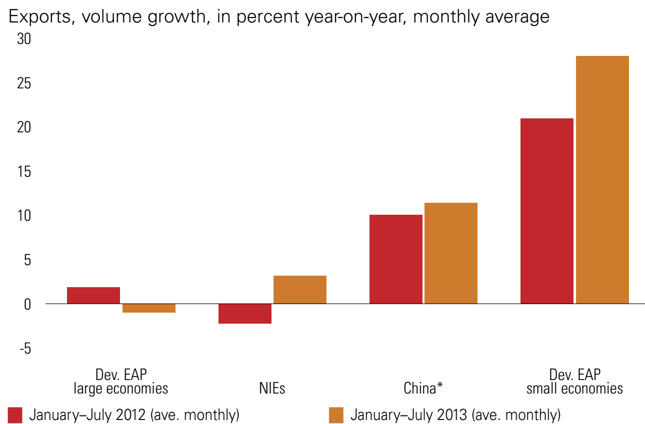
Source: Haver Analytics.
Note: *Deflated by Consumer Price Index (2011 = 100). rhs = right-hand side.

External Sector: Is Export Slowdown Bottoming Out?

Exports are showing signs of recovery beginning in the third quarter. In China, exports expanded 5 percent year-on-year (yoy) in July and 7 percent in August after contracting 3 percent in June. The average monthly export growth rate in China in the first eight months of the year is now higher than over the same period a year ago (Figure 8). In Vietnam, exports grew 16 percent yoy in August and 20 percent in September, pushing the average monthly export growth rate for the small developing EAP economies far ahead of its pace a year ago. And in Thailand, exports grew 4 percent yoy in August after declining during the three previous months. Average monthly export growth rates for the large EAP economies combined are still negative, however. Meanwhile, export growth among the region's newly industrialized economies (NIEs) has turned positive over the first seven months of the year, compared to the same period last year. This augurs well for regional exports because

the NIEs are important suppliers of and markets for parts and components in regional and global supply chains. Moreover, the Baltic Dry Index, a leading indicator of global trade and production, has turned up in September, suggesting that the global trade cycle may have bottomed out (Figure 9).

Figure 8. Export growth is picking up in China and several EAP countries



Source: CEIC.
Note: Developing EAP large economies are Indonesia, Malaysia, the Philippines, and Thailand. Developing EAP small economies are Cambodia, Lao PDR, and Vietnam.
* For China, January–August 2012 and January–August 2013

Figure 9. The Baltic Dry Index suggests that the global trade cycle may have bottomed out

Source: Bloomberg.

The recovery in export growth comes on the heels of a poor trade performance in the first half of the year. Developing East Asia's exports grew 7.2 percent during January to June over the same period a year ago in nominal value terms, barely improving on last year's annual performance of 6.2 percent.[1] External demand from the United States, the European Union, and Japan, the market for a combined 40 percent of the region's exports, had been weak in the first half of the year. East Asia ships another 34 percent of its exports intra-regionally, including to the East Asian NIEs, but these consist mainly of parts and components used in regional and international production networks for which the final products are still bound for the advanced economies. Exports of computers, telecommunications equipment, and electrical machinery, which comprise 31 percent of the region's total exports, picked up in the first quarter but trended down in the second, affecting, in particular, China, Malaysia, the Philippines, and Thailand.[2] Exports of apparel and textiles, comprising 11 percent of the region's total exports, were stable, however, a welcome development for Cambodia and, to a lesser extent, China and Fiji.[3] Exports of vehicles and parts, the region's third-largest manufacturing production network contributing 4 percent of the region's total exports, were weak, affecting specially Thailand.[4]

Subdued global commodity markets have hurt the region's resource exporters. Metal and mineral prices have declined the most—46 percent from their post-crisis high in February 2011 to July this year (Figure 10). Agricultural food prices are down 14 percent from July last year and energy prices, 12 percent, from March. Resource exports are important foremost to Indonesia.[5] Indonesia's terms of trade has deteriorated sharply

1 Between 2002, when China joined the World Trade Organization, and 2008, before global trade collapsed with the global financial crisis, exports by developing East Asia grew an average 22 percent a year.

2 Computers, telecommunications equipment, and electrical machinery were 49 percent of the Philippines' total exports in 2012, 34 percent of China's, 33 percent of Malaysia's, and 21 percent of Thailand's.

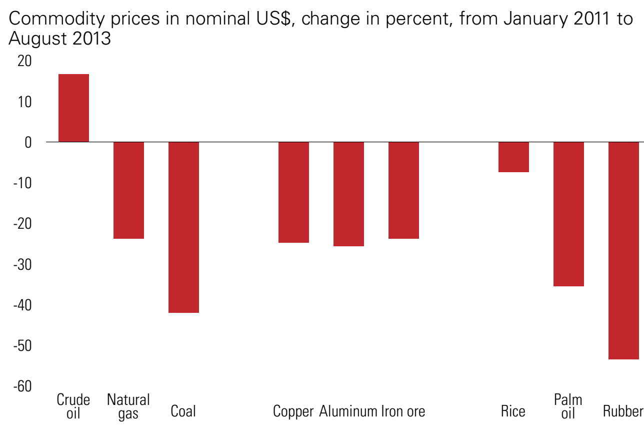
3 Apparel and textiles comprised 75 percent of Cambodia's total exports in 2012, 13 percent of China's, and 10 percent of Fiji's.

4 Vehicles and parts were 10 percent of Thailand's total exports in 2012.

5 Fuels were 33 percent of Indonesia's total exports in 2012; agricultural commodities, 24 percent; and ores and metals, 6 percent.

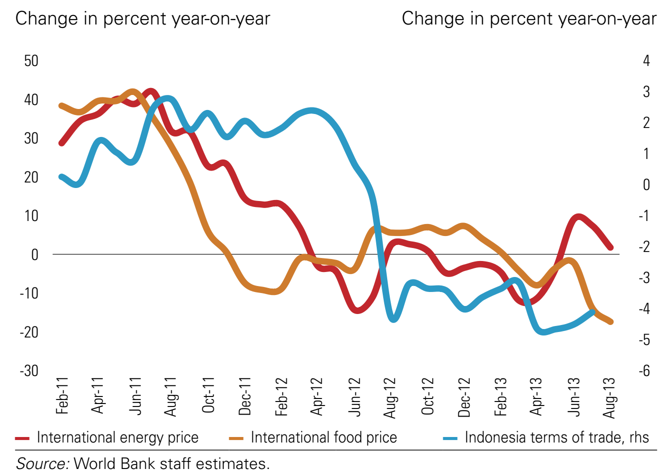
since mid-2012 (Figure 11). Fuel exports are large in Malaysia and Vietnam.[6] East Asian coal, petroleum, and natural gas exports have been in negative growth territory since mid-2012. Ore and metal exports are important to Mongolia and Lao PDR.[7] Monthly ore and metal exports have been declining since January 2012. Agricultural exports are a significant part of total exports in Fiji and Samoa and are important as well to Thailand, Malaysia (palm oil) and, to a lesser extent, the Philippines.[8]

Figure 10. Global commodity prices have been on a downward trend in recent years…



Source: World Bank staff estimates.

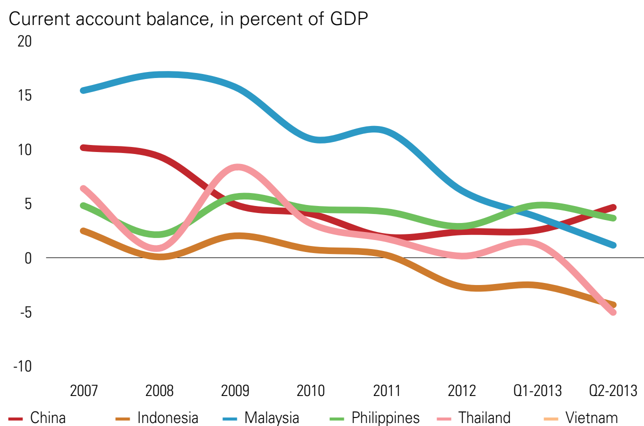
Figure 11. …hurting the terms of trade of EAP's resource exporters



Source: World Bank staff estimates.

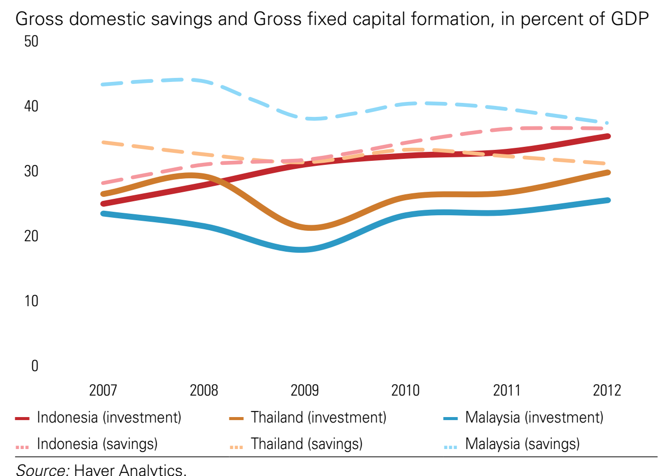
Current account balances deteriorated in most EAP economies in the first half of the year. Indonesia, which posted its first current account deficit since the Asian financial crisis last year, reported deficits in the first and second quarters of this year, as well (Figure 12). Private savings are under pressure from lower commodity prices, and public savings from slowing revenue growth and subsidy spending that remain high despite recent reductions (Figure 13). In Thailand, the current account balance, which was barely positive last year, turned into

Figure 12. Current account balances have deteriorated in Indonesia, Thailand, and Malaysia…



Source: Haver Analytics.

Figure 13. …on higher investment and lower savings rate



Source: Haver Analytics.

6 Fuel exports were 20 percent of Malaysia's total exports in 2012, and 9 percent of Vietnam's.

7 Ore and metal exports were 42 percent of Mongolia's total exports in 2012, and 53 percent of Laos's.

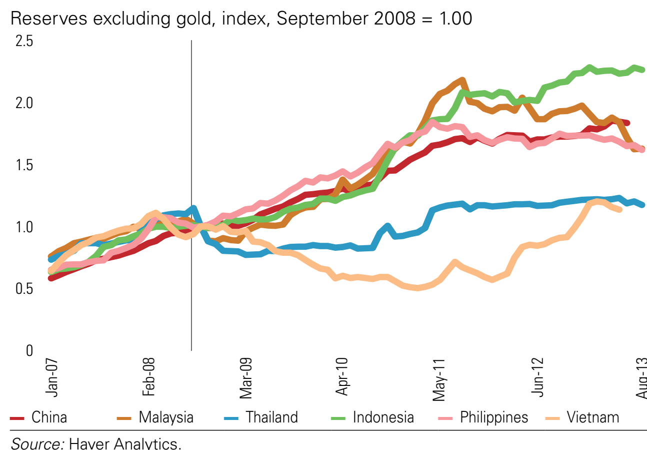
8 Agricultural exports were 68 percent (including mineral water) of Fiji's total exports in 2012, 31 percent of Samoa's, 18 percent of Thailand's, 15 percent of Malaysia's, and 10 percent of the Philippines'.

a deficit in the second quarter. Savings rates have declined due to rising household leverage and fiscal support schemes, driving private consumption higher. In Malaysia, the current account surplus, in double digits since 2003, narrowed last year and compressed further in the second quarter. Public savings are lower following stimulus packages implemented since the global financial crisis. Meanwhile, in China, the current account balance, which narrowed from a historical high of 10.1 percent of GDP in 2007 to 2.3 percent of GDP last year, bounced back to 4.6 percent of GDP in the second quarter.

Although several EAP countries have lost international reserves from current account deficits or capital outflows, reserves remain generally adequate across the region. Reductions in reserves since the beginning of the year (January to July) have been largest for Indonesia, US$20.1 billion; Thailand, US$7.6 billion; and Malaysia, US$1.4 billion. Still, the recent drawdowns represent a fraction of the hefty buildup of reserves since the beginning of the global financial crisis five years ago. Reserves in Indonesia at the end of July are 1.6 times their levels in September 2008 (Figure 14). Moreover, reserve adequacy ratios are robust (Table 1).

Figure 14. Despite recent drawdowns, the foreign reserves situation in most EAP countries has improved in recent years

Reserves excluding gold, index, September 2008 = 1.00



Source: Haver Analytics.

Table 1. Reserve adequacy ratios remain strong across the region

Reserves, in months imports, and Reserves to short-term debt ratio

	Reserves, in months imports		Reserves/ short-term debt	Reserves/ debt due within one year
	2012	**Jun-13**	**2012**	**2012**
China	21.9	23.8	6.1	8.1
Indonesia	6.3	5.5	2.6	2.1
Malaysia	9.6	9.5	4.6	3.9
Philippines	11.9	11.8	9.9	4.7
Thailand	7.5	7.0	3.0	8.2
Vietnam	2.3	3.0		

Source: World Bank staff estimates based on IMF, International Financial Statistics, and BIS-OECD-IMF-WB, Joint External Debt Hub.

Financial Markets: A Return to Volatility

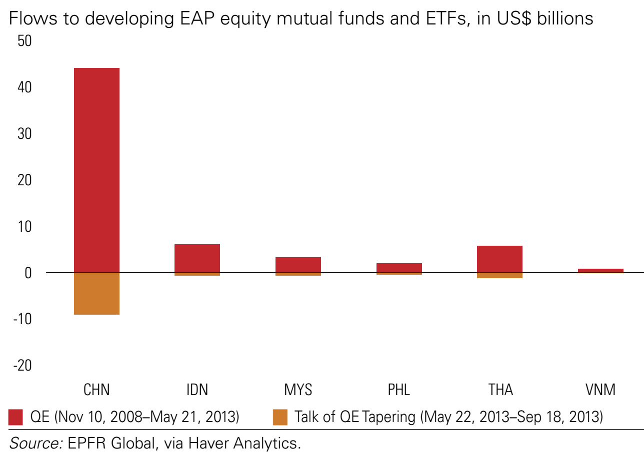
Portfolio flows to the region and other developing areas have become more volatile following talk by the U.S. Federal Reserve (Fed) of an imminent drawdown of the monetary stimulus. As U.S. Treasury yields rose markedly higher beginning in late May, international investors rebalanced their portfolios away from emerging market assets and into developed economy equities. According to survey data,[9] some US$12 billion was withdrawn from developing EAP equity funds (mutual funds and exchange traded funds [ETFs], Figure 15) and US$3.4 billion from bond funds (Figure 16) in the four-month period from May 22 to September 18. The survey data represent only a part of total portfolio flows on a balance-of-payments (BOP) basis—about

9 The private data firm Emerging Portfolio Fund Research (EPFR) Global tracks traditional and alternative funds domiciled globally (the funds currently hold US$19 trillion in total assets) and reports individual and institutional fund flow and fund manager asset allocation data by country, sector, and security on a daily, weekly, and monthly basis.

one-half for equity and one-eighth for bonds, according to one estimate (Miao and Pant 2012). Assuming these ratios apply to the total portfolio flows, the BOP portfolio equity outflows from developing EAP would have been US$24 billion, and the bond outflows, US$35.2 billion. While large on an average monthly basis, the fund outflows are a fraction of fund inflows accumulated previously,[10] since the beginning of quantitative easing by the U.S. Federal Reserve in November 2008.

Figure 15. Recent withdrawals from EAP equity funds have been the largest for China…

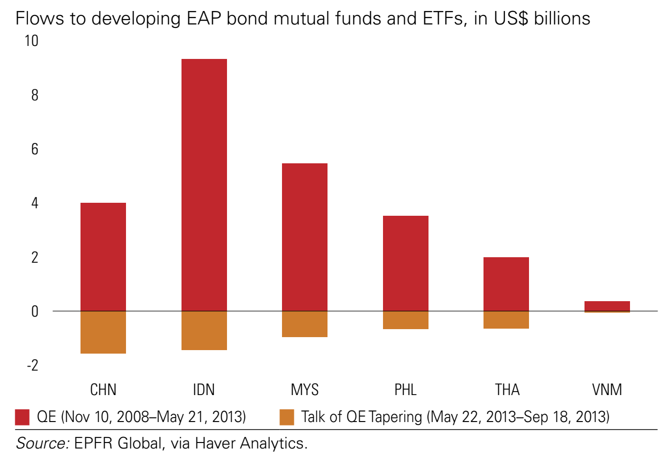
Flows to developing EAP equity mutual funds and ETFs, in US$ billions



Source: EPFR Global, via Haver Analytics.

Figure 16. …and from EAP bond funds, Indonesia

Flows to developing EAP bond mutual funds and ETFs, in US$ billions

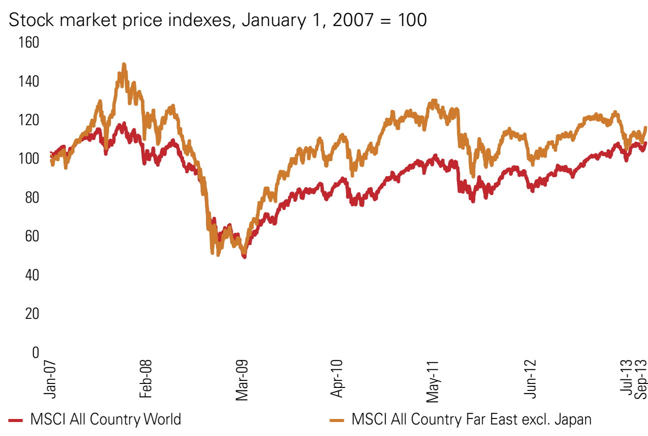


Source: EPFR Global, via Haver Analytics.

The volatility in portfolio flows has been accompanied by volatility in financial asset prices. The regional composite index for emerging East Asia's stock markets (the Morgan Stanley Capital International [MSCI] All Country Far East excluding Japan) lost more than 10 percent of its value in three months from May 22 to August 21 (Figure 17), before recovering 6 percent since. The Indonesian share market has been hardest hit,

Figure 17. The regional stock market composite has lost 5 percent since May 22

Stock market price indexes, January 1, 2007 = 100

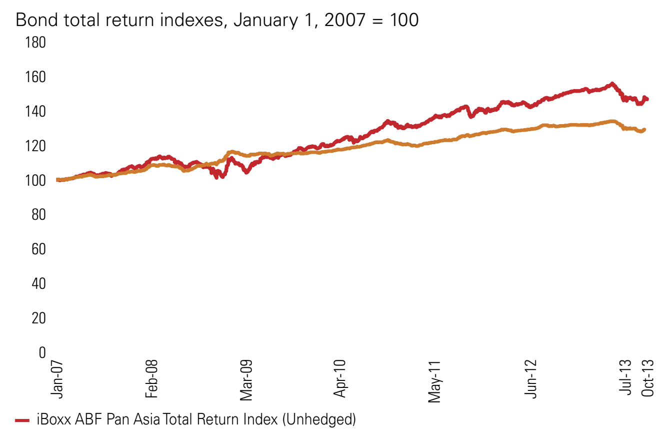


Source: MSCI, via Thomson Reuters Datastream.

Note: The MSCI AC (All Country) Far East excluding Japan Index is a free-float-adjusted market-capitalization-weighted index that measures the equity market performance of China; Indonesia; Malaysia; the Philippines; Thailand; Hong Kong SAR, China; Republic of Korea; Singapore; and Taiwan, China. The MSCI World Index is a free-float-adjusted market-capitalization-weighted index that measures the equity market performance of 24 developed markets.

Figure 18. And the regional bond market index has dropped 13 percent

Bond total return indexes, January 1, 2007 = 100



Source: Markit, via Bloomberg.

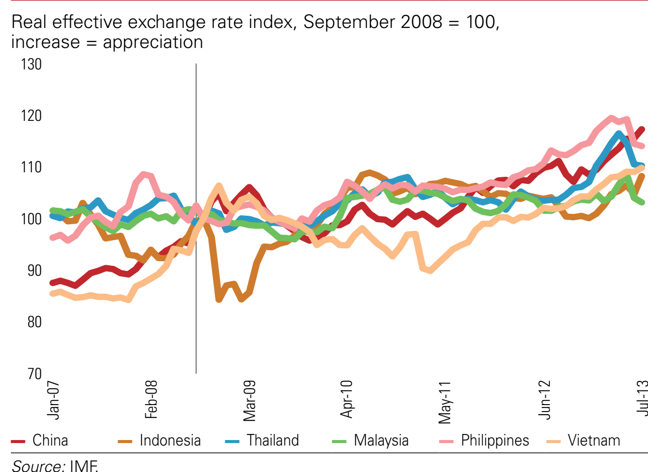
Note: The Markit iBoxx ABF Pan-Asia Index tracks the performance of local-currency-denominated bonds issued by governments and quasi-government entities in China; Indonesia; Malaysia; the Philippines; Thailand; Hong Kong SAR, China; the Republic of Korea; and Singapore.

10 From November 10, 2008 (when the Federal Reserve embarked on its first quantitative easing operation, QE1) to May 21, 2013 (before the Federal Reserve signaled its intent to gradually taper quantitative easing, with the Chairman's congressional testimony on May 22).

losing 24 percent; followed by Thailand, 21 percent; and the Philippines, 20 percent. Meanwhile, the yields on 10-year local currency government bonds have risen sharply, meaning that bond prices have fallen (Figure 18). The 10-year yield rose most steeply for Indonesia, by 273 basis points; followed by Thailand, 86 basis points; and Malaysia, 76 basis points. By most standards, the recent changes are significant. However, the price corrections are small compared to the strong increase in asset values, since monetary stimuli in advanced economies spilled into developing economy financial markets. In Indonesia, the Philippines, and Thailand, for instance, share prices had climbed around 300 percent from November 2008 to May 2013.

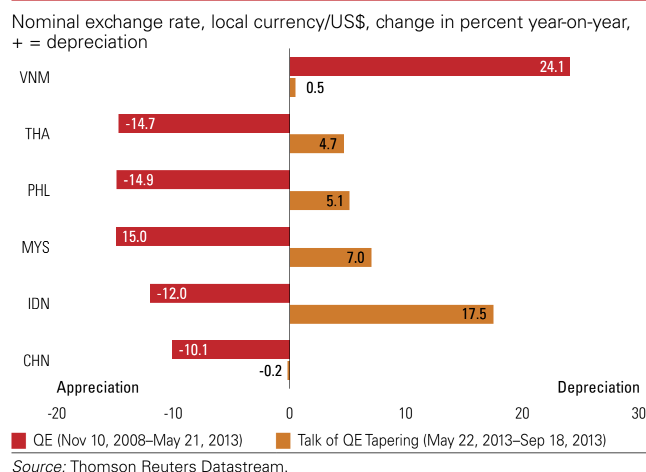
Since talk of QE tapering began in late May, exchange rates have unwound part of their recent appreciation. At the end of May, exchange rates in the region were 10 to 20 percent appreciated, in real effective terms, from their levels at the beginning of the global financial crisis (Figure 19). The paths taken by different currencies have varied, but most had appreciated since the start of the third round of quantitative easing by the United States in September last year. Part of that appreciation has been unwound since the start of the tapering talk (Figure 20). Currency appreciation in the past was considered to disadvantage developing East Asia economies because of their reliance on exports. The recent exchange rate depreciation could help to restore part of the lost competitive advantage. But it could also hurt unhedged foreign currency debtors in the region.

Figure 19. All major EAP currencies had appreciated since September 2008



Source: IMF.

Figure 20. The Indonesian rupiah has practically unwound its recent appreciation



Source: Thomson Reuters Datastream.

Fiscal and Monetary Policy: Measured Responses

Governments have eschewed large fiscal measures to support growth this year. In August, Indonesia offered fiscal incentives to promote foreign investment and help contain the current account deficit. The package includes tax deductions for export-oriented, labor-intensive industries, agriculture-based investment programs, and research and development activities. In July, China announced a set of fresh measures aimed at boosting growth that stand in marked contrast to the massive stimulus package of 2008–09. The new measures are limited and targeted: tax breaks for small businesses, reduced fees for exporters, and the opening up of the railway construction market to private participation. Vietnam, which recently amended its corporate income tax and value-added tax laws, decided to continue with its existing set of tax incentives for enterprises, despite their likely adverse effect on revenues. In January, the government announced deferrals of corporate and

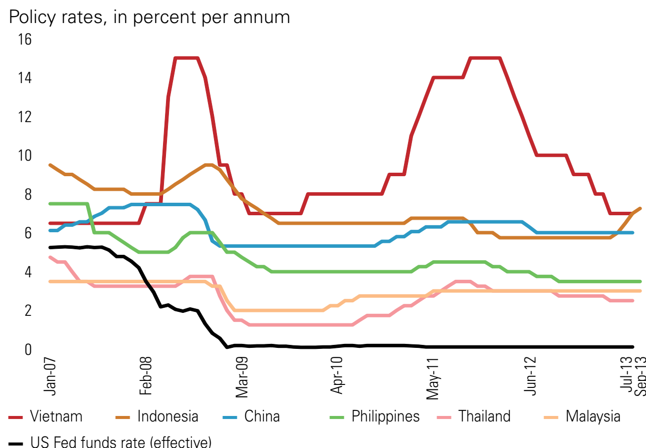
value-added taxes for SMEs, labor-intensive enterprises in selected sectors, enterprises engaged in the sale and leasing of houses, and enterprises that produce iron, steel, cement, and construction tiles. The National Assembly voted in June to cut the corporate income tax rate from 25 to 22 percent starting January 1, 2014 and to 20 percent from January 1, 2016 for most enterprises, with even lower rates for the small and medium enterprises.

Some countries have started to address issues involving fiscal sustainability. Notwithstanding political challenges ahead of the 2014 elections, the ruling coalition in Indonesia passed a revised 2013 budget raising prices on subsidized fuel—on petroleum by 44 percent and on diesel fuel by 22 percent—starting in late-June, while compensating low-income households with an Rp 3.0 trillion (US$273 million) cash transfer bill. The sizable increase in prices on subsidized fuel is a major reform and follows on the missed opportunity to adjust prices in 2012, when inflation was lower. The direct fiscal savings from the price hike is estimated at Rp 42 trillion (US$3.8 billion) in 2013, 0.4 percent of GDP, and Rp 85 trillion (US$7.7 billion) in 2014, 0.9 percent of GDP. In early September, Malaysia announced an immediate reduction in fuel subsidies by 10 percent, shaving RM 1.1 billion (US$343 million) off the subsidy bill, equivalent to 0.1 percent of GDP. More fiscal consolidation measures are expected, including the much anticipated goods and sales tax.

Indonesia was the first developing East Asian country to tighten monetary policy, and the only one thus far. The central bank raised the policy rate (BI rate) and the overnight deposit rate (Fasilitas Bank Indonesia, FASBI) by 25 basis points in June, 50 basis points in July, and 75 basis points in September (Figure 21). The tightening was aimed at curbing inflation, which topped 8.8 percent in August from 4.3 percent last year in the aftermath of fuel price increases, and defending the Indonesian rupiah, which depreciated 13.2 percent in August from end-December last year. Elsewhere, monetary policies remain accommodative. Thailand cut the overnight policy rate 25 basis points in May, triggered by the disappointing growth in the first quarter. Exports had borne the brunt of a stronger Thai baht, which appreciated 5.0 percent in the year through April, the month before the rate adjustment. Vietnam cut the policy rate 100 basis points in March and another 100 basis points in April. Credit growth has not been responsive to the rate cuts as both banks and SOEs remain burdened with balance sheet problems. The rest of the Central Banks in the region remain on hold (Figure 21 and Figure 22): Malaysia, for two years and five months now (since May 2011); China, a year and two months (since July 2012); and the Philippines, 11 months (since October 2012).

Figure 21. Most EAP countries have maintained accomodative policy rates

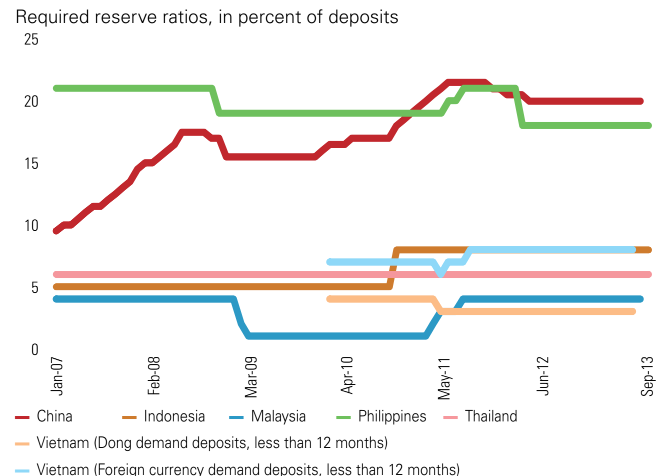
Policy rates, in percent per annum



Source: Haver Analytics.

Figure 22. China has kept bank-required reserve ratios elevated

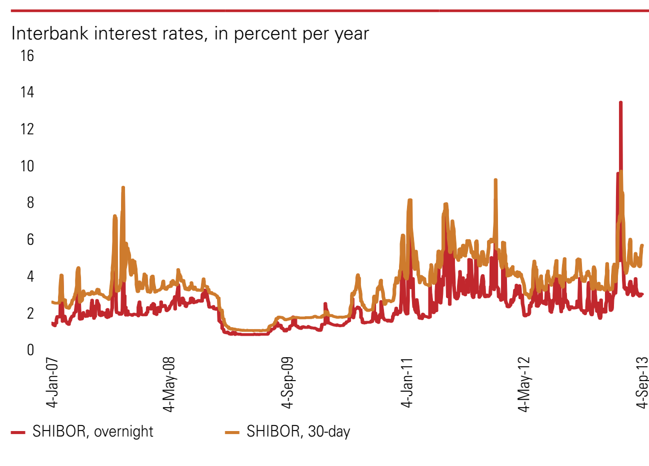
Required reserve ratios, in percent of deposits



Source: Haver Analytics.

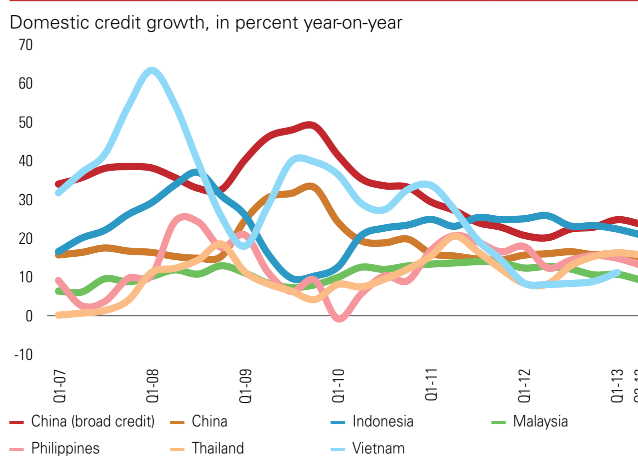
After a pickup mid-to-late last year, credit growth has moderated in several of the region's larger economies. A temporary liquidity squeeze in the interbank market in June provided China an opportunity to trim credit expansion, which had topped Y1.0 trillion (US$163 billion) in the first 10 days of that month alone. The Central Bank withheld liquidity support to signal official disapproval of poor liquidity management at medium and small banks, particularly those that had grown excessively reliant on interbank borrowing. The decision unsettled credit and asset markets: interbank and repo rates spiked (Figure 23), investors exited the stock market, and offshore fund managers sold Chinese assets. The central bank subsequently intervened to prevent a credit crunch that would have unduly affected small borrowers, providing liquidity support to select banks using reverse repo operations. The intervention slashed interbank rates, although to levels higher than before the liquidity crunch. The episode illustrates how difficult unwinding expansive monetary policy has become. Credit growth in China remained robust during August at 21 percent, but is expected to moderate in the rest of the year. Elsewhere, credit growth slowed in the second quarter in Indonesia, Malaysia, the Philippines and Thailand (Figure 24).

Figure 23. China interbank rates spiked in June 2013



Source: IMF, International Financial Statistics.

Figure 24. Domestic credit growth has trended downward, most notably in Vietnam, although it remains above 20 percent in China and Indonesia



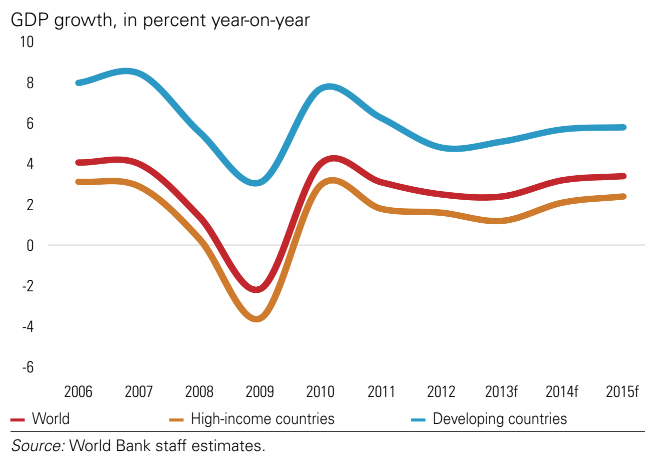
Source: CEIC.

The authorities in the region have employed macro-prudential measures to contain the risks arising from recent credit expansion. China followed up on measures begun since 2011 to curb private property investment, which had grown by more than 30 percent in the last two years. In March, the State Council imposed a 20 percent tax on profits from the resale of homes and announced credit controls on purchases of second residences. Recently, the authorities announced further curbs: a limit to one home purchase for single persons, an increase in the minimum down payment for second homes in Beijing, and an increase in the down payment for second homes in Shanghai. Lower loan-to-value ratios for vehicle loans and property mortgages remain in place in Indonesia. In July, Malaysia's central bank lowered the maximum term for personal loans from 25 to 10 years, and for property loans, from 45 to 35 years in a bid to hold down the rapid increase in household debt. Rising 12 percent per year over the last five year, a growth rate outpacing that of nominal GDP, household debt stood at 83 percent of GDP at the end of the first quarter, among the highest in developing East Asia. In the Philippines, the central bank has restricted trust funds from accessing the special deposit account (SDA), the central bank's tool to mop up excess liquidity, starting in November. Some ₱1.6 trillion (US$36.4 billion), 17 percent of GDP and about the same size as that of the money supply (M1), is in the SDA at end-August, funds that may flow into deposits and thereby increase the level of liquidity in the system.

I.B. Outlook and Risks

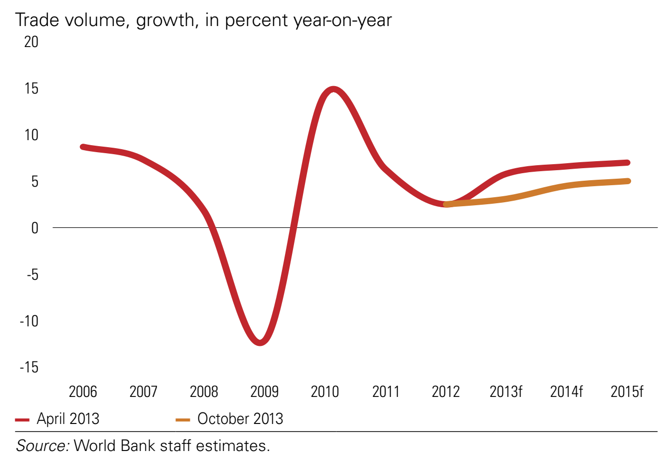
The global economy is broadly on track to meet growth expectations this year—2.4 percent, slightly lower than last year's 2.5 percent. The modest acceleration in growth among the advanced economies in the second quarter is expected to continue through the year. The gradual strengthening of quarterly growth in the high-income countries will show up in the whole-year growth of 2.1 percent in 2014 and 2.3 percent in 2015. Developing country growth is expected to improve from 4.8 percent this year to 5.3 percent in 2014 and 5.6 percent in 2015. The projections are broadly in line with underlying potential and will be supported by a gradual recovery in external demand from the high-income economies. Global growth should hit 3.1 percent in 2014 and 3.4 percent in 2015. Even then, the forecast global growth rates for 2014 and 2015 will remain below the pre-crisis growth rates of 4.0 percent in 2006 and 2007 (Figure 25). The comparatively modest recovery will be underpinned by a slower than expected upturn in global trade. Last April, we had forecasted a 5.8 percent expansion in global trade this year. At this time, seven months of data show that the likely annual growth rate in global trade will only be around 3.1 percent this year (Figure 26).

Figure 25. Global growth will pick up in 2014 and 2015, but remain modest



Source: World Bank staff estimates.

Figure 26. Global trade is also expected to expand albeit more slowly than previously expected



Source: World Bank staff estimates.

EAP Region Will Contribute the Most to Global Growth this Year

We are revising our earlier regional growth forecast (World Bank 2013a) for developing East Asia downward to 7.1 percent this year and 7.2 percent in 2014. Consistent with rebalancing objectives, growth in China is expected to ease to the official indicative target of 7.5 percent this year (Table 2). Previous projections had pinned greater weight on the effect of credit on investment than warranted by recent findings on the declining growth efficiency of both credit and investment (see Part II). The 7.5 percent growth rate for the year would still mean more robust growth in the second half of the year compared to the first, which would carry over in next year's projection of 7.7 percent. Adjusting to weaker terms of trade and tighter financial conditions, Indonesia's growth rate will moderate this year. The adjustment will carry into next year, when growth is

Table 2. East Asia and Pacific: GDP Growth Projections

percent change from a year earlier

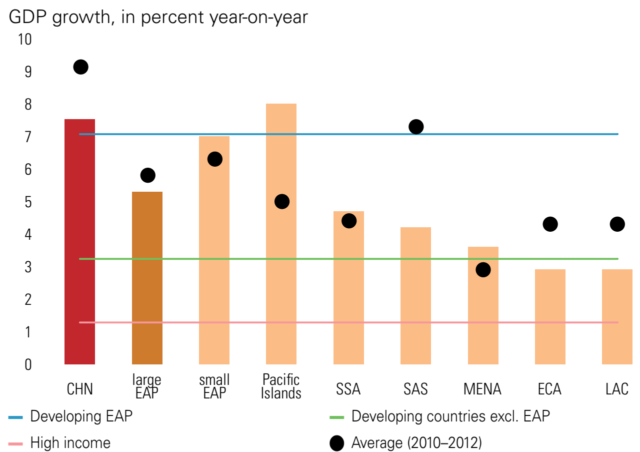
			Forecast	Forecast	Forecast	Changes from Apr-13* (in percentage points)	
	2011	**2012**	**2013**	**2014**	**2015**	**2013**	**2014**
East Asia	7.1	5.9	6.0	6.4	6.4	-0.5	-0.3
Developing East Asia	8.3	7.5	7.1	7.2	7.2	-0.7	-0.4
China	9.3	7.8	7.5	7.7	7.5	-0.8	-0.3
Indonesia	6.5	6.2	5.6	5.3	5.8	-0.6	-1.2
Malaysia	5.1	5.6	4.3	4.8	4.8	-0.8	-0.6
Philippines	3.6	6.8	7.0	6.7	6.8	0.8	0.3
Thailand	0.1	6.5	4.0	4.5	5.0	-1.3	-0.5
Vietnam	6.2	5.2	5.3	5.4	5.4	0.1	-0.3
Cambodia	7.1	7.3	7.0	7.0	7.0	0.0	-0.2
Fiji	1.9	2.3	2.4	2.1	2.2	0.2	-0.2
Lao PDR	8.0	8.2	8.0	7.7	8.1	0.4	0.0
Mongolia	17.5	12.4	12.5	10.3	10.0	-0.5	-1.2
Myanmar	5.9	6.5	6.8	6.9	6.9	0.3	0.3
Papua New Guinea	10.7	8.7	4.5	10.0	20.0	0.5	2.5
Solomon Islands	10.7	4.8	4.0	3.5	3.7	0.0	-0.5
Timor-Leste	10.8	10.6	10.4	10.2	11.5	0.0	0.0
Developing East Asia excluding China	4.6	6.2	5.2	5.3	5.7	-0.5	-0.7
ASEAN	4.7	5.6	5.1	5.1	5.4	-0.3	-0.6
Assumptions about the external environment:							
World	3.1	2.5	2.3	3.1	3.4	0.0	0.7
High-income countries	1.8	1.6	1.3	2.1	2.3	0.0	0.6
Developing countries	6.3	4.7	4.8	5.3	5.6	-0.3	-0.2

Source: World Bank data and staff estimates.
*World Bank, "East Asia and Pacific Economic Update: A Fine Balance", April 2013.

projected to be more than 1 percentage point weaker than previously forecast, on more modest investment. The largest downward adjustment is for Thailand, which entered into technical recession in the second quarter. But growth during the second-half of 2013 is expected to improve due to strong revival in exports and robust private consumption. Weak performance in the first half of the year, underpinned by poor exports, will drag down growth this year in Malaysia, developing East Asia's most export-intensive economy. Fiscal consolidation and delays in public investment will keep growth lower than previously forecast in 2014. Vietnam is roughly on track to grow modestly this year. Growth will remain sluggish next year, with gains in macroeconomic stabilization still fragile and subject to several downside risks including more activist policies that, if pursued, are bound to stoke inflationary pressures and undermine stability gains. In contrast, the Philippines is expected to maintain its growth momentum into the near to medium term, spurred by strong private consumption, itself growing on the back of healthy remittances and a heady business process outsourcing (BPO) industry, as well as by a planned doubling of public infrastructure spending by 2016. We are revising baseline growth projections upward in 2013 and in 2014. We expect growth to further accelerate in 2015, with most EAP economies growing at the same or a modestly higher rate in 2015 compared to their 2014 levels. While expanding more slowly than our previous forecast, developing East Asia will continue to lead other regions (Figure 27) and contribute the most to global growth this year (Figure 28).

The growth outlook for the region's smaller economies is generally more encouraging. We are maintaining the forecast for Cambodia for 2013. Increases in rice production, an acceleration of garment exports, and more tourist arrivals will keep growth strong this year. Growth will be higher in Lao PDR this year than originally

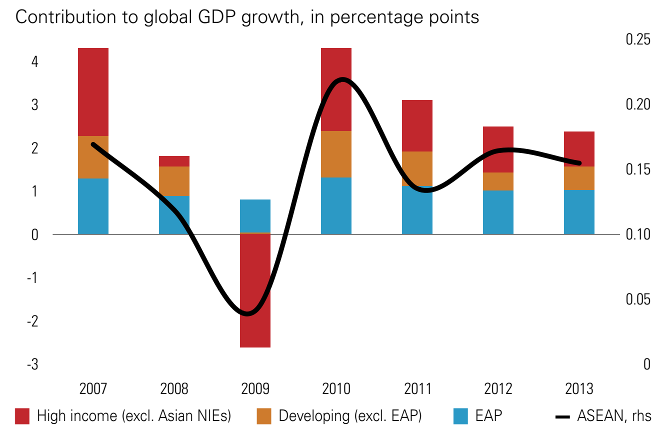
Figure 27. Developing EAP will still lead high-income and all developing regions this year…



Source: World Bank data and staff estimates.

Note: Excluding China, the other large developing EAP countries are Indonesia, Malaysia, the Philippines, and Thailand. The small countries are Cambodia, Lao PDR, Mongolia, Myanmar, Timor-Leste, and Vietnam.

Figure 28. …and account for 40 percent of global growth, about the same proportion as last year



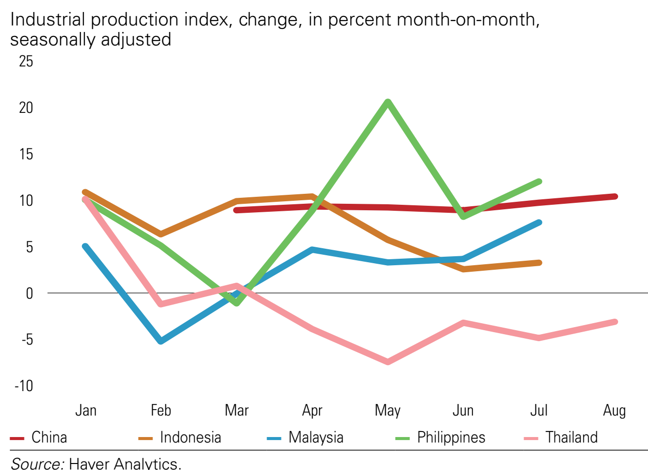
Source: World Bank data and staff estimates.

expected, based on upwardly revised data on cement and hydropower production. The development and completion of several large projects will keep the contribution of the hydropower sector to growth robust through the near term. An extraordinary expansion of construction and strong agricultural production will support growth to double digits again in Mongolia this year. Public infrastructure investment will progress further with ready financing from the proceeds of last year's global bond issue, keeping growth also high next year. Growth is expected to be another half a percentage point higher this year than last in Myanmar. Foreign investment has been strong, including in energy, garments, and food and beverages. In Timor-Leste, prospects have not changed from April—growth will be slightly more moderate this year compared to last year. Lower agricultural production, hurt by a prolonged rainy season, and slower budget execution, due in part to a late budget approval and a longer adjustment period for the new government, are negative factors.

In the Pacific Islands, the near-term prospects continue to be mixed, as they have historically been for these small, geographically isolated countries subject to numerous shocks including natural disasters. Post-cyclone reconstruction will provide a boost to growth in Fiji next year, as will additional investment in tourism and mining. In contrast, sugar production, currently half that from six years ago, will remain sluggish, keeping growth modest in 2014 and 2015. The near-completion of the huge US$19 billion LNG Project in Papua New Guinea sets the stage for a sharp rise in the level of aggregate GDP in 2014 and especially in 2015 as gas exports commence. However, the drawdown of project construction activity will put pressure on employment and incomes and amplify the effects on domestic demand of already weak global commodity prices, generating minimal growth in non-resource GDP. Growth will be lower than previously forecast in the Solomon Islands in 2014 and 2015. Slower output and revenue growth and tighter financing conditions underlie growth forecasts in the near term.

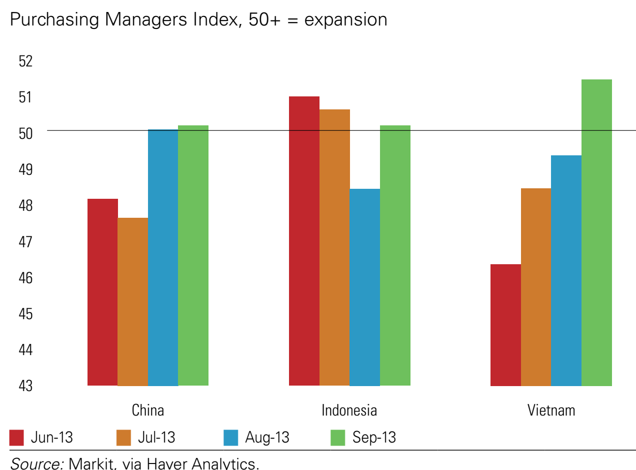
In general, for the larger economies, the projections for 2013 are predicated on improvements in the second half of the year over the first. The expected uptrend will carry over into higher growth in 2014 (except in Indonesia, where the recovery will come in 2015). Early data for the third quarter lends some support to this view, at least for China. Industrial production surprised on the upside in July and August compared to June (Figure 29). The Purchasing Managers Index (PMI), a leading indicator, returned to levels signaling expansion

Figure 29. Industrial production improved in China in July and August



Source: Haver Analytics.

Figure 30. The PMI advanced above 50 in China in August and September, and in Indonesia and Vietnam in September, indicating a recovery in manufacturing



Source: Markit, via Haver Analytics.

in August (Figure 30). In the ASEAN countries, the picture is rather mixed. Industrial production cycled up in Malaysia and the Philippines, but remained subdued in Indonesia in July.

Headline Risks Are On the Downside

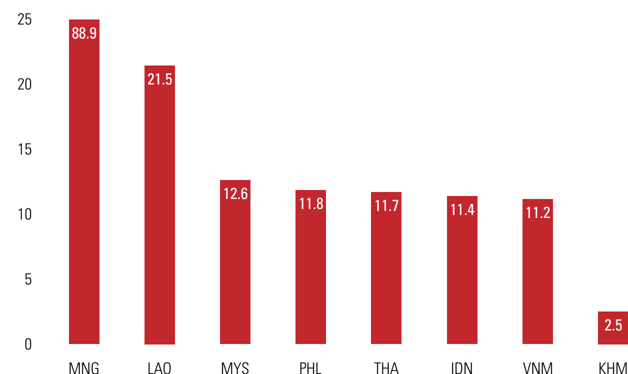
While the balance of risks to our base case regional forecast lies on the downside, recent strengthening of global production and the trade cycle could serve as a mitigating factor. Among the headline risks, a sharper than expected slowdown of investment in China will have an adverse impact on the EAP region, particularly on suppliers of capital goods and industrial raw materials to China. Also, as early evidence shows, a tapering of the exceptional U.S. monetary policy response to the global financial crisis will, through reduced capital flows and higher interest rates, affect real activity in many economies in the region. These risks will, to some extent, be offset by the improving global trade situation and depreciated currencies in several EAP countries.

A greater than expected slowdown of investment in China would adversely affect the suppliers of capital goods and industrial raw materials that have benefited from China's industrial expansion, infrastructure spending, and real estate development. Restructuring an economy as enormous and diverse as China is inherently complex and difficult. Our base case scenario assumes that the transition away from an export- and investment-led growth pattern and to a consumer- and services-based growth path will be gradual and orderly. However, because rebalancing involves the reversal of long-standing policies (low interest rates for manufacturers, state-owned enterprises, and property developers, for instance) that have successfully underpinned growth over three decades, the adjustment could be sharp and disorderly. An abrupt reduction in investment would drag down growth because of the large share of investment in output and the limits to which consumption could rise high enough and fast enough to offset the downturn. The ensuing slowdown would have global consequences because China's investment boom has helped make up for part of the shortage in demand from advanced economies since the global financial crisis, benefiting both producers of capital goods and suppliers of industrial raw materials.

A slower-growing China will affect commodity exporters the most. We had previously estimated that a sharp 5 percentage point decline in Chinese investment growth would cut GDP growth in China by 1.4 percent and in the EAP region by 0.6 percent (World Bank 2013b). More recent analyses (Ahuja and Nabar 2012; IMF 2012a, 2012b) show finer nuances: (i) that the growth effects on top global producers of capital goods (including Germany, Japan, and Korea) will be small but nontrivial; (ii) countries with strong supply chain links with China, including those in Asia (Korea and Malaysia) will also be affected including under second- and third-round effects; and (iii) in contrast to more diversified resource exporters (for example, Brazil and Canada), commodity suppliers with less well-diversified economies and with a disproportionate reliance on China for exports will be the most vulnerable.[11] Several EAP countries count in this third category, principally Mongolia and Lao PDR (Figure 31 and Figure 32).

Figure 31. Mongolia and Lao PDR are most exposed to a slowdown in China…

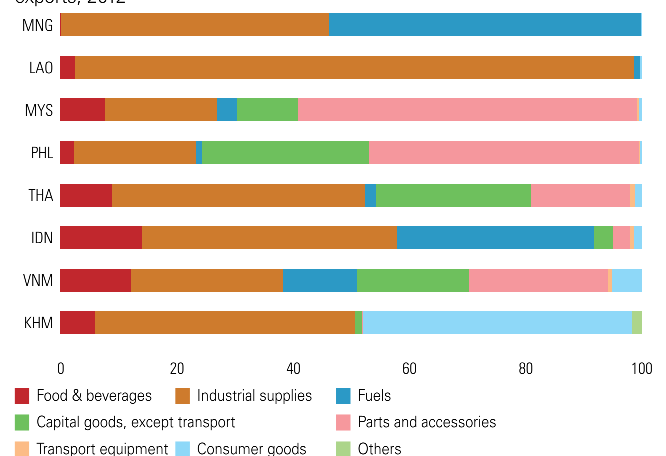
Exports to China, in percent of total country exports, 2012



Source: IMF, Direction of Trade Statistics (DOTS).

Figure 32. …considering they ship mostly industrial raw materials that feed on China's investment boom

Exports to China by economic classification, in percent of total country exports, 2012



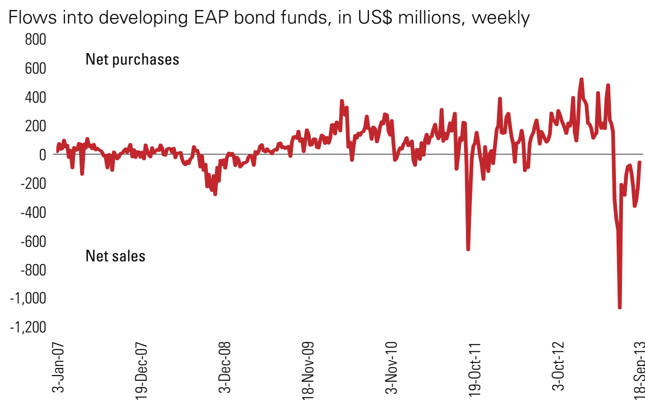
Sources: UNCTAD, COMTRADE.

Although the normalization of monetary policy in the United States should ultimately benefit developing countries, the adjustment could be disruptive. The withdrawal of extraordinary monetary stimulus in the United States will reduce liquidity in the global economy; more normal capital flows will ease appreciation pressures on emerging market currencies. The withdrawal of monetary stimulus will also signify a firm recovery in the United States, benefiting countries integrated in trade and finance with the world's largest economy. The adjustment, however, can turn out to be disruptive, as shown by the recent volatility in the financial markets of many developing countries at the time when tapering of QE became more likely (Figure 33). Since the U.S. Federal Reserve first signaled its intent to gradually withdraw monetary stimulus, interest rates have risen, portfolio flows have reversed, and asset prices have taken a fall in EAP and in other developing areas. Although the postponement of tapering in September brought some relief, volatility in financial markets is likely to persist for some time to come. Developing economies have recently proposed international monetary policy coordination, but the idea has been rebuffed by the United States and other advanced economy central banks, which contend that the conduct of domestic policy should be independent of its foreign effects.

11 See IMF 2012a and IMF 2012b.

Figure 33. Foreign investors have sold EAP bonds since late May

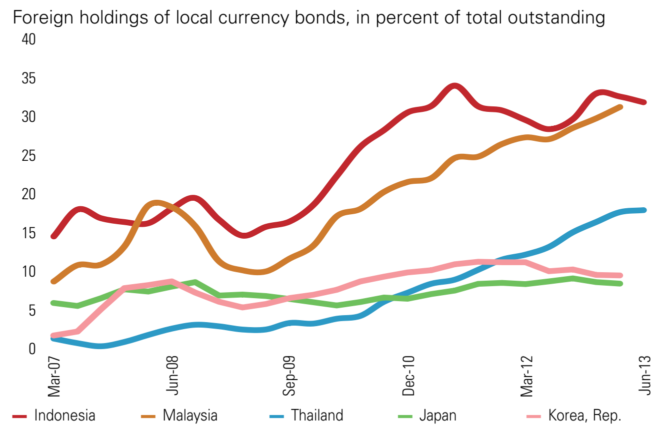
Flows into developing EAP bond funds, in US$ millions, weekly



Source: EPFR Global, via Haver Analytics.

Figure 34. Foreign holdings of local bonds are larger in Indonesia, Malaysia, and Thailand than in Japan or Korea

Foreign holdings of local currency bonds, in percent of total outstanding



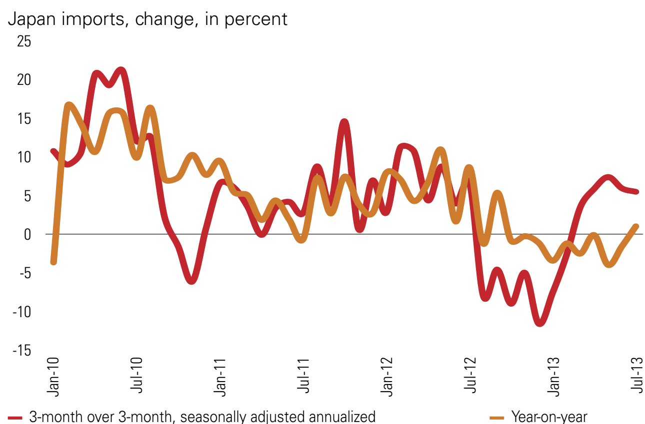
Source: ADB, Asian Bonds Online.

The countries in the region reporting comparatively larger fund withdrawals have had comparatively larger foreign participation in their financial markets (Figure 34), putting them at risk of further volatility. They have also had either large current account deficits (Indonesia) or sharp credit expansions (Thailand and Malaysia). Economic imbalances and financial vulnerabilities put these economies at risk of a tightening of global financial conditions. Capital outflows and increases in long-term rates have real economic consequences. Higher interest rates, for one, may hurt fixed investment, and consequently, potential growth. In Part II of this volume, we document the impact of quantitative easing on the region, track the recent turbulence in financial markets, and assess the vulnerability of the region's economies to the risks posed by the withdrawal of U.S. monetary stimulus.

Progress in Japan's reflation efforts may provide an upside to our base case growth forecasts for the region… Efforts to boost money supply and to expand government spending have helped to strengthen consumption and lift growth in Japan in the first half of the year. Whether the impact of this round of extraordinary monetary and fiscal stimulus can be sustained in the long run depends crucially on progress in the "third arrow" of the turnaround plan—growth-promoting structural reforms. Detailed reform proposals are expected in the

Figure 35. Japanese imports from developing EAP have started to improve

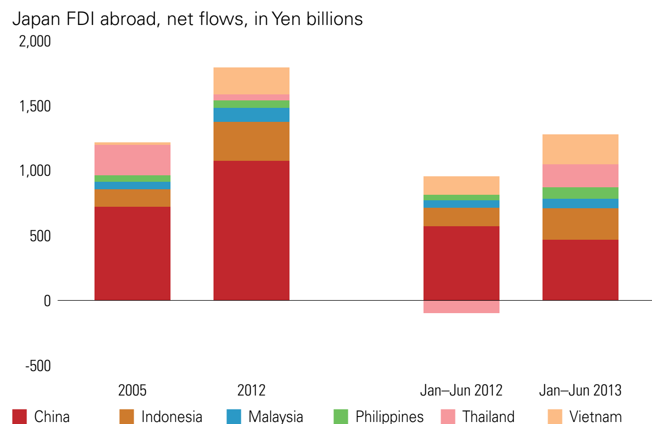
Japan imports, change, in percent



Source: IMF, Direction of Trade Statistics.

Figure 36. Japanese FDI to developing EAP, including to Thailand, revived in the first half of this year

Japan FDI abroad, net flows, in Yen billions



Sources: Japan External Trade Organization (JETRO) and Japan Ministry of Finance.

third quarter this year. Implementation of the consumption tax hike in 2014, a critical reform to ensure fiscal sustainability, is scheduled in the fourth quarter. So far, monetary expansion has weakened the yen 20 percent in real effective terms since September last year. Gains by Japanese exporters in third-country markets are expected to benefit East Asian suppliers of parts and components in regional production networks (World Bank 2013c). Recent data on Japanese exports and imports, including imports from the region, are starting to improve (Figure 35).

...Including through more Japanese FDI. Japanese FDI to the region was 47 percent higher in 2012 than in 2005, despite a reversal of flows from Thailand because of the effects of the 2011 floods. In addition, FDI rose another 49 percent in January to June in 2013 over the same period a year ago (Figure 36). Specifically, positive flows returned to Thailand, at a rate twice the outflows a year ago. Expectations of an even weaker yen is encouraging Japanese companies to invest more, which should have positive spillover effects on EAP countries with strong trade and investment ties with Japan. The ability of the developing East Asian economies to gain from these developments will, in large measure, depend on their own structural reforms, which should solidify their FDI pull factors.

I.C. Policy Considerations

As the global growth cycle undergoes change, adjustments to fiscal and monetary policy are needed in many EAP countries. In the East Asia and Pacific region, as in other developing areas that countered the global financial crisis with stimulus measures, adjustments to policy are needed to address the vulnerabilities that have built up since the crisis and from the expansive fiscal and monetary responses to the crisis. But while necessary in the short run, these adjustments will not, by themselves, be sufficient to lift potential output in the medium and long term. Complementary structural reforms will provide the foundation for sustainable and equitable growth going forward.

Fiscal Policy: Rebuilding Buffers

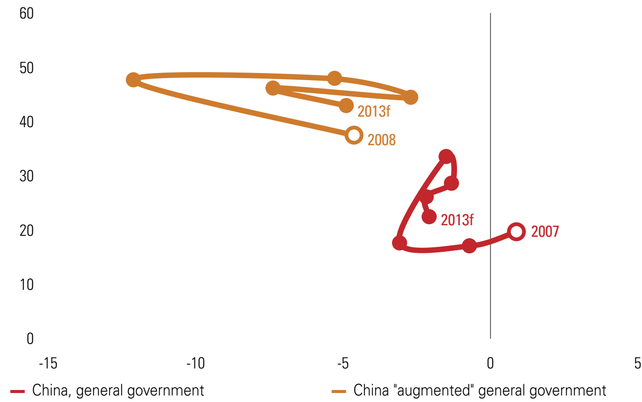
Governments in the region generally have to address fiscal risks, rebuild policy buffers, and create fiscal space, including the space necessary to spend in support of long-term growth objectives. In Vietnam, public finances have come under stress in recent years from slower growth, lower revenue buoyancy, and stimulus spending. The government will need to find savings from recurrent spending to bolster fiscal buffers. In China, the fiscal space is considerably more limited than official data suggest. The "augmented" general government deficit and debt measures, which account for off-budget funding and quasi-fiscal activity of local governments, are considerably higher than conventional measures of general government deficit and debt (Figure 37). Even the higher "augmented" measures remain modest, especially the augmented debt-to-GDP ratio. Nevertheless, unwinding off-budget and quasi-fiscal activity is desirable—not least because off-budget borrowing is more expensive than on-budget borrowing. Henceforth, China should consider an on-budget stimulus, focused on consumption, in response to any sharp downturn in economic activity. In the Philippines, the government needs to create the fiscal space for infrastructure and social spending. A broadening of the tax base, improvements in tax compliance, and reductions in exemptions will aid the effort. The recently approved sin tax reform is a step in the right direction, but more needs to be done to get revenues at the desirable level of nearly 20 percent of GDP.

The reform of subsidy systems, particularly of energy subsidies, is a challenge for several countries and remains integral to fiscal consolidation. Although aimed at protecting consumers, subsidies often aggravate fiscal imbalances, crowd out priority public spending, and depress private investment (IMF 2013b).[12] In Indonesia, the June fuel subsidy cut was an important step, but its beneficial impact has already been dampened by a weaker Indonesian rupiah, and energy subsidies remain high. Therefore, there continues to be a strong case for building on the recent reforms by increasing the flexibility of subsidized prices and aligning them more with market prices. In Malaysia, the recent cut in fuel subsidies will need to be followed by medium-term fiscal measures to make a significant dent in federal government debt, which increased from 40 percent of

12 Energy subsidies are pervasive globally and impose fiscal and economic costs on most regions. On a pretax basis, energy subsidies amounted to 0.2 percent of global GDP or 2.0 percent of total government revenues for 176 countries in 2011. On a post-tax basis, which accounts for the negative externalities from energy consumption, the subsidies are much larger, reaching 2.9 percent of global GDP or 8.5 percent of total government revenues. The cost of the subsidies is particularly large for oil exporters: they account for two-thirds of the global pretax total and one-third of the global post-tax total.

Figure 37. China's fiscal position is less favorable, when the quasi-fiscal activities of local governments are accounted for

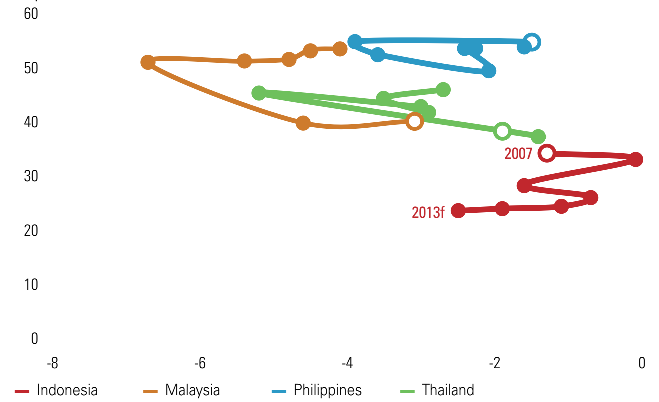
General government balance, and General government debt, in percent of GDP, 2007–13



Source: IMF 2013a.
Note: Data for 2013 are forecasts.

Figure 38. Medium-term fiscal consolidation, including fuel subsidy reform, will help Malaysia control government debt

Central/general government balance, and Central/general government debt, in percent of GDP, 2007–13



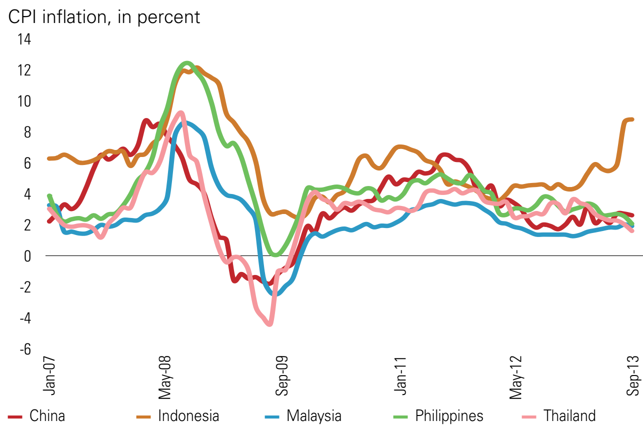
Source: World Bank data and staff estimates.
Note: Data for 2013 are forecasts.

GDP in 2008 to 53 percent in 2012 (Figure 38). The government is working on replacing universal fuel subsidies with cash transfers, but it is critical that these be targeted at the neediest to support fiscal sustainability. The rice subsidy program in Thailand, which intends to shore up rural incomes through higher support prices, will have to be financed either through loans by the Government or the release of stockpiles; the latter could lead to lower rice prices.

Monetary Policy: Unwinding Stimulus

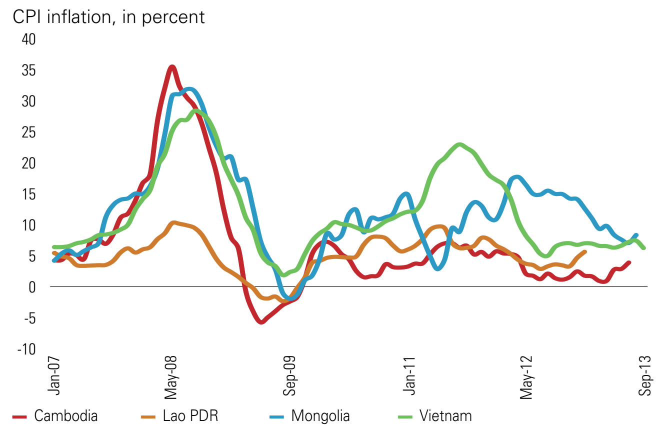
The authorities in the region should be ready to respond to a rise in interest rates in the advanced economies. With policy rates steady for extended periods, central banks have the room to respond to potential capital outflows or foreign exchange pressures by raising policy rates. Indonesia hiked rates in June and July as headline inflation reached 5.9 and 8.6 percent (Figure 39). Inflation rose to 8.8 percent in August, triggering another rate hike in September, and may rise further in the fourth quarter, largely reflecting the fuel price hike in July. Elsewhere, subdued inflation continues to support monetary policy accommodation. In China, headline inflation remained flat at 2.6 percent in August, well below the government's target of 3.5 percent. Forecasts for 2013 put the number at 2.7 percent. More modest food prices and stable fuel prices kept headline inflation in Malaysia at 2 percent in July. The recent reduction in fuel subsidies, pickup in external demand starting in the second half of 2013, and base effects will add to inflation risk next year, with the headline rate possibly reaching 3.2 percent in 2014. Similarly, lower commodity, particularly food, prices kept headline inflation in the Philippines at 2.8 percent through August, below the target range of 3 to 5 percent. Impending electricity price adjustments and outflows from the SDA will contribute to higher inflation next year, and the headline rate could reach 4 percent in 2014. Vietnam has successfully curbed its persistently high inflation rates, with headline inflation declining to 7.3 percent in July 2013, from 23.0 percent in August 2011 (Figure 40). Projections are for a 7.4 percent inflation rate in 2014.

Figure 39. Facing higher inflation, Indonesia hiked rates starting in June



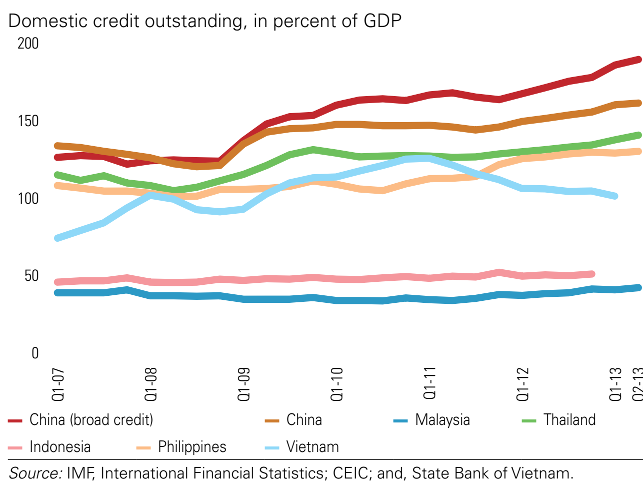
Source: Haver Analytics.

Figure 40. Headline inflation has trended downward in Vietnam and the region's smaller economies



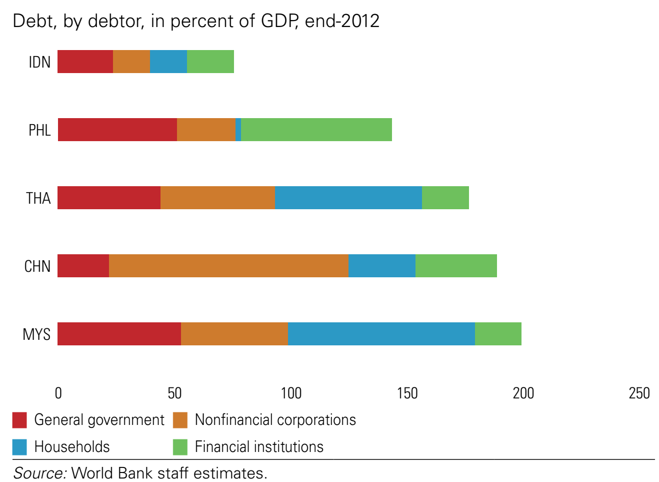
Source: Haver Analytics.

Figure 41. Several EAP countries have seen rapid growth in credit in recent year



Source: IMF, International Financial Statistics; CEIC; and, State Bank of Vietnam.

Figure 42. Household debt is largest, in percent of GDP, in Malaysia and Thailand



Source: World Bank staff estimates.

Central banks and financial sector supervisors must redouble their efforts to maintain financial stability. While credit growth has slowed in most of the region's larger economies, the massive credit creation in response to the global economic crisis has built up vulnerabilities in the financial system and raised the risks to financial stability. In China, where the stock of broad credit (Total Social Financing) has increased by 60 percentage points of GDP in the five-year period from 2008 to 2012 (Figure 41), almost a third of all credit has originated from the shadow banking system, the less well-regulated and supervised part of the financial system. Recently China created a "financial regulatory inter-ministerial joint conference system" to better manage and coordinate regulatory policies across the financial system. In Malaysia, where household debt has exceeded 80 percent of GDP (Figure 42), recent measures to tighten personal and property lending may be followed by further increases in the real property gains tax to further temper credit growth. In Thailand, household debt now exceeds 60 percent of GDP, largely as a result of expansive policies following the 2011 floods. As the United States normalizes monetary policy and global interest starts to rise, these debts may be harder to service (see Part II for an assessment).

Exchange Rate Policy: Maintaining Flexibility

Flexible exchange rates offer developing East Asia better protection against external shocks, and greater monetary policy independence. The developing EAP economies have commonly and frequently relied on foreign reserve accumulation to resist appreciation pressures on their currencies, including during the wave of capital inflows associated with the expansion of global liquidity following the global financial crisis. The developing EAP economies, however, have allowed relatively greater movement in their currencies in response to depreciation pressures. In principle, policy makers should allow exchange rates to respond to changing fundamentals. At the same time, if they need to guard against risks of disorderly adjustment, they may reasonably resort to intervention to smooth excessive exchange rate volatility. They may also encourage financial market participants to use hedging tools to address foreign exchange volatility risk.

EAP economies face several policy options if the U.S. Federal Reserve decides to taper its QE program. Some of the preventive measures include reducing excessive reliance on short-term and foreign-currency-denominated debt and building policy buffers to respond to changing global liquidity conditions. Once tapering is announced, the appropriate response will involve a mix of exchange-rate depreciation and higher interest rates, so as to strengthen current account balances, maintain capital inflows, and avoid domestic overheating. The appropriate combination will depend on the economy's starting position, including the level of economic activity, inflation, and the degree of exposure to foreign-currency-denominated liabilities. In addition, some intervention in foreign exchange markets, running down reserves, may help moderate excessive exchange-rate volatility or short-term liquidity pressures.

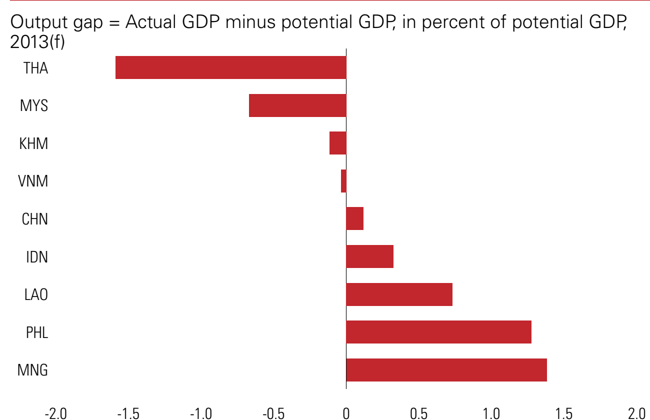
Structural Reforms: The Key to Future Growth

With growth running at or near potential level this year and next for most countries in the region, subsequent progress at upgrading growth and tackling poverty depends crucially on structural reforms. Countries need to pursue reforms that expand the productive capacity of their economies and afford their populations the opportunity to share in the gains of progress. Structural reforms are of primary importance at this stage for three reasons. First, closed or narrowing output gaps (Figure 43 and Figure 44) mean that further acceleration of growth cannot be realized without the expansion of capacity and gains in productivity. The reform agenda in many countries in the region is well understood, but the urgency of the reforms was overshadowed by the need to respond to the global financial crisis. Second, a nascent global upturn from the lingering effects of the financial crisis, led by firmer growth in the United States, affords most countries in the world and in the region the opportunity to rekindle reforms in a way that enables them to benefit from the recovery in the high-income economies and to put their own growth on a more solid footing and sustainable path. And third, the current political setting is conducive to further reforms in many countries in the region. The governments in China and Cambodia are new, the ruling coalition in Malaysia has won a fresh electoral mandate, and the administration in the Philippines is riding a high wave of popularity at midterm. The opportunity presents itself to expend political capital on reforms with solid returns.

In China, the government aims to transition to a new growth model that is less credit-dependent, less investment-driven, and more efficient, sustainable, and inclusive. Since the global financial crisis, China

Figure 43. Most of developing EAP is growing at or near potential this year…

Output gap = Actual GDP minus potential GDP, in percent of potential GDP, 2013(f)

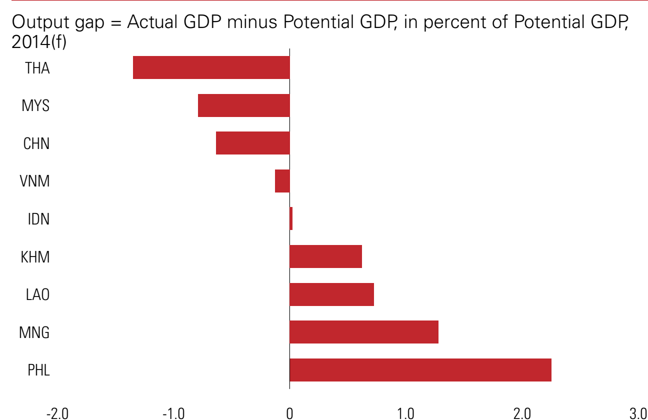


Source: World Bank staff estimates.

Note: Potential output is defined as the trend growth in productive capacity of the economy, that is, it is estimated level of output attained when the entirety of the capital stock and effective labor supply is employed.

Figure 44. …and next year

Output gap = Actual GDP minus Potential GDP, in percent of Potential GDP, 2014(f)



Source: World Bank staff estimates.

Note: Potential output is defined as the trend growth in productive capacity of the economy, that is, it is estimated level of output attained when the entirety of the capital stock and effective labor supply is employed.

has made substantial progress in structuring a less export-dependent economy. It has remained resilient during and since the global financial crisis by embarking on a credit-supported investment-led stimulus program. However, the strategy is reaching its limits with a buildup of vulnerabilities and risks in the bank and nonbank financial sectors and in local government finances. In Part II of this report, we document the deterioration in the efficiency of credit use and the decline in the productivity of investment since China embarked on a rapid credit expansion five years ago. The structural reforms needed to address these challenges rebalance demand from investment-led to consumption-based growth are fundamentally difficult. The Central Committee of the Chinese Communist Party is expected to approve new economic policies during its forthcoming Plenum later this year. In this regard, it is likely that the authorities will consider reforms to the country's urbanization strategy, land management, and residency (hukou) system. Reform of the financial system is also on the agenda so as to ensure that capital is allocated to its most productive uses. Finally, China is contemplating reforming local government finance, devolving more tax powers to lower-level governments, and restructuring local government debt.

Among the region's large middle-income countries, the enduring challenge is to raise investment in human and physical capital and to improve productivity. Indonesia needs a more open trade and investment regime and greater regulatory certainty, and the Philippines needs to enhance domestic competition and relax limits on foreign ownership—in order for both economies to catalyze private investment. In Thailand, an appropriate medium-term fiscal framework should further strengthen investor confidence. Investment in infrastructure is crucial in all of these economies. In Thailand, investment projects in the transportation sector should raise economy-wide productivity. The same priority holds for Indonesia, where improvements in connectivity and freight logistics, including hard and soft infrastructure investment, should help address supply bottlenecks. In the Philippines, infrastructure is generally poor in a wide range of sectors, from energy to transportation, and well-planned and well-executed public-private partnerships should help alleviate the deficiencies. Investment in human capital is as much a necessity, because it not only serves to raise productivity but also helps address the challenges of equity and inclusiveness. Indonesia needs to improve worker skills to raise the capacity of the economy to innovate. In Malaysia, the authorities continue to implement an "economic transformation program" aimed at raising Malaysia to high-income status by 2020. While progress in some areas of the structural reform agenda has been uneven (for example, a proposed new civil service pay scheme has been scrapped and the

minimum wage for foreign workers and certain firms has been delayed to 2014), key improvements have been made in revenue collection, and measures have been taken to increase women's labor force participation. In the Philippines, despite strong economic performance over the last decade, the benefits of growth have yet to spread to the broader population, with unemployment stuck at around 7 percent and poverty stubbornly elevated. Expanded coverage of public health care, conditional cash transfers, and longer compulsory schooling should help address basic needs and support a more productive workforce.

The Pacific Island countries share several structural reform priorities. Papua New Guinea and Timor-Leste face similar challenges in promoting growth outside the extractive sector. Priorities for Papua New Guinea and Timor-Leste include realizing agricultural potential through complementary investments in extension services or marketing, and investments in efficient public services to reduce the very high operating costs facing investors. In Timor-Leste, the government is preparing critical legislation to enable formal land management and usage rights. For the smaller Pacific Island countries, mitigating the impacts of inevitable exogenous shocks will, depending on the country, require accumulation of fiscal buffers, better design, and improved targeting of social protection mechanisms and measures to strengthen disaster risk reduction. Continued investment in human capital through strengthened public health and education systems will support higher living standards and increased access of Pacific workers to larger regional labor markets. Improved management of natural resources, including fisheries and forests, is a priority, with strengthened regulatory frameworks necessary to increase revenues and ensure sustainable management of stocks. Targeted improvement in infrastructure and the business environment has the potential to spur increased tourism investment in some cases.

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Part II. Selected Emerging Issues

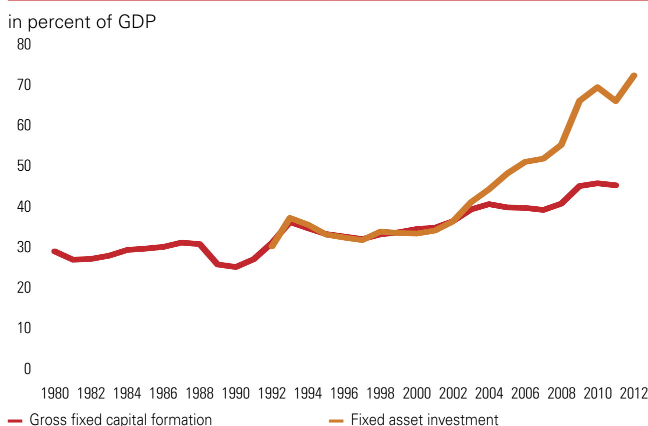
II.A. China's Credit Boom May Have Run Its Course[1]

China responded to the global financial crisis with a massive, investment-heavy stimulus program, supported by a vast credit expansion. The growth it triggered does not appear sustainable over the long term. Massive new lending in recent years has raised debt in all sectors of the economy, posing some risks to financial stability. The rapid expansion of shadow banking poses serious challenges, since shadow banking is closely linked to the banking system, is less regulated, and operates with implicit guarantees from banks and local governments. The rise in local government debt is also a concern, given the complexity and opacity of municipal finances. Policy action should focus on three key areas: containing the rapid growth of credit in the economy and tightening financial supervision; rationalizing municipal finance; and broadening and deepening financial sector reforms.

Investment, Credit, and Shadow Banking: The Nexus

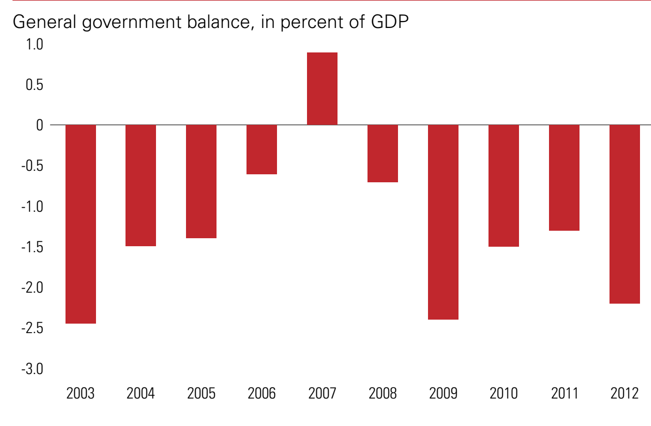
China responded to the global financial crisis with a massive, investment-heavy stimulus program. Investment had grown steadily in China, rising from under 30 percent of GDP in 1980 to nearly 40 percent of GDP in 2005, and accounting for two-fifths of the average 10 percent GDP growth over the period. But the stimulus program, amounting to 12 percent of GDP over three years, provided further impetus to investment: between 2007 and 2009, gross fixed capital formation rose from 39 to 45 percent of GDP, and fixed asset investment (FAI)[2] from 52 to 66 percent of GDP (Figure 1). The government budget's contribution to the stimulus program

Figure 1. Investment spending accelerated in response to the crisis



Source: CEIC and Haver Analytics.

Figure 2. The central government limited fiscal support for the stimulus



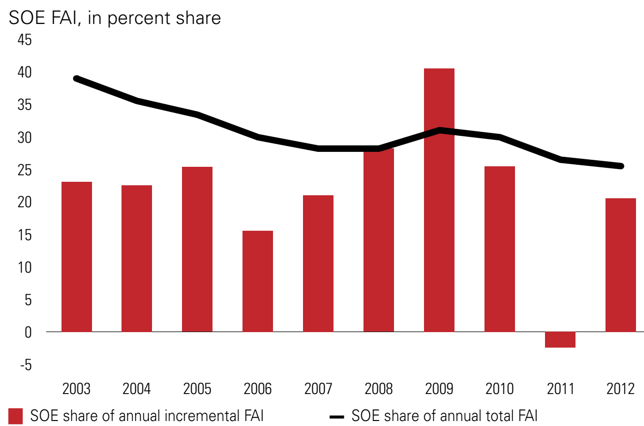
Source: IMF

1 This note was prepared by Tony Ollero, with contributions from Roberto Rocha, Karlis Smits, and Jun Wang.

2 FAI is a much broader concept and measure of investment than gross fixed capital formation (GFCF). Used in official national accounts, GFCF corresponds to the concept of gross capital formation and represents the acquisition of fixed assets as well as additions to the value of nonproduced assets. China's FAI, however, includes land sales and purchases of used capital, both of which are excluded from GFCF because they represent the transfer of assets rather than the creation of new capital.

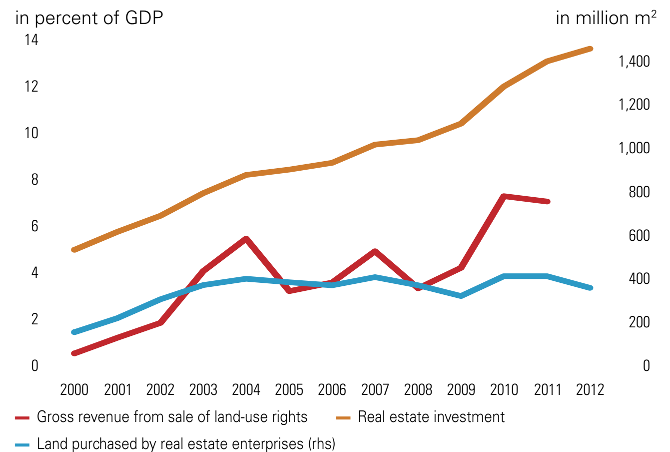
was modest: focusing on countercyclical infrastructure spending, a fiscal surplus of 0.9 percent of GDP in 2007 turned into a deficit of 2.4 percent of GDP in 2009 and 1.5 percent in 2010 (Figure 2). More significant stimulus support was provided by state-owned enterprises (SOEs) and by local governments, through off-budget and quasi-fiscal activities. SOEs temporarily reversed their declining share in aggregate investment, accounting for as much as 40 percent of the incremental FAI in 2009 (Figure 3). And local government projects, financed largely through local government financing vehicles (LGFVs), which were assigned the revenues from sales of land-use rights (Figure 4),[3] vastly exceeded central government projects.

Figure 3. State-owned enterprises ramped up capital spending during the crisis



Source: CEIC.

Figure 4. Sales of land-use rights topped seven percent of GDP in 2010 and 2011



Sources: OECD (2013) and CEIC.

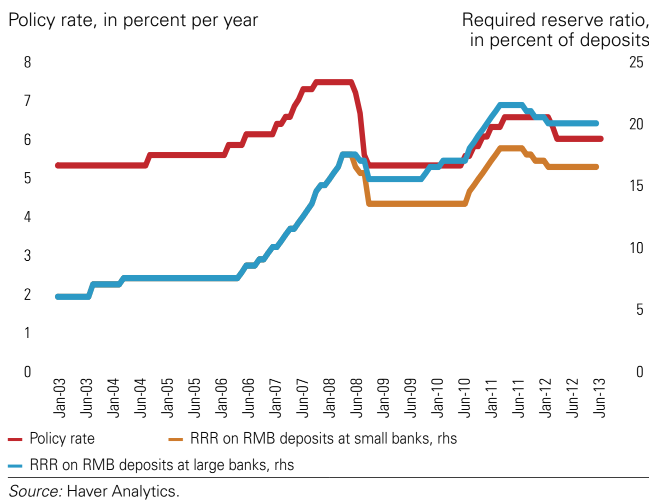
The acceleration in investment spending following the onset of the global financial crisis was supported by a vast credit expansion. The bulk of investment in China has historically been financed by retained earnings, reflecting both the robust profits of and the low dividend payouts by Chinese corporates. But credit played a crucial role in the recent run-up in investment. China placed the burden of supporting the stimulus program and the domestic-demand-led recovery on monetary policy. The People's Bank of China (PBC) cut the policy rate four times from 7.5 percent in August 2008 to 5.3 percent in December 2008, and then kept the rate pegged through September 2010 (Figure 5). The central bank also lowered the required reserve ratio on RMB deposits at large and small banks from 17.5 percent in August 2008 to 13.5 percent in December 2008. Moreover, the central bank relaxed bank loan quotas and lifted broad money (M2) growth targets in late 2008 and through 2010.

This loose monetary policy spurred massive credit creation: total credit flows[4] doubled, from 21 percent of GDP in 2007 to 40 percent of GDP in 2009 (Figure 6). Bank loans, which still form the bulk of new

3 Specifically, LGFVs are separate legal entities organized to engage in long-term infrastructure projects for local governments. Local governments converted land from agricultural to commercial use, sold the land-use rights to property developers, and assigned the revenue stream to LGFVs. LGFVs used the land revenues as collateral for credit. Property developers increased their land acquisitions and accelerated real estate investment to 14 percent of GDP by 2012 (these land acquisitions, recorded in FAI, and the rise in land prices, partly account for the difference between FAI and gross fixed capital formation). The ensuing rise in land values allowed local governments to become even more leveraged.

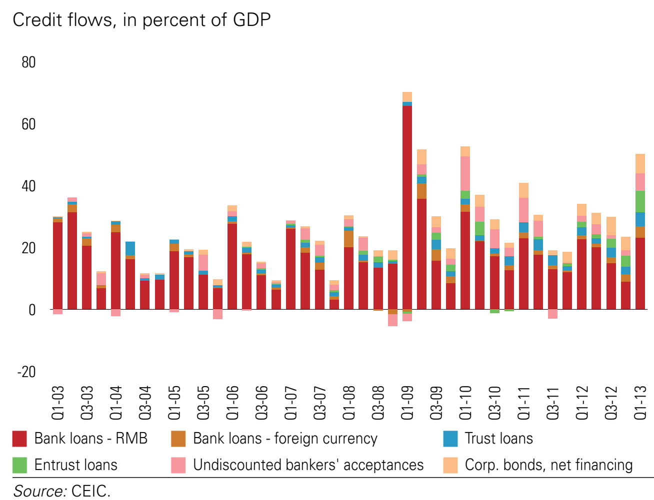
4 Credit flows are derived from the PBC's Total Social Financing (TSF) statistics. TSF is a measure constructed by the central bank to reflect the amount of liquidity provided by the aggregate financial system to the real economy. The bulk of TSF consists of credit flows: bank loans, in RMB and foreign currencies; undiscounted bank acceptance bills (short-term debt issued by a firm and guaranteed by a commercial bank, which treats them as an off-balance-sheet item); trust loans (trust company client funds invested as loans to the real sector); entrust loans (loans that corporates lend to each other using banks as book entry entities); and corporate bond financing (corporate bonds held by financial institutions). A residual category lumped as other sources includes insurance, micro lending, and industry funds. TSF also includes enterprise equity financing (nonfinancial corporate equity held by financial institutions), which, however, is small (around 3 percent of total TSF beginning in 2002, when the data first become available). Enterprise equity financing from credit flows are excluded here.

Figure 5. The central bank kept monetary policy loose for an extended period



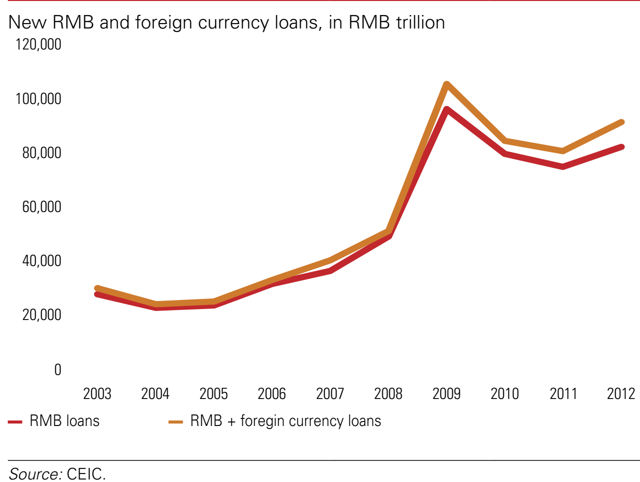
Source: Haver Analytics.

Figure 6. Aggregate new credit topped 68 percent of GDP in the first quarter of 2009



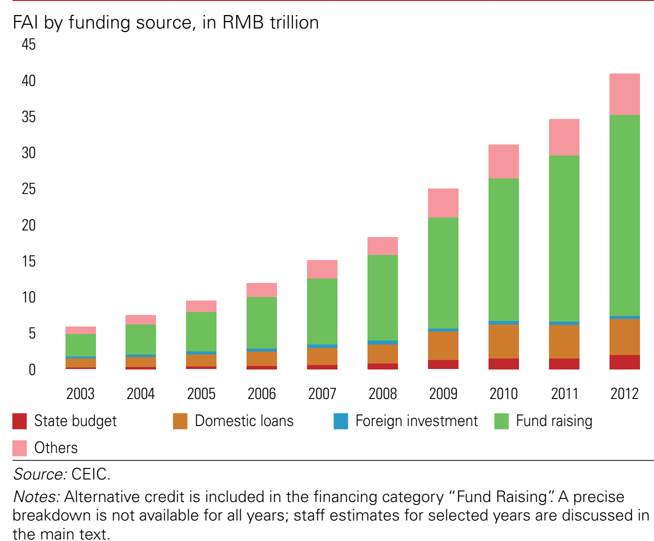
Source: CEIC.

Figure 7. New bank loans more than doubled between 2008 and 2009 and financed 16 percent of all fixed asset investment in 2009



Source: CEIC.

Figure 8. Fixed asset investment funded by alternative credit has increased dramatically



Source: CEIC.
Notes: Alternative credit is included in the financing category "Fund Raising." A precise breakdown is not available for all years; staff estimates for selected years are discussed in the main text.

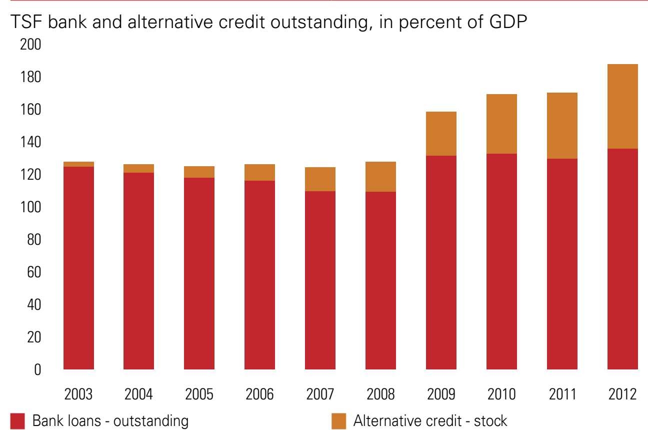
credit (accounting for 59 percent of total new credit in 2012), more than doubled between 2008 and 2009 (Figure 7), financing 16 percent of all FAI in 2009. Alternative credit instruments (principally entrust loans, trust loans, bankers' acceptances, and financial institution holdings of corporate bonds) have gained in importance over time, growing from 19 percent of all credit flows in 2009 to 33 percent in 2012. The share of alternative instruments in FAI financing is harder to trace (Figure 8), but our estimates suggest that it equaled 11 percent in 2012, rising sharply to approximately 25 percent in the first quarter of 2013.

The large expansion of alternative credit reflects the rise of the shadow banking system in China, particularly in the aftermath of the global financial crisis and the subsequent loose monetary policies.

The development of China's shadow banking system[5] predates the global financial crisis. Its growth was broadly associated with two factors. On the supply side, households' desire to diversify away from bank deposits, whose interest rates are regulated. On the demand side are the relatively low borrowing costs of corporates and their strong demand for credit, which could not be fully satisfied by the formal banking system owing to reserve requirements and other prudential restrictions (Goldman Sachs 2013). Since the crisis, the shadow banking system has grown, reflecting the expansion in global and domestic liquidity, subsequent efforts by commercial banks to avoid restrictions (such as credit quotas, loan-to-deposit caps, and capital adequacy ratios) in the regulated banking sector by securitizing loans, and efforts by regulators to diversify credit risks away from commercial banks by promoting direct financing.

Figure 9. Nonbank and off–balance-sheet bank credit has outpaced regular bank lending

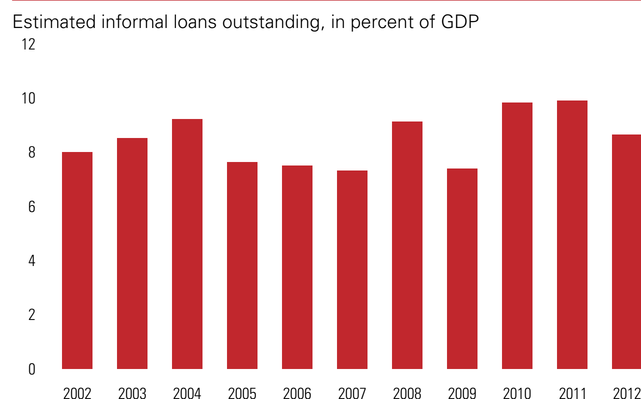
TSF bank and alternative credit outstanding, in percent of GDP



Source: IMF 2013a.

Figure 10. Informal loans, not included in official credit data, rose by three percent of GDP during 2007–2011

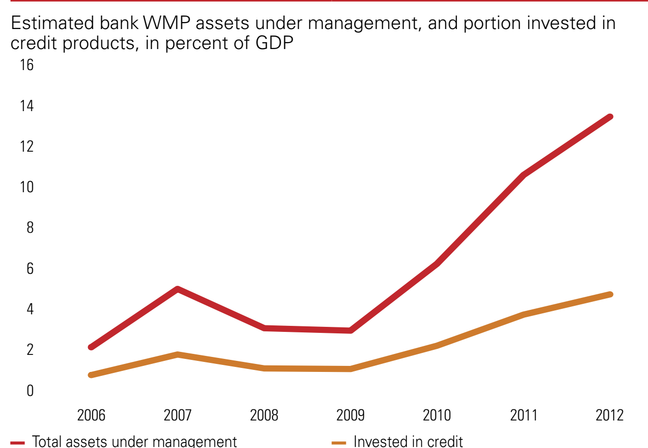
Estimated informal loans outstanding, in percent of GDP



Source: Goldman Sachs (2013).

Figure 11. Credit funded from banks' wealth management products was estimated at five percent of GDP in 2012

Estimated bank WMP assets under management, and portion invested in credit products, in percent of GDP



Source: Goldman Sachs (2013).

Table 1. Estimates of the size of China's shadow banking system range from 24 to 69 percent of GDP

Assets of the shadow banking system, in RMB and USD trillion, and in percent of GDP

	Estimate Date	Size (RMB trillion)	Size (USD trillion)	% GDP
UBS (low)	Oct-12	13.7	2.2	24
BA	Jul-12	14.5	2.3	28
ANZ (low)	Dec-12	15.0	2.4	29
ANZ (high)	Dec-12	17.0	2.7	33
S&P	Apr-13	22.9	3.7	44
GS	Feb-13	23.5	3.7	45
UBS (high)	Oct-12	24.4	3.9	46
Hua Tai	Dec-12	25.0	4.0	48
Barclays	Dec-12	25.6	4.1	49
Citibank	Jan-13	28.0	4.5	54
GF Sec.	Dec-12	30.0	4.8	57
JPM	May-13	36.0	5.9	69

Source: Federal Reserve Bank of San Francisco 2013; and JPMorgan 2013.

5 The Financial Stability Board defines shadow banking as consisting of "credit intermediation involving entities and activities outside the regular banking system" (Financial Stability Board 2012). The World Bank's definition is similarly worded: "a set of activities, markets, contracts and institutions that operate partially or fully outside the commercial banking sector, and, as such, are either lightly regulated or not regulated at all" (World Bank 2012).

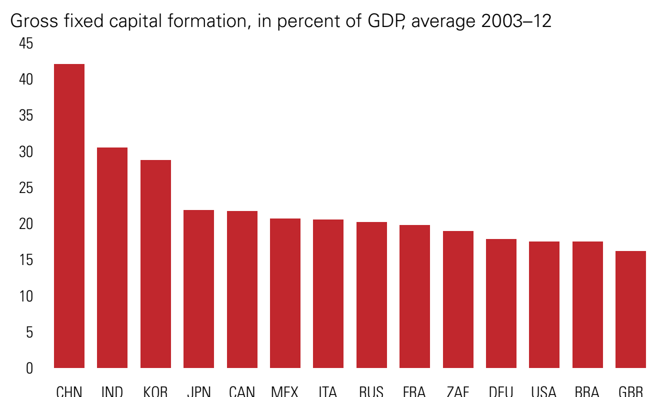
Crude estimates of the size of the shadow banking system, based on the PBC's Total Social Financing (TSF) statistics,[6] suggest that nonbank and off-balance-sheet bank credit flows amounted to 12 percent of GDP in 2012, and their outstanding credit stock stood at approximately 50 percent of GDP (Figure 9). This number is an underestimate, since TSF data do not include either informal loans[7] (Figure 10) or loans securitized through brokers' asset management channels. Moreover, credit funneled from bank's Wealth Management Products (WMPs) may be greater than reported by the banks (Figure 11). In fact, some estimates of the size of China's shadow banking system are much larger than what can be derived using TSF data alone—as much as 69 percent of GDP (Table 1).

Overinvestment?

Although China's credit-induced, investment-led intervention supported growth during the global financial crisis, neither an investment- nor credit-intensive growth model appears sustainable over the long term. There is growing evidence, although no firm consensus in the existing macroeconomic literature, that China overinvests.[8] China's investment-to-GDP ratio is high by most standards (Geng and N'Diaye 2012), whether compared to countries with similar development strategies during equivalent periods in their history, countries with similar income levels, or the major advanced and developing economies (Figure 12). And China's capital stock, while relatively modest on a per worker basis,[9] is large relative to GDP (Figure 13). One important recent study concludes that China has been overinvesting over the last decade, currently by as much as 10 percent of GDP (Lee, Syed, and Xueyan 2012).[10] As a result, the same authors suggest a rationalization of

Figure 12. China's investment has been the highest among the major advanced and developing economies

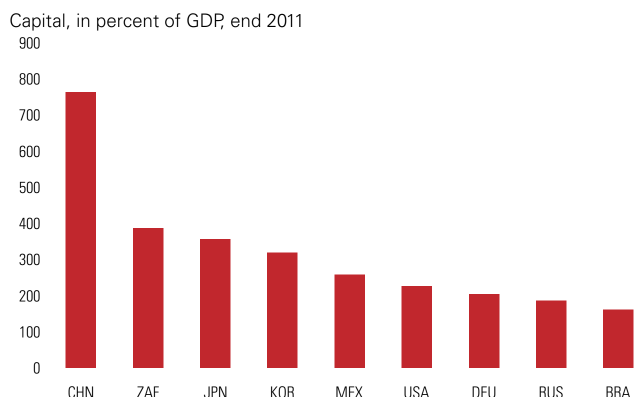
Gross fixed capital formation, in percent of GDP, average 2003–12



Source: World Bank, *World Development Indicators.*

Figure 13. And its capital stock is comparatively large relative to output

Capital, in percent of GDP, end 2011



Source: World Bank staff estimates using capital stock data from OECD 2013.

6 We define shadow banking credits as the sum of trust loans, entrust loans, undiscounted bankers' acceptances, and corporate bonds held by financial institutions. In contrast, RMB bank loans and foreign currency bank loans are classified as regular bank credit

7 That is, loans provided by individuals to corporates without using financial institutions as intermediaries.

8 See Ding, Guariglia, and Knight (2010) for a comprehensive survey of the literature.

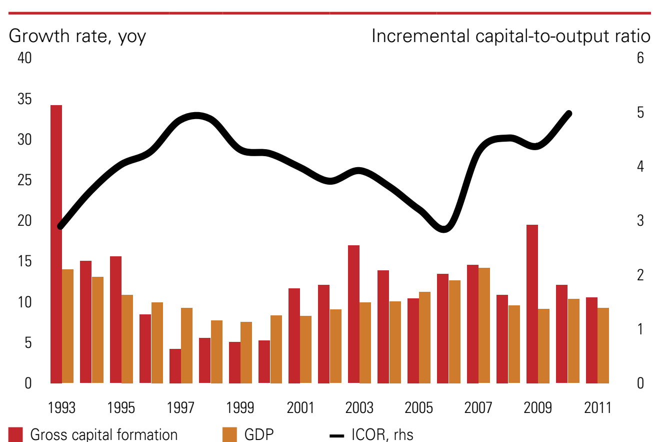
9 The capital stock per worker at end-2011 stood at US$68,000 in China, compared to US$317,000 for top-ranked Japan, US$215,000 for the United States, US$175,000 for Germany, US$141,000 for the Republic of Korea, and US$83,000 for South Africa (OECD 2013).

10 China's investment-to GDP-ratio is rated against a "norm," computed from a regression (a panel of 36 countries, including China's East Asian peers, during 1955–2009) on fundamentals including the level of economic development of a country (real GDP); the availability of financing (savings-to-GDP and credit-to-GDP); the cost of capital (real lending rate); the potential contribution of the external sector to investment (exports-to-GDP); demographics (the age dependency ratio); and macroeconomic uncertainty (standard deviation of the three-year rolling real GDP growth rate).

investment and its reorientation away from manufacturing and real estate and toward agriculture and services (Lee, Syed, and Xueyan 2013).

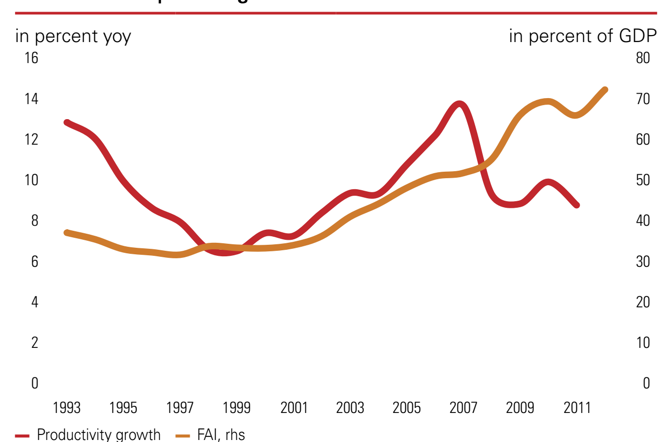
Many microeconomic studies also find strong evidence of the inefficiency of investment in, and the misallocation of investment across, various sectors of the economy, both of which indicate that China overinvests. These inefficiencies are associated with investment by SOEs (Dollar and Wei 2007), and in the Western and inland provinces compared to those along the Eastern coast (Wu 2008). Over time, the efficiency of investment has declined (Figure 14). During the global crisis, the growth of productivity was falling even as China embarked on an investment boom (Figure 15). Greater investment in manufacturing has raised industrial capacity in many sectors at a time of slowing overall growth.[11] The authorities recognize that growth has become too dependent on the continued expansion of investment and have articulated the need to internally rebalance the economy toward consumption-led growth, starting with the current five-year development plan.

Figure 14. Long-running efficiency gains reversed in the mid-2000s



Source: World Bank, World Development Indicators, and staff estimates.
Note: ICOR=change in capital stock, higher values indicate lower efficiency of investment.

Figure 15. Productivity growth was dropping as the investment spurt began



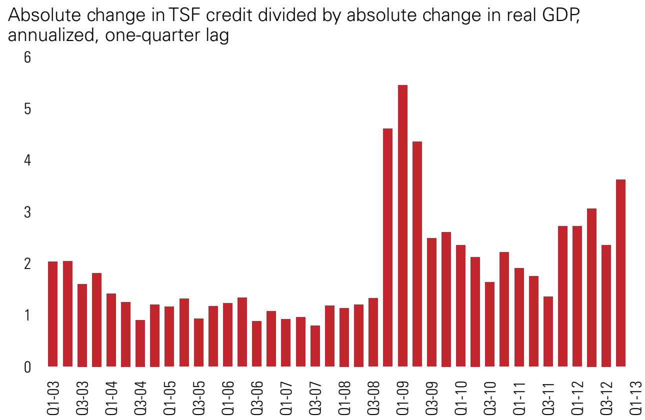
Source: Haver Analytics and CEIC.
Note: Productivity=output per employed person.

Similarly, the efficiency with which credit is used in the economy has deteriorated during the recent credit expansion. Before the global financial crisis, 1.4 units of credit were sufficient to generate one unit of GDP (measured with a one-quarter lag). That ratio has risen to an average 2.7 since 2009, topping 4.6 in the last quarter of 2008 and 5.4 in the first quarter of 2009 as the stimulus got underway (Figure 16). The pattern is robust to measuring the growth efficiency of credit with a two-quarter or even a four-quarter lag (Figure 17). Credit growth picked up again in the second half of 2012, with new credit flows exceeding 50 percent of GDP in the first quarter of 2013. As credit growth picked up, the inefficiency indicator similarly inched higher. The declining marginal impact of credit on growth partly reflects the growing inefficiency of the investment that is supported by the new credit creation, including real estate development and local government infrastructure. But it is also indicative of the deployment of credit for purposes other than real economic activity. Using credit to service existing debt, for instance, does not generate new investment and activity.

11 Industrial capacity utilization was 78 percent in the first half of 2013, including 75 percent for the steel industry, well below the international average. Since July, the Ministry of Trade and Information has issued administrative orders to more than 1,500 companies, in industries ranging from steel to chemicals, to cut excess production capacity by end-2013.

Figure 16. The growth efficiency of credit has deteriorated…

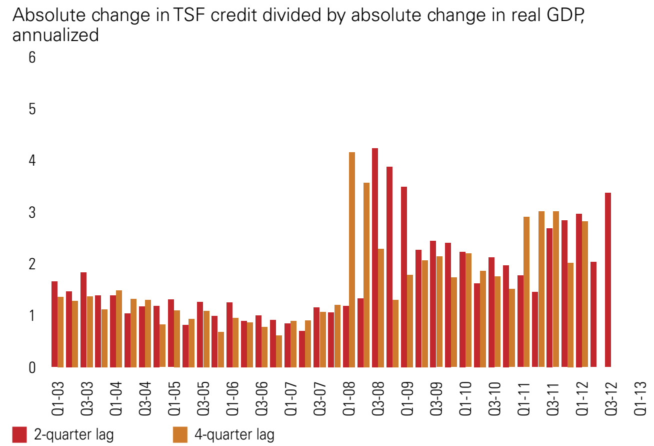
Absolute change in TSF credit divided by absolute change in real GDP, annualized, one-quarter lag



Source: World Bank staff estimates.

Figure 17. …including when measured with different lags

Absolute change in TSF credit divided by absolute change in real GDP, annualized

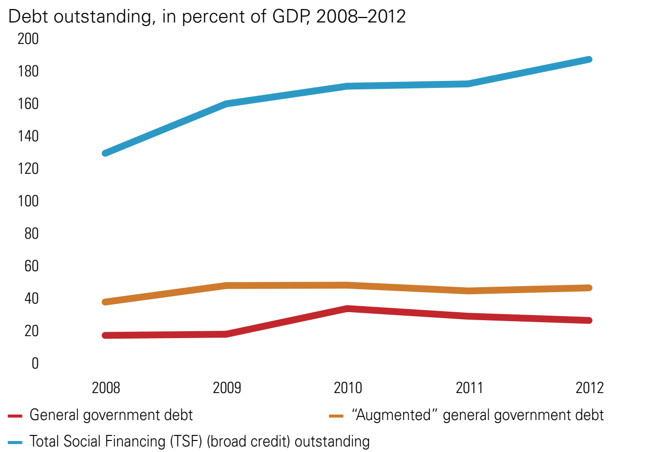


Source: World Bank staff estimates.

Massive new lending in recent years has raised debt everywhere in the economy. "Augmented" general government debt, a measure that includes off-budget and quasi-fiscal borrowing by the government,[12] reached 46 percent of GDP in 2012 (Figure 18); and even these are only partial estimates of total government debt.[13] Total credit outstanding in the economy, measured by the stock of TSF credit, rose from 127 percent of GDP in 2008 to 187 percent of GDP in 2012. Private sector estimates (including, for example, by McKinsey) place Chinese national debt (central government, households, nonfinancial corporates, and the financial sector) well

Figure 18. "Augmented" general government debt exceeded 46 percent of GDP in 2012; total credit outstanding exceeded 186 percent of GDP

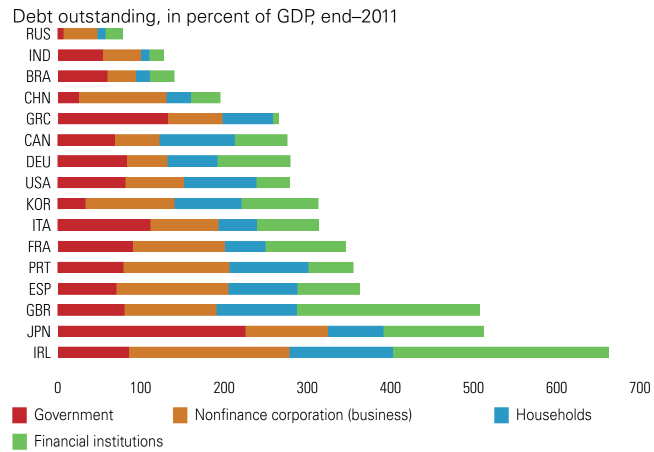
Debt outstanding, in percent of GDP, 2008–2012



Source: IMF 2013a.

Figure 19. China's national debt ratio high for emerging economies, but trails that of advanced economies

Debt outstanding, in percent of GDP, end–2011



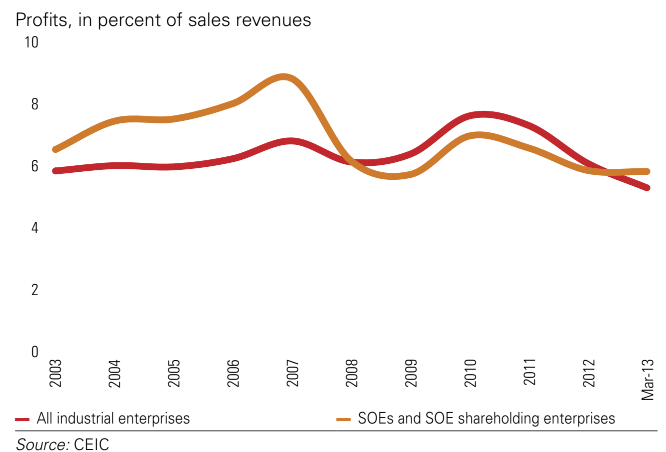
Source: McKinsey Global Institute 2010.

12 The general government sector consists of all government units (the central government, state governments, and local governments) and all nonmarket nonprofit institutions controlled by government units (see IMF 2001). The IMF has constructed an "augmented" general government account for China that includes off-budget funds and LGFVs, to cover the considerable off-budget and quasi-fiscal activity in China that is conducted primarily at the local-government level (IMF 2013a).

13 The IMF's "augmented" fiscal debt data for China, because it is intended to provide a picture of fiscal policy stance rather than net worth in a balance sheet sense, excludes several liabilities including the debt of the Ministry of Railways, which has been moved to a new SOE (part of the public corporations sector, but not of the augmented general government); contingent liabilities: the debt of nonfinancial SOEs, the outstanding debt of policy banks, the nonperforming loans in the banking sector, the old nonperforming loans assumed by the asset management companies, and pension fund liabilities; and social security funds (since China does not consolidate social security into the general government accounts).

in excess of 200 percent of GDP at end-2011 (Figure 19). Overall, total debt has clearly risen rapidly to a historically high level.

Figure 20. Profitability has declined at industrial firms including at state-owned enterprises



Source: CEIC

China's rising debt stock poses some risks to the economy. The combination of rapid credit creation and slowing growth creates vulnerabilities. Debt service capacity is potentially an issue given declining profitability among industrial enterprises, particularly SOEs (Figure 20). Profits of SOEs had been healthy since 2000, following their restructuring beginning in the mid-1990s (Lee 2009; Naughton 2007). But robust profits had been due in no small part to the strong monopoly position of large SOEs in core sectors of the economy, the low cost of capital and other factor inputs, and continuing financial support from the state and state-owned banks. The recent global economic downturn, excess industrial capacity, and lower sales volumes have since pressured profits, particularly at manufacturing enterprises, and consequently diminished their ability to service debt.

Debt service is also a potential problem for the non-SOE corporate sector, as evidenced by the falling ratio of earnings before interest and taxes (EBIT) to interest expenses among listed private companies.[14] That said, China's national debt as a share of GDP is still not as high as that of the major advanced economies, much less that of the highly indebted euro area crisis countries. Moreover, since much credit creation in China is supported by high domestic savings, a debt crisis appears unlikely when assessed against dependency on external finance: gross domestic savings has exceeded gross investment in all years since 1994. And emerging economies with high savings rates generally have high debt levels (UBS 2013).

Special Concerns: Shadow Banking and Local Government Debt

The rapid expansion of shadow banking poses challenges to financial stability, given that shadow banking is closely linked to the banking system, is less regulated, and operates with implicit guarantees from banks and local governments. China's shadow banking system is small compared to more advanced countries[15] and is still relatively simple, consisting largely of direct credit and informal securitization[16] rather than more complex intermediation and risk transformation. But it has grown rapidly in a short period, and now supplies a significant part of domestic credit. As a result, shadow banking can pose systemic risks to the stability of the financial system, for three reasons.

14 IMF (2013b). See Box 1.1 in Chapter 1 for recent trends in the EBIT to Interest Expenditure ratio for a panel of 917 nonfinancial companies.

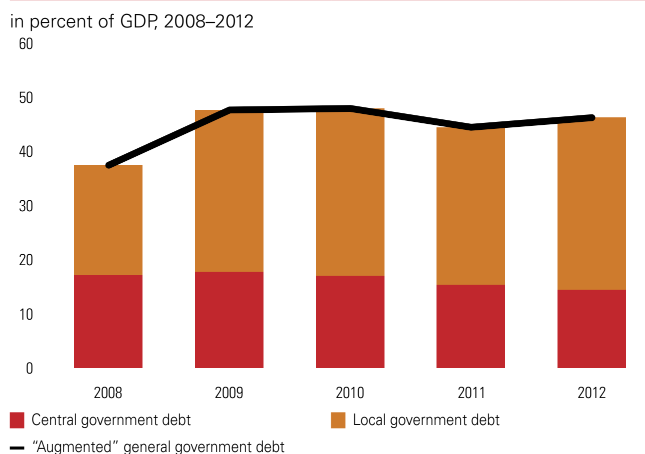
15 According to the Financial Stability Board (2012), three markets account for 81 percent of the US$67 trillion total assets of the global shadow banking system: the United States, with US$132 trillion (152 percent of GDP), 35 percent of the total; the euro area, US$22 trillion (168 percent of GDP), 33 percent of the total; and the United Kingdom, US$9 trillion (370 percent of GDP), 13 percent of the total.

16 China began experimenting with formal securitization before the global financial crisis, with China Construction Bank issuing the first asset-backed securities (ABS) deal in 2005. Regulators halted these pilot efforts during the crisis and restarted them in 2012. But progress has been slow, and credit-based ABS comprised under 1 percent of total bonds outstanding at mid-2013.

First, the shadow banking and the banking sectors in China are closely interconnected, through direct and indirect linkages.[17] Second, many aspects of shadow banking are unregulated or only lightly regulated. For instance, informal loans, which charge higher interest, indicating higher risk, have no capital requirement. Likewise, banks are exposed to risks in WMPs. They offer high-interest on off-balance-sheet WMPs to attract funds and then allow the WMPs to mature before the end of the month, so that the funds flow back to the bank balance sheet as deposits to meet regulatory loan-to-deposit ratios. Third, loss attribution rules in shadow banking are fuzzy. Investors consider trust products and WMPs to be guaranteed by banks because previous cases of loss were compensated for by the banks, at the behest of regulators. There is also a general perception that LGFV debt is guaranteed by local governments, and some of it *is* in fact informally guaranteed, legal restrictions notwithstanding.

The rise in local government debt is also a concern, given the complexity and opacity of municipal finances. This lack of transparency has led to debt levels higher than would otherwise be acceptable to lenders, investors, and policy makers. Local governments are not allowed by law to incur a budget deficit and can only issue bonds with the approval of the State Council. A trial program allowing local units to issue bonds directly and under quota limits was begun in 2011 but remains limited. With few formal ways to borrow, local governments have instead borrowed through LGFVs, some 6,576 of which had been set up by 2010. The National Audit Office estimated local government debt at 27 percent of GDP at end-2010, a sevenfold absolute increase over just two years. Some four-fifths of this debt was in the form of bank loans. The IMF's "augmented" general government debt data place local government debt at 32 percent of GDP in 2012, up from 20 percent in 2008 (Figure 21).[18]

Figure 21. Local government debt, including debt of Local Government Financing Vehicles, may have exceeded 32 percent of GDP in 2012



Source: IMF 2013a.

Table 2. Some Private-sector estimates of local government debt are even higher

	Estimate date	Yuan (trillion)	% GDP
Local government debt at end–2010:			
National Audit Office	Jun-11	10.7	27
Local government debt at end–2012:			
Moody's	Jun-13	12.1	23
Fitch	Apr-13	12.9	25
UBS	Apr-13	16.5	32
Credit Suisse			36
Standard Chartered			38
Oxford Analytica	May-13	20.0	40

Sources: Moody's Investors Service 2013; Oxford Analytica 2013; Standard Chartered 2011; UBS 2013.

Many private-sector estimates are higher, at as much as 40 percent of GDP at end-2012 (Table 2). Moreover, alternative credit figures prominently in recent new lending: trust loans and LGFV bond issuance

17 For instance, trusts are distributed by banks for a fee income. Entrust loans work as bridge loans, by which corporates repay or roll over bank loans, and have banks acting as book entry entities. Corporate bonds are commonly underwritten by banks, which bought a little over half of corporate bond issues last year. Banks lend to corporates and securitize the loans through their WMPs. The WMPs are created, managed, and distributed by banks, for which they earn fee income. Loans securitized from brokers' WMPs are created at the request of banks. And informal loans work as bridge loans by which small and medium enterprises and property developers repay or roll over bank loans.

18 These data include the debt of LGFVs but exclude the debt of local-government-owned SOEs (IMF 2013a). The latter are classified as part of the public corporation sector, which is distinct from the general government sector.

grew by three-fourths in 2012 (UBS 2013). Local governments do have significant assets to meet their liabilities: they hold land reserves worth 10 percent of GDP, and own shares in local SOEs worth a similar amount.[19] This lends support to the view that local governments are not facing a solvency crisis. In addition, the central government has the financial capacity to support troubled local governments. Nonetheless, the above concerns about debt servicing and asset quality apply also to local government debt and assets. As the economy slows, local governments may face weaker revenues from taxes and land sales, and may not have sufficient cash-flow to pay interest. Anecdotal evidence of new debt being incurred to service older debt is plentiful, although the information has yet to be compiled in any systematic official or private data series.[20] Similarly, questions have been raised about the rates of return of LGFV projects (Oxford Analytica 2013).

Policy Conclusions

The internal rebalancing of the economy away from an investment-dependent growth model provides the context for addressing the issues and risks associated with the recent episode of credit expansion and debt accumulation. Policy action in three key areas will help advance the reform agenda.

First, the authorities need to contain the rapid growth of credit in the economy and tighten financial supervision. This applies particularly to those parts of the financial system that are less well regulated, and from which credit has flowed massively and rapidly. Greater financial sector discipline will help ensure that only positive net present value real sector investment projects are funded.

Second, municipal finance should be rationalized. The framework for local government financing of capital projects must be revamped. The system of local government borrowing should be reformed within strict limits, with clear rules on borrowing, on allowed sources of borrowing, on debt resolution, and on the disclosure of comprehensive financial accounts by local governments. Closely related is the reform of land management. A stronger local tax base, and stricter rules on land taking and compensation for it, would reduce both the need and the possibilities for land financing.

Third, policy makers should broaden and deepen financial sector reforms. A gradual reduction in the government's role in the financial system, as exemplified by interest rate regulation, together with improved governance in banks, will promote efficient financing and investment decisions. A recent decision to remove the floor on lending rates, giving banks more freedom to set borrowing costs, constitutes a step in the right direction.

19 UBS (2013) assumes a conservative 40 percent ownership stake of local governments in local SOEs, whose equity value (including both listed and unlisted firms) is estimated by the Ministry of Finance at Y 13 trillion as of end-March 2013.

20 Standard Chartered warned of local government insolvency in 2011, suggesting that 80 percent of local government loans would not be able to cover debt service. In June 2013, the National Audit Office reported an inability to repay debt and an increase in debt rollovers in a sample of 36 local governments and their LGFVs. Recently, State Council directed the National Audit Office to conduct a nationwide audit of all government-related debt obligations.

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II.B. The End of Quantitative Easing[21]

Quantitative easing (QE), particularly in its early stages, had a positive impact on capital flows to East Asia and Pacific and on regional financial markets. That said, QE accounted for only part of the total variation in capital inflows and asset prices. Conversely, any scaling back of QE in the United States will result in higher borrowing costs, lower capital inflows, and a decline in asset prices in East Asia and Pacific. This will affect investment and potential output, and raises concerns about potentially overextended domestic financial sectors. Estimates of the impact vary widely, but it is likely to prove larger in economies characterized by greater financial openness, significant current-account deficits, rapid credit growth in recent years, or large increases in debt. Countries may be able to reduce the cost of their borrowing by strengthening their own domestic institutions and further improving the investment climate.

Quantitative Easing and its Tapering

In the aftermath of the 2007–08 global financial crisis, major advanced economy central banks turned to unconventional monetary policy (UMP) measures. The goals were first to unfreeze financial markets, and subsequently to provide stimulus to the economy. The measures involved purchasing private and public assets, supplying liquidity to banks through refinancing windows, and extending lending maturities. This was supplemented by "forward guidance" to market participants, in the form of public commitments to keep monetary policy expansionary for a considerable time to come.

Recent statements by the U.S. Federal Reserve indicate plans to gradually unwind, or "taper," its Quantitative Easing (QE) program;[22] this has led to significant volatility in regional financial markets. From late May through June, and again in late August, concerns about rapid tapering were associated with increased yields on U.S. treasuries, declines in capital flows to East Asia and Pacific (EAP), and broad-based and deep falls in regional asset prices. The greatest impact was felt in Indonesia, but the asset sell-off affected most of the region's emerging markets, including Malaysia, the Philippines, and Thailand (see below, as well as Part I of this Economic Update, for more details). Many of these adjustments were largely reversed in September, as it became clear that any tapering would occur later than anticipated.

This note discusses the impact of past UMP, and the potential impact of any future tapering of QE, on regional capital inflows and asset prices. It also briefly discusses the wider implications for economic activity in the region.

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21 This note was prepared by Tony Ollero and Nikola Spatafora. Sanket Mohapatra (DECPG) provided substantive contributions to Section III. The note draws on analytical work carried out by the World Bank's DEC group, including, in particular, Dilek Aykut and Aart Kraay. Eung Ju Kim provided data support.

22 See Chairman Bernanke's Congressional testimony on May 22, 2013, and his press conferences on June 19 and September 18, 2013: www.federalreserve.gov/newsevents/testimony/bernanke20130522a.htm; www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf; www.federalreserve.gov/mediacenter/files/FOMCpresconf20130918.pdf.

Conceptual Framework

UMP programs have had two broad objectives: repairing financial markets and easing credit conditions.[23] Early on, the goal was to inject liquidity into financial markets to stabilize them, shore up confidence, avoid abrupt deleveraging and asset-price collapses, and bring down liquidity and risk premia. Later, the aim became to lower real interest rates, ease credit conditions, and encourage spending by firms and households, so as to promote growth and employment. Unconventional measures were required because short-term nominal policy rates were already near zero, limiting the scope for traditional interventions. The programs varied in their details, but all involved significant increases in the size, and changes in the composition, of central banks' balance sheets. The U.S. Federal Reserve and the Bank of England have focused on bond markets, purchasing government bonds and/or mortgage-backed securities on a large scale to increase market depth and liquidity, extend maturities, and drive long rates down. The European Central Bank has concentrated on direct lending to banks, while the Bank of Japan has adopted a hybrid approach.

UMP may exert international spillovers. Regardless of the precise nature of the intervention, large-scale UMP that significantly reduces advanced economy borrowing costs and increases confidence may, in an environment of financial globalization and trade openness, exert spillovers on developing EAP. Two key transmission mechanisms are:[24]

- **Portfolio Rebalancing.** Lower long-term risk-adjusted yields in advanced economies (whether on bank loans, corporate bonds, government bonds, or equities) will spur investors to search abroad for higher yields. As a result, capital flows to developing countries will increase.

- **Confidence.** A credible commitment to backstop financial markets will reduce perceived risk and risk aversion. A broad-based increase in confidence may also encourage flows into riskier asset classes, including emerging markets. That said, increased confidence in advanced economies may actually reduce the pressure for capital outflows to developing countries.

To the extent that UMP increases either capital flows to developing countries or general confidence, it will encourage increases in local (debt and equity) asset prices and investment. Greater capital inflows will also create pressures for exchange-rate appreciation. Conversely, a tapering of QE would reduce capital flows to developing countries, local asset prices, and investment, and act to depreciate their exchange rate.

The Impact of Quantitative Easing So Far

The UMP-driven search for yield, coupled with stronger growth in developing countries vis-à-vis advanced economies, appears to have triggered a surge in capital flows to developing countries, and to EAP in particular. Between 2008 and 2012, net capital flows to developing countries rebounded from

23 See IMF (2013a) for an extensive review of UMPs.

24 See Chen et al. (2012) and Fratscher, Lo Duca, and Straub (2013) for further discussion of the potential transmission mechanisms underlying international spillovers from QE.

US$490 billion to over $800 billion (World Bank 2013). Flows to EAP more than doubled, to reach US$460 billion (4.6 percent of GDP).

This note focuses on the impact of QE in the United States, given its global importance, and on the prospects for its gradual unwinding. There were four main episodes of QE:

- **QE1.** Major Federal Reserve purchases of mortgage-backed securities and other "toxic assets" in the early stages of the crisis, beginning in late 2008.
- **QE2.** Federal Reserve purchases of U.S. Treasury securities in the second half of 2010.
- **"Operation Twist."** Federal Reserve purchases of long-term bonds and corresponding sales of short-term bonds, starting in late 2011.
- **QE3.** A renewed program of Federal Reserve purchases of private mortgage-backed securities beginning in late 2012.

There is a broad consensus that QE helped restore the functioning of financial markets and significantly reduced domestic long-term yields and credit spreads, especially in its early phases, at the peak of market turmoil (IMF 2013a). In the United States, the cumulative effects of QE on long-term Treasury bonds are estimated at between 90 and 200 basis points (bps). Initial announcements were especially effective, partly by decreasing the risks of financial collapse and a sharp recession, and partly because they were less widely anticipated. In the U.K. and especially Japan, the overall impact has been smaller.

The limited existing literature on international spillovers from QE concludes that these programs did lift asset prices globally (IMF 2013b). Identifying the precise effects of QE is complicated, given that the policies were announced and implemented in the midst of significant turmoil in global financial markets. Analyses focusing on East Asia find that QE, and in particular QE1, by lowering U.S. yields and credit default swap spreads, significantly contributed to the postcrisis rebound in capital flows to EAP (Cho and Rhee 2013). Studies dealing with emerging markets more broadly confirm that QE, and again QE1, in particular, lifted local bond and equity prices. The evidence on capital flows and exchange rates is more mixed: QE1 had an ambiguous effect, reflecting its positive impact on confidence in the U.S. economy, whereas QE3 was more clearly associated with rebalancing toward emerging markets.[25] QE2 also had some announcement effects, although the euro area crisis makes it difficult to evaluate its medium-term impact.

The literature also suggests that the magnitude of the international spillovers from QE depends on market conditions, and has diminished as markets normalized. Later QE rounds had small effects relative to the underlying volatility in the relevant series.[26] In part, this may reflect a reduction in the "surprise content"

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25 For instance, Fratzscher, Lo Duca, and Straub (2013), analyzing data on flows into bond and equity mutual funds, find that QE1 was followed by capital flows from emerging markets into the United States, partly reflecting a generalized "flight to quality" at the start of the crisis. In contrast, QE2 and QE3 were followed by capital outflows from the United States to emerging markets. Ahmed and Zlate (2013), analyzing balance-of-payments data for a smaller set of emerging markets, find that growth and interest rate differentials, as well as capital controls, are significant predictors of capital flows. However, QE did not have a statistically significant impact on overall emerging market capital inflows; it did change their composition toward portfolio inflows, but was only one among several important factors. Chen et al. (2012) find that QE1, in particular, substantially reduced global yields, and increased emerging market capital inflows and asset prices. Likewise, the IMF (2013b) finds a significant impact of QE on emerging market capital inflows, and in particular on bond inflows.

26 For instance, Moore et al. (2013) conclude that QE1 and QE2 reduced emerging market government bond yields by, respectively, 17 bps and 2 bps. More generally, each 10-basis-point reduction in long-term U.S. Treasury yields lowers emerging market yields by only 1.7 bps.

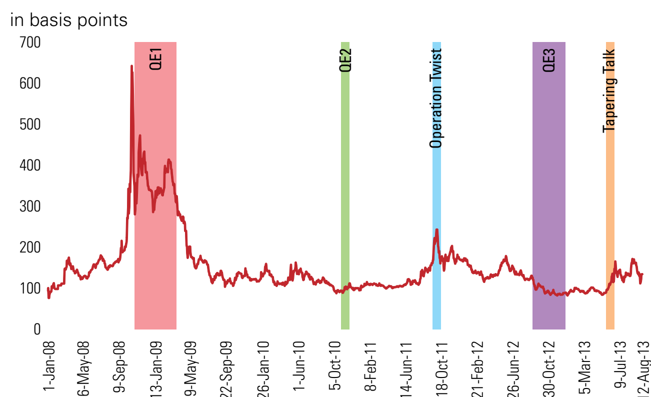
of the announcements (IMF 2013b); substantial, unexpected shifts could still have strong effects. But it also points to the importance of country-specific factors in driving capital inflows.

This section gauges international spillovers to EAP using event studies. In particular, the section considers market developments (a) when important announcements were made about each QE program, (b) when the programs were implemented,[27] and (c) in the aftermath of Chairman Bernanke's speech of May 22 on QE tapering.

The data broadly confirm that QE, especially in its early stages, had a positive impact on capital flows to EAP and on regional financial markets. That said, QE accounted for only part of the total variation in capital inflows and asset prices. Country-specific factors, as well as global shifts in perceptions of financial risk, also had a significant impact, particularly on equity markets. More specifically, analyzing the various elements in the transmission mechanism:

- **QE helped calm markets and reduce perceived sovereign risks.** Sovereign credit default swap spreads[28] for EAP reacted positively to the QE announcements, particularly QE1, Operation Twist, and QE3 (Figure 22). QE2 had no effect, possibly because it was widely anticipated. Overall, average spreads compressed from a peak of 590 bps, immediately before the QE1 announcement, to 80 bps in mid-May 2013.

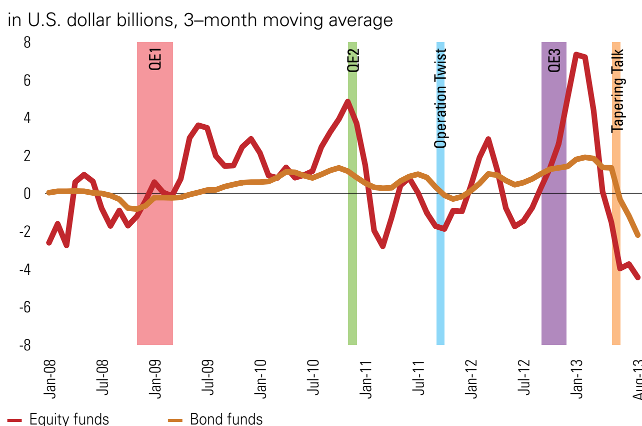
Figure 22. Sovereign credit default swap (CDS) spreads, East Asia and Pacific



Source: Thomson Datastream.

Note: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering. "East Asia and Pacific" refers to the composite of credit default swap spreads for five-year governments for China, Indonesia, Malaysia, the Philippines, and Thailand.

Figure 23. Flows into bond and equity mutual funds and ETFs, East Asia and Pacific



Source: EPFR Global.

Note: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering. "East Asia and Pacific" refers to China, Indonesia, Thailand, Malaysia, the Philippines, and Vietnam.

- There were **strong flows into EAP bond and equity funds** after the QE1 announcement and through its implementation, reversing the outflows during the global financial crisis (Figure 23). These inflows fell off and were volatile during QE2 implementation, reflecting the euro area sovereign debt crisis, and during Operation Twist. The inflows increased sharply during and immediately after the QE3 announcement. In 2012, net portfolio equity inflows and bond inflows reached, respectively, 0.3 percent and 0.4 percent of

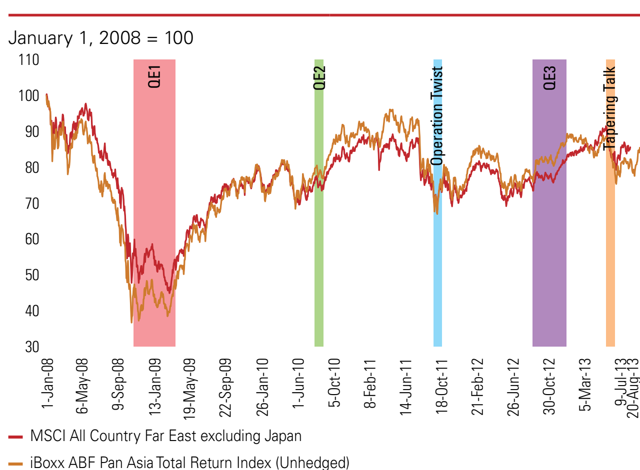
27 Following IMF (2013c), Cho and Rhee (2013), and publicly available information, the following announcement and implementation windows were considered. QE1: announced November 2008–March 2009, implemented December 2008–August 2010. QE2: announced November 2010, implemented November 2010–June 2011. Operation Twist: announced September 2011, implemented September 2011–December 2012. QE3: announced September–December 2012, implemented January 2013 onward.

28 Credit default swap spreads represent the cost of insuring sovereign debt against default; hence, they serve as a measure of sovereign credit risk.

regional GDP. Following that, flows declined steeply beginning in February 2013. In general, equity flows have proved much more volatile than bond flows, with far less of the variation explainable in terms of QE announcements.

- **10-year government bond yields declined** after each QE announcement, experiencing a broad fall through May 2013 (Figure 24). The Morgan Stanley Capital International (MSCI) **equity indexes for EAP recovered** rapidly following the QE1 announcement and during its implementation. Prominent examples include the equity markets in Hong Kong, SAR; the Republic of Korea; and Indonesia. The indexes remained at high levels during QE2 implementation, although they fell during late 2011, again reflecting the euro area crisis. The indexes also reacted positively to the QE3 announcement, remaining fairly stable until May 2013. Overall, between end-2008 and May 2013, stock prices quadrupled in Indonesia and the Philippines, and rose nearly as much in Thailand.

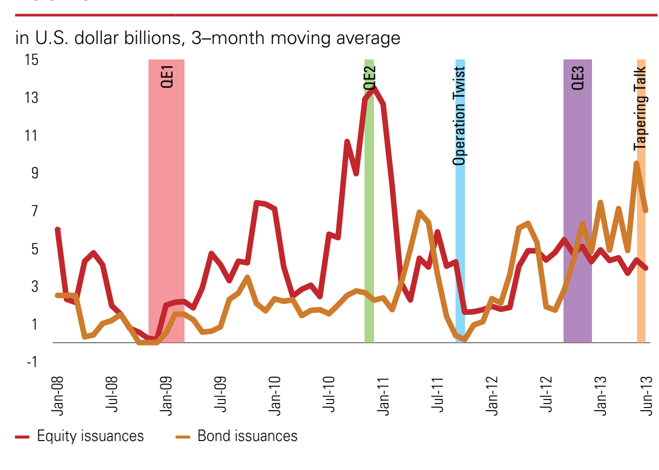
Figure 24. Bond and equity indexes, East Asia and Pacific



Source: Thomson Datastream and Bloomberg.

Note: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering. The "MSCI AC (All Country) Far East excluding Japan Index" is a free-float–adjusted, market-capitalization–weighted index that measures the equity market performance of China, Hong Kong SAR, Indonesia, the Republic of Korea, Malaysia, the Philippines, Thailand, Singapore, and Taiwan, China. The "Markit iBoxx ABF Pan-Asia Index" tracks the performance of local-currency–denominated bonds issued by governments and quasi-government entities in China, Hong Kong SAR, Indonesia, the Republic of Korea, Malaysia, the Philippines, Thailand, and Singapore.

Figure 25. New bond and equity issuances, East Asia and Pacific



Source: Dealogic.

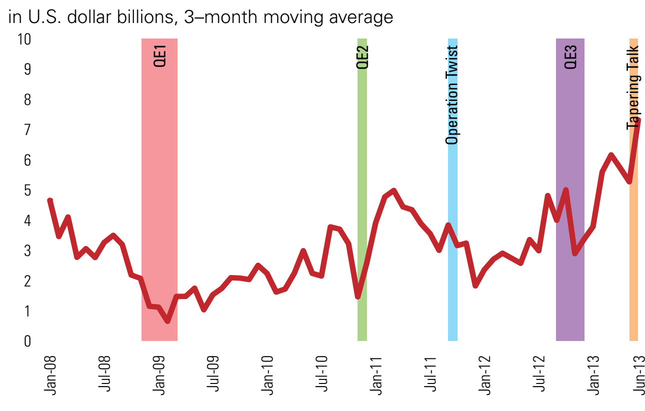
Note: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering.

- Likewise, new **bond and equity issuances reacted positively** to the QE1 announcement and implementation (Figure 25). There was a drop-off starting in January 2010, but flows recovered after mid-2010. For equity, the QE2 announcement was followed by a peak in issuance. Activity then fell off during QE2 implementation, stabilizing at around US$5 billion per month late in Operation Twist and through much of the QE3 period. For bonds, activity proved extremely volatile during QE2 and Operation Twist. It recovered sharply following the QE3 announcement, reaching a postcrisis peak of US$9 billion in May 2013.

- Similarly, new **syndicated bank borrowing rose** steadily after the QE1 announcement (Figure 26). Activity reacted positively to the QE2 announcement, but like bond issuance proved volatile during the QE2 and Operation Twist period. It rose sharply during QE3 implementation, exceeding US$7.5 billion in June 2013. Overall, cross-border loans accounted for two-thirds of total inflows over the last three years.

Figure 26. New syndicated bank loans, East Asia and Pacific

in U.S. dollar billions, 3–month moving average

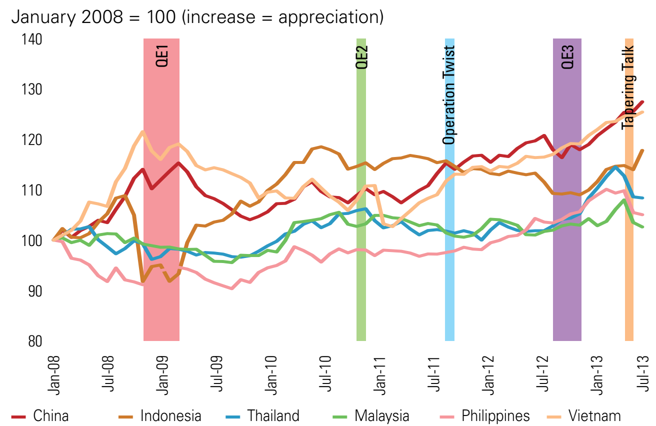


Source: Dealogic.

Notes: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering.

Figure 27. Real effective exchange rates, East Asia and Pacific

January 2008 = 100 (increase = appreciation)



Source: IMF.

Notes: Shaded segments designate the announcement windows for each QE program, together with the 30-day period following the May 22 speech on QE tapering.

As part of the macroeconomic response to QE:

- **Real effective exchange rates appreciated** by 5 to 25 percent overall between January 2008 and June 2013 (Figure 27). Individual exchange-rate paths varied significantly.[29] In those economies where currencies appreciated relatively less (such as Hong Kong, SAR; and Malaysia), housing prices increased relatively more (Cho and Rhee 2013).

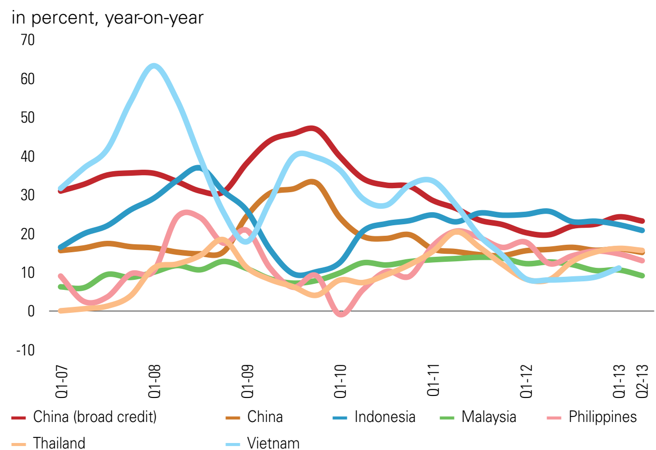
- **International reserves increased significantly, and current accounts remained relatively solid.** The major exception was Indonesia, whose current account swung into deficit in 2012 (reflecting weaker prices for commodities such as coal and palm oil), and has since deteriorated to a 4.4 percent of GDP deficit (2013 Q2). Related to this, Indonesia's reserves have decreased by 20 percent over the last two years.

- **Monetary conditions eased significantly.** Some countries, such as Thailand, lowered the policy rate; others, such as Indonesia, lowered the bottom of the interest-rate corridor. Between 2008 and 2012, domestic credit in Indonesia grew at a particularly rapid average 21 percent per year. Malaysia, the Philippines, and Thailand also recorded fast credit growth, on the order of 10 percent or more per year on average (Figure 28).

- **Only limited use was made of tighter macroprudential regulation and capital-flow**

Figure 28. Domestic credit growth

in percent, year-on-year



Sources: CEIC and IMF, IFS.

29 China and Vietnam depreciated during QE1, but then appreciated. Indonesia appreciated sharply during QE1 implementation, stabilized through QE2, depreciated through Operation Twist, and then appreciated during QE2. Thailand depreciated midway through QE1, recovered midway through QE2, and then appreciated more sharply through May 2013. Malaysia and the Philippines followed a similar pattern.

management measures. For instance, Indonesia introduced and then tightened capital-flow management measures, including a minimum holding period for central bank bills; and also introduced prudential limits on consumer and mortgage lending. Thailand relaxed controls on capital outflows.

Conversely, recent uncertainty surrounding the tapering of QE has led to considerable financial turbulence in EAP; Indonesia has been affected most strongly. Between late May and end-August 2013, amid expectations of rapid tapering and a generalized repricing of risk, U.S. long-term yields spiked by approximately 100 bps, average credit default swap spreads for EAP widened to 120 bps, and regional equity and bond funds experienced outflows of more than US$25 billion. Long-term bond yields rose by over 320 bps in Indonesia, and approximately 100 bps in Malaysia, the Philippines, and Thailand. Emerging Asia's composite stock market index fell by more than 10 percent, with Indonesia, the Philippines, and Thailand all undergoing declines of 20 percent or more. Long-term bond yields rose by over 250 bps in Indonesia, and 75 bps in Malaysia and Thailand. New equity and bond issuances moderated. And currencies depreciated (in nominal dollar terms) by over 10 percent in Indonesia, and over 6 percent in Malaysia, the Philippines, and Thailand. In September, as concerns about tapering diminished (especially in the wake of the Federal Reserve FOMC meeting on September 18), many of these developments were largely reversed.[30]

Prospects

The tapering of QE will increase global interest rates and reduce capital flows to developing countries. Existing studies identify a strong impact of U.S. monetary policy on global interest rates (Kennedy and Palerm 2013). Likewise, global push factors, including, in particular, increases in U.S. interest rates, do affect capital flows to emerging markets, through the portfolio-rebalancing channel (IMF 2013b). In addition, higher U.S. interest rates may encourage a reassessment of country-specific vulnerabilities. Bond flows may be particularly sensitive, and hence a particularly important potential source of risk.

Economies may be especially vulnerable to the extent that they have significant external financing requirements, saw rapid credit growth when interest rates were low, or have experienced large increases in debt. Indeed, markets appear to be discriminating on the basis of country fundamentals. Indonesia's high bond yields partly reflect its current-account deficit. Again, in Indonesia, and in Malaysia, the Philippines, and Thailand, there are concerns about rapid credit growth leading to financial-sector overextension. Gross national debt now exceeds 150 percent of GDP in Malaysia, China, and Thailand, and 100 percent of GDP in the Philippines (Figure 29; see also note on "China's Credit Binge May Have Run Its Course," in this Economic Update). Specific concerns include a sharp increase over the last few years in household debt in Malaysia and Thailand,[31] and high leverage in state-owned enterprises in Vietnam.

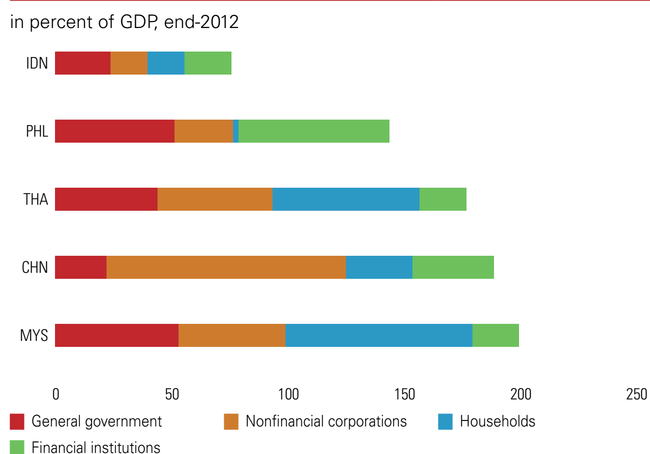
Quantitatively, the likely impact of tapering on yields and capital flows remains unclear, but may well prove relatively large. Two factors will amplify the impact of tapering, compared with the relatively small

30 For instance, during the first three weeks of September, stock markets in Indonesia, the Philippines, and Thailand recovered more than the half of the losses incurred after May 22, and those in Malaysia rose above the May 22 levels. Likewise, most EAP currencies appreciated against the U.S. dollar, with some returning to their May 22 levels.

31 For instance, loans to households in Thailand increased from nearly 55 percent to 77 percent of GDP between 2009 and 2013.

Figure 29. Debt stock outstanding

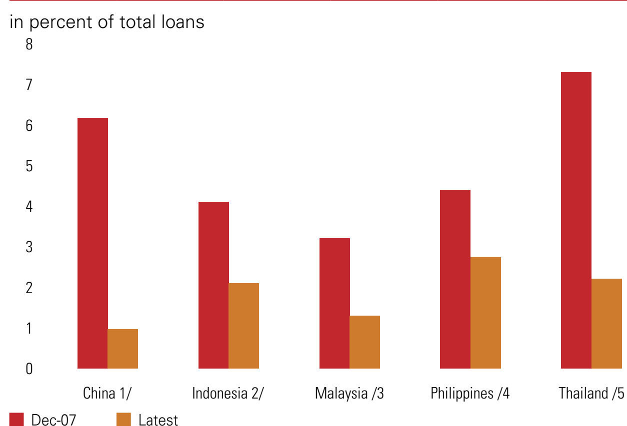
in percent of GDP, end-2012



Sources: World Bank staff estimates.

Figure 30. Bank nonperforming loans

in percent of total loans



Sources: National Statistical Agencies.

Note: Latest values refer to either June 2013 (China and Thailand) or March 2013 (all other countries). The values are exclusive of bad-loan transfers to asset management companies (AMCs).

1. Covers only the major commercial banks for 2002–04, and all commercial banks for 2005–10.

2. Excludes the Indonesian Bank Restructuring Agency's AMC. Data for 1997 to 2002 exclude state banks; the data source is the Monetary Division of Bank Indonesia. Data from 2003 cover all commercial banks including state banks; the data source is the Banking Supervision Division of Bank Indonesia.

3. Excludes Danaharta. This series, used by Bank Negara Malaysia, is net of provisions and excludes interest in suspense. Beginning financial year 2010, banking institutions are required to report impaired loans in accordance with the Guideline on the Classification and Impairment Provisions for Loans/Financing. The reporting of nonperforming loans has since been discontinued.

4. Includes interbank loans.

5. Excludes transfers to AMCs. The jump in headline nonperforming loans in December 2002 was a one-off increase, reflecting a change in definition, and did not affect provisioning.

effects often associated with the later stages of QE. First, tapering was relatively unanticipated. Second, and related, tapering may lead to a significant reevaluation of country-specific risks. Still, the lack of consensus suggests that volatility is likely to remain elevated for an extended period. World Bank (2013) points out that, if real base rates return to their long-term averages, they could rise from 190 bps in June 2013 to approximately 320 bps (the mean level during 1990–2007). In turn, this could cause developing-country yields to rise by between 150 and 270 bps, with countries with worse credit histories and greater spreads toward the upper end of this range.

As for capital inflows, IMF (2013b) implies that a 130 bps increase in the U.S. 10-year yield would reduce capital flows to emerging markets by only 2 percent—significantly less than what was observed between end-May and August 2013. However, these effects could be compounded by induced changes in risk perceptions and risk appetite. In contrast, IMF (2011) suggests that an *unanticipated* 130 bps rise in U.S. real interest rates may on average cause a significantly higher 13-percentage-point-of-GDP reduction in net capital inflows in the first quarter, and a 32.5-percentage-point-of-GDP cumulative reduction after two years. The impact would be larger in countries with greater financial links with the United States, and would primarily affect bond rather than equity flows.

Higher interest rates and lower capital inflows will in turn affect broader economic activity and output. Over the long run, investment and potential output will decrease. Simulations suggest a 130 bps increase in U.S. long-term yields may reduce potential output growth rates in developing countries by 0.6 percent per year (World Bank 2013).

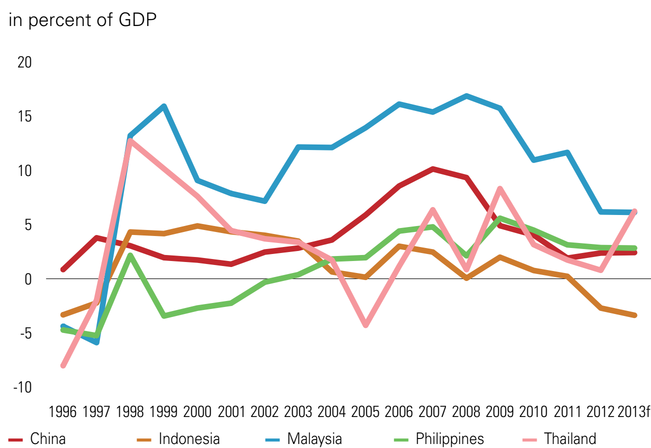
In the short run, and in line with our discussion of country-specific vulnerabilities, there are concerns about potentially overextended domestic financial sectors, which could experience sharp, sudden adjustments, disruptions, and difficulties in rolling over loans. Tighter global financing conditions may be reflected in a "sudden stop" in capital inflows, a particular concern in those economies, such as Indonesia,

where foreign holdings of local securities have been rising rapidly.[32] The effects would be compounded by currency depreciation in the presence of unhedged foreign-currency exposure. More broadly, a rise in global interest rates will affect credit conditions in any economy financially integrated with the rest of the world. Higher global interest rates will, among other things, reduce emerging-market asset prices, with potentially disruptive adverse balance-sheet effects for any leveraged asset holders, including banks and households. And all these effects would be exacerbated by a general slowdown in the region, reflecting, for instance, rebalancing in China (see Part I of this Economic Update).

Still, most EAP economies are in a relatively strong position to face this shock, with significantly lower vulnerabilities than in the run-up to the 1997–98 Asian crises. Exchange rate regimes are more flexible. Current account positions are relatively solid, with the above-mentioned exception of Indonesia (Figure 31), and net external debt has diminished. Foreign-exchange reserves have increased, and are adequate to cover short-term external financing requirements (Figure 32); again, the main outlier is Indonesia, where short-term external debt stands at 49 percent of reserves (end-2012). Financial systems are better regulated, nonperforming loans have decreased steadily over time (Figure 30), and reliance on external borrowing in foreign currency has declined sharply, reducing vulnerability to currency mismatches during periods of sharp exchange rate volatility (Citi Research 2013). For instance, the banking sector in Indonesia retains a solid 16 percent ratio of capital to risk-weighted assets. And public debt remains relatively low.

Figure 31. Current account

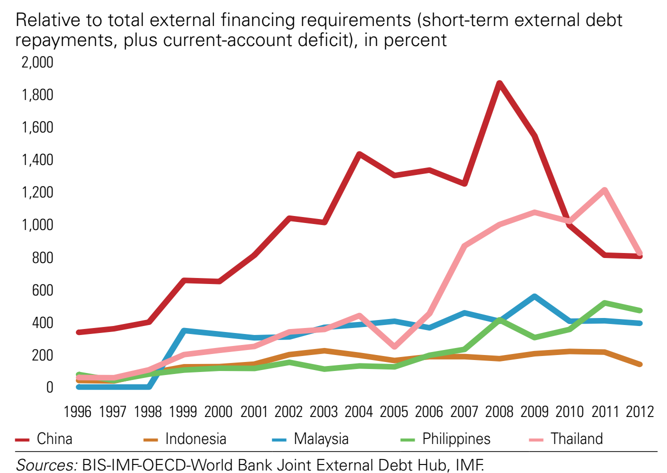
in percent of GDP



Sources: CEIC, IMF.

Figure 32. Foreign exchange reserves

Relative to total external financing requirements (short-term external debt repayments, plus current-account deficit), in percent



Sources: BIS-IMF-OECD-World Bank Joint External Debt Hub, IMF.

The impact of QE tapering on EAP capital inflows may to some degree be offset by monetary accommodation in Japan. Japan's new strategy to exit deflation and revive growth involves aggressive monetary easing, fiscal expansion, and growth-enhancing structural reforms. In particular, the Bank of Japan's new Quantitative and Qualitative Monetary Easing framework seeks to double the monetary base (an increase of 27 percent of GDP) in two years, expanding the scope and scale of asset purchases to achieve the recently adopted 2 percent inflation target. The potential financial spillovers, through expanded bank lending, portfolio rebalancing, and increased outward foreign direct investment, remain unclear and will depend on developments in both interest rates and Japan's domestic outlook. Capital outflows have so far remained moderate, reflecting Japan's relatively inward-looking financial system. Also, based on past trends, only a modest share

32 Nonresidents accounted for approximately 32 percent of local-currency bonds in Indonesia and 15 percent in Thailand (as of April 2013).

of any additional portfolio flows will go to emerging EAP economies (IMF 2013b). Nevertheless, the impact on recipient countries with relatively thin capital markets could be large. The impact on regional output will additionally depend on exchange rate developments, with the yen already weakening by 20 percent since the announcement of the new strategy, and on the success of Japan's fiscal expansion and structural reforms.

Conclusions

Plans by the Federal Reserve to taper its QE program will result in a less favorable external financing environment for EAP. The region will face higher borrowing costs, lower capital inflows, and a decline in regional asset prices. In the long run, this will affect investment and potential output. In the short run, it also raises concerns about potentially overextended domestic financial sectors. Estimates of the impact vary widely, but it is likely to prove larger in economies characterized by greater financial openness, significant current account deficits, rapid credit growth in recent years, or large increases in debt.

However, changes in U.S. monetary policy will themselves reflect, and may be partly offset by, broader economic developments. An unwinding of the U.S. monetary stimulus will occur if, and to the extent that, the U.S. economy is strengthening. This will be a welcome development for countries that benefit, through trade or other linkages, from stronger U.S. growth.

In the short term, EAP economies face several policy options. In general, macroeconomic policy stances will need to be adjusted to contain or prevent a deteriorating current account, inflation, and asset-price bubbles, and to maintain capital inflows. The appropriate response will involve a mix of exchange-rate depreciation and higher interest rates, with the correct balance depending on the starting level of economic activity, inflation, and the degree of exposure to foreign-currency-denominated liabilities. Monetary tightening will help minimize any inflationary impact, but will affect growth negatively. In some countries, fiscal consolidation may help restore market confidence. In addition, some intervention in foreign exchange markets, running down reserves, may help moderate excessive exchange-rate volatility or short-term liquidity pressures. Those countries most vulnerable to swings in global capital flows should also reduce their reliance on short-term and foreign-currency-denominated debt.[33]

Over the longer term, developing EAP can reduce the cost of its borrowing by strengthening its domestic institutions and further improving the investment climate. Several economies have failed to generate sufficient, high-quality employment, particularly for their youth (see note on "At Work in East Asia and Pacific," in this Economic Update). Many are failing to develop a sufficiently sophisticated manufacturing industry. Potential measures to boost competitiveness and enhance stability include:

- Strengthening the rule of law and property rights, including by reducing rent-seeking opportunities
- Reforming financial systems, including by enhancing the quality of macroprudential and other financial regulations (as is on the agenda in China)

33 In contrast, capital flow management measures on outflows should only be used in a crisis situation, and "should always be part of a broader policy package that also includes macroeconomic, financial sector, and structural adjustment to address the fundamental causes of the crisis" (IMF 2012, 26).

- Accelerating the pace of structural reforms, including in labor markets (for instance, increasing female labor force participation and boosting labor skills in Malaysia), and in subsidy regimes (for instance, reforming fuel subsidies in Indonesia and Malaysia and rice subsidies in Thailand)
- Improving infrastructure, including in power and transportation (including in Indonesia, the Philippines, and Thailand). This will require significant progress in project appraisal, selection, implementation, and evaluation, coupled with mobilizing private financing
- Liberalizing foreign direct investment inflows, including in the natural resource and banking sectors (including in Indonesia and the Philippines).

Several economies failed to use the breathing space afforded by an extended period of low interest rates to improve their fundamentals. They should not now waste the near-term relief provided by developments in September.

Still, the outlook for most EAP economies is relatively favorable. Vulnerabilities are far more limited than in the past. Until recently, the key concern in emerging markets was excessive capital *inflows*. Lower capital flows will instead weaken pressures for exchange rate appreciation, ease concerns about a potential loss of competitiveness, and reduce the risk of asset bubbles. And global interest rates, even if significantly increased, remain at historic lows.

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Part III. The Medium-Term Development Agenda

III.A. At Work in East Asia and Pacific[1]

Labor markets and their contribution to growth and household well-being are a growing concern in East Asia and Pacific. Problems include high youth inactivity, rising inequality, and binding skills shortages. A key underlying issue is widespread economic informality, which increases household vulnerability to shocks, limits the tax base, and constrains innovation and productivity. Informality is both a consequence of relatively stringent labor regulations, and a reason for their widespread evasion. Key components of the appropriate policy response include macroeconomic stability, and a regulatory framework that encourages, in particular, the small and medium-size enterprises where most people in East Asia and Pacific work. It is also critical to "formalize" more work, so as to increase the coverage of essential work-risk and social protection, and to sustain growth. To this end, policies should encourage mobility of labor and human capital, and not favor some forms of employment (for instance, full-time wage employment in manufacturing) over others. Among the more specific challenges, mainly agrarian countries should focus on raising agricultural productivity. In urbanizing countries, good urban planning becomes critical. The Pacific Island Countries should provide youth with the human capital needed to succeed abroad as migrant workers.

The Triumph of Work for Well-Being

Economic development in East Asia and Pacific (EAP) is a triumph of working people. EAP has experienced industrialization, urbanization, and economic diversification at historically unprecedented rates. In the last two decades, rapid changes boosted agricultural output and triggered large movements of people to towns and cities and into work in factories and firms, raising factor productivity in most of the region. The concentration of working people and enterprises boosted output in fast-growing cities. Countries that were low income a generation ago successfully integrated into the global value chain, exploiting their labor cost advantage. In 1990, the region held about a third of the world's labor force. Leveraging this comparative advantage, developing EAP's share of global GDP grew from 7 percent during 1990–92 to 17 percent during 2009–11.

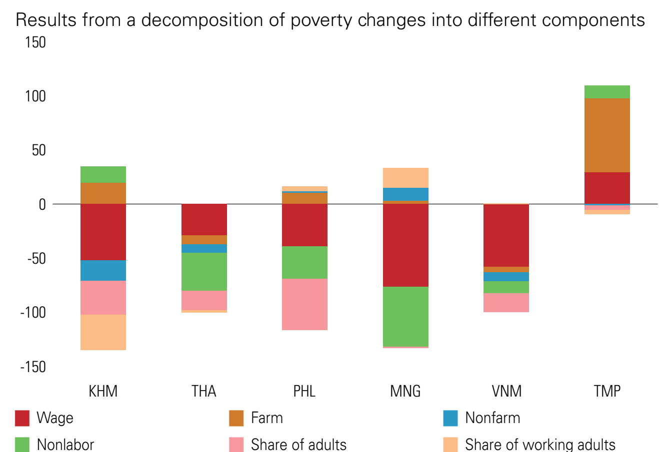
Sound policies and good economic institutions have encouraged private-sector-led growth and demand for work, and enhanced resilience. Price stability, low public debt, and relatively light taxation in many parts of the region facilitated doing business and investment. Widespread access to adequate health and education ensured a strong foundation of human capital. Given these strong fundamentals and increasing integration with the global economy, EAP was able to sustain high growth rates and maintain its resilience during the global financial crisis of 2008–10. A number of EAP countries continued to generate employment in 2009 and 2010, in contrast to the job losses experienced by most Central and Eastern Europe countries, and muted employment growth in other developing regions.

1 This note was prepared by Truman Packard and Trang Van Nguyen and is based on a forthcoming World Bank report, "At Work in East Asia Pacific."

Sustained high rates of economic growth have been necessary, though not sufficient, to ensure well-being from work. Growth has improved employment outcomes, fueled gains in living standards, and mitigated social tensions. The rise in labor productivity in EAP during the 1990s and 2000s was far greater than in Latin America, Eastern Europe, and the OECD countries. China's threefold and Vietnam's almost twofold growth in labor productivity since 2000 are particularly impressive. Households reaped the benefits of greater productivity in higher earnings: rising labor income accounted for more than 40 percent of poverty reduction in the late 2000s in a number of EAP countries (Figure 1). The share of the region's population living in extreme poverty (that is, on less than US$1.25 a day) declined by more than half since 1990, from the highest level across all regions to among the lowest. Working people experienced stark changes in their lives within a generation: shifts from rural farms to urban factories, the breakdown of village institutions and community property rights, and the weakening of extended family structures. But these changes neither created significant political debate nor catalyzed social tension, because so many were moving out of poverty and into the urban middle class, against a backdrop of fast growth. In that sense, as argued in the *World Development Report 2013: Jobs* (World Bank 2012), work has been the conduit connecting and enabling three critical development transformations: *productivity gains, improvements in living standards,* and *greater social cohesion*—which are collectively referred to here as increases in "well-being." For much of their recent history, EAP countries have managed to achieve these three development transformations in tandem.

Figure 1. Income from work explains a large share of the reduction in poverty

Results from a decomposition of poverty changes into different components



Sources: Staff estimates based on Cambodia Socio-Economic Survey (2007, 2010), Thailand Household Socio-Economic Survey (2006, 2009), Philippines Family Income and Expenditure Survey (2006, 2009), Vietnam Living Standards Measurement Survey (2004, 2010), Mongolia Household Socio-Economic Survey (2007/8, 2011), and Timor-Leste Survey of Living Standards (2001, 2007).

Rising Challenges to Well-Being from Work

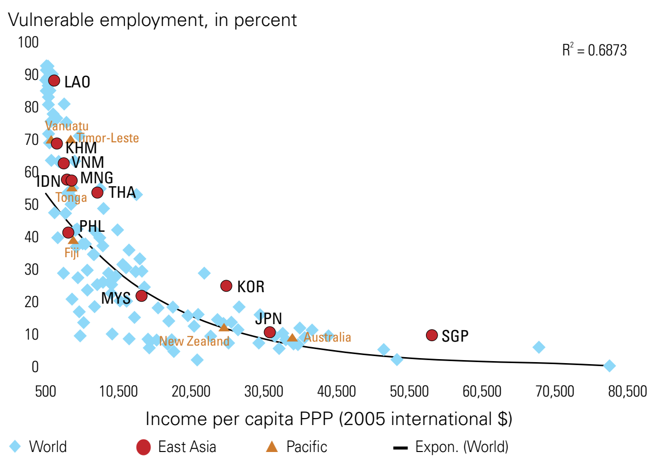
In the last few years, the news headlines about work in EAP have started to change. Among the usual articles about growth, productivity, and poverty reduction are stories of a very different character. Since 2009, reports of discontent and sometimes drastic action by Chinese factory workers in protest against poor working conditions have become more frequent. There have been growing instances of strikes in Indonesia, a twofold increase of "wildcat" strikes in Vietnam over 2011, and frequent clashes between garment-factory workers and police in Cambodia. These reports seem at odds with the widely accepted narrative of the region's rise, and signal rising demand for government action to sustain household and social well-being from work.

Widespread economic *informality*—work and other transactions in unregulated and untaxed markets—is critical to understanding the growing concerns about work and well-being, despite the region's successes. The exact dimensions of the informal economy are difficult to measure, because only proxies are available. As a region, EAP has the second-highest share of the labor force working outside of wage and salaried employment, surpassed only by countries in Sub-Saharan Africa. A large portion of this activity in agrarian countries like Lao PDR, Cambodia, and Papua New Guinea reflects "structural informality," since

many still work in subsistence or small-shareholder farming. Typically, this type of informal work decreases with structural change away from agriculture. However, in all middle-income countries, even those with large manufacturing and service sectors, a persistent share of the labor force continues to work beyond the reach of taxation, regulation, and protection. This informal work (whether measured as nonfarm self-employment, those working without a labor contract, people working in microenterprises with five or fewer workers, or the segment of the workforce that fails to contribute to social security) is higher in many EAP countries than in other countries at similar income levels (Figure 2).

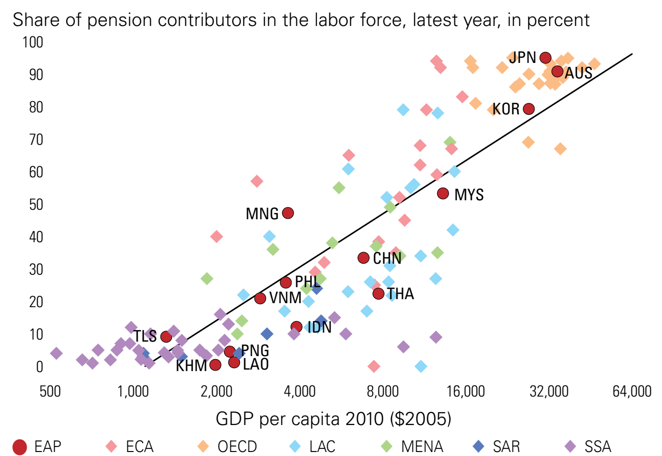
Figure 2. "Informal" forms of work are more common in East Asia and Pacific than other countries at similar levels of development

a. Own Account and Unpaid Family Workers as a Share of the Labor Force (2010)



Source: Staff estimates, using *World Development Indicators.*

b. Share of the Labor Force that Contributes to Pensions (Latest Available Year)

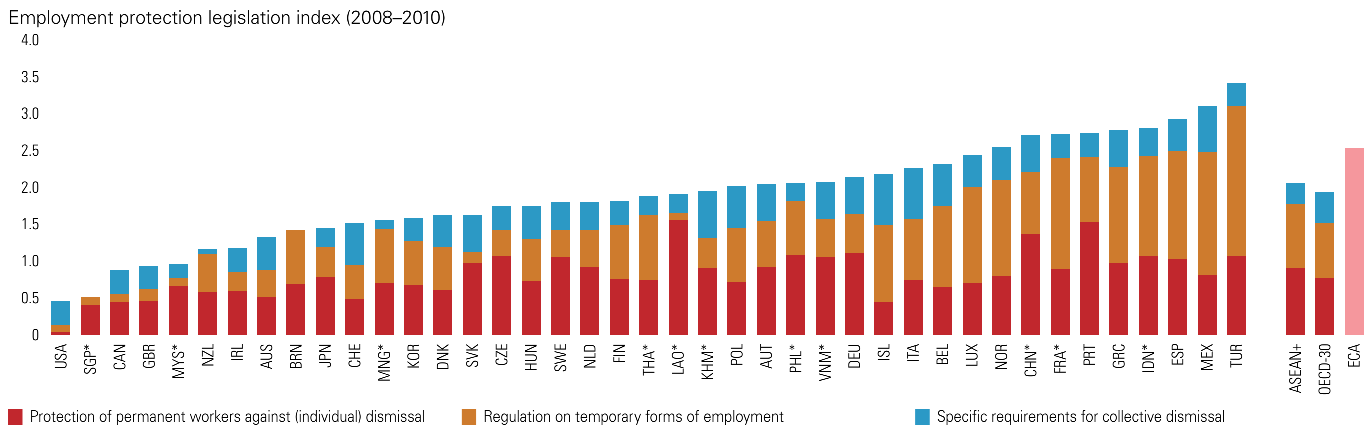


Sources: World Bank Pensions Database (2013) and *World Development Indicators.*

High levels of informal work in EAP are not per se harmful, but may have undesirable side effects. The informal economy provides a living to many who would otherwise be destitute. And, across the region, many informal workers and enterprises are well integrated into domestic, regional, and international production chains. Often, the output of the informal economy either is an intermediate input to formal-sector factories and firms, or is consumed by people who themselves work in or provide services to the formal economy. The problem arises when the prevalence of informal economic activity constrains innovation and productivity, when the tax base is so small that governments find it difficult to provide public goods, and when working informally limits households' options for managing shocks to their well-being or makes it more difficult for them to seize opportunities.

The high levels of informal work in EAP are both a consequence of relatively stringent de jure labor and social protection policies, and a reason for their widespread evasion. Overall, the history of state intervention in labor and social protection policy in EAP is modest relative to that of countries in other regions. EAP governments started regulating their labor market much later than in Latin America and Central and Eastern Europe, and provide fewer social programs. But several governments in emerging East Asia have recently stepped into this arena of policy making with levels of intervention similar to Southern European countries (Figure 3). For instance, formal employment protection legislation is highly restrictive in Indonesia, where workers whose employment is regulated enjoy more de jure protection than workers in France, Greece, or Portugal, and only slightly less protection than workers in Spain. In China, workers in regulated employment are de jure more difficult to dismiss than workers in Belgium and Italy. In the Philippines, as a result of labor

Figure 3. Some countries in East Asia and Pacific have similar restrictions on dismissal as countries in Southern Europe



Source: Staff estimates.

Notes: Score ranges from 0 (least stringent) to 6 (most restrictive). *denotes ASEAN+ countries. OECD average includes a sample of 30 countries; values refer to 2010. ECA values are for 2007, and only reflect a total (with no breakdown by category).

regulation, the average statutory minimum wage, relative to value added per worker, exceeds the level in 90 percent of countries in the world.[2] Cambodia and Indonesia are not far behind.

Even labor regulations set at reasonable levels but poorly implemented can aggravate the market failures they were designed to overcome. Evidence on the impact of minimum wages and employment protection legislation on employment outcomes across countries is mixed. Set at reasonable levels, the impact of these regulations has been found to be negligible in countries with strong institutions and higher administrative capacity. However, even where labor regulations have a limited impact on overall employment, unemployment, and wages, they have distributional consequences that favor prime-aged men at the expense of women, young people, and those who work part time and in self-employment. For instance, minimum wages in ASEAN disproportionally lower the employment opportunities of low-skilled people, women, youth, and recent entrants into the labor market (Box III.1).

The prejudicial impact of labor regulation on the forms of work that are prevalent in most EAP countries is a growing problem that creates both segmentation and exclusion. The extent of informal activity is positively associated with levels of de jure employment protection and labor taxation. In China, the 2008 Labor Contract Law attempted to expand social insurance coverage, financing it through increased payroll taxes. This was associated with a lower probability of local employed residents' being protected (Giles, Wang, and Park 2013).

Louder and More Frequent Calls for Action

Questions about the links between work and well-being have started to surface in EAP with greater frequency and urgency. This is to be expected since most EAP countries, including the most populous (China and Indonesia), are now at a development stage where the three transformations propelled by work (gains in

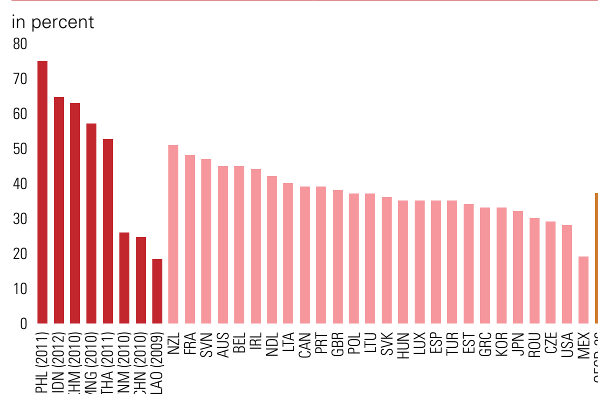
2 For instance, it is much higher than in Belgium and France, as well as in high-income countries in the region, such as Australia and New Zealand.

Box III.1. Minimum Wages in the ASEAN-4[1]

Introduction

Rising inequality and persistent poverty in East Asia are generating increasing interest in the use of minimum wage policies. In Indonesia, the Philippines, Thailand, and Vietnam, major reforms to minimum-wage policies have been recently implemented or are under discussion. Thailand, for instance, introduced a nationwide minimum wage of 300 baht per day early in 2013, while Indonesia is discussing the movement to a two-tier monthly minimum wage. Both policy changes entail quite dramatic increases over previous levels,[2] and concerns exist as to their effects, especially given the already high levels of statutory minimum wages in ASEAN countries (Figure BIII.1).[3]

Figure BIII.1. Ratio of Minimum wages to average wages in East Asia and the OECD



Source: World Bank (2013a).
Note: OECD figures are for 2010.

Overview of Minimum Wage Regimes in the ASEAN-4

Minimum wage regimes in the ASEAN-4 are complex. As is common throughout the developing world, the ASEAN-4 countries differentiate minimum wages by age, geographical area, sector, and/or category of work, with Indonesia and the Philippines delegating wage setting to subnational authorities, and Vietnam also providing for regional variation.[4] In the Philippines, this results in over 200 different daily minima, ranging from ₱190 to ₱426, which are frequently changed.[5] Multiple minimum wage regimes are designed to tailor wages to sectoral differences in productivity and labor intensity, and to account for regional cost-of-living differences. However, these regimes necessitate a complex system of oversight by the relevant authorities or by trade unions (Cunningham 2007).

In recent years, many ASEAN-4 countries have put forth policies to reform minimum wage regimes. In early 2013, Thailand unified 32 minimum wages into a common rate of 300 baht per day, making it the only country in the region with a national minimum, albeit a very high one. Vietnam, after long applying different rates to the foreign and domestic sectors, homogenized the private-sector minimum wage in 2011, leaving only four region-specific minimum wages. Indonesia, which currently presides over a variegated regime similar to the Philippines, has mooted introducing two-tier monthly minimums of US$228 for Jakarta and US$ 208 for the rest of the country. The Philippines is piloting the adoption of a two-tier regime, with a mandatory fixed "floor

1 This box was prepared by Andrew Beath. The box is based on the forthcoming World Bank report, *Minimum Wage Policy: Lessons with a Focus on the ASEAN Region*, by Ximena Del Carpio and Laura Pabon.

2 For Thailand, a 39.5 percent increase in the prevailing minimum wage in the 70 poorest provinces. For Indonesia, a 44 percent increase in the minimum wage in Jakarta.

3 The ratio of minimum wages to average wages exceeds 50 percent in Cambodia, Indonesia, Mongolia, the Philippines, and Thailand. Indeed, in the Manila region, in 2012, minimum wages were set at almost 90 percent of average wages (World Bank 2013b). The ratio of minimum wages to average value added per worker exceeds 40 percent in Cambodia, Indonesia, Lao PDR, the Philippines, and Vietnam—levels unmatched by any OECD country.

4 In contrast, advanced economies in the region, such as Hong Kong and South Korea, apply minimum wages to all employees without regard to regional or occupational differences.

5 Since 1989, when Congress decentralized minimum wage setting to the regions, minimum wages have been adjusted almost every year. The minimum wage in the Manila region, for instance, has been adjusted 17 times in the last 22 years (World Bank 2013b).

wage" set by the regional wage boards based on the poverty threshold and average wage, supplemented by an optional second tier consisting of an industry- or firm-specific rate based on productivity.

Complex regimes, abundant exceptions, lax enforcement, and high levels of informality limit the coverage of minimum wages in the ASEAN-4. In Thailand, minimum wages do not apply to government, domestic, or agricultural employees, or to part-time or student workers. Similarly, the Philippines applies minimum wages only to wage and salary workers in certain private companies; as a result, minimum wages are estimated to cover less than a third of the country's workforce.[6] Enforcement regimes are generally underresourced,[7] resulting in widespread noncompliance even in the formal sector. Currently, over half of agricultural and nonagricultural workers in the Philippines earn less than the minimum, while noncompliance rates are estimated at around one-third in Thailand and Indonesia and approximately 10 percent in Vietnam.

The Impact of Increases in the Minimum Wage

Economic theory provides limited guidance as to the effects of minimum wages. Neoclassical economic analysis, assuming perfect information and competitive labor markets, implies that imposing minimum wages above market-clearing levels will increase wages but reduce (formal) employment. However, when these assumptions are relaxed, predictions become less clear. Where an employer enjoys monopsony power (that is, hiring decisions by one firm affect the market-clearing wage), minimum wage increases need not reduce employment. Hence, contextual factors (including the competitiveness of the labor market, enforceability of minimum wage laws, elasticities of labor demand, information asymmetries, and impediments to labor mobility) ultimately determine the overall effects of minimum wages. Context-specific empirical evidence is thus critical to understanding the impacts of changes to minimum wages in particular countries.

Empirical evidence on minimum wages in the ASEAN-4 is thin, but indicates that high minimum wages limit the access of poor workers to formal sector jobs. Studies of labor markets in Indonesia, Thailand, and Vietnam show that increases in minimum wages are associated with a reduction in formal sector employment,[8] although the change may be at least partially offset by increased informal employment.[9] Evidence from the Philippines indicates that a 10 percent minimum wage increase in the manufacturing industry reduced formal employment in the sector by up to 8 percent, and that the high level of minimum wages may inadvertently undermine the country's garment industry (World Bank 2013b). Low-income or otherwise vulnerable workers (including women, youth, recent labor-market entrants, the low-skilled, nonmanagerial nonproduction workers such as cleaners or guards, elderly workers, and those employed by small firms) are particularly likely to be shut out of the formal labor market as a result of overly high minimum wages.[10]

6 World Bank (2013b). In the Philippines, the following firms can be temporarily exempted from paying minimum wages: (i) firms with less than 10 employees, (ii) firms less than three years old, (iii) firms having economic difficulties, (iv) firms that have suffered from disasters, and (v) worker-owned firms.

7 In 2011, the Philippines possessed only 270 labor inspectors, who were each assigned approximately 238 covered firms. An ILO report estimates that 40 percent of the Thai workforce is subject to labor legislation.

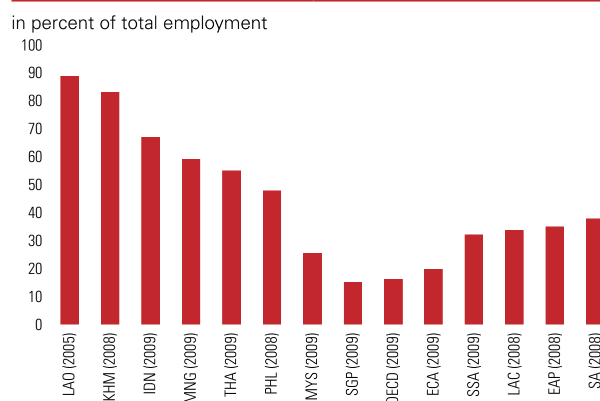
8 In Indonesia, minimum wages had a negative effect on levels of formal employment, particularly among small firms (Alatas and Cameron 2008; Del Carpio, Nguyen, and Wang 2012; Harrison and Scorse 2010). In Vietnam, increases in the real minimum wage reduced employment in domestic, but not foreign firms (Del Carpio, Nguyen, and Wang 2013). In the Philippines, real minimum-wage increases had negligible effects on overall employment, owing to the limited coverage of minimum wage rules and high noncompliance (Del Carpio, Margolis, and Okamura 2013). However, sectors with high coverage and compliance experienced negative employment effects (Lanzona 2012).

9 Comola and De Mello (2011) find that an increase in the minimum-to-mean ratio produces growth in informal employment and a positive net increase in total employment.

10 See Del Carpio, Nguyen, and Wang (2012) and Hallward-Driemeier, Rijkers, and Waxman (2010) for Indonesia; Del Carpio, Messina, and Sanz-de-Galdeano (2013) for Thailand; and Del Carpio, Nguyen, and Wang (2013) for Vietnam.

Given the limited coverage of minimum wages in the ASEAN-4, the vast majority of poor workers in the region do not benefit directly from minimum wage increases.[11] The majority of poor workers in the ASEAN-4 are self-employed, employed in the informal sector, or otherwise exempt from minimum wages (Figure BIII.2). There is some evidence from developing economies outside the region that minimum wage increases benefit informal sector workers indirectly, by boosting their bargaining power or through so-called "lighthouse" or benchmarking effects.[12] However, studies for ASEAN find no evidence of these positive wage effects for informal workers.[13]

Figure BIII.2. Self-employment rates in ASEAN+



Source: World Bank Indicators, 2010.

The existence of multiple minimum-wage regimes in the ASEAN-4 creates serious problems. These complicated regimes are hard to administer and enforce. They are poorly understood by employers and workers, limiting their ability to serve as benchmarks for informal or otherwise uncovered workers (see above) (Cunningham 2007). Multiple minimum-wage regimes potentially "crowd out" firm-level wage bargaining; in addition, they can distort the economy by discouraging sectors or regions with relatively high minimum wages (ILO 2008).

Policy Recommendations

Minimum wages have not proved to be an effective tool for reducing poverty or inequality in the ASEAN-4. Under current regimes, poor workers are generally not covered by minimum wage policies, and therefore do not directly benefit from them. In addition, the limited number of poor workers with formal sector jobs have suffered most from the adverse employment effects of minimum wage increases, including by being pushed into informal employment.

Minimum wages should be set at levels appropriate for vulnerable workers. Minimum wages should be benchmarks that limit the exploitation of vulnerable workers and protect their purchasing power, but do not inadvertently cause their exclusion from formal employment. To this end, minimum wages should be set at levels consistent with the productivity levels of unskilled workers. In some ASEAN-4 economies, minimum wages have served as a method of wage fixing, and have been set at levels which are unrealistically high for all but a subset of workers (ILO 2008). Such policies invite noncompliance and promote informal jobs, reducing social protections and tax revenues.

Simplifying, standardizing, and enforcing minimum wages is a key priority. Among the ASEAN-4 economies, only Thailand has instituted a unified national minimum wage. By moving to appropriately set, standardized minimum wages, governments can reduce compliance costs and improve predictability for employers, enhance benchmarking effects for informal workers, stimulate firm-level collective bargaining, and reduce

11 Over half of the benefits from minimum wage increases in Indonesia in 2003 accrued to nonpoor households, and only one-in-four poor households experienced a wage increase (Bird and Manning 2004).

12 See Boeri et. al. (2010); Dinkelman and Ranchhod (2010); and Gindling and Terrell (2004).

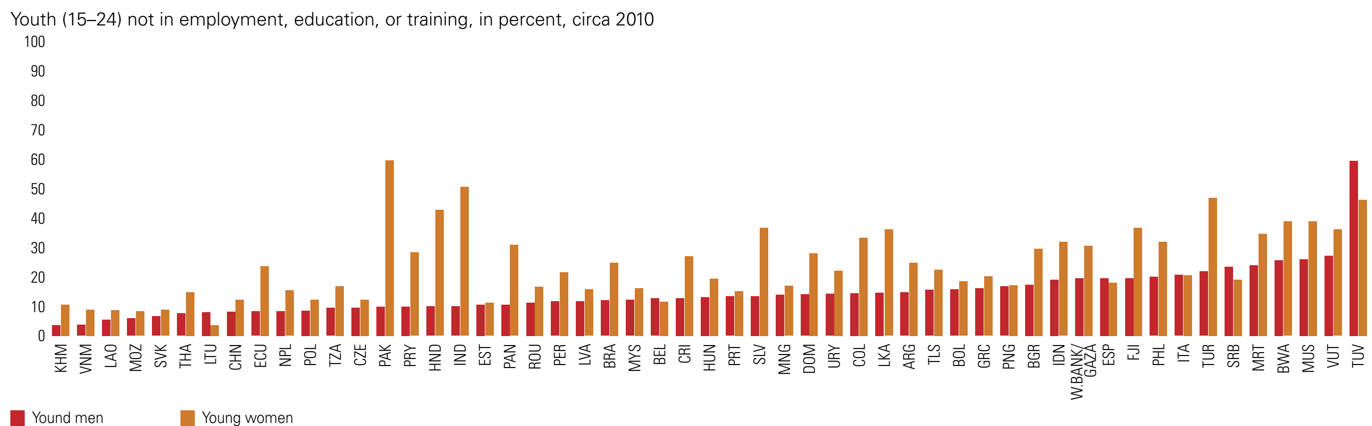
13 For instance, Chun and Khor (2010) find that increases in the minimum wage for formal-sector employees in Indonesia have no spillover effects on the income of the self-employed. An additional consideration is that minimum wages may increase poverty by increasing the price of basic goods (Bird and Manning 2004 2008).

distortions. Where it proves necessary to make accommodations for special groups, such as youth, alternative policies should be considered, including training or wage subsidies. Finally, to increase compliance with minimum-wage policies, sufficient resources should be allocated to labor inspectors to audit employers and impose penalties.

productivity, living standards, and social cohesion) are no longer happening at similar rates. Some countries experience direct threats to social cohesion, specifically from high youth unemployment and inactivity, as well as high and rising income and consumption inequality.

For the region as a whole, more than 30 percent of people aged 15–24 are not in employment, education, or training. Fiji, Indonesia, the Philippines, Tuvalu, and Vanuatu have among the highest rates of youth inactivity in the world (Figure 4). High levels of youth inactivity have been linked to violence and eroding social cohesion, providing a strong motivation for governments to pay closer attention to the opportunities for youth to work or build human capital. Even where violence is not yet a concern, high rates of disengagement among youth can have a lasting impact on their future economic prospects, and ultimately limit the productive potential of a country as a whole.

Figure 4. Youth Inactivity is high in some of the Pacific Island Countries, Indonesia, and the Philippines



Source: World Development Report 2013 Core Statistical Tables, based on the World Bank's International Income Distribution Database (I2D2).

While the region's economic success has been accompanied by gains in average living standards, growing skill premia have led to rising inequality, for instance in China, Indonesia, and Lao PDR.[3] Rising skill premia in many parts of the region raise concerns among policy makers about widening income disparities and the risk of social polarization.

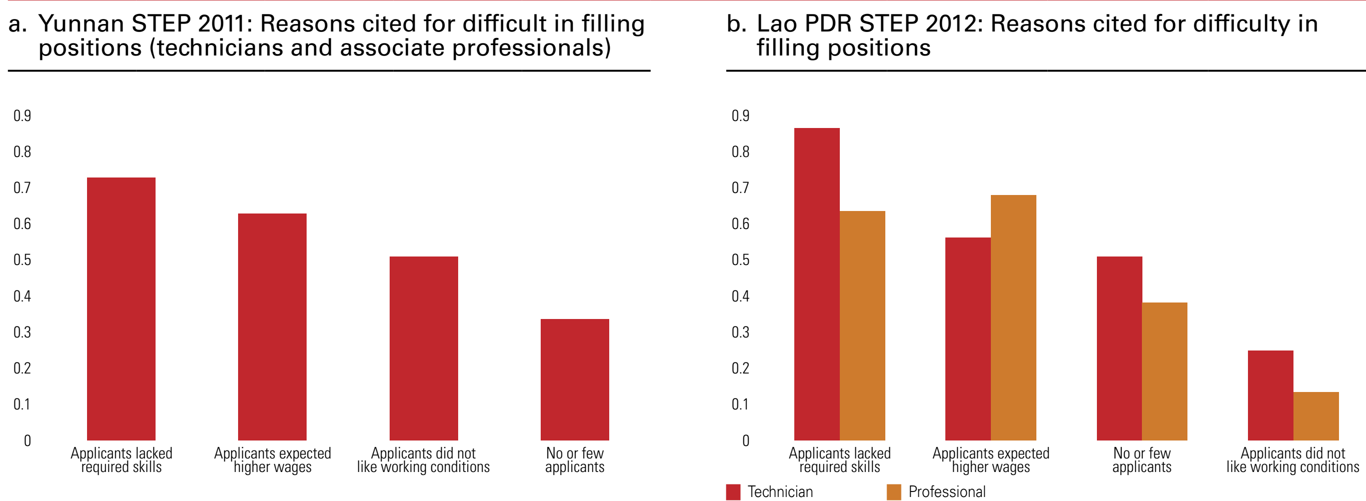
But the threats to well-being from work are wider ranging: the growing challenges to social cohesion are linked to a general slowing of economic growth in the region. The challenges are more pronounced in countries where productivity and living standards have been lagging for some time. For instance, in recent

3 The Gini coefficient of consumption inequality in China increased from approximately 35 percent in the mid-1990s to 42 percent in the mid-to-late 2000s. Among salaried workers in Indonesia, annual wage increases between 1999 and 2003 amounted to 9.3 percent for nonpoor employees, but only 6 percent for poor and near-poor employees.

years, despite economic growth, the Philippines experienced much slower poverty reduction than its neighbors, reflecting the low productivity of most forms of employment created by the economy. Many economies, including Cambodia, Lao PDR, Indonesia, and the Philippines, need to find ways to create and sustain productive work, amidst more difficult global economic prospects and more intense competition. Countries can ill afford to ignore what appear to be increasingly restrictive business environments.[4]

In addition, skills shortages in the labor force in many EAP countries are becoming a binding constraint. Skill gaps threaten growth when health and education systems and the existing labor force adjust slowly to fast-evolving demand, and when incentives for people to invest in skills, and for firms to choose technologies, are distorted by outdated policies. Shortages in basic skills in Cambodia, Lao PDR, and several Pacific Island Countries, as well as gaps in advanced skills across the region's labor force, are motivating more government attention to health, education, and training systems (Figure 5). Slower growth rates in the region, and slower gains in living standards than many have come to expect over the last two decades, have led to louder and more frequent calls for governments to become more active to ensure sustained and more widespread well-being from work.

Figure 5. Employers cite lack of skills among applicants as the top reason for persistent vacancies



Source: Liang and Chen (2013), based on the Skills toward Employability and Productivity (STEP) employer survey.

The discussion of well-being from work is pushing to the political forefront and, if ignored, can threaten the social contract. In contrast to the history of today's high-income countries, the rapid economic changes in emerging EAP countries have not been accompanied by a parallel development of social and civic institutions to accommodate the interest of different groups and classes. As a result, many countries now face the difficult challenges of slowing growth, increasing inequality, and an unprecedented pace of structural transformation without the support of strong formal civic, labor, and social welfare institutions. Against this backdrop, households and governments in the region are starting to question how policies can ensure that work continues to improve well-being through higher productivity and living standards, and greater social cohesion. The development trajectories of East Asia's high-income success stories also included periods when similar calls for "inclusive growth" and "jobs strategies" were heard. But the answers that made sense for those countries at the time may not be viable today in a far more integrated, rules-based global economy.

4 In the World Bank's *Ease of Doing Business* indicator, Indonesia (ranked 129th), the Philippines (138th), and Cambodia (140th) score poorly. China (91st) and Vietnam (98th) score moderately.

How can Policy Sustain Well-Being from Work in East Asia and Pacific?

The most powerful policies to sustain well-being from work reach far beyond the labor market, and aim to establish sound fundamentals. The most important policies are those that ensure price stability, maintain a fiscal stance that encourages investment and innovation, and implement a regulatory framework for factor and product markets that encourages enterprise, particularly in the small and medium-size enterprises (SMEs), where most people in EAP work. In setting the fundamentals of macroeconomic policy, the business environment, and human capital development, policy makers should take into account all forms of economic units (from farms to microenterprises, SMEs to corporations), as well as all forms of work (wage and nonwage, full time and part time) that exist in the region. Policy makers should be alert to laws and regulations that intentionally or unintentionally influence firms' decisions about how much capital or labor to employ, or household decisions about where and how much labor to supply. A policy stance that biases firms' and households' decisions will result in structural imbalances: too much capital and not enough labor in one part of the economy, or vice versa. These imbalances can become embedded economically and politically, and hinder countries' ability to adjust, evolve, and grow.

With sound fundamentals in place, as policy makers turn their attention to the market for labor and human capital, and to social protection, they should pay close attention to the many ways people in EAP earn a living. Governments stepping further into this still relatively new arena of policy making should not respond to increasing calls for intervention with policies that were designed and evolved in very different contexts. The prevailing models of labor regulation and social protection developed in countries where salaried employment was the most common way to work, and during periods in their history when men were by far the largest group in the work force. Indeed, evidence, including from EAP, shows that these models benefit prime-aged men in full-time wage employment.

Policy makers should focus on measures that favor all working people, even if they work for themselves or hire others to work for them. In principle, labor regulation and social protection should benefit all working people and their dependents, and not favor any sector, location, or manner of economic engagement. For instance, the new emphasis in several Scandinavian countries on protecting people rather than jobs is a way of providing protection against labor market risks, without tying this protection to where or how a person works. A national system of modest, noncontributory unemployment benefits, financed by general revenues, could relieve employers of costly severance schemes, lower the distortionary impact of labor taxes, and provide some incentive for workers currently without any protection to register their work and businesses. In several countries, governments are already experimenting with delinking financial protection and risk pooling for health from where and how people work. Thailand's universal health coverage model is the most successful example of this approach, and is credited with extending both coverage and usage.

Governments also have a role in making and sustaining investments in public goods, and in capturing opportunities to increase well-being from work that would remain unexploited if left purely to market incentives. The *World Development Report 2013* offers a typology that policy makers can apply to identify their particular challenges in maximizing well-being from work, and with which they can prioritize public investments. The typology takes account of countries' levels of development, demography, natural endowments, and political circumstances, and helps policy makers determine which of these factors are dominant in shaping the opportunities and constraints on the demand and supply for labor and human capital. The eight country types

Figure 6. Countries can be classified into eight types by their specific challenges; most countries in EAP fall into more than one type

a. Types and defining characteristics

Type	Defining characteristics
Agrarian	Majority of the population lives in rural areas
Conflict-affected	Livelihoods altered by war and violence
Urbanizing	Agricultural modernization and rural-urban migration rapidly taking place
Resource-rich	Extractive industries make a substantial contribution to exports
Small islands	The size of the population doesn't support economies of scale or specialization
High youth unemployment	Youth unemployment rates and idleness rates at unusually high levels
Formalizing	An urban middle class and a large share of informal employment coexist
Aging	Rapidly increasing old-age dependency ratios

b. Plausible mapping of EAP countries

Type	Countries
Agrarian	Cambodia, Lao PDR, Myanmar, Papua New Guinea, Thailand, Timor-Leste, Vietnam
Conflict-affected	Solomon Islands, Timor-Leste
Urbanizing	China, Indonesia, Lao PDR, Malaysia, Mongolia, Philippines, Vietnam
Resource-rich	Indonesia, Lao PDR, Mongolia, Myanmar, Papua New Guinea, Timor-Leste
Small islands	Fiji, Kiribati, Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu
High youth unemployment	Indonesia, Mongolia, Philippines
Formalizing	China, Malaysia, Mongolia, Philippines
Aging	China, Indonesia, Thailand, Vietnam

Source: Staff analysis, based on the *World Development Report 2013*.

are *Aging, Agrarian, Conflict-Affected, Formalizing, High-Youth Unemployment, Resource-Rich, Small Island State* and *Urbanizing* (Figure 6).

The above typology of challenges to well-being from work offers new and useful insights. First, the typology demonstrates how diverse the region is, in that EAP countries can be mapped to at least one of all eight types. There is no single dominant set of challenges, as there is in other emerging market regions.[5] Second, most countries can reasonably be mapped to more than one type, reflecting the dynamism of the region. Third, setting aside the types determined by natural endowments (such as the small Pacific Island states and "resource-rich" economies), most EAP countries are "agrarian" or "urbanizing." Indeed, given the stage of development of the region's population giants, most people in EAP live and work in the "agrarian" or "urbanizing" contexts. This is important because, as stressed in the *World Development Report 2013*, when countries are (or are close to) urbanizing, all three development transformations tend to happen at a similar pace: productivity and wages are increasing, living standards are rising, and there is greater social cohesion as more people move out of poverty and into the middle class. But when countries have substantially urbanized, one or more of the transformations can start to lag. This story is unfolding in the region now, prompting demand for policy attention.

Applying the typology to EAP countries suggests the following guidance as to the most salient policy challenges.

Small island countries. In small island countries, employment creation led by private enterprise is significantly constrained by small and dispersed populations. Outside of niche sectors, small size makes it almost impossible to achieve economies of scale. Moreover, the Pacific Island Countries are particularly constrained by great distances, which conspire against their gaining competitiveness even in activities where endowments would otherwise give them a comparative advantage. Given these constraints, policy makers have to focus on preparing young people with the human capital they will need to succeed abroad as migrant workers. In doing

5 For instance, the dominant challenge in Europe and Central Asia is mostly aging, in Latin America and the Caribbean it is mostly formalizing, and in the Middle East and North Africa it is mostly high youth unemployment.

so, service provision itself can become a force for employment creation when populations are dispersed on difficult-to-reach islands. And while the Pacific Island Countries are too constrained by economic geography to compete in manufacturing, and find it difficult to process their natural resources for export, managing the exploitation of these resources and tourism nevertheless offers opportunities for work. Also, as improvements in information and communications technology bring the islands closer to distant markets, opportunities for work in call centers and other business services may become more readily available. Again, investments in human capital to prepare people to take advantage of these opportunities would be wise.

Agrarian economies. For countries that are still mainly agrarian (particularly Cambodia, Lao PDR, Myanmar, Papua New Guinea, and Timor-Leste), the policy priority to increase well-being from work is to raise agricultural productivity, in order to free labor and human capital to work in rural off-farm enterprises and eventually to migrate to towns and cities. The instruments to increase agricultural productivity and facilitate the structural transition are land reform, agriculture extension programs, price deregulation, rural infrastructure, and good-quality education and health services. Ignoring such measures will result in low productivity and persistently high poverty, as discussed in the *Philippines Development Report 2013: Creating More and Better Jobs* (World Bank 2013a). To sustain well-being from work, governments should identify and remove policies and programs that create implicit or explicit restrictions on working people moving off the farm and into rural nonfarm industry or urban manufacturing and services. Vietnam's experience in the 1990s and the first decade of the 21st century is an often-cited example of success. The danger to be avoided is urbanization *despite* policy rather than being enabled by policy, characterized by efforts to discourage people from moving, unproductive use of land, people migrating in search of better health and education services, cities unprepared for fast population growth, and rapid divergence in living standards between town and country.

Urbanizing economies. For countries that are rapidly urbanizing (particularly China, Indonesia, Mongolia, the Philippines, and Vietnam), the policy priority is to make cities work better. Somewhat counterintuitively in a discussion of well-being from work, the factor market that policy makers should pay the greatest attention to is the market for land. Since land is the least mobile factor of production, good urban planning becomes the key to increasing the flexibility and efficiency of land use. Urban planning becomes the area of policy with the greatest impact on the incentives of firms in towns and cities to form, to grow, to move up the value chain, and thus to create and sustain demand for labor and human capital. Also important are urban infrastructure and service provision, to ensure that growing cities with plenty of skilled people foster economies from agglomeration rather than incur burdening costs from congestion. The examples of both Japan and the Republic of Korea are instructive in this regard.

Formalizing economies. In several countries where urbanization is well advanced (including China, Malaysia, Mongolia, and Vietnam), governments are also facing the challenges of "formalizing" more work, in part to increase the coverage of essential work-risk and social protection. The key is to avoid forming or entrenching a policy and regulatory framework that creates labor market segmentation. Segmentation can be caused by differences in how income from different sources is taxed; by rules for providing credit that explicitly or implicitly exclude self-employed people and small businesses, as well as businesses owned by women; by differences in the types of work that are recognized in the labor code and the types that have no legal recognition or accommodation; and especially by how nonwage social protection benefits are designed and financed. Models of labor regulation and social protection that tie eligibility to certain places, industries, and forms of work, and that are financed by mandatory contributions from employees and employers, create segmentation by design. In most low- and middle-income countries, this segmentation is further aggravated by institutional and administrative weaknesses. The typical result is the exclusion and disenfranchisement of many working people

from social protection and labor institutions. To avoid segmentation, policies in the areas of macroeconomics, business regulation, human capital development, and labor and social protection should take into account *all* forms of economic production and all forms of work in the region. Doing so will encourage factor mobility and an efficient factor allocation, helping countries make the difficult transition out of middle-income status.

"Business as Usual" is no Longer an Option

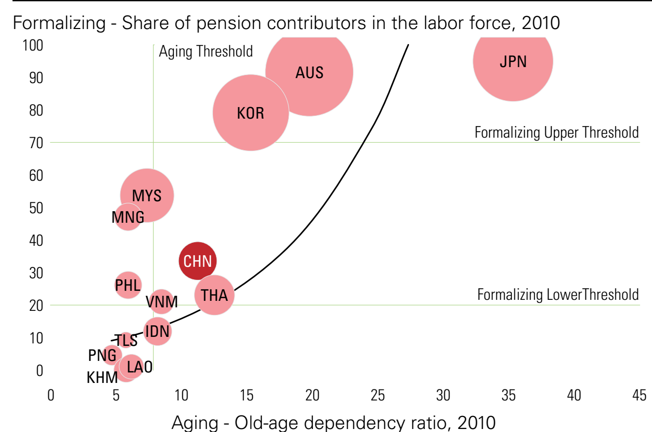
The EAP faces a future of moderating rates of economic growth, and pressure to respond to rising threats to well-being from work. Not taking action will increasingly threaten social cohesion, constrain productivity, and limit gains in living standards.

Policy makers in EAP have greater opportunity to respond appropriately than their counterparts in other regions. The good news is that the history of policy interventions in EAP, particularly in the arenas of labor and social protection, is short relative to that of countries in Latin America and Central Europe. As a result, the costs of transitioning from a biased stance (that favors certain factors of production, sectors of activity, or ways of working over others) to a policy stance that favors all working people are likely to be much lower. For instance, while Latin American and Central European governments might find it appealing to provide "noncontributory" forms of social protection, instead of those financed by employer and worker contributions, the transition costs of such a shift may be hard to afford for those often heavily indebted governments. In contrast, EAP governments face limited "legacy costs," fiscally as well as politically: there are relatively fewer vested interests and social protection "sacred cows" in the region.

On the flip side, the risks of ignoring or aggravating biases in the current policy framework are relatively high for EAP, since its population is aging faster than any other region in history (see note on "Aging in East Asia and Pacific," in this Economic Update). In China, the statistics authorities reported the first ever contraction of their working-age population in 2012. The Republic of Korea already has the lowest population replacement rates in the world. And if life expectancy in Japan is a suitable benchmark, many people in East Asia can expect to live very long lives. Even in the relatively youthful countries of the Pacific, an epidemic of noncommunicable, "lifestyle" diseases will soon impose health care costs similar to those of old age. The challenges of population aging will accompany, and complicate attempts to tackle, the challenges discussed above, such as the need to formalize work (Figure 7).

Figure 7. The constraints on growth from a large informal economy are a danger as countries age

Overlapping Challenges: Aging and Formalizing Jobs (bubble size = income per capita, 2010)



Sources: World Bank Pension Database 2013; and United Nations Population Division.

Most policy models currently in place in EAP are likely to discourage longer working lives, constrain the productivity of older working people, deprive working people of the foundational skills they need to easily reskill throughout their lives, or discourage forms of work that appeal to the elderly (in particular, part-time, irregular hours). Across the entire region, greater emphasis on better nutrition and prevention could lengthen productive working lives and ease the burden of health care costs. The policy options presented in the forthcoming report, "At Work in East Asia Pacific" (World Bank 2013b), will help EAP countries boost productivity and sustain growth, becoming rich before they get old.

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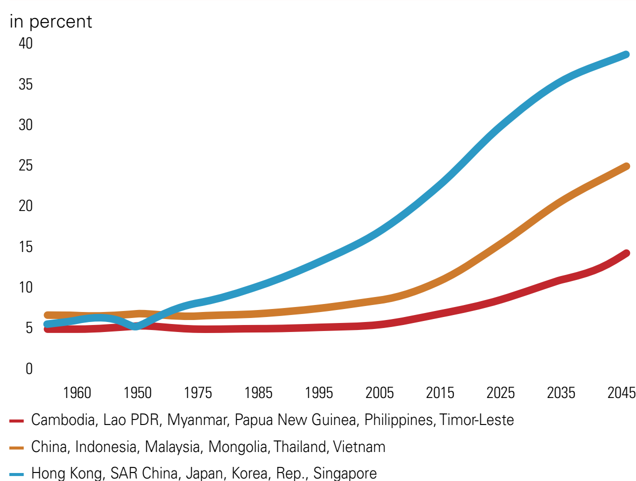
III.B. Aging in East Asia and Pacific[6]

East Asia and Pacific is in the midst of the most rapid population-aging process ever seen. Aging is driven by declining fertility and increasing life expectancy and is occurring at relatively low income levels. It will have major effects on the labor force and aggregate growth, although with significant differences across countries. The effects may be compounded by urbanization, as a result of lower labor force participation rates among the urban elderly. There are also growing concerns about the elderly poor, as family support networks become stretched. Aging raises several critical policy challenges. First, extending productive working lives, sustaining the skills of aging workers, and increasing labor force participation rates. Second, reforming pension systems to increase coverage and financial protection, taking into account administrative capacity and fiscal sustainability. Third, reforming health care systems, including, in particular, care for the aged and long-term care, and through changes in how health care providers are paid.

Rapid Demographic Changes

East Asia and Pacific (EAP) is in the midst of the most rapid population aging process ever seen. Several East Asian countries are experiencing within a period of 30 years a change in age composition that took a century or more to unfold in the OECD countries. Japan already has the oldest population in the world, and the Republic of Korea, China, and Thailand are tracking its path (Figure 8). A number of "younger" countries like Indonesia and Vietnam will also start to age rapidly in the coming decade. Across the region, population aging is driven by a combination of dramatic falls in fertility and sharp increases in life expectancy (Figure 9). The most advanced economies, such as Korea and Japan, are leading the way with total fertility rates (TFRs) of 1.1 to 1.3. An intermediate group of largely middle-income countries (MICs) is also aging rapidly: TFRs have fallen to 1.5 in China (and as low as 0.7 in Shanghai), and 1.6 to 1.7 in Thailand and Vietnam. At the other end of the spectrum, the Pacific countries, Cambodia, Lao PDR, and Timor-Leste, still have relatively young populations, but they are also witnessing rapid fertility declines and increases in average age.

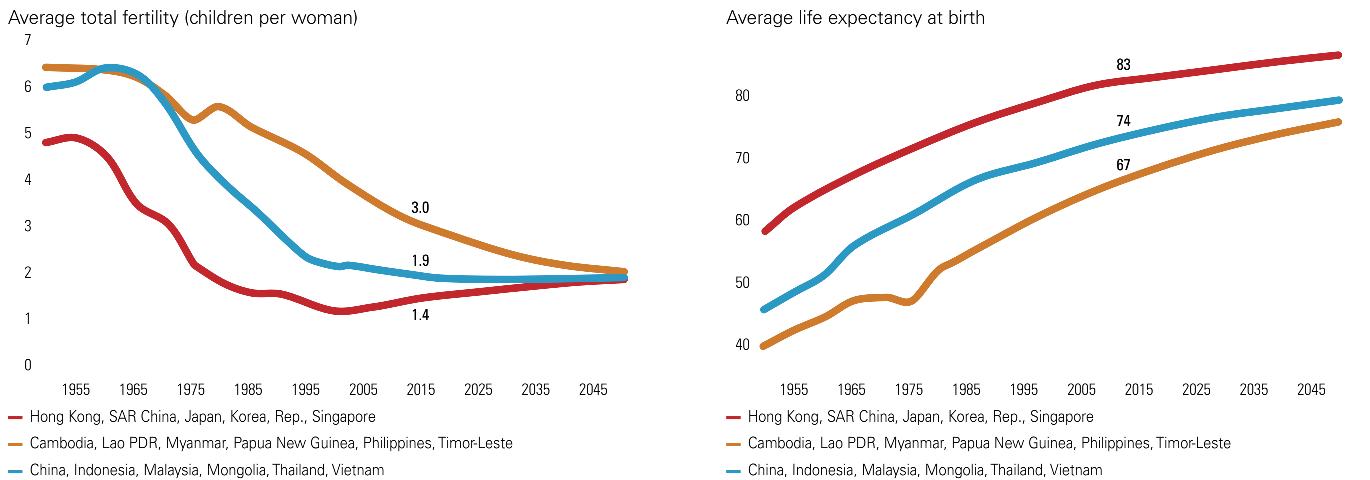
Figure 8. Share of total population over age 60, 1950–2040



Source: United Nations World Population Prospects (UNWPP) 2010 revision (medium TFR scenario).
Notes: Group averages not weighted by population.

6 This note was prepared by Philip O'Keefe, Nithin Umapathi, and Aparnaa Somanathan, and is based on work being carried out in a preparation for a World Bank report to be published in 2014.

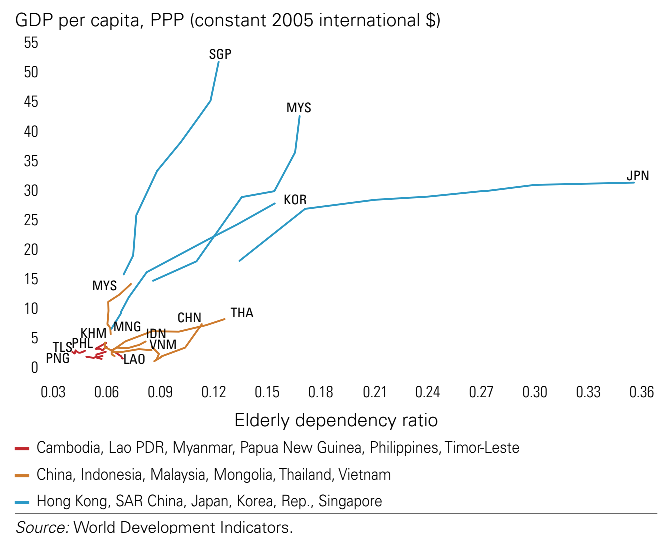
Figure 9. Fertility and life expectancy, 1955–2045



Source: United Nations World Population Prospects (UNWPP) 2010 revision (medium TFR scenario).
Note: Group averages not weighted by population.

Population aging in developing EAP is occurring at relatively low income levels. Developing EAP is three to five times poorer than advanced EAP economies were at comparable stages of elderly dependency (Figure 10). The same is true for OECD countries. This is giving rise to concerns about "getting old before getting rich."

Figure 10. Elderly dependency ratio and GDP per capita (Purchasing Power Parity)

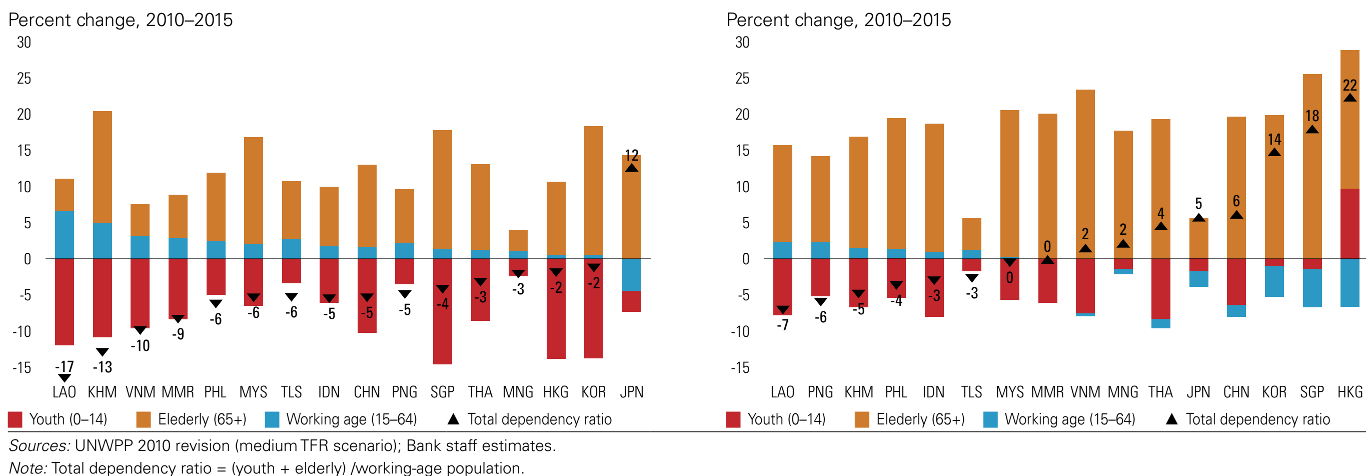


Source: World Development Indicators.

Fertility decline and increased life expectancy in developing EAP will have major effects over the coming decades on the labor force and dependency ratio, although with significant differences across countries. Aging is universal across EAP, but the relationship between youth, working age, and elderly populations varies markedly across the region (Figure 11). In this decade, throughout developing EAP, the increase in the elderly share will be offset by a decline in the youth share, leading to a rising share of the working-age population and a fall in total dependency ratios (defined as the youth and elderly, relative to the working-age population). However, by the 2020s, for the intermediate, largely MIC group, the rising elderly share of the population will begin to translate into flat or declining working-age populations. In contrast, for younger EAP countries, there will still be modest growth in the working-age population share and a continued fall in total dependency ratios.

The elderly in EAP are more likely to work than in most other regions; however, there is substantial variation across countries, and the picture may change with further urbanization. The labor force participation rate (LFPR) for people over 60 in EAP is significantly higher than in Europe and Central Asia (ECA) or in the OECD, and approximately the same as in Latin America and the Caribbean (Figure 12). However, in some EAP countries, the LFPR of elderly rural people significantly exceeds that of elderly urban people; further, in countries like China, the LFPR of elderly urban people is falling. This raises the concern that elderly LFPR may

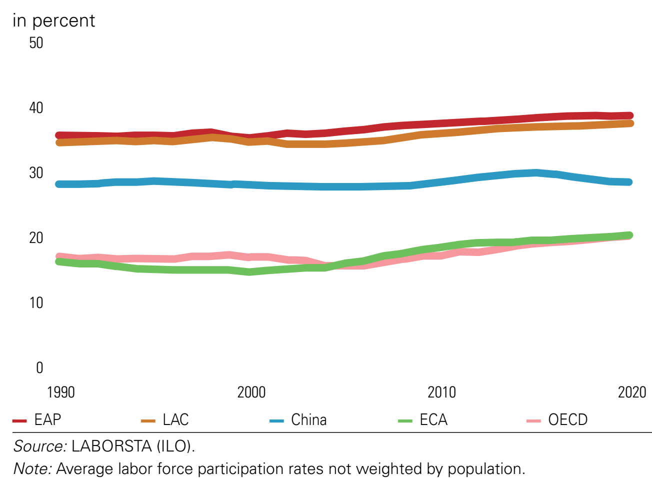
Figure 11. Changes in share of youth, of working age, and of elderly populations, and in total dependency ratio, 2010–15 and 2020–25



Sources: UNWPP 2010 revision (medium TFR scenario); Bank staff estimates.
Note: Total dependency ratio = (youth + elderly) /working-age population.

fall in the face of ongoing urbanization, and potential accompanying factors such as higher coverage of pension schemes. The experience of Japan, Korea, and Singapore demonstrates the necessity of exploring policies to boost labor force participation, both among older people (especially in urban areas) and among working-age women.

Figure 12. Labor force participation rate for 60+ population, for selected regions and for China

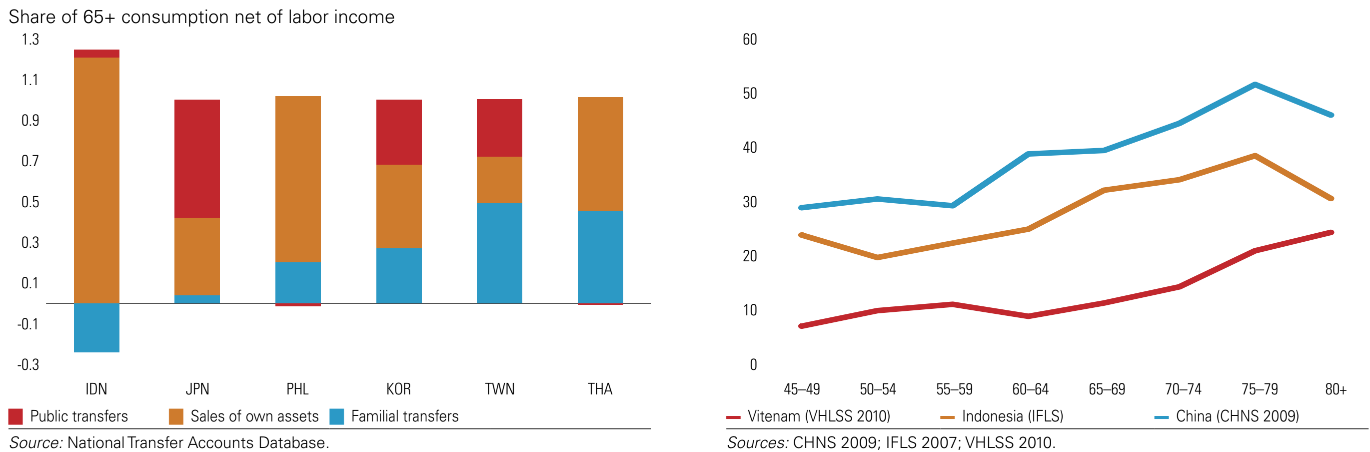


Source: LABORSTA (ILO).
Note: Average labor force participation rates not weighted by population.

Demographic shifts will affect aggregate growth in East Asia negatively; again, the effects will vary across countries. During 1965–90, the sharp increase in the working-age population share, together with the associated increases in savings, investment, and human capital, yielded a "demographic dividend," which accounted for as much as a third of East Asian growth (Bloom and Canning 2003). Conversely, future declines in the share of the working-age population will exert a drag on economic performance. However, the effects will vary sharply across EAP. Importantly, in all aging developing countries, such as China, Indonesia, Malaysia, and Vietnam, there is still substantial scope for productivity convergence through TFP growth and human capital deepening to offset demographic impacts on growth.

There are growing concerns about the elderly poor in EAP as populations age and traditional support networks become stretched. EAP societies pride themselves on the role of family and informal networks in providing support to the elderly (Figure 13, left-hand panel). Despite this, in East Asia poverty tends to be higher among the elderly, with the exception of the very old (Figure 13, right-hand panel). In addition, in some countries urbanization is reducing the share of the elderly who reside with their adult children. China, for instance, has seen a decline in the co-residence of the 65+ with adult children from over 70 percent to 38 percent between 1990 and 2011. Finally, the attitudes of both the elderly and their children toward whether the state, the family, or older people themselves should be the primary source of old-age support are shifting, with likely implications for how robust the traditional networks will remain.

Figure 13. (l) Sources of support for 65+, for selected EAP countries, early-mid-2000s; (r) Rural Poverty rates 45+, for Vietnam, Indonesia, and China, late 2000s



Source: National Transfer Accounts Database.

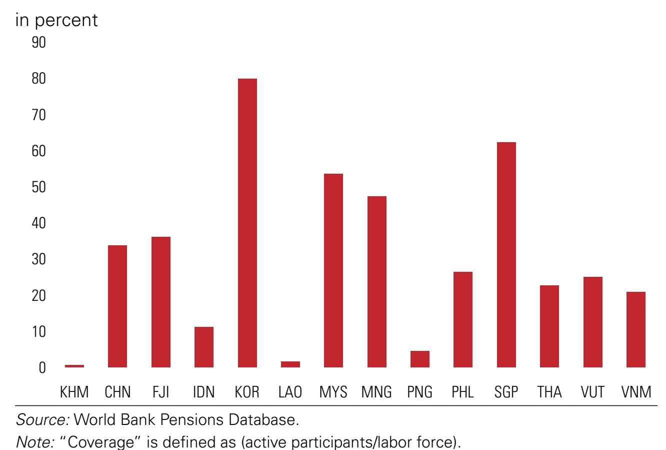
Sources: CHNS 2009; IFLS 2007; VHLSS 2010.

Social Security Systems

Developing EAP is aging, with pension systems that provide significantly lower coverage and substantially less financial protection than OECD and ECA countries at comparable stages of the demographic transition (Figure 14). At the same time, several countries (including China, Vietnam, and Indonesia) have committed to rapid coverage expansion. Other countries, such as Thailand, Timor-Leste, and several Pacific islands, have achieved universal coverage of noncontributory elderly social pensions. But balancing adequacy and fiscal sustainability remains a challenge, whatever the approach to expanding coverage.

As EAP countries age, they are also undergoing a rapid change in disease patterns: health systems will have to transform in response to the growing importance of noncommunicable diseases (NCDs). In China, over 80 percent of deaths are already due to NCDs, and years of life lost from NCDs will increase by approximately 40 percent between 2010 and 2030 as a result of aging and other factors (World Bank 2011). Aging is also associated with increased morbidity and a greater need for chronic and long-term care services. Health systems in developing EAP are not well placed to respond to an increase in NCDs and aging. There is overreliance on hospital care for everything from primary to long-term care, a situation exacerbated by weak gatekeeping and referral systems. At all levels of care, spending on pharmaceuticals is excessive, reflecting both overprescription and inefficiencies in procurement. This skews the composition of health spending (for instance, pharmaceuticals consume over half of total health spending in Vietnam), and has a particular impact on the elderly, who tend to be more reliant on medication. Efforts to prevent NCDs by addressing lifestyle-related conditions are underdeveloped. And most countries have no long-term care system, beyond hospitals and the

Figure 14. Coverage of contributory pensions, in late 2000s



Source: World Bank Pensions Database.
Note: "Coverage" is defined as (active participants/labor force).

family. There are also too few qualified general practitioners (GPs), who should form the backbone of primary care systems (for instance, China has less than 0.1 GP per 1,000 population, compared to approximately 1.7 in Australia and 0.7 in Korea).

Many EAP governments have committed to achieving universal health coverage through social health insurance and/or tax financing in the coming decades, a policy of particular importance for the elderly. Out-of-pocket payments currently account for a large share of health financing (over 45 percent in all low- and middle-income EAP, and as high as 80 percent in Myanmar), leaving households, and especially the elderly, vulnerable to catastrophic health care costs. While most health systems have higher coverage than pension systems (China, around 95 percent; Vietnam, over 60 percent; and general-revenue-financed systems, such as the Pacific islands, in principle have universal coverage), the financial protection offered is partial and variable.

Policy Implications of Aging

The implications of aging cut across several areas of economic and social policy, and differ in their acuteness and urgency across EAP countries at different stages of the demographic transition. While aging presents serious challenges, most countries in developing EAP face a relatively blank policy canvas that is not overly constrained by unaffordable legacy commitments to the elderly. This inheritance is reinforced by societal attitudes that do not expect the state to "do it all." EAP can also draw upon a century of global experience, including from older EAP countries such as Japan and Korea. At the same time, social expectations are shifting and there are growing demands on the state to support the elderly. As a result, EAP countries are redefining the social contract between the state and both older and younger citizens. In this process, they confront several policy challenges.

Increasing the Effective Labor Force

Extending productive working lives as populations age is an imperative, which involves several elements. The first is the removal of disincentives to continue working later in life. Tax treatment of work and transfer incomes should not create a penalty for working beyond the official retirement age. Pensions also need to be reformed (see below). Second is the introduction of flexible work arrangements, such as job sharing and part-time work, to make retirement less of a "cliff" and more of a "glide." Japan's "continued employment" legislative mandate to employ older workers provides an interesting example; for instance, Toyota is piloting a half-time system for workers over age 60. Third is the cost-effective adaptations of workplaces to make them responsive to older workers' needs. Firms such as BMW, through simple and low-cost workplace adjustments, have substantially enhanced the productivity and satisfaction of older workers. Related to all this, the differences in age profiles across EAP economies offer major opportunities for intraregional migration to mitigate the effects of rapid aging, even though the political economy challenges should not be underestimated.

A particularly complex policy challenge lies in sustaining or even enhancing the skills of aging workers. While there is support for lifelong learning that promotes competency upgrading across the life cycle, it is less clear how to reform training systems to achieve that goal, and how to improve on the cost-effectiveness of training interventions for older workers. More research is also needed on the productivity of older workers in

EAP; here, global research indicates a nuanced picture depending on the nature of skills demanded and the primary labor market challenges faced by older workers (Skirbekk 2008). Enhancing the productivity of the aging population also has a sectoral dimension, since in many EAP countries older workers are more likely to be found in agriculture.

Measures are needed to increase the LFPR of working-age people, especially women. While labor force participation rates among women are relatively high in EAP, they remain notably lower than among men, with a substantial gap in countries like Malaysia. This is a particular concern since women live longer than men, and are therefore disproportionately represented among the elderly. In this area, the experience of countries such as China, Korea, Singapore, and Taiwan, China, with paid parental leave and public subsidies for child care provides lessons for developing EAP, albeit ones that need to take account of fiscal possibilities and suitable delivery models. Less clear is the relevance to developing EAP of pronatalist policies, which directly subsidize child bearing, such as baby bonuses, child allowances, and preferential tax treatment for families with children (Jones 2011).

Pension Reform

Aging makes the challenges of pension reform pressing, with a need to balance coverage, financial protection, administrative capacity, and fiscal sustainability. Reforms of existing systems to enhance sustainability and labor market incentives are needed, at the same time that countries are aiming to expand pension coverage from often low bases. With respect to existing pension systems, several countries recognize the need to raise the average age of retirement among those entitled to pensions. In a number of cases, this involves raising the normal retirement age, introducing actuarially fair early retirement provisions, and gradually harmonizing male and female retirement ages (as both ECA countries, and EAP countries including Japan, Korea, and the Philippines, have done). Beyond this, some countries need to assess the sustainability of formal pension schemes to ensure that key parameters (such as replacement rates and indexation rules) are sustainable, while still providing adequate old-age protection. Some of these policy choices assume particular significance in countries where workers have experienced large, sustained wage increases over their working lives.

There are also structural questions for pension reform. One is the appropriate balance between contribution-based and general-revenue financing of pensions and elderly support. A number of countries (for instance, Thailand, Timor-Leste, and several Pacific countries) already have general-revenue-financed universal social pensions over age 60/65. Others subsidize contributory schemes from the budget to incentivize informal sector participation (for instance, China and Thailand). Developing affordable approaches to extend coverage to the massive informal sectors in EAP will require creative thinking on the financing mix and scheme design. For instance, China has since 2010 brought over 350 million informal workers into innovative new pension schemes, albeit ones with modest benefits. A second question is the appropriate balance between defined-benefit and defined-contribution elements in existing schemes. A third question is the appropriate degree of differentiation between different types of workers (public sector versus private sector, or formal sector versus informal sector), and what degree of scheme integration best balances the need to incentivize participation of nonformal workers with appropriate labor market incentives and the need for labor mobility.

Health Care Reform

Aging requires reform of health care systems, including, in particular, care for the aged and long-term care (LTC). Reforms are needed in any event to address the noncommunicable disease (NCD) epidemic, but aging increases their urgency. One necessary structural reform is a major strengthening of primary care, in terms of both primary prevention (for instance, diabetes screening) and better management of NCDs (for instance, antihypertensives and statins). This requires comprehensive reform of medical education to produce a new cadre of GPs and family doctors, and other investments to ensure that the primary level can effectively perform its service and referral functions. These must be reinforced by reforms to payment systems to remove financial incentives for treatment in hospitals. Once primary care is strengthened, referral systems should ensure effective gatekeeping to control unnecessary visits to hospitals, especially for chronic conditions from which older people disproportionately suffer.

It is also crucial to reform how health care providers are paid, moving away from fee-for-service payment systems, toward systems that do not directly link payments to utilization and include explicit caps based on population norms or other clinical criteria. This will also encourage case-based management of patients, particularly those such as the elderly with chronic conditions. Also, excess cost growth must be controlled through the introduction of more effective price and volume controls, better governance, and other reforms that aimed at addressing inefficiencies in the system. An important component of this involves strengthening pharmaceutical policy, for instance, through more efficient procurement, and incentives to increase use of generics. Such reforms will also slow the growth of out-of-pocket payments and thus improve financial protection for all, but especially for older people with chronic conditions. Financing LTC on top of existing health expenditures poses challenges. OECD countries have tended to formalize LTC financing through insurance or budgetary allocations, and institutionalize LTC delivery. While this may be needed in the long run in EAP, there are innovative examples of community-based approaches to LTC and aged-care services in the region that build on traditions of family-based care (for instance, Thailand), and need to be explored.

Conclusions

In addressing the aging challenge, EAP countries still largely have their destiny in their own hands, through the policy choices that they are currently making or will make in the near future. In contrast, in the OECD, ECA, and Latin America and the Caribbean countries, legacy commitments made decades ago with limited attention to demographic trends make reforms challenging. Of course, EAP countries do not face a blank policy slate. There are existing policy commitments (for instance, defined-benefit pension schemes) that shape the response to aging. However, in relative terms, the policy space for EAP countries to shape a sustainable, positive, and balanced response to aging is significant. And for many, there is a demographic window that allows for considered policy formulation, and adjustment of existing policies, before the peak of the aging wave.

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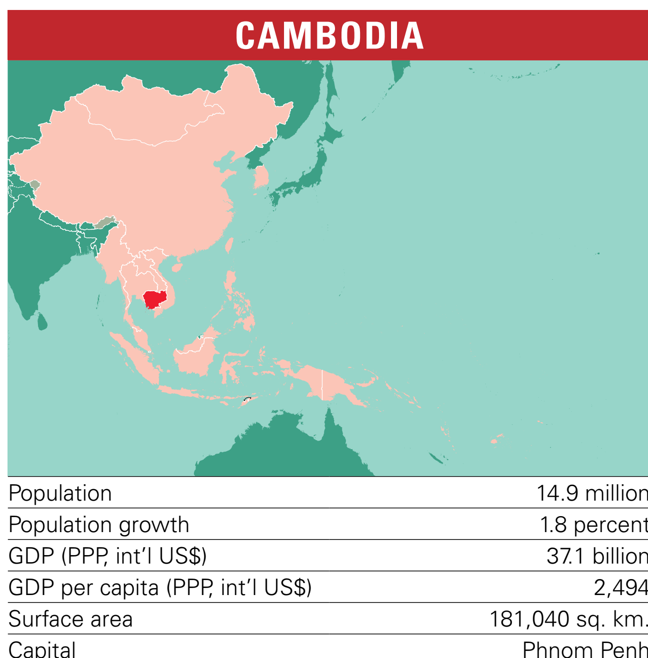
Country Pages and Key Indicators

CAMBODIA



Population	14.9 million
Population growth	1.8 percent
GDP (PPP, int'l US$)	37.1 billion
GDP per capita (PPP, int'l US$)	2,494
Surface area	181,040 sq. km.
Capital	Phnom Penh

Source: World Development Indicators.

Summary

The Cambodian economy remains robust amidst a challenging global economic environment, and prospects for meeting the growth projection of 7 percent in 2013 appear favorable. Overall macroeconomic outlook remains positive, having sustained agricultural growth with favorable weather conditions, continued strong performance of the tourism sector, and a resilient garment sector. The economic outlook, however, faces some risks. It is unclear how big an impact the political uncertainty postelections is having on foreign direct investment (FDI) and growth, even with some improvements on the external front with initial signs of improvements in the U.S. and European Union (EU) economies.

Recent Economic Developments

The Cambodian economy remains robust amidst the challenging global economic environment. Real GDP growth was 7.3 percent in 2012, and is projected to reach around 7 percent in 2013. GDP growth has been driven by a sustained strong agricultural sector growth, resilient exports, rebounding construction activity, and a robust tourism sector.

Adaptation to changes in destination markets for garments, expanded cultivated area, and a diversification in sources of tourism have helped Cambodia's three key engines of GDP growth sustain their momentum. The garment export industry has adapted to export market conditions, focusing on lower-end garment products for the U.S. market and higher-end products for the European market. In the agricultural sector, rice production has continued its high growth. Rising cultivated areas of rice crops (both area expansion and irrigation) account for up to 80 percent of annual rice production increase during the last four years. Successful diversification of tourism markets, attracting arrivals from Eastern Europe, East Asia, and the Pacific regions, has resulted in a continued high growth in the tourism sector. During the first six months of 2013, garment exports accelerated further, growing at 18 percent year-on-year (yoy), while the tourism sector continues its high-growth trajectory, with a tourist arrival growth rate of 19 percent yoy.

As a result of the rapid pace and pattern of growth that enables benefits to be shared by a larger number of people, Cambodian poverty has fallen sharply. Economic growth broadened over the last years thanks in large part due to the sustained growth in the agricultural sector favored by increases in rice prices in the global markets. The percentage of poor people was more than halved within seven years to around 20 percent in 2011. Despite this large poverty reduction, the vast majority of the families who were lifted out of poverty were so only by a small margin, implying that those families moved from being poor to being just near poor.

The current account deficit (excluding official transfers) widened to 10.1 percent of GDP in 2012 from 7.9 percent of GDP in 2011. Compared to 2011, higher imports in 2012 were driven mainly by rising petroleum, motor vehicle, and construction materials imports. The large current account deficit (as a percentage of GDP) that Cambodia runs is helping address the importing needs of investment.

The capital account surplus substantially increased, thanks to the increasingly large FDI, which peaked at US$1.4 billion in 2012. FDI continued to grow over the first half of 2013, and investor interest appeared to continue during the election period, unlike in past elections.

As a result of the capital account surplus, the overall balance of payments remains positive, increasing international reserves. Gross international reserves rose to US$3.5 billion or 3.7 months of imports in 2012, compared to US$3.0 billion or 3.4 months of imports in 2011. By June 2013, the gross international reserves reached US$3.6 billion.

The Consumer Price Index (CPI) has eased, dropping to 2.5 percent by the end of 2012, compared to 4.9 percent in 2011. This is due to the stabilization of the main product categories, in particular food prices, which represent 43 percent of the consumer basket. In June 2013, yoy inflation picked up marginally, reaching 2.9 percent due to slightly elevated foods prices. Inflation is projected to remain in low single-digit figures during the short term.

The nominal exchange rate has remained stable, while financial deepening continues. The Cambodian riel (CR) is pegged to the U.S. dollar, and has been hovering at around CR 4,000 per dollar. The exchange rate slightly depreciated and reached CR 4,062 per dollar in June 2013.[1] The financial deepening continues and a growing number of banks are entering the Cambodian market. Competition among banks has contributed to narrowing the U.S. dollar interest rate spread, and driving some efficiency into the market; however, there are also significant risks to having a large number of banks due to supervision capacity challenges. The recent credit growth of about 30 percent yoy has benefited the agricultural sector, which received US$570 million or 10 percent of the total credits by end-2012, compared to only US$100 million or 5 percent of the total credits by end-2008.

During the first five months of 2013, domestic revenue continued to improve but at a slower pace, rising only at 9.6 percent yoy, compared to 24.7 percent in 2012.[2] Public expenditure performance, however, appears slow. The budget deficit (excluding grants) should remain as budgeted at around 5.4 percent of GDP. Fiscal management remains appropriate and supportive of macroeconomic stability, but there is significant room for domestic revenues to be further improved and for greater efficiency in spending. In 2012, Cambodia restored its fiscal space, thanks to a high growth of revenue, estimated to reach 14.4 percent of GDP in 2012, compared to 13.1 percent in 2011. The government, however, continues to depend heavily on donors, whose funds account for almost 80 percent of the total public investments or 34 percent of the total public outlays.

Outlook and Emerging Challenges

The overall macroeconomic outlook remains positive, due to sustained agricultural growth with favorable weather conditions, continued strong performance of the tourism sector, and a resilient garment sector. The economic outlook, however, faces some risks. It is unclear how big an impact the political uncertainty postelections is having on FDI and growth, even in light of some improvements on the external front. GDP growth in 2013 is projected at around 7 percent and in 2014 could be close to 7 percent.

The overall debt sustainability outlook remains favorable. The 2012 joint Word Bank/IMF Debt Sustainability Analysis shows that Cambodia's debt distress rating remains low. The government's policy of avoiding nonconcessional borrowing has been a key factor in sustainable debt management. Cambodia's external public debt and publicly guaranteed debt stock is estimated to reach 30.1 percent of GDP in nominal terms by the end of 2012.

1 Official midpoint exchange rate, the National Bank of Cambodia.

2 Preliminary fiscal data for 2013

Cambodia: Key Indicators

	2011	2012	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	7.1	7.3	7.0	7.0	7.0
Domestic demand (% change yoy)	1.0	11.9	9.0	8.3	8.7
Industrial Production Index (2000=100)	300.8	315.9	341.1	363.3	388.7
(% change yoy)	14.5	5.0	8.0	7.0	7.0
Consumer Price Index (% change yoy)	4.9	2.5	5.0	6.0	5.0
Public Sector					
Government revenues (% GDP)	13.2	14.4	14.2	14.5	14.8
Government expenditures (% GDP)	22.8	19.7	19.6	20.0	19.0
Government balance (% GDP)	-9.6	-5.3	-5.4	-5.5	-4.2
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-1,490	-1,949	-2,082	-2,637	-2,956
Exports of goods (millions US$)	5,220	6,016	6,918	7,714	9,102
(% change yoy)	34.4	11.4	15.0	11.5	18.0
Key export (% change yoy) 1/	31.7	7.0	18.0	15.5	20.0
Imports of goods (millions US$)	6,710	7,965	9,000	10,350	12,058
(% change yoy)	22.7	18.7	13.0	15.0	16.5
Current account balance (millions US$) 2/	-1,015	-1,437	-1,499	-2,066	-2,217
(% GDP)	-7.9	-10.1	-9.6	-12.0	-11.8
Foreign direct investment (millions US$) 3/	785	1,410.2	1,452.5	1,626.8	1,748.8
External debt (millions US$)	3,611	4,281	4,726	5,229	5,634
(% GDP)	28.1	30.2	30.2	30.4	29.9
Short-term debt (millions US$)	66.8	67.0	66.9	66.7	66.5
Debt service ratio (% exports of g&s)	1.2	1.2	1.3	1.5	1.5
Foreign exchange reserves, gross (millions US$)	3,032	3,463	3,844	4,151	4,525
(months of imports of g&s)	3.4	3.3	3.2	3.1	3.0
Financial Markets					
Domestic credit (% change yoy)	37.7	34.0	28.0	25.0	25.0
Short-term interest rate (% p.a.)	15.0	13.7	13.0	13.5	13.5
Exchange rate (CR/US$, eop)	4,039.0	3,995.0	4,000.0	4,063.6	4,076.0
Real effective exchange rate (2000=100)	124.8	128.6			
(% change yoy)	1.9	3.0			
Memo: Nominal GDP (millions US$)	12,828	14,196	15,649	17,214	18,845

Sources: National data sources; IMF; and World Bank staff estimates.
e = estimate.
f = forecast.
p = projection.
1/ Garments.
2/ Excluding official transfers.
3/ From 2011, includes FDI related to public-private power sector projects.

CHINA

Population	1.4 billion
Population growth	0.5 percent
GDP (PPP, int'l US$)	11.5 trillion
GDP per capita (PPP, int'l US$)	9,233
Surface area	9,6000,000 sq. km.
Capital	Beijing

Source: World Development Indicators.

Summary

Recent activity data point toward stabilization of the slowdown. Annual GDP growth is expected to be 7.5 percent for 2013. Nevertheless, risks have built up in the Chinese economy. First, the key risk is a disorderly rebalancing from investment-led to consumption-based growth. Second, investment is increasingly dependent on credit growth and low borrowing costs. Third, rapid credit growth has increased the level of local government debt. The government acknowledges that the economy is facing some headwinds, but says risks are manageable and is planning to introduce reforms that address these vulnerabilities.

Recent Economic Developments

China's Q2 GDP growth registered 7.5 percent (yoy), down from 7.7 percent in 2013Q1. According to official data, sequential quarter-on-quarter (qoq) growth rose to 1.7 percent in Q2 (7.0 percent annualized) from 1.6 percent (6.6 percent annualized) in Q1. For the first half of 2013, the contribution of investment to growth was 4.1 percentage points, followed by that of consumption (3.4 percentage points) and net exports (0.1 percentage point). Q2 data suggest that investment has been the main driver of growth.

However, recent activity data point toward stabilization of the slowdown. Leading indicators such as the purchasing managers' index suggest a recovery in economic activities. The Purchasing Managers Index (PMI) dropped to near the borderline of 50 in June, but picked up in August to 51.0, indicating a recovery in the manufacturing sector.

On the supply side, industrial production growth weakened in June but then recovered in recent months. The reading dropped to 8.9 percent yoy in June from 9.2 percent in May, but then improved to 9.7 percent in July and surprised on the upside in August (10.4 percent yoy). More specifically, the output growth of power and steel accelerated in recent months, suggesting a stabilization of the moderation in the economy.

On the demand side, investment growth remains robust. Urban fixed asset investment growth was flat in July compared to June (19.3 percent yoy) but rebounded to 21.4 percent yoy in August. Manufacturing fixed asset investment (FAI) growth improved in line with improved export. Railway FAI growth picked up in August, likely driven by the government's efforts to boost railway project construction. In contrast, property FAI growth edged down, and the growth of new home starts dropped to -20.1 percent in August from 45.2 percent in July.

As another indicator of domestic demand, retail sales growth accelerated. In real terms, it rose to 11.6 percent in August from 11.3 percent in July. However, data by component suggest that the improvement mainly comes from that in government-spending-related items, construction material, and home appliance sales. In contrast, gold, jewelry, and automobile sales growth has recently moderated.

Export growth recovered in recent months, indicating an improvement in external demand. China's export growth jumped to 5.1 percent yoy in July from

-3.1 percent in June. It further accelerated to 7.2 percent yoy in August, surprising the markets on the upside. Import growth moderated to 7.0 percent yoy in August from 10.9 percent in July. Trade surplus widened to US$28.6 billion in August from US$17.8 billion in July. Monthly data by destination show that the growth in export was led by that for ASEAN (30.8 percent yoy), Hong Kong (6.4 percent), the United States (6.1 percent), and the EU (2.5 percent), implying a strengthening external environment.

The recovery in exports together with improved economic outlook might reverse the direction of capital outflows to inflows. In the meantime, the Y/US$ exchange rate may be stabilized given the rising strength of the U.S. dollar and the keenness of the Chinese government to maintain confidence and financial stability.

Headline CPI inflation remains mild, and producer price index (PPI) deflation is moderating. CPI inflation remained flat at 2.6 percent yoy in August, well within the government's 3.5 percent target. Meanwhile, PPI deflation eased further, helping firms recover their profit margins.

The latest credit data suggest stable and robust credit growth. Total Social Financing (TSF) jumped to Y 1,570 billion in August from Y 809 billion in July, while yoy growth of outstanding TSF remained around 21 percent. New loans rebounded slightly to Y 711 billion in August from Y 700 billion in July, with yoy outstanding loans growth moderating to 14.1 percent in August from 14.3 percent in July. Credit growth might moderate in the rest of 2013 due to seasonality reasons. However, another interbank liquidity squeeze may be unlikely, since the government will be less willing to disturb the financial markets using administrative measures.

Outlook and Emerging Challenges

The state media have reaffirmed the official growth target of 7.5 percent, which implies that the government may continue the moderate fiscal measures in infrastructure, public housing, and renewable energy sectors to ensure that growth does not fall below the target. Monetary policy will likely remain neutral, given the moderate inflation and the risks accumulated in the financial sector.

Despite the slowdown in Q2, China's economic outlook has significantly improved, given the latest data. July and August data point toward a recovery in growth momentum in Q3. However, the pickup in domestic demand is still mainly government led, and thus might be unsustainable. In the meantime, advanced economies have started to show signs of recovery, albeit slowly. The contribution of net exports to China's growth may recover gradually. Given these factors, annual GDP growth is expected to be 7.5 percent for 2013.

There are upside risks to our 2013 projection. First, the external environment might recover at a faster pace than expected. Second, the impact of the ongoing growth-supportive fiscal measures may be greater than we anticipate.

We expect GDP growth for 2014 to be 7.7 percent, noting the carryover effect due to the slowdown in the first half of 2013. Our baseline assumption is a steady qoq growth rate of around 1.8 percent. For 2015, we expect 7.5 percent annual growth, assuming a robust but slightly moderating growth path.

In summary, given the anticipated reforms and the latest developments, China's economic outlook has brightened. Nevertheless, risks have built up in the Chinese economy, and the risks and concerns are as follows.

First, the key risk is a disorderly rebalancing from investment-led to consumption-based growth. Capital accumulation plays a more important role in driving growth, but the economy has rapidly become less efficient over time, as indicated by falling total factor productivity. Other growth drivers such as net exports and consumption will likely remain weak.

Therefore, when investment can no longer be the main source of growth, the economy will suffer a major downturn.

Second, investment is increasingly dependent on credit growth and low borrowing costs. Thus, a cutback in credit growth or an increase in borrowing costs will likely dampen investment going forward. Restraints on traditional bank lending, if they occur, will likely affect investment in sectors of the economy that are dominated by state-owned enterprises, principally gas, water, electricity, rail transport, and urban public transport. Restraints on nontraditional bank lending, which seem more likely given recent policy pronouncements, will likely affect investments in real estate development and local government infrastructure.

Third, rapid credit growth has increased the level of local government debt. The level of local government debt is estimated to be within the range of 30 to 39 percent of GDP as of end 2012, but levels vary across municipalities.

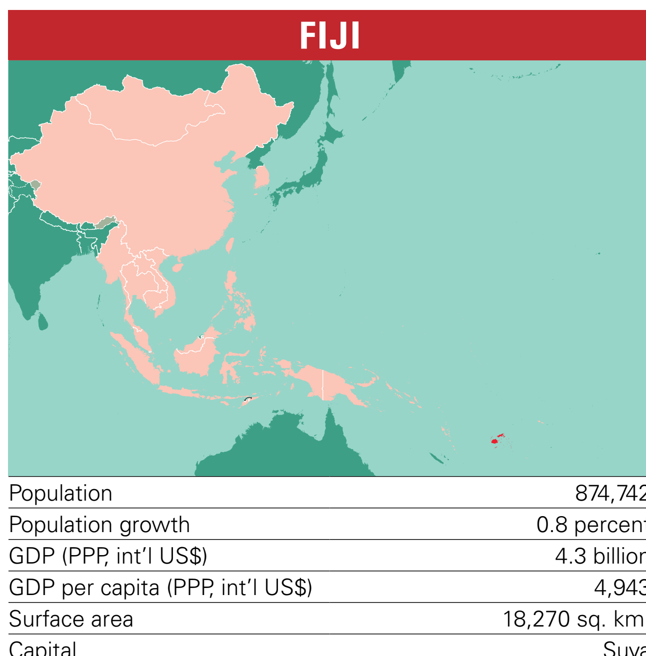
The leadership acknowledges that the economy is facing some headwinds, but says risks are manageable and is planning to introduce reforms that address these vulnerabilities. The Central Committee of the Chinese Communist Party is expected to hold its third plenum in November. In particular, the plenum may give signals on fiscal reform, devolution of powers to lower-level governments, the financial sector, debt levels, urbanization and the residency (hukou) system, and land rights. These are complex and politically sensitive interconnected issues, requiring careful reform if the government is not to lose control over the process.

China: Key Indicators

	2011	2012	2013f	2014f	2015f	2012		2013					2013
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	May	Jun	Jul	Aug
Output, Employment, and Prices													
Real GDP (% change yoy)	9.3	7.8	7.5	7.7	7.5	7.4	7.9	7.7	7.5				
Domestic demand (% change yoy)	10.2	8.3	7.2	7.5	7.1								
Industrial production index /1 (% change yoy)	10.4	7.9	7.5	7.5	7.5	9.1	10.0	9.6	9.1	9.2	8.9	9.7	10.4
Unemployment (%) 2/	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1				
Real wages (% change yoy)	8.5	9.1	9.0	9.0	9.0								
Consumer Price Index (% change yoy)	5.4	2.6	2.7	3.0	3.0	1.9	2.1	2.4	2.4	2.1	2.7	2.7	2.6
Public Sector													
Government revenues (% GDP)	22.0	22.6	22.3	21.8	21.3								
Government expenditures (% GDP)	23.1	24.1	23.9	23.5	23.2								
Government balance (% GDP)	-1.8	-1.5	-1.6	-1.7	-1.8								
Domestic public sector debt (% GDP) /3	15.2	14.9	15.1	15.4	15.7								
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$)	157.9	232.8	304.0	368.0	414.0	79.5	83.3	43.5	65.7	20.4	27.1	17.8	28.5
Exports of goods (billions US$)	1,899.3	2,050.1	2,216.0	2,403.0	2,591.0	541.3	554.2	508.9	544.1	182.8	174.3	186.0	190.6
(% change yoy) 4/	20.3	8.0	8.1	8.4	7.8	4.5	9.4	18.3	3.7	0.9	-3.3	5.1	7.2
Key export (% change yoy) 5/	20.2	7.3	8.1	7.9	7.3	4.9	9.7	19.2	3.5	0.6	-3.4	4.9	
Imports of goods (billions US$)	1,741.4	1,817.3	1,912.0	2,035.0	2,177.0	461.8	470.9	465.4	478.4	162.3	147.2	168.2	162.1
(% change yoy) 4/	24.9	4.3	5.2	6.4	7.0	1.6	2.7	8.5	5.0	-0.1	-0.9	10.8	7.0
Current account balance (billions US$)	136.1	193.1	218	249	285	70.8	45.1	47.6	48.2				
(% GDP)	1.8	2.3	2.4	2.4	2.5								
Foreign direct investment (billions US$) /6	116.0	111.7				24.3	28.3	29.9	32.1	9.3	14.4	9.4	
External debt (billions US$)	695.0	737.0											
(% GDP)	9.3	8.9											
Short-term debt (billions US$)	500.9	540.9											
Debt service ratio (% exports of g&s)	1.7	1.6											
Foreign exchange reserves, gross (billions US$)	3,187.6	3,318.1	3,603.4	3,902.5	4,218.6	3,291.7	3,318.2	3,449.2	3,503.3	3,521.4	3,503.3		
(months of imports of g&s)	22.0	21.9	21.2	21.3	21.5	85.5	84.6	88.9	87.9	21.7	23.8		
Financial Markets													
Domestic credit (% change yoy)	14.3	15.0				16.3	15.0	14.9	14.2	14.5	14.2	14.3	
Short-term interest rate (% p.a.) 7/	3.3	3.3				3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Exchange rate (RMB/US$, eop)	6.30	6.29	6.17	6.10	6.06	6.34	6.29	6.27	6.17	6.18	6.18	6.18	6.17
Real effective exchange rate (2000=100)	115.8	118.3				115.5	118.3	122.6	124.8	124.8	124.8	126.0	
(% change yoy)	6.1	2.2				1.4	2.2	5.3	6.9	6.8	6.9	7.9	
Stock market index (Dec. 19, 1990=100)/8	2,199	2,269				2,086	2,269	2,237	1,979	2,301	1,979	1,994	2,098
Memo: Nominal GDP (billions US$)	7,508.5	8,226.9	9,250.0	10,277.0	11,403.0	,,	,,	,,	,,	,,	,,	,,	,,

Source: National data sources.
f = forecast.
1/ Annual data are not comparable with the quarterly and monthly data. Annual data cover all industrial enterprises, while the quarterly and monthly data refer only to those enterprises with sales value above Y 5.0 million. 2/ Official urban unemployment only, not including laid-off workers. 3/ Central government debt/GDP. 4/ Nominal growth rate.
5/ Manufactured exports. 6/ Gross FDI used. 7/ Central Bank loans to financial institutions, less than 20 days. 8/ Shanghai Stock Exchange A-Share Price Composite.

FIJI



Population	874,742
Population growth	0.8 percent
GDP (PPP, int'l US$)	4.3 billion
GDP per capita (PPP, int'l US$)	4,943
Surface area	18,270 sq. km.
Capital	Suva

Source: World Development Indicators.

Summary

Fiji's economy is estimated to have grown by 2.3 percent in 2012, and is expected to grow by a further 2.4 percent in 2013, largely on the back of additional investment in the tourism and mining sectors, as well as government funded infrastructure projects. While fiscal policy has been supportive of growth, Fiji faces challenges in the short to medium term in addressing fiscal sustainability, particularly accumulating government debt. More specifically, the state's guarantee on debt to fund the purchase of the new fleet of airplanes (by the national airline) will not only cause a significant deterioration in the current account in 2013, but increase contingent liabilities to nearly 30 percent of GDP.

Recent Economic Developments

The Fijian economy is estimated to have grown by 2.3 percent in 2012, and is expected to grow by a further 2.4 percent in 2013. This is lower than the official projection since it incorporates the negative impacts of Cyclone Evan in late 2012 and early 2013, which resulted in damages and weaker tourist arrivals to Fiji. However, post-cyclone reconstruction activity is expected to provide a boost to the economy. The economy will also be supported by additional investment in the tourism and mining sectors, as well as by infrastructure projects such as roads. Private consumption growth is expected to be driven by tax cuts, public sector pay raises, and low interest rates. However, the performance of the sugar industry will remain sluggish.

Sugar output was poor in 2012, and the industry's long-term structural problems (low productivity of growers and mill inefficiencies) are no closer to being solved. According to the Ministry of Finance, the government's reform program spent around US$84 million between mid-2011 and late 2012 on the rehabilitation of mills, debt restructuring, and improving the production of sugarcane. However, sugar production in 2012, at 155,000 tons, was around half of the output reported in 2006. Although the fall in sugar production is partly a result of natural disasters, higher production costs and land lease payments have also played a part. Meanwhile, the price paid for sugar by the EU under its Cotonou Agreement will continue to decline rapidly, and a large portion of aid that would otherwise have been provided to Fiji by the EU to smooth the transition to lower prices will be withheld until elections are held in 2014.

Investment in the tourism and mining sectors is expected to continue in 2013 and 2014. In May 2013, Chinese-owned DRK Energy purchased a 19.2 percent stake in the Vatukoula gold mine. DRK and Vatukoula have announced that they will work together on a planned expansion program aimed at boosting production for export. Construction of Fiji's first casino began in June 2013. The US$290 million casino will add 200 rooms to the resort area of Denarau Island, and is expected to take around two years to complete. The quarterly construction survey estimates that the value of construction works put in place in the first quarter of 2013 was US$40 million, up 10 percent compared to the same quarter in 2012.

Inflation is expected to remain moderate. In April 2013, inflation fell to just 1 percent, the lowest year-on-year (yoy) increase in more than three years, before rising to 1.7 percent in June. Inflation is expected to pick up to a moderate level of 3 percent by year end, reflecting potential domestic price pressures stemming from the effects of public sector pay rises.

The current account balance is projected to deteriorate substantially in 2013, largely explained by the purchase of three aircraft by the national airline—valued at around US$600 million (15 percent of GDP). In the first four months of 2013, a 13.4 percent decline was noted for export earnings due to declines in sugar, timber, and gold exports. However, imports, excluding aircraft, grew by 3.7 percent for the same period, together leading to a 21.5 percent widening of the trade deficit. The recent opening of a second large hydroelectric power station and the expected introduction of sugarcane-based biofuel generation could help reduce fossil fuel dependency, which may offset increases in other import categories. Tourist arrivals fell by around 5 percent in the first quarter of 2013 compared to the same period in 2012. This is largely a result of recent cyclones. The outlook for the country's tourism industry is more encouraging—forward booking is reportedly up and air services have become more frequent, enabled by the purchase of new aircraft by Fiji Airways. However, the recent depreciation of the Australian dollar could dampen tourist arrival from the main source country. Inward remittances rose by 20 percent cumulative to May 2013 compared to the same period in 2012. Foreign reserves improved to US$941 million at the end of July 2013, equivalent to 5.1 months of imports of goods and nonfactor services (GNFS).

The announced 2013 budget projects a widening of the deficit, from 1.7 percent of GDP in 2012 to just under 3 percent of GDP in 2013, largely explained by a 30 percent increase in infrastructure spending. Operating revenue is expected to rise from US$991 million (27.4 percent of GDP) to US$1,053 million (27.6 percent of GDP) on the back of expected growth in the economy and changes to tax rates. Operating expenditure is expected to rise from US$779 million (21.5 percent of GDP) to US$825 million (21.7 percent of GDP), partly explained by an increase in staff salaries and wages. The minimum salary for all established staff will rise to F$10,000 (US$5,320), while government wage earners will receive a 10 percent across-the-board increase. The budget also allows for an expansion of welfare assistance to the poorest Fijians by broadening the social safety net to cover to poorest 10 percent of the population and introducing a social pension scheme to benefit those aged 70 and above. Capital expenditure, mainly on roads, is expected to increase from US$295 million (8.1 percent of GDP) to US$385 million (10.1 percent of GDP).

Revenue collections outperformed in the first half of the year, although 60 percent of forecast revenue remains to be collected in the second half of 2013. According to the Fiji Revenue and Customs Authority (FRCA), the government collected US$440 million in total revenue during January–June, which was US$16 million (3.8 percent) higher than forecast in the budget for 2013, and represented an increase of 11.7 percent over the same period from a year earlier. The better-than-expected outturn mainly resulted from stronger consumer spending, which pushed up value-added-tax revenues. Reductions in personal income tax rates, wage increases, higher remittances, and better employment prospects are likely to have contributed to stronger consumer spending. Increased consumer demand for foreign goods has also pushed up the collection of import duty, which, at US$105 million in the first half of 2013, was US$3.2 million ahead of the budget and up by 22 percent y-o-y. The strong performance also reflected improved tax compliance, which is an important theme in the 2013 budget. The FRCA has reportedly clawed back a significant amount of revenue after several investigations were initiated in early 2013, and lower tax rates have possibly encouraged greater tax compliance. However, lightening the income tax burden has inevitably reduced tax revenue from this source, with income tax collection during January–June falling by

11.6 percent y-o-y, and coming in at US$2.7 million under target.

Outlook and Emerging Challenges

Fiji faces challenges in the short to medium term to address fiscal sustainability, particularly accumulating government debt. Public debt has remained above 50 percent of GDP. Although the 2013 budget indicates the government's plans on fiscal consolidation, the projected increase in government borrowing unveiled in the 2013 budget will add to public debt. Furthermore, according to Standard and Poor's 2013 ratings assessment of Fiji, the state's guarantee on debt to fund the purchase of the new fleet of airplanes will increase contingent liabilities to nearly 30 percent of GDP. However, reforms to the national pension fund have significantly reduced the financial risk to the government from this entity.

Fiji: Key Indicators

	2011e	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	1.9	2.3	2.4	2.1	2.2
Tourist arrivals (thousands)	675	661	670	670	690
(% change yoy)					
Unemployment rate (%)					
Consumer Price Index (% change yoy)	7.7	1.5	3.0	3.0	3.0
Public Sector					
Government revenues (% GDP)	26.2	27.9	28.8	28.8	28.9
Government expenditures (% GDP)	27.6	29.6	31.8	31.6	31.5
Government balance (% GDP)	-1.4	-1.7	-3.0	-2.8	-2.6
Domestic public sector debt (% GDP)	40.6	40.2	40.3	41.2	41.5
Foreign Trade, BOP, and External Debt 1/					
Trade balance (millions US$)	-837	-744	-1,333	-899	-937
Exports of goods (millions US$)	554	625	575	601	629
(% change yoy)	2.7	12.7	-8.0	4.5	4.7
Key export (% change yoy) 2/	147.3	7.3	-24.5	-0.5	-0.4
Imports of goods (millions US$)	1,898	1,950	2,495	2,090	2,163
(% change yoy)	22.9	2.7	27.9	-16.2	3.5
Current account balance millions US$)	-183	-41	-632	-210	-226
(% GDP)	-4.9	-1.1	-15.9	-5.2	-5.4
Foreign direct investment (millions US$)	416	266			
Total external debt (millions US$)	612	679			
(% GDP)	16.3	17.9			
Short-term debt (millions US$)					
Debt service ratio (% exports of g&s)	9.0	2.6			
Foreign exchange reserves, gross (millions US$)	830	923			
(months of imports g&s)	5.0	5.2			
Financial Markets					
Domestic credit (% change yoy) 3/	3.9	6.6			
Short-term interest rate % p.a.)	2.2	0.6			
Exchange rate (F$/US$, eop)	1.82	1.77			
Real effective exchange rate (2000=100)	91.9	96.0			
(% change yoy)	4.6	4.5			
Memo: Nominal GDP (millions US$)	3,754	3,785	3,879	3,968	4,083

Source: National data sources.
e = estimate.
f = forecast.
1/ BOP time series undergoing revisions. Rise in debt service ratio in 2011 reflects the maturity of the US$150 million global bond.
2/ Sugar.
3/ Domestic credit to the private sector.

INDONESIA

Population	246.9 million
Population growth	1.2 percent
GDP (PPP, int'l US$)	1.2 trillion
GDP per capita (PPP, int'l US$)	4,956
Surface area	1,904,570 sq. km.
Capital	Jakarta

Source: World Development Indicators.

Summary

Indonesia's economy is adjusting to weaker terms of trade and tighter international liquidity. Policy settings have shifted so as to support this adjustment, notably including an increase in subsidized fuel prices. In the baseline scenario, growth should moderate but remain resilient. However, the risk of a more significant dislocation cannot be ruled out. This places a premium on continued macroeconomic policy flexibility, making more progress to lift the competitiveness and sustainable growth rate of the economy, and on protecting the vulnerable from the impact of moderating growth and current inflationary pressures.

Recent Economic Developments

Indonesia's economy has slowed over 2013, with growth weighed down by sluggish export growth and weaker investment momentum. Real GDP growth in the second quarter was 5.8 percent year-on-year (yoy), down from 6.0 percent in the first quarter and annual growth of 6.2 percent in 2012. Fixed investment demand, in particular, has moderated significantly, with gross fixed capital formation up by 4.7 percent yoy in the second quarter, well off its recent peak of 12.5 percent growth yoy in Q2 2012. Capital goods imports have fallen accordingly, but import volumes overall still picked up in the second quarter. Export volume growth, while positive, has remained weak. On the production side, nontradable sectors such as construction (up 6.9 percent yoy in Q2) and services (up 7.5 percent) have continued to drive growth. In contrast, weakness is evident in the commodities sector, where real output shrank by 1.2 percent yoy in Q2. Outright price deflation in the mining sector has also helped push down overall GDP inflation to 14-year lows, causing nominal GDP growth to decelerate much more significantly than real GDP growth, roughly halving from a 15 percent average annual pace in 2011, to 7.8 percent in Q2 2013.

Following the first annual current account deficit since 1997, of 2.8 percent of GDP in 2012, Indonesia's external balances have continued to be in focus. In the second quarter, a record quarterly current account deficit of US$9.8 billion was registered, equivalent to 4.4 percent of GDP and significantly wider than the 2.2 percent of GDP quarterly deficit seen in the first quarter. The wider current account reflected the combination of flat export revenues, and a seasonal rise in income outflows and import demand ahead of the Lebaran holiday period. Significant portfolio investment outflows since May, as seen also in many other emerging markets, added to the pressure on the overall balance of payments, which recorded a deficit of US$2.5 billion.

Against the backdrop of mounting economic pressures, and following the passing of a revised budget in June, the government raised subsidized fuel prices for the first time since 2005, by a substantial 33 percent, on average, alongside an Rp 30 trillion package of compensation measures to help shield the poor from the impact of higher fuel prices. While spending on energy subsidies is still projected to remain substantial, this price adjustment marks an important step forward in improving the quality of public spending. This welcome reform has, however, come at the cost of a temporary increase in inflation,

which increased to 8.8 percent yoy in August 2013, reflecting primarily a fuel-price-induced jump in the CPI in July.

As in many other major emerging markets and as discussed elsewhere in this report, Indonesia's financial markets have been under pressure since May, as global liquidity tightened in anticipation of U.S. Federal Reserve asset purchase "tapering." Exchange and interest rates have been responding to these market pressures. The rupiah has weakened by 20 percent against the U.S. dollar year-to-date, and official currency reserves have declined by US$19.7 billion over 2013 to US$93 billion in August. Bank Indonesia has lifted its overnight deposit and reference interest rates by 150 basis points since June, along with taking a series of measures aimed at improving currency market conditions, streamlining liquidity management, and selectively reigning in credit growth (notably in the property sector). In response to the particularly marked deterioration in market conditions in early August, the government also announced a package comprising a range of measures designed to support exports and FDI, dampen import demand, and limit the negative employment and poverty impacts of slower growth and higher inflation.

Outlook and Emerging Challenges

In the base case, GDP growth in 2013 is projected to slow moderately to 5.6 percent, declining to 5.3 percent in 2014. Private consumption is expected to remain the main driver of growth, potentially boosted by early preelection spending toward the end of 2013 and into 2014. Investment is expected to expand at a much more moderate pace than in 2012. Unlike in 2012, net exports are not expected to be a significant drag on growth over the remainder of 2013, as import volume growth decelerates in line with slower investment growth, and export volume growth remains positive, albeit subdued.

The current account deficit is expected to stand at US$29.3 billion, or 3.4 percent of GDP, in 2013, before narrowing in 2014 to 2.6 percent of GDP. The overall balance of payments is also expected to record a sizable deficit in 2013, reflecting a shortfall in net investment inflows relative to the current account financing need, and resulting in a drawdown of approximately US$18 billion in foreign currency reserves. The overall balance-of-payments deficit is expected to shrink significantly in 2014, reflecting a smaller current account deficit and overall net investment inflows.

Inflation pressures are projected to moderate in month-on-month terms following the mid-2013 price surge triggered by the June subsidized fuel price increase and the seasonal impact of Ramadan. Headline inflation in Q4 2013 is projected at 9.8 percent yoy compared with 4.3 percent yoy in Q4 2012, and inflation to average 7.3 percent in 2013 and 6.7 percent in 2014. This base case assumes that second-round inflation will remain contained, allowing the price impact of the June fuel price increase to drop out of the base by mid-2014. However, while core inflation has so far remained little changed, there is a clear risk of some second-round effects from the recent spike in headline inflation, particularly given other cost-push inflation pressures.

Risks to the economic outlook are sizable and to the downside, as domestic demand is impacted by higher generalized consumer price inflation (eroding purchasing power and consumer confidence), higher interest rates (dampening hitherto rapid credit growth), and potential negative wealth and corporate investment activity effects from the stock price and currency declines seen since May. Forecast uncertainty is amplified by the difficulty in predicting how consumer and investor sentiment will respond to significant, ongoing economic and policy adjustments. Much also depends on the future course of external demand from key trading partners such as China and the United States, and international commodity prices.

The likely narrowing of Indonesia's growth differential with its major trading partners is broadly

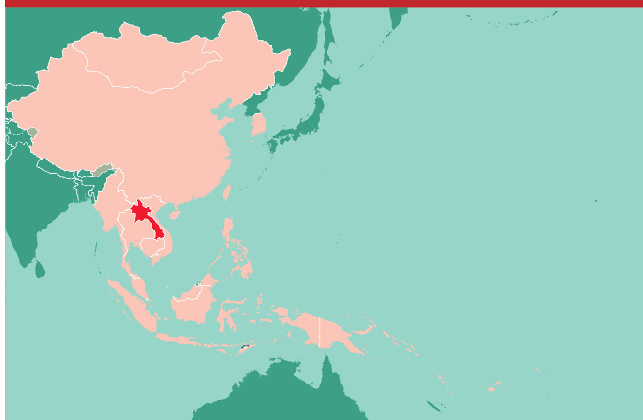
positive for restoring its external balances. However, the significant market and policy adjustments now occurring do bring risks, placing a premium on clear macroeconomic policy communication and coordination, and on effectively mitigating the negative impact of higher inflation and lower growth on the vulnerable. In this respect, the implementation and timing details of the government package announced in August will be closely watched, as will the composition of the 2014 budget, expected to be approved by late October. In general, as the political cycle intensifies ahead of elections in 2014, maintaining the momentum on improving the regulatory environment, and lifting public infrastructure investment and social spending (including by redirecting wasteful, and still very costly, energy subsidy spending) can help Indonesia reinforce the structural underpinnings of strong growth and maintain a favorable outlook for economic growth and development.

Indonesia: Key Indicators

	2011	2012	2013f	2014f	2015f	2012		2013					2013
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	May	Jun	Jul	Aug
Output, Employment, and Prices													
Real GDP (% change yoy) 1/	6.5	6.2	5.6	5.3	5.8	6.2	6.1	6.0	5.8				
Domestic demand (% change yoy)	5.7	6.2	5.1	5.0	5.0	6.0	4.8	5.0	4.7				
Industrial Production Index (2000=100)	140.0	142.9				138.7	149.3	144.7					
(% change yoy)	4.1	2.1				13.7	6.9	3.8					
Unemployment (%)	6.6	6.3											
Real wages (% change yoy)	4.7												
Consumer Price Index (% change yoy) 2/	3.8	4.3	9.8	4.4	4.8	4.3	4.3	5.9	5.9	5.5	5.9	8.6	8.8
Public Sector 3/													
Government revenues (% GDP)	16.3	16.2	16.0	16.0	16.0								
Government expenditures (% GDP)	17.4	18.1	18.6	18.3	18.1								
Government balance (% GDP)	-1.1	-1.9	-2.5	-2.3	-2.1								
Government debt (% GDP)	24.3	23.9	23.5	24.1	24.0	23.7	23.4	13.0	12.9				
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 4/	24.2	-1.7				0.8	-2.4	-0.9	-3.7	-0.6	-0.8		
Exports of goods (billions US$) 5/	200.8	188.5				45.5	47.1	45.2	45.7	16.1	14.7		
(% change yoy)	27.0	-6.1				-13.0	-7.2	-6.5	-3.9	-1.8	-3.7		
Key export (% change yoy) 6/	32.8	-6.6				-20.3	-10.4	-13.4	-13.1				
Imports of goods (billions US$) 5/	166.0	179.9				42.4	46.3	43.6	46.3	16.7	15.6		
(% change yoy)	30.3	8.4				-0.7	4.9	-2.1	-1.0	-1.4	-3.4		
Current account balance (billions US$)	1.7	-24.4				-5.3	-7.8	-5.8	-9.8				
(% GDP)	0.2	-2.8	-3.4	-2.6	-1.9	-2.4	-3.6	-2.6	-4.4				
Foreign direct investment (billions US$)	19.2	19.4				5.9	5.7	4.1	4.2				
External debt (billions US$)	224.8	252.4				243.6	252.4	254.3	258.0	258.5	258.0	260	
(% GDP)	26.6	28.7				28.0	28.8	28.9	29.1				
Debt service	92.5	169.4											
(% exports of g&s)	46.1	89.9											
Foreign exchange reserves, gross (billions US$)	110.1	112.8				110.2	112.8	104.8	104.8	105.1	98.1	92.7	93.0
(months of imports of g&s)	6.7	6.3				6.3	6.3	5.9	5.5				
Financial Markets													
Domestic credit (% change yoy)	24.4	24.2				23.9	22.7	22.9	21.2	21.0	20.6		
Short-term interest rate (% p.a.) 7/	6.6	5.8				5.8	5.8	5.8	5.8	5.8	6.0	6.5	7.0
Exchange rate (Rp/US$, ave)	8,770	9,387	10,400	11,400	11,400	9,544	9,630	9,695	9,818	9,802	9,929	10,278	10,924
Real effective exchange rate (2000=100)	160.1	158.8				158.0	156.0	160.0	163.2	163.8	163.5	161.2	161.2
(% change yoy)	-0.1	-0.8				-2.0	-2.3	-0.2	2.0	2.3	2.4	0.9	1.6
Stock market index (Aug. 1982=100) 8/	3,746	4,119				3,977	4,314	4,730	4,974	5,069	4,819	4,610	4,195
Memo: Nominal GDP (billions US$)	846.3	878.0	836.9	803.9	850.5	222.1	217.9	221.2	225.1				

Sources: National data sources and World Bank staff estimates.
f = forecast.
1/ Based on GDP 2000 base.
2/ End of period.
3/ Government projections.
4/ Goods and services trade balance.
5/ Goods trade on BOP basis from Bank Indonesia with exception of monthly figures from Budan Pasat Statistik (BPS).
6/ Crude oil and gas exports.
7/ Policy rate.
8/ Jakarta Composite Index, end of period.

LAO PEOPLE'S DEMOCRATIC REPUBLIC



Population	6.6 million
Population growth	1.9 percent
GDP (PPP, int'l US$)	19.4 billion
GDP per capita (PPP, int'l US$)	2,926
Surface area	236,800 sq. km.
Capital	Vientiane

Source: World Development Indicators.

Summary

Lao PDR is expected to maintain high GDP growth of about 8 percent in 2013. High growth continues to be driven by construction and new production activity in the hydropower sector, and by strong activity in the services, construction, and food processing sectors, aided in part by accommodative macroeconomic policies. Overall inflation has generally trended upward, fueled by nonrice food prices. The fiscal deficit widened sharply in FY12/13 because of a combination of an increase in public sector wages and compensation, and a decline in mining revenue. In addition, domestic credit has continued to grow at a fast clip, with an accommodative monetary policy and buoyant demand in the construction, commerce, and service sectors. Strong foreign direct investment (FDI) and accommodative fiscal and monetary policies have contributed to a further widening of the external current account deficit. Foreign reserves have continued to decline, and the reserve coverage of imports is expected to reach the lowest level in a decade. There are indications that the expansionary bias of fiscal and monetary policies observed so far in 2013 may be partly removed, which could lead to marginally slower growth in 2014 and an easing in emerging fiscal and external imbalances.

Recent Economic Developments

The Lao economy is expected to grow at 8 percent in 2013, fueled by a vibrant resource sector, continued FDI-financed investment in hydropower, and accommodative macroeconomic policies. The hydropower sector (both completed projects in operation and projects in the construction/ development phase), and the construction, food processing, and services sectors remain the major contributors to this growth. The upward revision of 0.4 percentage points from November 2012's projection reflects recent data for cement and hydropower outputs. Furthermore, the hydropower contribution to GDP will benefit from the completion[3] and development of several large hydropower projects including the Hongsa Lignite, Sayaboury, Nam Ou, and Xepian Xe Namnoi projects, which also offer a positive spillover to the construction, food, and services sectors. Growth in the services sector was strong across main subsectors, in wholesale and retail trade, tourism, transportation and telecommunication, and banking.

Overall inflation has continued to rise since early 2013 due to a continuous increase in nonrice food prices. Overall CPI inflation is projected at 6 percent for 2013, compared to 4.3 percent in 2012. Headline inflation increased from 6 percent year-on-year (yoy) in February 2013 to 6.8 percent in August primarily due to high food inflation, which rose from about 12 percent to 17 percent during the same period. A key driver of this effect is the continued surge in meat and the fast increase in vegetable prices, owing to, reportedly, unusual developments in local demand and supply conditions.[4] While energy

3 Completed projects that will commence full operations in 2013 include Nam Ngum 5 and the Theun Hinboun expansion project.

4 In response, the Ministry of Industry and Commerce (MOIC) recently issued an order (MOIC Order No. 650, dated April 1, 2013) to temporarily suspend exports of livestock and divert them for local supply.

inflation has remained low, core inflation moderated slightly during the same period.

In FY12/13, the fiscal deficit is expected to worsen due to a combination of a large increase in public sector wages and benefits, and a decline in mining revenues. Total revenue growth is expected to slow due to lower grants and lower mining revenue in 2012 as a result of a fall in copper prices and higher mining production costs that partly offset the volume and gold price gains in 2012. Nevertheless, nonresource taxes (particularly the value-added tax and excise taxes) have a positive performance outlook. For the year as a whole, the public wage bill will have risen by about 125 percent in 2013 from the previous year. As the new wage increase was implemented, total expenditure in the first half of FY12/13 increased by 35 percent yoy compared to 10 percent yoy in the first half of the last fiscal year. As a result, the fiscal deficit is expected to widen sharply to 6.1 percent of GDP, from 1.3 percent in 2012. The overall nonresource fiscal deficit is expected to climb to 9.7 percent in FY12/13 while the nonmining fiscal deficit is likely to reach 8.8 percent from 5.5 and 4.6 percent, respectively. The rapid widening in the deficit appears to have strained the cash position of the government in recent months and may be encouraging the authorities to take offsetting measures on short-term spending.

Further fiscal pressure has also emanated from a growing trend of local government reported encouragement of private prefinancing and execution of public infrastructure projects. These projects are prefinanced by private contractors citing development priorities of concerned regional authorities despite limited prior budget allocations, with related risks of creating contingent liabilities and intensifying pressure on the budget and the fiscal stance. While the current number and size of active and planned prefinancing arrangements remains unclear, the authorities will need to develop clear regulations and policies to manage these projects.

Foreign exchange reserves and net foreign assets continue to fall in mid-2013. Reserves stood at US$530 million in June, down 12.4 percent yoy for Q2 2013, while net foreign assets fell significantly by 57 percent yoy. Reserves coverage is expected to reach the lowest level in a decade, with only 1.6 months of goods and services imports, or about 2.6 months of nonresource imports. The ratio of reserve-to-foreign-currency deposits fell progressively from about 60 percent two years ago to around 26 percent in June 2013.

Domestic banking credit growth has slowed, but remained high in June 2013, at 28.2 percent yoy, driven mainly by private sector credit. Private sector credit growth has primarily come about from accommodative policy in the face of increasingly buoyant credit demand growth in the construction, commerce, and service sectors. Broad money grew by 28 percent yoy in June supported by deposits and credit growth.

Outlook and Emerging Challenges

Growth in 2014 is projected to moderate at 7.7 percent taking into account the increased downside risks in the regional economy and the slowdown in some real sectors. There are also indications that the authorities may pull back somewhat on the strongly expansionary bias in their fiscal and monetary policies. Key growth drivers are expected to come from services (wholesale and retail, transportation, and telecommunication), and food processing and beverages, supported by continued domestic demand. Construction and construction-related industry are expected to still grow fast, albeit at a slower pace compared to the high base in recent years. The resource sector is expected to provide a smaller contribution this year since new commercial operation of major power projects is not expected to come onstream in 2014.

Inflation is projected at 6 percent (yoy) in 2014, in line with 2013. The key driver has been an upward pressure from food inflation, especially from nonrice food items in light of stronger internal consumption demand. Even with slightly less accommodative

macroeconomic policies going into 2014, the inflation momentum is expected to remain steady in the near future.

The fiscal deficit in FY13/14 is projected at 5.8 percent of GDP, assuming, on current policy plans, a further 35 percent increase in public wages. Fiscal policy would focus on expenditure containment measures for nonwage recurrent expenditures, as well as efforts to improve revenue administration, including at the decentralized level. There are indications, however, that the authorities may go some way to tightening their fiscal policy, contain spending growth, and seek additional revenue efforts, although specific details remain unclear at the current juncture.

With strong past and projected GDP growth, the assessment of risks of debt distress has been revised from high to moderate in 2012, and remains so in 2013 and for the medium term, even despite the recent widening of the fiscal deficit. This said, debt sustainability would need to be reassessed altogether if the government went ahead with plans for large infrastructure projects.

The overall balance of payment is expected to exhibit a slight surplus in 2014 as strong capital inflows are expected to compensate the still widening current account deficit. The current account deficit is expected to remain high due in part to the large need for capital goods imports supporting the ongoing construction of large-scale hydropower projects. In addition, nonresource imports growth is likely to outpace nonresource exports growth. At the same time, the uncertainty in the global economy and possible moderation of growth in some emerging markets could have further implications for Laos, including through lower FDI and lower mining export prices, with a negative impact on Lao export earnings and government revenues.

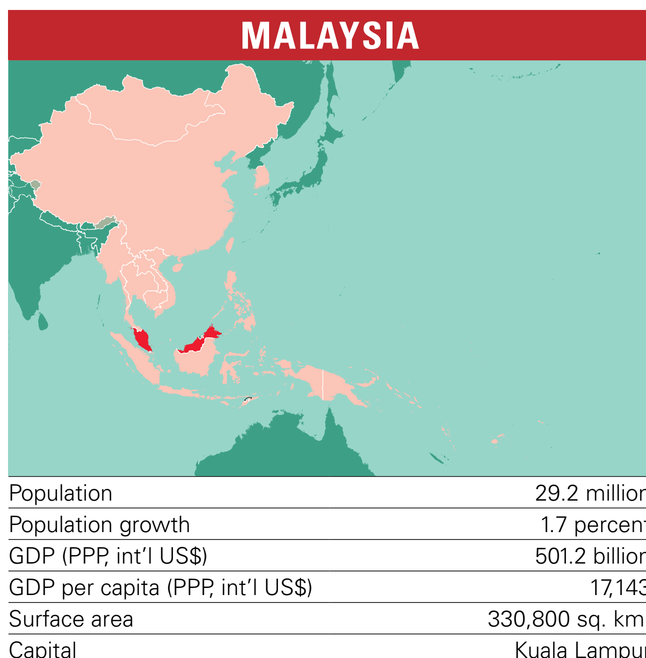
As regards prospects for longer-term inclusive growth, shortages of labor, especially skilled labor, has remained one of the top constraints in doing business and is a potential hindrance to nonresource sector growth. Businesses, particularly in the manufacturing and services sectors, are reporting difficulty in finding labor (even unskilled labor) due to demand and supply mismatch, relatively high labor turnover, and migration. The government is working on updating its Human Resource Development Strategy that will provide an important framework for education and labor market development going forward.

Lao PDR: Key Indicators

	2011e	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	8.0	8.2	8.0	7.7	8.1
Consumer Price Index (% change yoy)	7.6	4.3	6.0	6.0	6.0
Public Sector 1/					
Government revenues (% GDP)	18.5	19.7	18.7	18.9	19.2
Government expenditures (% GDP)	21.2	21.0	24.8	24.7	25.1
Government balance (% GDP) 2/	-2.7	-1.3	-6.1	-5.8	-6.0
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-760	-1,477	-2,310	-2,450	-2,588
Exports of goods (millions US$)	2,628	2,892	2,939	3,004	3,201
(% change yoy)	22.3	10.0	1.6	2.2	6.6
Key export (% change yoy)	16.1	11.8	-0.1	0.9	0.3
Imports of goods (millions US$)	3,388	4,369	5,249	5,454	5,789
(% change yoy)	30.8	29.0	20.1	3.9	6.1
Current account balance (millions US$)	-850	-1,440	-2,322	-2,498	-2,677
(% GDP)	-10.3	-15.3	-20.8	-20.0	-18.9
Foreign direct investment (millions US$)	1,067	1,764	2,618	2,491	2,572
External debt (millions US$)	7,623	8,887	10,419	12,181	13,332
(% GDP)	82.9	87.5	94.2	102.0	102.3
Debt service ratio (% exports of g&s)	63.2	60.5	78.5	76.0	69.1
Foreign exchange reserves, gross (millions US$) 3/	679	739	707	785	886
(months of imports of g&s)	2.3	1.9	1.6	1.7	1.8
Financial Markets					
Domestic credit (% change yoy) 4/	38.2	26.6	24.3	23.2	21.3
Short-term interest rate (% p.a.) 5/	7.0				
Exchange rate (Kip/US$, ave)	8,058	7,982	7,862	8,000	8,000
Exchange rate (Kip/US$, eop)	8,004	7,967	7,931	8,000	8,000
Real effective exchange rate (2000=100)	127.2				
(% change yoy)	4.0				
Memo: Nominal GDP (millions US$)	8,253	9,418	11,176	12,493	14,138

Source: National data sources.
e = estimate.
f = forecast.
1/ Fiscal year basis.
2/ After grants.
3/ Excluding gold.
4/ Domestic credit, excluding government lending funds.
5/ Treasury bill rate.

MALAYSIA



Population	29.2 million
Population growth	1.7 percent
GDP (PPP, int'l US$)	501.2 billion
GDP per capita (PPP, int'l US$)	17,143
Surface area	330,800 sq. km.
Capital	Kuala Lampur

Source: World Development Indicators.

Summary

Although Malaysia's economy slowed in the first half of the year, domestic demand kept GDP growth at 4.2 percent despite further contraction in exports. Strong domestic demand drove faster growth of imports, especially of capital goods, compared to exports. As a result, the current account surplus narrowed to its lowest level since the Asian financial crisis. Responding to capital outflows and a downgrade to its sovereign ratings outlook that drove government bond yields higher and equity markets lower, Malaysia's policy makers took action to rein in the fiscal deficit and contain the decline in the current account surplus. The economy is likely to face greater domestic headwinds going forward as fiscal consolidation takes a bite out of consumption and investment. The external outlook has improved, however, and both exports and production appeared to have turned the corner since July.

Recent Economic Developments

GDP growth slowed in the first half of 2013 largely on account of weak external demand. GDP expanded 4.2 percent year-on-year (yoy) compared to 5.9 percent in the previous six months (2.5 percent compared to 6.0 percent on a sequential or Seasonally Adjusted Annual Rate [SAAR] basis). On the demand side, the weakness can be attributed primarily to exports, whereas domestic demand remained robust, with the value added produced and absorbed domestically estimated to have expanded by a faster rate in the first half of 2013 compared to the previous six months (9.3 percent compared to 8.8 percent). Most sectors of the economy slowed, especially agricultural commodity sectors (palm oil and rubber) and financial services. The mining sector improved upon the contraction in the previous quarter, while strength in domestic demand was aligned with the expansion in services, which accelerated by 4.3 percent over the last quarter (Q1'13: 3.8 percent, SAAR).

Fixed investment slowed in the second quarter of 2013, while household and government consumption remained robust. Following strong performance in the previous five quarters, gross fixed capital formation contracted on a sequential basis (-2.9 percent quarter-on-quarter [qoq] SAAR in Q2 compared to 44 percent qoq SAAR in Q1; yoy growth remained positive, however), while private and public consumption remained strong. Despite softer commodity prices, particularly for crude palm oil, private consumption was bolstered by a round of higher salaries and bonuses for the civil service, accommodative credit conditions, and the Bantuan Rakyat 1 Malaysia (BR1M) cash transfers, which were distributed to close to 70 percent of Malaysian households in early 2013. Growth in public consumption expanded markedly in Q2 2013, reflecting higher spending on supplies and services and sustained spending on emoluments.

Exports contracted on a year-on-year basis for the fourth quarter in a row as commodity exports (especially palm oil and rubber) slowed and electrical and electronic exports showed no signs of recovery. While imports of intermediate goods mirrored weak exports, and imports of capital goods contracted from the previous quarter in line with fixed investment, as

a result of the larger decline in exports and softer commodity prices, the current account surplus narrowed to the lowest level since the fourth quarter of 1997, at 4.6 percent of GDP (Q1'13: 5.1 percent of GDP). Despite the deterioration in the current account, the balance-of-payments deficit narrowed modestly to -0.4 percent of GDP (Q1'13: -1.6 percent of GDP) due to stronger capital inflows in the beginning of the quarter.

A combination of the U.S. Fed's mulling about the timing of "tapering" its highly accommodative monetary policy and concerns about the sustainability of large current account deficits in some countries, notably India and Indonesia, led to large capital outflows in June and August. Although vulnerabilities in Malaysia were not as pronounced compared to other countries, investors were concerned about the sharp reduction in the current account surplus, large degree of foreign holdings of domestic debt, and initial lack of fiscal reforms following the general election. As a result of capital outflows, the currency depreciated and government bond yields increased: the ringgit declined 10 percent against the U.S. dollar since late May, and as of early September, Malaysia's 10-year ringgit yield had jumped 44 basis points. Malaysia's stock market was also not spared, losing about 7.3 percent of market capitalization between July and end-August before recovering since then.

While eventual Fed tapering is likely to lead to further capital outflows, risks of a crisis are limited. Malaysia has significant external assets (at end-August, international reserves stood at US$134.8 billion, down from US$141.4 billion at end-May), equivalent to 9.3 months of imports, and a deep domestic financial system that can absorb securities sold by foreigners. Moreover, the government has embarked on more meaningful fiscal consolidation, and a degree of currency depreciation will be welcomed by the struggling export sector.

The government has taken further steps toward fiscal consolidation. Pressured in July and August by a downgrade of the outlook of its foreign currency ratings by Fitch, capital outflows that raised government bond yields, and fears of a "twin deficit," the government in early September announced an immediate 10 percent cut in fuel subsidies and a "sequencing" (delay) of public investments. More measures toward fiscal consolidation are expected to be included in the upcoming budget, notably additional cuts to fuel and food subsidies, and the announcement of a Goods and Services Tax (GST) likely to be implemented in 2015.

Inflation has remained subdued. Although there were expectations that prices would pick up in 2013 from a weak 1.7 percent in 2012, inflation has so far been modest, underpinned by relatively stable energy prices and by a moderation in food inflation further to slower increases in global food prices. Given the fuel price hike in September and the prospect for further subsidy cuts, including to industrial prices of electricity, inflation is expected to pick up in the fourth quarter of 2013 and into 2014.

Monetary policy remains stable to manage offsetting forces. The policy interest rate has been kept at 3 percent for the last 27 months. The strength in domestic demand, credit growth, and the prospect of higher interest rates in advanced economies would suggest higher rates, but low inflation, continued weakness in the export sector, and the potential impact of higher policy rates on household budgets (and by implication banks) argue for a continuation of the current interest rate environment.

Outlook and Emerging Challenges

The near-term outlook for Malaysia suggests a pickup in growth in the second half of the year as external demand bottoms out along with increased confidence in the recovery of advanced economies. Domestic demand will start facing headwinds from fiscal consolidation earlier and more extensively than previously anticipated, although investment growth should retain some momentum given the extended implementation period of many ongoing projects. GDP growth for 2013 is now estimated at 4.3 percent, with the bulk of the downgrade in the

forecast coming from the weak performance in the first half of the year.

The impact of further fiscal consolidation and possibly tighter credit conditions on domestic demand will weigh on the growth outlook in 2014 and 2015, although the improved external environment would partly mitigate those headwinds. While consumption growth is expected to pick up modestly in 2015 as the effects of fiscal consolidation start to wear out, growth in capital formation is expected to slow further, while still remaining at elevated levels compared to pre-2008 levels. An acceleration of Malaysia's structural reform agenda could present upside risks to the 2015 forecasts.

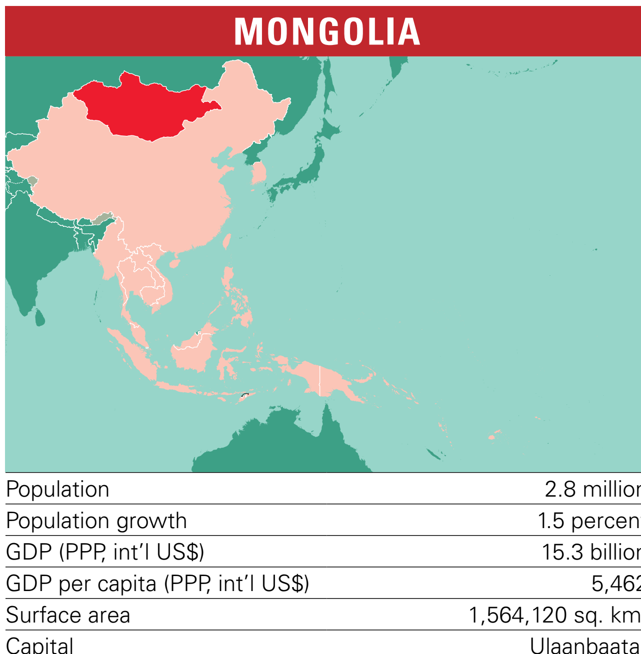
Fiscal policy is expected to remain on a track of consolidation through 2015, with the goal of reaching a deficit of 3 percent of GDP. This will require that the government adopt a medium-term perspective to fiscal policy and a commitment to controlling emoluments and supplies and services, as well as continued efforts to raise nonoil tax revenues. Under current baseline assumptions, the deficit is expected to narrow from 4.1 percent in 2013 to 3.6 percent in 2014 and 3.3 percent in 2015. On the external side, the current account surplus is expected to narrow to 3.4 percent of GDP in 2013.

Malaysia: Key Indicators

	2011	2012	2013f	2014f	2015f		2012		2013				2013
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	May	Jun	Jul	Aug
Output, Employment, and Prices													
Real GDP (% change yoy)	5.1	5.6	4.3	4.8	4.8	5.3	6.5	4.1	4.3				
Domestic demand (% change yoy)	6.8	11.3	7.8	6.7	6.5	13.4	8.4	8.7	8.3				
Industrial Production Index (2000=100)	108.4	113.1				112.2	116.9	111.8	115.7	116.8	115.8	118.9	
(% change yoy)	1.2	4.4				2.5	5.8	-0.1	3.7	3.3	3.3	7.6	
Unemployment (%)	3.1	3.0				3.0	3.1	3.2	3.0	3.3	2.8	3.0	
Real wages (% change yoy) 1/	0.6	4.7				3.1	5.1	5.3	4.4	3.3	7.0	6.2	
Consumer Price Index (% change yoy)	3.2	1.7	2.5	3.2	3.0	1.4	1.3	1.5	1.8	1.8	1.8	2.0	
Public Sector													
Government revenues (% GDP) 2/	21.0	22.1	21.4	21.7	21.9								
Government expenditures (% GDP) 2/	25.8	26.5	25.5	25.3	25.2								
Government balance (% GDP) 2/	-4.8	-4.5	-4.1	-3.6	-3.3								
Total public sector debt (% GDP) 2/	51.6	53.3	53.5	52.9	51.9	52.2	53.3	53.8	54.6				
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 3/	47.5	36.2	36.6	43.0	34.6	7.5	10.5	6.9	4.9	0.9	1.4	0.9	
Exports of goods (billions US$)	228.8	227.9				55.9	57.9	55.0	53.1	18.1	17.9	18.7	
(% change yoy)	14.6	-0.4				-1.6	-2.4	-2.6	-8.5	-5.1	-6.9	4.5	
Key export (% change yoy) 4/	9.4	-5.0				-3.6	-2.8	0.9	-2.9	1.7	-3.9	12.0	
Imports of goods (billions US$)	179.2	187.2				47.7	46.6	47.0	47.1	17.2	16.5	17.8	
(% change yoy)	14.1	4.4				6.8	-0.7	4.8	-2.6	-2.3	1.3	6.2	
Current account balance (billions US$)	33.5	18.6				3.1	7.5	2.8	0.8				
(% GDP)	11.0	6.4	3.4	2.6	3.0	4.1	9.4	3.7	1.1				
Foreign direct investment (billions US$) 5/	12.0	9.4				3.1	1.9	3.0	2.9				
External debt (billions US$)	81.0	82.6				84.7	82.6	85.6	89.6				
(% GDP)	28.0	27.1				28.4	27.1	28.0	29.0				
Short-term debt (billions US$)	32.7	30.4				32.8	30.4	32.8	36.0				
Debt service ratio (% exports of g&s)	10.3	10.1				10.0	9.8	10.4	11.1				
Foreign exchange reserves, gross (billions US$)	133.6	139.7				137.5	139.7	139.7	136.1	141.4	136.1	137.8	
(months of imports of g&s) 3/	9.3	9.6				9.0	9.7	9.7	9.1				
Financial Markets													
Domestic credit (% change yoy) 6/	13.2	12.0				12.4	11.1	11.1	9.6	9.3	9.1	9.3	9.4
Short-term interest rate (% p.a.) 7/	2.9	3.0				3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Exchange rate (RM/US$, eop)	3.18	3.06				3.07	3.06	3.09	3.18	3.09	3.18	3.25	3.30
Real effective exchange rate (2000=100) 8/	99.8	99.7				99.0	100.0	100.4	102.5	104.6	100.5	99.6	96.79
(% change yoy)	-0.2	-0.2				-0.7	2.2	0.0	3.3	4.9	2.2	1.1	-2.6
Stock market index (Jan. 1, 1997=100) 9/	1,509	1,610				1,637	1,689	1,672	1,774	1,769	1,774	1,773	1,728
Memo: Nominal GDP (billions US$)	289.2	305.1				76.2	79.7	75.4	77.2				

Source: National data sources, World Bank staff estimates.
f = forecast.
1/ Manufacturing wages only. 2/ Federal government only. 3/ Balance of goods and services. 4/ Thermionic valves and tubes, photocells, etc.
5/ Inward FDI. 6/ Total loans in the banking system. 7/ Overnight Policy Rate (OPR). 8/ Source: BIS. 9/ FTSE Bursa Malaysia Composite, end-period.

MONGOLIA



Population	2.8 million
Population growth	1.5 percent
GDP (PPP, int'l US$)	15.3 billion
GDP per capita (PPP, int'l US$)	5,462
Surface area	1,564,120 sq. km.
Capital	Ulaanbaatar

Source: World Development Indicators.

Summary

Mongolia's economy recorded another double-digit growth period in the first half of 2013 and is expected to continue double-digit growth in the latter half of the year, largely due to the new copper production from the Oyu Tolgoi mine. Yet, the economy has become increasingly vulnerable due to large external imbalances, significant off-budget spending, and rapid credit growth, amidst an uncertain external environment. Meanwhile, foreign and domestic investor confidence remains fragile and translates into weaker FDI. Macroeconomic management needs to put more focus on economic stability, and continuous efforts are needed to improve the investment environment.

Recent Economic Developments

The Mongolian economy grew at 11.3 percent in the first half of 2013, down from 12.4 percent in 2012 and its peak of 17.5 percent in 2011. The double-digit growth in the first half was possible due to the strong rebound of growth in the second quarter (14.3 percent on a year-on-year basis) from 7.1 percent in the first quarter. Despite the moderate pace of expansion in the mining sector, at 7.4 percent amidst the weak global coal market, robust agricultural production growth at over 20 percent and strong expansion in construction led the strong growth in the second quarter, which largely benefited from the aggressive monetary easing and public infrastructure projects funded by the Chinggis bond issued last year.

National inflation rose to 9.4 percent in August from 8.1 percent in July, a turnaround from its downward trend throughout the year. Despite the loose monetary policy, inflation pressure has been contained at the single-digit level by supply-side measures including for meat, fuel, and imported goods through the Price Stabilization Program of the central bank.

A significant current account deficit (US$2 billion) continued for the first seven months of the year, while capital inflow declined significantly, putting heavy pressure on the local currency value. Total exports (US$2.7 billion) were down by 5.9 percent from a year ago, mainly due to a significant drop in coal exports (down by 49 percent). Meanwhile, the net capital inflow (US$1.2 billion) slowed significantly from a year ago (US$2.4 billion), largely due to a significant drop in FDI. Net FDI was US$1.4 billion for the first seven months, a 46 percent decrease from a year ago. A large external imbalance and loose monetary policy has been putting pressure on the foreign exchange market. The exchange rate against the U.S. dollar has depreciated by around 20 percent since July through mid-September.

After recording an 8.2 percent budget deficit in 2012, the budget has been experiencing a significant revenue shortfall in 2013, and a fiscal consolidation plan was announced in September. As a revenue shortage became highly likely given the fiscal outturn over the first eight months of 2013, the government announced a fiscal consolidation plan to reduce the budget deficit to the structural deficit ceiling of 2 percent of GDP stipulated by the Fiscal Stability Law. The plan is expected to be finalized through Cabinet discussions by end-September.

Yet, the fiscal consolidation plan does not include off-budget public investment projects that are being financed by the proceeds of the Chinggis bond (US$1.5 billion) that was issued in November 2012. Off-budget spending will likely increase significantly in the second half, despite the consolidation plan of the official budget expenditure. The authorities have not released information on disbursements of the Chinggis bond proceeds.

Monetary policy has been increasingly loose through various policy lending channels. The Bank of Mongolia loosened the monetary stance by cutting policy rates by 275 basis points in the first half of the year, which was accompanied by a significant liquidity injection. The monetary easing was done through (a) provision of discounted loans to select industries under the Price Stabilization Program since November 2012; (b) liquidity injection to banks in the form of one-year deposits since May to stimulate the economy; and (c) a housing sector lending program including Tog 800 billion in low-interest rate mortgage lending since June. As a result, the central bank's loans to commercial banks jumped by Tog 2.8 trillion between November 2012 and July 2013—equivalent to over 15 percent of GDP—and the reserve money grew by 59 percent in July from a year ago. One of the systematically important banks—Savings Bank—declared bankruptcy and its asset and liabilities were transferred to the government-owned State Bank on July 22, after a default of significant lending to its major shareholder. The swift action of the Bank of Mongolia and the Ministry of Finance in managing the degrading situation of Savings Bank contributed to maintaining the stability of the overall banking system. However, the failure of Savings Bank highlights the importance of a transparent and accountable banking system.

Outlook and Emerging Challenges

The Mongolian economy is likely to continue double-digit growth in 2013, thanks mainly to the expansion of copper exports from the new Oyu Tolgoi mine. However, the large trade deficit will likely remain, since the fast growth translates into continuous large import demand, given the limited capacity of the domestic manufacturing industry. Inflation will likely be under continuous pressure from the recent depreciation trend of the local currency and an expansionary macroeconomic policy.

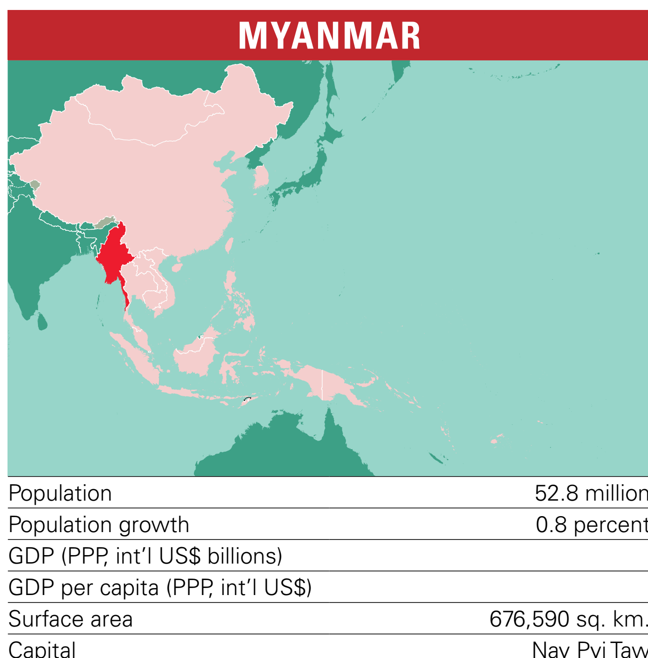
In light of the uncertain external environment and growing economic imbalances, economic management needs to focus on ensuring economic stability based on a sustainable economic policy framework. Macroeconomic policies need to be readjusted to strengthen the policy space against future economic shock and to reduce pressure on economic imbalances. The first priority is to ensure proper implementation of the Fiscal Stability Law. The recent announcement of a fiscal consolidation plan is a positive sign, but the off-budget spending of the sovereign bond proceeds needs to be included in the budget, as well. It is also important that the fiscal resources are "spent well." Spending growth needs to be curbed to a manageable level, given the limited absorptive capacity of the economy. Public projects need to be implemented under a proper and transparent management process. The monetary authorities need to reassess the impact of the loose monetary policy on external and internal economic balances. The rapid growth of private sector credit may increase the vulnerability of the banking sector to abrupt external shocks or an economic downturn. Strengthened supervision of banks and close monitoring of the soundness of banks are required. Finally, efforts to restore long-term capital inflow into the economy are critical for stable investment. The new draft Investment Law currently under discussion could provide a good foundation on which to strengthen the business climate for foreign and domestic investors.

Mongolia: Key Indicators

	2011	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output and Prices					
Real GDP (% change yoy)	17.5	12.4	12.5	10.3	10.0
Mineral GDP (% change yoy)	7.3	8.0	13.4	25.6	15.3
Consumer Price Index, Ulaanbaatar (% change yoy)	9.4	14.2	10.0	12.0	9.5
Public Sector					
Government revenues (% of GDP)	40.3	35.7	35.4	33.5	32.6
Government expenditures (% of GDP)	45.1	46.6	47.2	41.1	38.5
Government balance (% of GDP)	-4.8	-10.9	-11.8	-7.6	-5.9
Public sector debt (% of GDP)	36.7	61.4			
Foreign Trade, BOP, and External Debt					
Exports of goods (millions US$)	4,817	4,384	4,261	5,113	5,883
(% change yoy)	65.6	-9.0	-2.8	19.9	15.0
Imports of goods (millions US$)	6,598	6,738	6,522	6,717	7,388
(% change yoy)	101.3	2.1	-3.2	2.9	9.8
Current account balance (millions US$)	-2,758	-3,362	-3,259	-2,198	-1,856
(% of GDP)	-31.7	-32.8	-29.7	-16.7	-11.6
Foreign direct investment (millions US$)	4,620	4,407	1,951	2,228	
Gross official reserves (millions US$)	2,630	4,126	2,188		
Financial Markets					
Domestic credit (% change yoy, eop)	75.8	-7.5			
Base policy rate (% p.a., eop)	12.3	13.3			
Exchange rate (Tog/US$, eop)	1,395.40	1,392.10			
Real effective exchange rate	8.6	2.9			
(% change yoy, eop)	-5.6	8.0			
Stock market index (2000=100, eop)	4,059	3,444			
Memo: Nominal GDP (billions US$)	7.9	10.1			

Sources: National data sources, World Bank staff estimates.
e = estimate.
f = forecast.

MYANMAR



Population	52.8 million
Population growth	0.8 percent
GDP (PPP, int'l US$ billions)	
GDP per capita (PPP, int'l US$)	
Surface area	676,590 sq. km.
Capital	Nay Pyi Taw

Source: World Development Indicators.

Summary

The Myanmar economy continues to be strong and the outlook remains positive. Real growth in 2012/13 reached 6.5 percent and is projected to increase further to 6.8 percent in 2013/14. Average inflation in 2012/13 was very low at 2.8 percent but has risen noticeably in recent months, as has money supply and credit. Following a steady trend of appreciation in the last half of calendar year 2012, the nominal exchange rate depreciated significantly since the turn of 2013 but has recently stabilized. A strong tax revenue performance in 2012/13 ensured that the overall fiscal deficit declined despite expenditure increases. While gross international reserves continue to accumulate, the current account deficit has been widening, mainly due to a continued surge in imports in response to the relaxation of many restrictions. Following the resolution of arrears to bilateral and multilateral creditors, Myanmar has recently been classified as being at low risk of debt distress by a joint World Bank-IMF Debt Sustainability Analysis. The continuing reform momentum points to a positive outlook in the short to medium term, although a key challenge will be the capacity of the government to remain focused on the economic agenda in the run-up to the 2015 elections.

Recent Economic Developments

The economy continued to accelerate in 2012/13, with real GDP growth estimated to have been 6.5 percent, driven mainly by gas production, construction, and services. Gas exports are estimated to have reached US$4 billion in 2012/13, surpassing the 2011/12 record of US$3.5 billion. In the services sector, growth was strong in the tourism and financial sectors. The economy also showed strong performance in other areas. Foreign direct investment grew from 3.7 percent of GDP in 2011/12 to 5.2 percent in 2012/13. Most of this investment was in the energy sector, garment industry, information technology, and food and beverages. In agriculture, rice production declined slightly due to flooding in some areas and drought in others, but exports in 2012/13 doubled to 1.5 million tons. This was due to a significant increase in exports to China, where demand for imported rice surged after the introduction of a government price support scheme saw domestic rice prices increase from US$272 per ton in 2010 to US$421 in 2013. In 2013/14, real GDP growth in Myanmar is projected at 6.8 percent due to continued growth in foreign investment and a stronger performance in agriculture.

Inflation in 2012/13 averaged a low 2.8 percent but has risen noticeably in recent months, as has money supply and credit. In 2012, inflation was generally very low, but the second half of the year saw a steady increase mainly due to rising food costs. Year-on-year inflation rose from 0.76 percent in June 2012 to 6.0 percent in December 2012. Since January 2013, inflation started declining again and reached 4.7 percent in April 2013. However, inflation rose to 5.5 percent in May, and indications are that it has continued to rise and may have reached 7 percent in August 2013. Key drivers of recent inflation increases are food prices, housing rental costs, and fuel. As a result, average inflation in 2013/14 is projected at 5.6 percent. Board money is estimated to have grown by almost 70 percent in 2012/13, up from 26 percent in 2011/12, although close to 25 percent of this growth was due to a revaluation of foreign-currency deposits following the introduction of a

managed float exchange rate regime. Commercial bank lending to the private sector grew by 50 percent in 2012/13, slightly lower than the 60 percent growth registered in 2011/12.

Following a steady trend of appreciation in the last half of calendar year 2012, the nominal exchange rate depreciated significantly since the turn of 2013, but has recently stabilized. The nominal exchange rate between the Myanmar kyat (K) and the U.S. dollar appreciated by 3 percent between August and December 2012, which raised concerns about its negative impact on Myanmar's export competitiveness, more especially as inflation was also rising. However, the exchange rate depreciated by almost 14 percent in the first half of 2013, reaching a high of K 970 to one U.S. dollar in June 2013. More recently, the exchange rate appears to have stabilized around this level. Meanwhile, the gap between the official and parallel exchange rates has narrowed significantly since the kyat was floated. A look at selected time data points shows that the gap has narrowed to less than 1 percent, down from 5 percent in May 2012.

Despite expenditure increases, the fiscal deficit in 2012/13 is estimated to have declined to -3.7 percent of GDP, down from -4.6 percent in 2011/12, due to strong revenue performance. There were expenditure increases due to increased civil service salaries and higher allocations to education and health. However, these were compensated for by higher gas and tax revenues. Tax revenues increased from 3.9 percent of GDP in 2011/12 to 6.4 percent in 2012/13, although the underlying factors behind this strong tax revenue performance are not clear. The approved budget for 2013/14 shows a continued increase in the allocation of resources to health and education, which have been significantly underfunded in Myanmar. Although still very low, the allocation to education increased from 0.8 percent of GDP in 2011/12 to 1.5 percent in 2012/13 and to 1.8 percent in the 2013/14 budget approved in March 2013. The allocation to health increased from 0.2 percent in 2011/12 to 0.8 percent in 2012/13 and 0.9 percent in the 2013/14 budget.

The current account deficit is estimated to have widened to around -4.4 percent of GDP in 2012/13, up from -2.4 percent in 2011/12, but gross international reserves continued to accumulate. The widening of the current account deficit is mainly due to a surge in imports following a relaxation of some import and foreign exchange restrictions. These include the abolition of the export first policy where, previously, only those importers who had earned foreign exchange through exports could be allowed to buy foreign exchange for imports, and more recently, the removal of import (and export) licensing requirements. Gross international reserves are estimated to have reached US$4.6 billion in 2012/13, equivalent to 3.7 months of imports. The growing reserves indicate that the current account deficit is more than covered through capital account inflows.

Following the resolution of arrears, total external debt ended at 24.8 percent of GDP in 2012/13, and a recent joint World Bank-IMF Debt Sustainability Analysis assessed Myanmar as being at low risk of debt distress. In January 2013, arrears to multilateral institutions (the World Bank and the Asian Development Bank) amounting to US$932 million were cleared, while an agreement was reached on the resolution of the US$10 billion arrears to Paris Club creditors which included a 50 percent write-off of arrears and restructuring of the remainder. This has resulted in a decline in Myanmar's total external debt, from 27.3 percent of GDP in 2011/12 to 24.8 percent in 2012/13. Further, a recent Debt Sustainability Analysis conducted jointly by the World Bank and IMF concluded that Myanmar was at low risk of debt distress.

Outlook and Emerging Challenges

The outlook remains positive in the short to medium term, but there are also challenges, particularly from the political front. Gas production is expected to increase significantly, with new fields coming onstream in 2013/14, while many development partners, including the World Bank, are likely to ramp

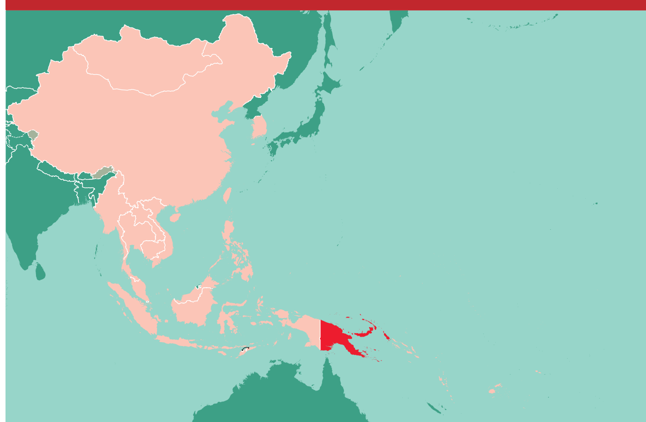
up their support to Myanmar following progress in the country's reengagement process with the international community. Further, opportunities for increased exports recently improved with the reinstatement of trade preferences to Myanmar under the EU's Generalized System for Preferences for least-developed countries, which will give Myanmar duty- and quota-free access to the EU market for all its exports, except arms and ammunition. The continued momentum for economic reforms is expected to result in higher foreign investment and trade. Significant recent reforms include the enactment of a new Central Bank Law that provides for a more autonomous Central Bank, further progress on exchange rate unification by phasing out Foreign Exchange Certificates, the award of licenses to two foreign mobile telephone service providers, and the passage of a new telecommunications law. However, an emerging challenge is likely to be the capacity of the government to remain focused on the economic reform agenda in the run-up to the fast approaching watershed elections in 2015. Likely sources of pressure include the need for lasting peace agreements with the ceasefire groups and the constitutional reform process.

Myanmar: Key Indicators

	2011/12	2012/13e	2013/14p	2014/15p	2015/16p
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)1/	5.9	6.5	6.8	6.9	6.9
Industrial Production Index 2/					
(% change yoy)	6.5				
Consumer Price Index (% change yoy, period average)	2.8	2.8	5.6	6.3	6.0
Public Sector					
Government revenues (% GDP) 3/	12.0	23.0	23.4	23.9	24.5
Government expenditures (% GDP) 3/	16.6	26.6	28.4	28.7	29.3
Government balance, official (% GDP) 3/	-4.6	-3.7	-5.0	-4.8	-4.8
Public sector debt (% GDP)	22.5	22.6	22.4	22.3	22.4
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-369	-2,022	-1,700	-1,229	-1,668
Exports of goods (millions US$)	9,427	9,644	11,276	13,707	15,142
(% change yoy)	19.4	2.3	16.9	21.6	10.5
Imports of goods (millions US$)	-9,795	-11,666	-12,919	-14,998	-16,810
(% change yoy)	30.8	19.1	10.7	16.1	12.1
Current account balance including grants (millions US$)	-1,264	-2,281	-2,436	-2,766	-3,068
(% GDP)	-2.4	-4.4	-4.3	-4.5	-4.6
Foreign direct investment (millions US$)	1,949	2,696	2,153	2,397	2,868
External debt arrears (billions US$) 4/	10.8	4.8			
Total external debt including arrears (billions US$)	15.3	13.7	11.7	13.2	14.7
(% GDP)	27.3	24.8	19.7	20.3	20.6
Debt service ratio (% exports of g&s)	10.7	2.2	4.2	3.9	3.7
Foreign exchange reserves, gross (millions US$)	4,026	4,599	5,537	6,477	7,625
(months of imports of g&s)	3.5	3.7	3.9	4.0	4.1
Financial Markets					
Domestic credit (% change yoy)	25.1	6.2	29.2	24.5	18.4
Short-term interest rate (% p.a.)					
Official exchange rate (K/US$) 5/	5.6	880.0			
Parallel effective exchange rate 5/	822.0	878.0			
(% change yoy)	-4.3	6.8			
Memo: Nominal GDP (millions US$) 6/	52,663	51,849	56,661	61,468	66,706

Sources: Myanmar Central Statistics Office, Ministry of Finance and Revenue, Central Bank of Myanmar, and IMF staff estimates.
e = estimate.
p = projections.
1/ IMF staff working estimates.
2/ Including manufacturing, power, construction, and energy and mining.
3/ Consolidated public sector including Union Government and State Economic Enterprises.
4/ In FY2012/13 and FY2013/14, the terms of bilateral arrears clearance agreement with Japan, the World Bank, and the ADB are incorporated.
5/ Authorities adopted a managed float on April 1, 2012.
6/ Real GDP is rebased to 2010/11 prices by the authorities.

PAPUA NEW GUINEA



Population	7.2 million
Population growth	2.2 percent
GDP (PPP, int'l US$)	20.8 billion
GDP per capita (PPP, int'l US$)	2,898
Surface area	462,840 sq. km.
Capital	Port Moresby

Source: World Development Indicators.

Summary

Papua New Guinea's (PNG's) economy is slowing from the very strong growth rates of recent years, as construction of the PNG liquefied natural gas (LNG) facility nears completion and weaker external demand weighs on domestic activity. Indicators give mixed signals about the extent of the slowdown. Fiscal policy is stimulatory, since revenues are weaker than budget expectations, while the government expects to disburse its greatly expanded spending plans it has budgeted for 2013, especially for subnational and capital spending. This provides some offset from weaker commodity-related incomes across the country and the conclusion of the PNG LNG construction phase. Stabilizing or weakening in nonresource production and incomes are expected to continue into the medium term. The start of LNG exports will raise headline GDP by as much as 50 percent, although the impact on gross national income (GNI), the current account, and government revenues will be far more modest.

Recent Economic Developments

Ninety percent of the US$19 billion PNG LNG project had been constructed by August 2013, and it appears set for its first exports in the second half of 2014. This represents an important inflexion point for the PNG economy. On the positive side, significant fiscal and investment risks associated with the project have diminished greatly, and overall GDP is expected to expand significantly in 2014 and 2015 as exports commence. On the negative side, discharging of the PNG LNG construction workforce is already amplifying the weakening in commodity prices and production, and to cut into incomes and domestic demand and associated spin-off investment activity, while fiscal pressures mount as the government expenditure remains elevated despite weakening revenues. Further, the impact of PNG LNG production on GNI will be far smaller than the impact on GDP, given that the project is approximately four-fifths owned by nonresidents, and tax-reducing allowances are expected to delay first significant tax payments until early in the next decade.

Economic indicators over the first half of 2013 have been mixed. The government raised its growth forecasts for 2013, from near 4 percent to near 6 percent, and several other observers also upwardly revised their growth expectations. The Treasury Department attributed its upgrade to stronger production from various resource projects, greater government spending on capital works, and to an adjustment in its profile of PNG LNG construction expenditure, with the Treasury measuring significantly more domestic LNG construction activity in 2013 than it had previously estimated. In contrast to these upward revisions, private sector operators across most sectors of the economy reported sales and investment conditions declining, generally by more than they had expected. The international prices of PNG's exports continued to fall, with some offset for local producers' incomes from the 11 percent depreciation in the PNG kina against the U.S. dollar between January and August 2013. Lower commodity prices have impacted both

existing resource operations and new investments, leading to a reinforcing cycle of lower demand, job cuts at manufacturers, and lower profitability for various investors. Most notable have been the Newcrest-owned mining projects, with hundreds of national and international jobs reportedly cut from the Lihir Gold operation. Project preparation on the Wafi-Golpu gold and copper resource has been delayed, with substantial multiplier effects reducing economic activity across the northern region of PNG. Domestic firms are yet to report significant support from the budgeted increases in government spending.

Government revenues in the first half of 2013 were somewhat weaker than had been anticipated or was achieved in the same period of 2012. The government expects revenues to be only modestly lower than its budget forecasts, notwithstanding sharp downward adjustments to assumed export prices (for example, average prices in 2013 of gold revised down US$280 to US$1,409 per ounce; copper prices revised down US$809 to US$7,238 per ton). Despite these adjustments, the assumptions were again above prevailing spot prices. The government expects stronger domestic tax receipts (notably, the goods and services tax and personal income taxes) to partially offset the impact of weaker commodity prices, despite the reports of lower turnover and worsening labor market conditions across the economy.

In contrast, the government expects its spending to exceed budgeted levels, due to overruns in provincial personnel emoluments. The government expects to fully disburse its expanded development budget, despite significant delays in the first half of the year and the usual lags in preparing more complex projects of the type included in the 2013 budget. Overall, weaker revenues and stronger spending raise the government's projection of its deficit toward 8 percent of GDP. However, if development expenditure occurs at historical rates for the remainder of the year, the deficit would be closer to 6 percent of GDP, although there also is some risk that the deficit may be higher, with receipts weaker than expected due to the lower value of turnover across the economy.

Inflation, as reported by the National Statistics Office, rose somewhat through the first half of 2013, to 3.2 percent year-on-year. This modest rise in prices appears to be due to tobacco and betalnut. The kina's depreciation creates some upside risks for inflation. The Bank of Papua New Guinea (BPNG) has intervened to slow the depreciation, resulting in a drop in foreign exchange reserves of almost US$0.5 billion between late 2012 and May 2013. However, weakening demand and new supply, especially in the urban property markets, are likely to slow overall price growth. The PNG CPI, based on 1976 consumption patterns, has been out of date for many years, bringing significant risks of policy not reacting to the actual rate of inflation.

Outlook and Emerging Challenges

Overall, while nonresource activity is expected to stabilize near current levels following a decade of strong growth, the risks to these forecasts are tilted to the downside. In the short term, there are reports of significant weather-related disruptions to production at the Ok Tedi mine midyear, while cash crop production remains weak. Into the medium term, the probability of any of the new resource or other projects currently under preparation being approved has declined, due to lower expected returns, scarcer capital, and higher investment costs. Various proposals for the second LNG project continue to be discussed, ranging from constructing a new liquefaction facility at a greenfield site in Gulf province, through to a joint venture with Exxon that uses the additional capacity at the PNG LNG site to construct a third and perhaps a fourth production train. But these have been discussed for some years, and it is not clear when an investment decision is to be expected. Structurally, new LNG projects risk selling at weaker prices as new conventional and unconventional supply becomes available from elsewhere in the region and globally. Meanwhile, the agricultural sector has witnessed

a decline in cash crop production in recent years. Complementary investments in extension and marketing services required to improve farmers' incentives and productivity have been lagging.

Macroeconomic risks could emerge on the fiscal front. PNG's headline public debt ratio provides a strong anchor for fiscal policy, but is weakened by the various debts and contingent liabilities held off-budget by parastatals. PNG can deliver better public services and goods even with slower spending growth, by tackling the weaknesses in funding chains for health and education or procurement which have been highlighted in recent work by the National Economic and Fiscal Commission, the Office of the Auditor General, and the National Research Institute.

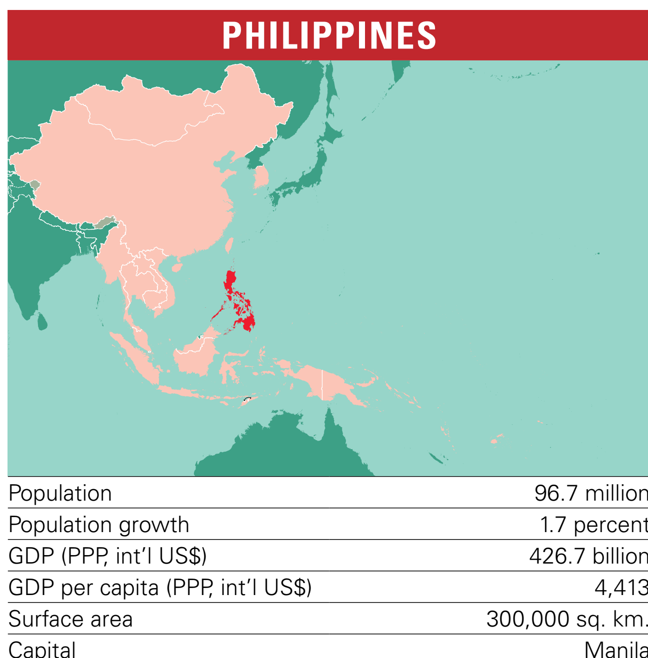
Efforts are being made to better manage the state's enterprises and mineral and oil and gas assets, notably through consolidation into a proposed "Kumul" holdings. This is a challenging task and outcomes will likely hinge on the quality of governance and transparency arrangements that are implemented. The government has also passed legislation taking ownership of the major Ok Tedi mine from the PNG Sustainable Development Program, with uncertain implications for SDP's ongoing social investment programs. These unfolding policy changes are likely to be followed closely by national and international investors aiming to make long-term commitments to sustainable and inclusive growth in PNG. Separately, the government is making efforts to address years of underinvestment in public sector capabilities, through restaffing the public service—again, a task that many governments have found challenging. Finally, recent announcements around spatial development, focusing on PNG's main towns, are consistent with the successful international experience of building on economic momentum by supporting development in existing core urban areas, while ensuring all citizens across the country are able to access the benefits and opportunities created by these centers.

Papua New Guinea: Key Indicators

	2011	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	10.7	8.7	4.5	10.0	20.0
Real nonmineral GDP (% change yoy)	13.0	9.0	3.8	0.0	3.0
Formal employment (BPNG index, % change yoy)	6.3	5.8	2.0	-2.0	1.0
Consumer Price Index (% change yoy)	6.9	1.6	6.0	6.0	5.5
Public Sector					
Government revenues & grants (% GDP)	30.4	29.6	28.4	26.3	23.5
Government expenditures (% GDP)	28.7	32.8	34.0	32.2	28.0
Government balance (% GDP)	1.7	-3.2	-6.5	-5.8	-4.5
Nonmineral government balance (% GDP)	-5.7	-6.7	-9.3	-7.6	-9.7
Public and publicly guaranteed debt (% GDP) 1/	22.3	26.7	31.6	32.0	29.0
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	1,093	-162	1,271	2,047	6,687
Exports of goods (millions US$)	6,954	6,249	5,977	6,694	11,945
(% change yoy)	19.0	-10.1	-4.4	12.0	78.4
Key export (% change yoy) 2/	9.2	-6.2	-1.8	12.5	102.8
Imports of goods (millions US$)	5,861	6,411	4,706	4,647	5,258
(% change yoy)	36.3	9.4	-26.6	-1.3	13.1
Current account balance (millions US$)	-2,303	-4,411	-2,017	-1,349	3,291
(% GDP)	-17.9	-29.1	-12.5	-7.6	13.7
Foreign direct investment (millions US$)	1,750	1,200	800	500	800
Total external debt (billions US$)	12.6	23.1	21.4	21.0	19.7
(% GDP)	97.8	152.8	132.8	118.6	81.7
Public debt service ratio (% exports of g&s)	1.3	0.7	1.4	1.2	0.8
Foreign exchange reserves, gross (millions US$)	4,126	3,804	3,000	3,500	4,000
(months of imports of nonmining g&s)	14.5	12.7	9.0	9.0	10.5
Financial Markets					
Domestic credit to private sector (% change yoy)	7.3	15.0	12.0	6.0	10.0
Short-term interest rate (% p.a.)	6.8	7.0	6.3	6.8	7.5
Exchange rate (K/US$, eop)	2.15	2.06	2.25	2.34	2.43
Real effective exchange rate (2005=100)	127.5	147.0	145.0	145.0	145.0
(% change yoy)	12.7	15.3	-1.4	0.0	0.0
Memo: Nominal GDP (billions US$)	12.9	15.1	16.1	17.7	24.1

Sources: National data sources; IMF; and World Bank staff estimates.
e = estimate.
f = forecast.
1/ Not including debts of state-owned enterprises, or assets of the Bank of Papua New Guinea.
2/ Mineral exports.

PHILIPPINES



Population	96.7 million
Population growth	1.7 percent
GDP (PPP, int'l US$)	426.7 billion
GDP per capita (PPP, int'l US$)	4,413
Surface area	300,000 sq. km.
Capital	Manila

Source: World Development Indicators.

Summary

The Philippines continues to exceed most expectations, with first-half growth of 7.6 percent. Growth was underpinned by consumption and services, with investment and manufacturing giving the extra boost. Amid the challenging global environment, the Philippines is expected to sustain high growth in the medium term. Full-year growth is projected at 7 percent, while growth in 2014 would remain robust at 6.7 percent. Going forward, the government needs to focus its attention on generating higher, sustained, and more inclusive growth—the type that creates more and better jobs and reduces poverty. These can be achieved with reforms to enhance competition, protect property rights, simplify regulations, and increase investment in infrastructure, education, and health.

Recent Economic Developments

The Philippine economy grew remarkably by 7.6 percent in the first half of 2013 (H1 2013), outperforming major economies in the region. Growth momentum was maintained at 7.5 percent in the second quarter of 2013 (Q2 2013), following the revised 7.7 percent growth in Q1 2013. Growth in H1 2013 surpassed China's 7.5 percent and was the highest among the ASEAN-5 economies.[5] The country's strong macroeconomic fundamentals, characterized by low and stable inflation, healthy external balance, and stronger government finances, have continued to shield the economy from the persistent weaknesses of the global economy.

GDP growth in H1 2013 was driven by the robust performance of private consumption and construction, and higher government spending. As in the previous quarters, the sustained inflow of remittances fueled private consumption, which grew by 5.3 percent and contributed 3.7 percentage points (ppt) to overall growth. Private construction increased by 22.1 percent, supported by the low interest rate environment and the robust demand for office and residential space by the booming business processing outsourcing (BPO) industry and its 800,000-strong workforce, which now constitutes a new middle class. Aside from the improved efficiency in government spending, the strong growth of public construction and government consumption reflected election spending, which historically contributed up to 2 ppt to H1 domestic demand growth. Exports, however, continued to decline and subtracted 4 ppt from overall growth given slack demand for electronic products in key trading partners, such as China and the United States.

On the production side, the services sector continued to be the main engine of growth, while manufacturing also provided a boost. The services sector benefited from the resilient growth of trade, financial intermediation, and real estate and other business activities. It expanded by 7.1 percent and contributed 4.1 ppt to overall growth. Despite the fall in exports, manufacturing grew by 10 percent and was driven by strong domestic demand for food, household appliances, chemical products, and industrial machineries and equipment. Growth in

5 Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

agriculture slowed to 1.4 percent from 3.6 percent in 2012 due to lower production of major crops, such as rice, coconut, sugarcane, and banana, largely offsetting the increase in fish harvests.

Despite weaker exports, sustained growth in remittances kept the country's external position healthy. Remittances remained largely unaffected by slower growth in advanced economies. It grew by 5.6 percent in H1 2013, on account of sustained deployment of skilled overseas Filipino workers (OFWs) mostly to Taiwan, Hong Kong, and the Middle East. And despite weaker exports, the contraction in imports resulted in a narrower trade deficit in H1 2013.

In recent months, financial markets experienced significant volatility as investors responded to the planned tapering of the U.S. stimulus program. The Philippine Stock Exchange index, which hit a record high of 7,350 points in May, lost almost 30 percent of its value by August before recovering half of its losses in mid-September. The interest rate spreads between the 2-year and 10-year bonds jumped to 250 basis points (bp) in July from a three-year low of 58 bp in March, before settling at 115 bp in August. Following the strong appreciation of the peso in 2012 and through June 2013, the peso depreciated by around 7 percent against the U.S. dollar.

Monetary policy stance remained accommodating, given the low inflation environment, but upside risks could arise from funds exiting the special deposit accounts. CPI inflation eased to an average of 2.8 percent through July, below the central bank's low-end target of 3 percent. Following three consecutive cuts in the rate of the special deposit accounts (SDA) in the first semester by a total of 150 bps, the Monetary Board tightened rules on the SDA facility by limiting access only to banks' trust accounts starting November 2013. With money supply growth reaching a six-year high of around 20 percent (yoy) in June, the outflow of SDA funds, which currently has placements of around Philippine peso (₱) 1.7 trillion (almost equivalent to the magnitude of narrow money [M1]), could pose significant upside risk to inflation.

Government finances continued to improve, with a fiscal deficit of 1 percent in H1 2013, below the government's target of 2 percent. Efforts to improve the efficiency and pace of government disbursements continued to pay off as reflected in the 12 percent growth of public spending. In terms of budget items, higher growth rates were seen in maintenance and other operating expenditures, which include social services spending, and infrastructure and other capital outlays. Revenue collection, however, grew by 13.7 percent, and is expected to further increase by 0.3 ppt of GDP due to incremental revenues from the "sin tax law." Further public finance reforms are underway. These include rationalizing fiscal incentives, improving customs administration to minimize smuggling, and enhancing accountability and transparency of the budget through the reform of the Priority Development Assistance Fund.

Outlook and Emerging Challenges

Amid the challenging global environment, the Philippines is expected to sustain high growth in the medium term. Baseline growth projections are revised upward from 6.2 percent to 7 percent for 2013, and from 6.4 percent to 6.7 percent for 2014. Private consumption, which comprises over 70 percent of GDP, would continue to drive overall growth on the back of sustained growth of remittances and growth of the BPO industry. A doubling of infrastructure spending from 2.5 percent to 5 percent of GDP by 2016, as announced by the President in his State of the Nation Address, would drive growth of government consumption, and both public and private investments. Further improvements in the investment climate would also contribute to higher foreign direct investment (FDI) inflows, which so far have manifested in an 87 percent increase in FDI pledges.

Downside risks to growth include a slower global recovery, uncertainties in advanced economies as

stimulus programs taper, potential asset bubbles in the real estate sector, and domestic reform lags. Protracted economic slowdown and financial market volatility in high-income countries could slow growth through weaker external demand and large capital outflows. Unchecked growth of the real estate sector, in particular shadow financing for real estate, is also a major source of risk. Finally, domestic reform lags, in particular reforms to raise tax revenues, could pull down infrastructure spending and, hence, overall growth.

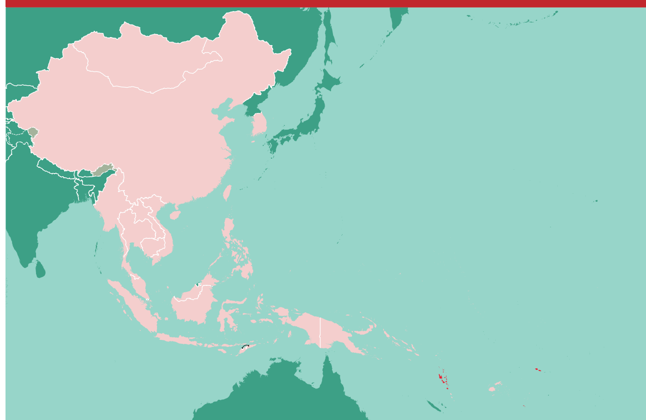
Going forward, the government needs to focus its attention on generating higher, sustained, and more inclusive growth—the type that creates more and better jobs and reduces poverty. The challenge of sustaining growth and creating more and better jobs will have to focus on raising the productivity of the majority of the country's workers, which requires increasing overall investments in human and physical capital. Increased investment levels and fiscal sustainability are possible only with efficient government spending financed by increased revenues through a combination of tax policy and administrative measures and improvement in the investment management process. In addition, opening up the economy to new entrants from within and outside the country to create more competition is an equally essential part of the policy reform agenda. With reforms that secure property rights, open competition, simplify business regulations, and increase investments in health, education, and infrastructure, the private sector will have the incentive to invest more and create jobs, and the country can attract more investments when, for instance, a rebalancing in the region takes place.

Philippines: Key Indicators

	2011	2012	2013f	2014f	2015f		2012		2013				2013
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	May	Jun	Jul	Aug
Output, Employment, and Prices													
Real GDP (% change yoy) 1/	3.6	6.8	7.0	6.7	6.8	7.3	7.1	7.7	7.5				
Industrial Production Index (1994 = 100)	93.0	100.2				101.1	106.2	101.9	n/a				
(% change yoy)	1.1	7.2				4.9	12.5	4.7	n/a				
Unemployment (%) 2/	7.1	7.0				7.0	6.8	7.1	7.5				
Nominal wages (% change yoy) 3/	4.6	4.9				4.7	7.0	7.0	2.2				
Real wages (% change yoy) 3/	0.6	2.0				1.0	4.1	5.0	0.5				
Consumer Price Index (% change yoy)	4.6	3.2	3.5	4.0	4.0	3.5	2.9	3.2	2.6				
Public Sector													
Government revenues (% GDP)	14.0	14.5	15.2	15.8	16.5	14.0	14.0	13.8	16.7				
Government expenditures (% GDP)	16.0	16.8	17.4	18.0	18.8	16.7	18.7	16.3	16.2				
Government balance (% GDP) 4/	-2.1	-2.4	-2.3	-2.3	-2.4	-0.7	-1.3	-2.6	0.4				
Domestic public sector debt (% GDP) 5/	49.2	53.5											
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 6/	-15.7	-14.8				-2.0	-3.7	-2.3	-1.8	-0.4	-0.4	-0.6	
Exports of goods (billions US$) 6/	47.6	51.6	54.2	58.5	63.8	13.3	11.9	12.1	13.5	4.9	4.5	4.8	
(% change yoy)	-6.8	8.5	5.0	8.0	9.0	6.6	10.1	-6.0	-2.7	-0.8	4.1	2.3	
Key export (% change yoy) 7/	-22.5	-1.0				-7.8	5.6	-28.1	-2.1	-10.6	5.8	8.7	
Imports of goods (billions US$) 6/	63.2	66.4	69.1	73.6	79.5	15.3	15.6	14.4	15.3	5.3	4.9	5.5	
(% change yoy)	2.6	5.1	4.0	6.5	8.0	1.9	6.5	-7.4	0.1	-2.4	-4.8	8.7	
Current account balance (billions US$) 6/	9.5	7.3	5.4	6.1	6.2	2.2	2.2	3.1	2.5	0.9	1.0		
(% GDP)	4.2	2.9	2.0	2.0	1.8	3.7	3.1	4.8	3.6				
Foreign direct investment (billions US$)	1.9	2.0	3.5	4.0	5.0	0.4	0.5	2.1	0.1	0.1	-0.1		
External debt (billions US$) 9/	60.4	60.3				61.7	60.3	59.0	58.0				
(% GDP)	27.0	24.1				24.7	24.1	n/a	n/a				
Short-term debt (billions US$) 9/	7.0	8.5				8.0	8.5	9.8	9.5				
Debt service ratio (% exports of g&s)	8.9												
Foreign exchange reserves, gross (billions US$) 9/	75.3	83.8	85.0	87.0	91.2	82.0	83.8	84.0	81.3	82.0	81.3	83.2	82.9
(months of imports of g&s) 10/	11.1	11.9	10.8	10.4	10.0	12.1	11.9	12.2	11.8	11.9	11.8	12.0	12.0
Financial Markets													
Domestic credit (% change yoy) 11/	14.7	7.8				12.0	7.8	15.6	11.5	13.4	11.4	12.5	
Short-term interest rate (% p.a.) 12/	4.6	4.0				3.9	3.6	2.8	2.2	2.2	2.2	2.0	
Exchange rate (₱/US$, ave)	43.3	42.2				41.9	41.2	40.7	41.7	41.3	42.9	43.4	43.9
Real effective exchange rate (2000=100)	126.7	132.8				134.7	136.3	141.4	140.4	141.9	142.5	136.8	136.4
(% change yoy) 13/	0.7	4.8				6.9	7.3	11.6	11.1	11.8	12.7	8.8	8.0
Stock market index (Jan. 2, 1985=100) 14/	4,189	5,168				5,249	5,538	6,418	6,850	7,216	6,402	6,575	6,334
Memo: Nominal GDP (billions US$)	224.1	250.2	272.1	306.9	343.4	61.0	72.1	65.0	68.2				

Source: National data sources.
f = forecast.
1/ The GDP series has a break in 2000. 2/ Figures are from the Labor Force Survey. 3/ Nonagriculture minimum wage, National Capital Region.
4/ IMF Government Financial Statistics basis. 5/ Total public sector domestic debt. Latest available data for 2012 is Q3. 6/ Central bank data, balance-of-payments BPM6 format.
7/ Electronic products and other electronics. 8/ Estimates. 9/ Central bank data, % of annual GDP for quarterly figures. 10/ Based on end-of-period gross international reserves.
11/ Based on Depository Corporations Survey. 12/ Interbank call rate. 13/ World Bank staff estimates. 14/ PSEi Composite, period average for annual figures.

SMALL PACIFIC ISLAND COUNTRIES



Kiribati	
Population	100,786
Population growth	1.5 percent
GDP (PPP, int'l US$)	248.0 million
GDP per capita (PPP, int'l US$)	2,461
Surface area	810 sq. km.
Capital	South Tawara
Samoa	
Population	188,889
Population growth	0.8 percent
GDP (PPP, int'l US$)	853.3 million
GDP per capita (PPP, int'l US$)	4,517
Surface area	2,840 sq. km.
Capital	Apia
Tonga	
Population	104,941
Population growth	0.4 percent
GDP (PPP, int'l US$)	527.4 million
GDP per capita (PPP, int'l US$)	5,026
Surface area	750 sq. km.
Capital	Nuku'alofa
Tuvalu	
Population	9,860
Population growth	0.2
GDP (PPP, int'l US$)	
GDP per capita (PPP, int'l US$)	
Surface area	30 sq. km.
Capital	Funafuti
Vanuatu	
Population	247,262
Population growth	2.2 percent
GDP (PPP, int'l US$)	1.1 billion
GDP per capita (PPP, int'l US$)	4,606
Surface area	12, 190 sq. km.
Capital	Port Vila

Source: World Development Indicators.

Summary

Growth in the small Pacific Island economies (Kiribati, Samoa, Tonga, Tuvalu, and Vanuatu) continues to be quite volatile, in response to economic conditions in remittance-sending countries and tourist markets, natural disasters, and the project cycles of donor-funded infrastructure investments. Governments are working to consolidate public expenditure and strengthen revenue in order to expand their fiscal space to respond to future shocks.

Recent Economic Developments

Economic growth in **Kiribati** was 2.8 percent in 2012, driven largely by donor-funded infrastructure projects. Growth of around 3 percent is expected during 2013, as construction activity associated with infrastructure projects continues. Inflation remained negative in 2012, due to lower prices for major imports, including rice, but is expected to average 2.5 percent during 2013, due to stabilizing import prices and pressure on some domestic services, including transport, from increased infrastructure spending.

The current account deficit widened to 31.4 percent of GDP during 2012, despite higher-than-average fishing license revenues, due to a surge in machinery and equipment imports associated with infrastructure projects. Remittances, which are dominated by transfers from seafarers, also dropped, due to the slowdown in world shipping activity. The current account deficit is expected to widen further to 43 percent of GDP during 2013, as imports increase and fisheries license revenues decline.

The Government of Kiribati continues to face major challenges to fiscal sustainability. Following a fiscal deficit of more than 21 percent of GDP in 2011, strong fishing license revenues in 2012 narrowed the fiscal deficit to 6.8 percent of GDP, while the government also cleared accumulated overdrafts with a commercial bank equal to around

7 percent of GDP. Prospects for maintaining the fiscal deficit and drawdowns from the Revenue Equalization and Reserve Fund[6] at sustainable levels are heavily dependent on future fishing license revenue performance, successful implementation of planned revenue reforms, and continued expenditure restraint. A deficit of 21 percent of GDP was projected for 2013, but a smaller deficit is likely given better-than-expected fishing license revenues during the year to date and expected budget support grants.

Samoa's economy has been hit hard by Cyclone Evan, which swept across the country in December 2012. After only just recovering from the full effect of the tsunami in FY2010, economic growth in Samoa declined to 0.9 percent in FY2013 (relative to the pre-cyclone projection of 2 percent). The recovery is expected to be prolonged because the cyclone damaged productive capacity across all sectors on the main island. Repeated, major natural disasters have constrained growth in Samoa over the last decade, but a loss of competitiveness has also played a role.

Largely as a result of the cyclone, the current account deficit is expected to have expanded to 13.1 percent of GDP in FY2013, up from 10 percent in FY2012. In the wake of the cyclone, exports of goods and tourism services have fallen, while recovery and rebuilding efforts have increased imports. Samoa secured rapid assistance from the IMF to ease pressure on the balance of payments. Inflation has dropped from an average of 6.2 percent in FY2012 to an average of 2 percent in FY2013, reflecting an easing of drought-induced food shortages in FY2012.

Expenditure on recovery and rebuilding efforts from repeated natural disasters has combined with subdued economic growth to place considerable stress on the Government of Samoa's fiscal position. Budget deficits averaged 6.5 percent of GDP in the three years to FY2012, and recovery expenditure in FY2013 has pushed the expected deficit up to 6.9 percent from a pre-cyclone projection of 4.8 percent. This fiscal pressure, combined with other borrowing, has seen the rapid accumulation of public debt, and Samoa is now at high risk of debt distress. Development partners have responded by increasing grant assistance for recovery and rebuilding.

Tonga's economy grew by about 0.5 percent during FY2013, as a result of low remittances, subdued tourism activity, and the withdrawal of fiscal stimulus following the completion of major infrastructure projects financed by China's EXIM Bank. Remittances were approximately 14 percent of GDP in FY2013, compared to nearly 30 percent in FY2009, reflecting demographic shifts and weak economic conditions in the main remittance-sending economies of the United States, Australia, and New Zealand. Weak external conditions also held back Tonga's tourism sector, as did disruptions to domestic air services associated with the exit of the primary airline operator following the launch of a new locally owned airline.

Private credit growth remains negative, as commercial banks reduce loan books and repair balance sheets damaged by the unwinding of a speculative lending bubble in 2008. Recent data suggest that deleveraging may soon be complete, with the equity-to-asset ratio now reaching 20 percent and loan loss provisioning stabilizing. Inflation remained moderate at 3 percent in FY2013, reflecting softening import prices for food and fuel. The National Reserve Bank of Tonga is maintaining an accommodative policy stance.

The current account deficit narrowed to 6 percent of GDP in FY2013, with declining imports associated with the completion of infrastructure projects offsetting the reduction in remittances. Foreign exchange reserves are equal to nearly eight months of import cover and are now 45 percent higher than

6 The Revenue Equalization and Reserve Fund, established with proceeds from phosphate mining prior to independence, is intended to serve a dual role as saving vehicle and source of ongoing budget support. Due to successive large deficits, however, drawdowns have exceeded sustainable levels. Due to unsustainable drawdowns and declines in asset values during the Global Economic Crisis, the real per capita value of the fund has declined by 18 percent since 2009.

in 2010, largely due to grant inflows. The fiscal deficit for FY2013 was around 1 percent of GDP, compared to a forecast small surplus. The deficit was driven by additional expenditure under a supplementary budget and shortfalls in donor budget support. These were partly offset by reductions in recurrent expenditure.

Economic growth in Tuvalu was an estimated 1.2 percent in 2012, and is expected to be somewhat higher in 2013 as a result of donor-funded airport and road upgrading projects. Inflation in the first quarter of 2013 was 2 percent year-on-year, driven largely by higher transport costs. The Government of Tuvalu is expected to achieve a balanced budget in 2013, with higher recurrent spending offset by higher-than-expected fishing license revenues (see box). With the moderate recovery of global financial markets, the national Trust Fund is expected to make distributions to rebuild government reserves, an important buffer given Tuvalu's extreme vulnerability to external shocks. The current account deficit is expected to narrow in 2013, from nearly 30 percent of GDP in 2012, largely as a result of high fishing license revenues. Remittances from seafarers continue to decline, from their peak over a decade ago. Grants play an important role in narrowing the current account deficit.

Following subdued economic activity in 2010 and 2011, growth in Vanuatu increased to 2.3 percent in 2012, driven by increasing tourist arrivals. Continued tourism growth together with new donor-financed infrastructure projects are expected to see growth increase to 3.3 percent in 2013.

The Reserve Bank of Vanuatu reduced its rediscount rate by 50 basis points to 5.5 percent in April 2012, in response to slowing financial activity. Following rapid credit growth in 2007, in part spurred by the entry of a new bank, private sector credit growth moderated from 9.4 percent in 2011 to 6.9 percent in 2012. Inflation was low, at 1.4 percent in 2012, and is expected to remain at that level in 2013. The current account deficit narrowed to 6.3 percent of GDP in 2012 from 8.1 percent the previous year, largely due to higher tourism receipts, and is expected to narrow further in 2013. Foreign direct investment contributed to an overall balance-of-payments surplus in 2012, with foreign exchange reserves rising to a comfortable seven months of import cover.

The Government of Vanuatu has maintained a conservative fiscal stance, with small budget deficits and low levels of public debt. The fiscal deficit in 2012 was 1.6 percent of GDP, down from 2.2 percent in 2011. Tax revenue, however, is relatively low against regional comparators, standing at 16.5 percent of GDP in 2012. Efforts to increase tax revenue are required if Vanuatu is to boost capital spending to adequate levels and expand public service delivery to meet the needs of its rapidly growing population.

Outlook and Emerging Challenges

Risks to growth in the small Pacific Island economies are tilted to the downside. Construction activity in each country is contingent on donor-funded projects proceeding according to schedule. Remittance flows and tourism activity in Samoa, Tonga, and Vanuatu are vulnerable to economic slowdowns in Australia, New Zealand, and the United States, while remittance flows in Kiribati and Tuvalu are vulnerable to any decline in global shipping, which would affect demand for their seafarers. In Kiribati, Tonga, and Tuvalu, fiscal sustainability is heavily dependent on continued consolidation. Tonga's strong efforts to date at fiscal consolidation could be undermined by increased expenditure in the lead-up to the 2014 elections, especially in the context of a planned civil service remuneration review. In Kiribati and Tuvalu, fiscal consolidation is in part dependent on the strength of fishing license revenues.

For Samoa, the challenge is to rebuild fiscal and external buffers in the wake of the succession of major natural disasters it has suffered. Policy priorities in Kiribati, Tonga, Tuvalu, and Vanuatu include continued progress with revenue policy and administration reforms to strengthen tax revenues.

For Kiribati and Tuvalu, effective implementation of regional fisheries agreements is also critical, to support increased and more stable fisheries revenues through the trading of quota permits (see box). For all of the small Pacific Island economies, continued investment in human capital is vital to facilitate labor mobility. In Tonga, this investment could reap additional dividends from the exploitation of emerging online work opportunities arising from its new broadband cable connection.

Box. An Opportunity for Growth and Resilience: The Vessel Day Scheme for Fisheries Management

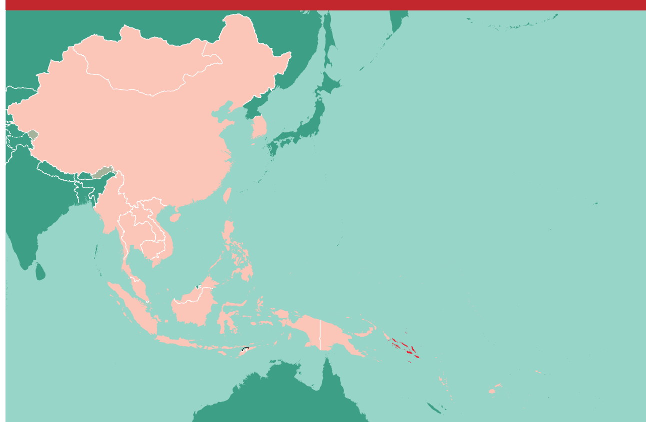
Fisheries resources are the most valuable resources available to several Pacific Island economies, including the archipelagos of Kiribati and Tuvalu. Their small size, dispersed populations, and remoteness from major markets constrain their ability to sustain economic growth based on globally competitive manufacturing and service industries. Instead, their growth potential depends largely on securing rents from natural-resource-based industries.

For several decades, Pacific Island countries have been working on ways to conserve their fish stocks and increase their fishing license revenues through the coordinated control of access by distant water fleets to their fisheries resources. Substantial progress has been achieved in recent years through the establishment of a Vessel Day Scheme (VDS) by the eight countries with the most significant tuna resources (the Federated States of Micronesia, Kiribati, the Marshall Islands, Nauru, Palau, Papua New Guinea, the Solomon Islands, and Tuvalu). Fully implemented in 2012, the VDS allocates a fixed number of "vessel days" to participating countries, through which each country can sell rights to purse seiner fishing vessels to undertake fishing activity in its exclusive economic zone (EEZ) on a 24-hour-period basis. Vessel days can be traded among participating countries, allowing them to mitigate the volatility of revenue from highly variable catch through the sale of vessel days when their allocations exceed the available catch within their EEZs. At present, the total number of vessel days issued under the VDS is equivalent to the total fishing effort in 2008.

Through imposing coordinated controls on access, the implementation of the VDS has allowed participating countries to generate significantly higher license fees, increase control of overall levels of fishing effort, and improve data collection, strengthening prospects for sustainable management of the resource. Some estimates based on limited data suggest the value of a fishing day may have increased from around US$1,350 in 2004 to more than US$5,000 in 2012, reflecting the impact of the VDS.

As long as the limit on total vessel days is set at a sustainable level and the VDS is properly implemented, it promises to provide Kiribati and Tuvalu with a more valuable and more stable flow of revenues from their fisheries than they have enjoyed in the past. Part of these higher revenues can be used to fund expenditure on essential public goods and services, including infrastructure. Importantly, these revenues can also be used to reinvest in the national trust funds that—if adequately capitalized—provide Kiribati and Tuvalu with vital fiscal buffers to respond to external shocks, thereby enhancing their resilience.

THE SOLOMON ISLANDS



Population	549,598
Population growth	2.1 percent
GDP (PPP, int'l US$)	1.7 billion
GDP per capita (PPP, int'l US$)	3,127
Surface area	28,900 sq. km.
Capital	Honiara

Source: World Development Indicators.

Summary

The moderation in the Solomon Islands' economic conditions evident in the second half of 2012 continued into mid-2013. The slowdown has been associated with a drop in the Solomon Islands' export prices to more normal levels, a return to trade deficits, declining investment, and slower government revenue growth. The moderation of the past year contrasts with the very rapid growth from 2010 through the first half of 2012, although that period of rapid growth may prove to be exceptional and the recent moderation a return to more normal conditions. The withdrawal of the military component of the regional assistance mission in mid-2013 appears to have proceeded smoothly. The extent to which recent strong growth has translated into broad-based improvements in living standards will be revealed by the results of the first comprehensive household welfare survey since 2006, which is scheduled to be released in 2014.

Recent Economic Developments

Weakening economic activity is linked to declining international prices and production of cash crops, and lower foreign and domestically financed investment. Meanwhile forestry and gold mining activity, key drivers of the surge in growth from 2010 through the first half of 2012, slowed in H1-2013, partly due to unusually wet weather temporarily disrupting output. The number of foreign investment applications fell in early 2013, as did the value of investment, although bank lending to the private sector rose, largely for personal loans. Manufacturing production was the outstanding exception to the general weaker trends. The central bank's manufacturing output index was 42 percent higher in the March quarter 2013 than a year earlier, both for domestic and external (tuna canning) sales. Reflecting all these trends, formal sector employment growth slowed to 3 percent year-on-year to March 2013 and fell in comparison with December 2012. The relative strength in government spending may be supporting consumption spending.

The international prices of Solomon Islands exports continued to retreat over H1-2013. The Solomon Islands' average export prices peaked in mid-2011, then fell by 20 percent over the following 18 months (in Solomon Islands dollar terms). Over the first half of 2013, they fell by a further 12 percent, returning them to the average levels of mid-2008 to mid-2010. Most notable in the first half of 2013 was the one-quarter fall in gold prices, from a peak of US$1,746 per ounce in October 2012, to below US$1,300 per ounce in July 2013. Cash crop farmers continue to respond to the retreat in prices by cutting production, amplifying the impact on rural incomes—copra production in the first half of 2013 was 5,925 tons, a little over one-third of the level a year earlier. The gold mine also reduced production compared with 2012, to an annual rate around 55,000 ounces. The fish catch in the first half of 2013 was 30 percent below the equivalent level of 2012, although the temporary reopening of bêche-de-mer exports provided some support to export values.

Imports slowed around the turn of 2013, before accelerating somewhat in the second quarter. Import values (in Solomon Island dollar [SI$] terms) increased by 15 percent in the year to the second quarter of 2013. Fuel imports, which constitute

one-quarter of imports, rose by one-quarter over this period, despite stable international prices. Machinery and transport equipment imports fell from historically high levels of the turn of 2013, but still made up almost one-quarter of total imports.

The exchange rate remained around SI$7.1 per U.S. dollar, notwithstanding the central bank's shift to peg the exchange rate against a basket of currencies rather than the U.S. dollar alone. Despite the deterioration in external flows, foreign exchange reserves remained at historical peaks, just below US$480 million in May 2013, compared with US$470 million at the end of 2012, or over 11 months of forward imports, a solid buffer to protect the Solomon Islands from potential external shocks. The central bank attributed the strength in reserves in 2012 to inflows of budget support and the external trade position, and their maintenance in 2013 to weaker imports.

Inflation moderated in Q2 2013, after a surge at the start of the year that was mostly due to adjustments in administered prices and factors impacting domestic food prices. Honiara consumer prices rose by 6.5 percent in the year to June 2013. Food prices rose by 6 percent over this period, largely due to higher domestic food prices due to temporary factors. Administered prices (especially water tariffs) continued to contribute to inflation as these were further adjusted to reflect the cost of supplying these goods and services.

The fiscal balance deteriorated over the first five months of 2013 to a small deficit of SI$22 million. Government deposits rose to SI$1.55 billion in June 2013, from SI$1.2 billion at the start of the year, which was their level in most months through 2012. Government revenues rose marginally from the same period in 2012, but this increase was less than had been budgeted. These shortfalls occurred across most revenue categories, including payments of pay as you earn (PAYE) tax receipts, customs and excise collections (due to weaker export values for logs and gold), and nontax revenues (due to the fall in the fish catch). In contrast, expenditures rose to above budgeted levels by the second quarter of 2013, largely due to higher payroll spending with the "relevelling" of teachers' salaries to incorporate a long-delayed pay adjustment. After the usual, very slow start, development spending, including capital spending, accelerated in May. Notable shifts in spending plans over the first half of 2013 included a rapid growth in payments for scholarships for overseas tertiary study, and in various streams of funds directly administered by individual members of parliament (loosely termed "constituency development funds"), which were partly funded by redirecting funds allocated to development projects.

Outlook and Emerging Challenges

The trends of the first half of 2013 of slower output and revenue growth and tighter investment conditions are expected to continue into the medium term under baseline projections. Projected growth rates are only modestly above population growth, increasing the importance of the government raising the effectiveness with which it turns its scarce resources into services delivered to the public. Recent trends show the imperative of providing public goods effectively, for example through delivering extension services to support farmers and help reverse recent falls in cash crop production. Significant risks continue to be centered on the outlook for logging, and have emerged around the outlook for production at the small gold mine given the retreat in international gold prices. Some upside risks emanate from potential investments in tuna canneries and a modest hydroelectric facility advancing to more advanced project preparation stages. Significant potential nickel mining investments have been delayed, however, due to uncertainty around the mining regulatory and tax regimes.

Solomon Islands: Key Indicators

	2011	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output and Prices 1/					
Real GDP (% change yoy)	10.7	4.8	4.0	3.5	3.7
Real GDP, excl. logging and mineral sectors (% change yoy)	7.3	3.5	5.5	3.8	4.0
Consumer Price Index (% change, period average)	7.4	5.9	6.0	5.0	4.7
Public Sector					
Revenues and grants (% GDP)	60.3	54.2	53.3	50.8	50.0
Expenditures (% GDP)	51.2	50.3	52.5	50.2	49.6
Recurrent (% GDP)	25.6	28.5	28.2	26.8	26.6
Development (% GDP)	25.5	21.8	24.3	23.4	23.0
Government budget balance (% GDP)3/	9.0	3.9	0.8	0.6	0.4
Noncommodity primary balance (% GDP)	-1.4	-4.3	-4.0	-3.7	-2.8
Public sector debt (% GDP)	22.2	17.9	16.0	13.9	13.8
Foreign Trade, BOP, and External Debt					
Current account balance (millions US$)	-59	-1	-22	-77	-66
(% GDP)	-6.7	-0.1	2.0	-6.5	-5.3
Goods trade balance (millions US$)	-5	47	0	-7	-18
Exports (millions US$)	418	493	489	526	536
o/w Logging (millions US$)	191	180	176	164	150
Imports (millions US$)	423	446	488	533	554
Services balance, net (millions US$)	-49	-58	-66	-95	-83
Income balance, net (millions US$)	-178	-111	-123	-150	-154
Current transfers, net (millions US$)	173	120	167	175	188
Foreign direct investment (millions US$)	141	67	27	34	36
(% GDP)	16.2	6.7	2.4	2.9	2.9
Foreign exchange reserves (millions US$)	412	480	530	560	590
(months of forward imports)	7.6	8.5	8.4	8.6	8.6
Financial Markets 5/					
Domestic credit to private sector (% change yoy)	4.7	4.0	8.0	8.0	8.0
Lending rate (%)	11.5	11.4	11.0	10.0	10.0
Exchange rate (SI$/US$, eop)	7.25	7.3	7.3	7.52	7.72
Real effective exchange rate Index (2005=100)	124.5	125.4	125.4	125.4	125.4
(% change yoy)	11.2	0.7	0.0	0.0	0.0

Sources: National data sources and World Bank staff estimates.

e = estimate.

f = forecast.

1/ Data and projections are from the Ministry of Finance and Treasury (MoFT); the National Statistics Office; IMF Country Report No. 11/359; and World Bank staff.

2/ Data for 2009 are from the 2011 Approved Recurrent Budget Estimates. Estimates for 2010 to 2012 are from the MoFT. The presentation of the data differs from the IMF Government Financial Statistics methodology largely in the treatment of donor-funded and donor-provided public services. The presentation differs from the Solomon Island Government's in 2012 by including among revenues and grants accountable cash grants from the Regional Assistance Mission to Solomoin Islands. Forecasts are by World Bank staff.

3/ Balances are shown before drawdown of SI$32 million in National Transport Fund resources in 2012.

4/ Data and projections through 2014 are from IMF Country Report No. 11/359 and World Bank staff.

5/ Data are from the Central Bank of Solomon Islands; IMF Country Report No. 11/359; and World Bank and IMF staff projections.

THAILAND

Population	66.8 million
Population growth	0.3 percent
GDP (PPP, int'l US$)	655.5 billion
GDP per capita (PPP, int'l US$)	9,815
Surface area	513,120 sq. km.
Capital	Bangkok

Source: World Development Indicators.

Summary

The Thai economy is projected to grow by 4 percent for the entire year. Real GDP growth in the first half of 2013 was supported mainly by household consumption, which was stimulated by the government's subsidy for first-time car buyers. In the second half of the year, exports, which have slumped in the first half, are expected to slowly recover, while growth of household consumption will slow. The economy is expected to grow at a higher rate next year as the global economy continues to recover. Large public investments are also expected to come online next year, supporting growth. However, there remains the risk of disbursement delays in these investments. Other external risks include the pace of recovery of the global economy and the volatility of capital inflows.

Recent Economic Developments

In the first half of the year, real GDP grew by 4.1 percent year-on-year, driven mainly by domestic demand. Household consumption was the major driver of growth in the first half of this year as consumers took advantage of the government's subsidy for first-time car buyers in the first quarter of the year.[7] Exports of services, primarily driven by tourism receipts, have reached record high this year, growing by more than 20 percent year-on-year (yoy) in the first half of this year. However, exports of goods (in US dollar terms) performed below expectations, rising by only 1.2 percent in the first half of the year, while imports grew by 3.2 percent yoy, in line with high growth in manufacturing of cars and pickup trucks for domestic sales.

Manufacturing growth in the first half of the year was driven mainly by vehicle production. Manufacturing grew by 2 percent yoy. Manufacturing of vehicles grew by 47 percent and 12 percent yoy in the first and second quarters of this year, respectively. This is primarily driven by growth in domestic purchases of cars and pickup trucks. However, manufacturing of other key products such as food, hard disk drives, and integrated circuits and semiconductors have contracted. This is in line with the exports contraction of these products.

Household consumption grew in the first half of the year, supported by the government's first-car subsidy program and growth in consumer loans. Household consumption grew by 3.4 percent driven by car purchases in the first quarter, which increased by 97 percent yoy. Household consumption was also supported by the increase of household loans by banks. Since last year, household loans have grown by more than 15 percent yoy, only to decelerate to 13.6 percent in July this year. As a result, household debt has reached a record high of close to 80 percent of GDP.

Exports of goods have underperformed while that of services have done very well. In light of the global economic slowdown, goods export growth (in U.S. dollar terms) in the first eight months of this year grew by only 1 percent yoy. Beginning in the second

7 Registration for this subsidy program, known as the First Car Program, ended in December 2012, but half of the cars and pickup trucks were delivered and paid for in the first half of 2013.

quarter, exports contracted in major export products such as electronics, electrical appliances, and agromanufacturing products. As a result, exports of goods in the second quarter contracted by 1.9 percent yoy. However, exports of services have risen with the inflows of tourists. Tourist arrivals in the first half of the year have increased by 20 percent yoy. Tourism receipts have contributed to the rise of export of services in real GDP by 24 percent yoy.

Capital flows have been volatile and are reflected by the exchange rate. Net Capital inflows into Thailand have been high starting the third quarter of last year and continued into the first half of this year. Net capital inflows into Thailand swung from US$3 billion in the first half of last year to US$7 billion in the second half. In the first half of this year, another US$7 billion have flowed into the country, with the bulk in the form of foreign loans by the banking and private sectors. By June, the trend had reversed as there was a net outflow of US$1.9 billion followed by another US$0.4 billion of net outflow in July. In August, the outflows were reinforced by news that Quantitative Easing in the United States will be tapered. The exchange rate also fluctuated with the net inflows despite intervention by the Central Bank in its attempt to smooth the baht volatility. The baht went from 31.7 to the U.S. dollar in June 2012 to B 29.10 in April 2013 to B 31.60 to the U.S. dollar in August.

The current account was in deficit while the capital account was in surplus in the first half of this year. The current account was in a US$1.3 billion surplus in the first quarter but was in a US$5.1 billion deficit in the second quarter. The capital account has registered positive net inflows for both quarters, however. Taking into account errors and omissions, there was a small overall balance of US$0.2 billion in the first half of the year. At the end of July, international reserves were at US$172.2 billion, which is 2.6 times of external debt.

Monetary policy has been accommodative to growth in an environment of low inflation. The policy rate has been at 2.75 percent since the last quarter of 2012 and was reduced to 2.5 percent in May this year when capital inflows peaked and there were signs of slowdown in domestic demand going forward. Inflation has been low at 2.7 percent yoy in the first seven months of this year. Low inflation was also supported by the decline in import prices by an average of 2.4 percent in the same period.

The implementation of the government's water management project has been delayed, but the government has been able to raise its on-budget investment. The B 350 billion water management project that was approved as an off-budget fund under the Emergency Decree after the 2011 floods have been delayed due to Constitutional Court ruling that consultations and environmental impact assessments have to be completed prior to implementation. As a result, its implementation, which was planned for this year, has been delayed. However, the government was able to disburse its on-budget funds of public investments, thus increasing public investments by 16.6 percent yoy in real terms in the first half of this year.

The government has continued its paddy-pledging scheme into this year. The government has so far implemented this program for four rice-growing seasons over two years. The scheme has to date cost the government B 660 billion (US$22 billion). Our estimates of the losses are around B 200 billion per year (a little short of 2 percent of GDP per year). The government has announced that it will continue the program into the next two growing seasons (October 2012–September 2013) at the same pledging price as last year, but will impose some limits and conditions to restrict the quantity.

Outlook and Emerging Challenges

Real GDP growth for 2013 is projected at 4 percent with a slight year-on-year slowdown in the second half of the year as household consumption slows while exports pick up slowly. Household consumption has shown signs of slowing, with the private consumption index contracting by 0.7 percent yoy

in July. With the recovery in the global economy, however, export growth in the second half of the year is expected to grow by more than that of the first half—1.2 percent yoy (in U.S. dollar terms). At the same time, exports of services (mainly tourism) are expected to remain buoyant, continuing to grow at double digits. The economy is expected to grow at a higher rate next year as the global economy continues to recover and large public investments are implemented.

The government has plans to implement large infrastructure projects in 2014. These include the delayed water management project and the upcoming seven-year B 2 trillion transport infrastructure investments. The B 2 trillion investments will be mainly in roads and rail; the latter includes dual rail tracking, high-speed trains, and mass transit in Bangkok. However, the investments will not be large next year since implementation would have just begun. Nevertheless, they will contribute to growth next year.

Major foreseeable challenges to Thailand's future growth are the pace of recovery of the global economy, the volatility of capital inflows, slowdown in household consumption, and the delays in public investments. A slower-than-expected recovery in the global economy and a faster slowdown in the Chinese economy will have a negative impact on Thai exports. The volatility of capital inflows will have implications on the exchange rate, which affects export revenues and import costs. The high leverage of households and car purchases that has been brought forward this year as a result of the First Car Program may dampen future growth of household consumption next year. Finally, delays in the long-awaited large public infrastructure projects will affect growth not only next year but also in the long run, since better water management and logistics improvements are crucial for Thailand's future growth.

Thailand: Key Indicators

	2011	2012	2013f	2014f	2015f	2012		2013					2013
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	May	Jun	Jul	Aug
Output, Employment, and Prices													
Real GDP (% change yoy)	0.1	6.5	4.0	4.5	5.0	3.1	19.1	5.4	2.8				
Domestic demand (% change yoy)	1.0	9.4	3.3	4.7	4.4	4.6	16.2	5.0	3.6				
Industrial Production Index (2000=100)	177.7	181.6				180.0	183.6	184.8	174.4	179.3	181.0	174.3	173.3
(% change yoy)	-8.5	2.2				-11.1	43.4	2.9	-4.9	-7.5	-3.2	-4.9	-3.1
Unemployment (%)	0.7	0.7				0.6	0.5	0.7	0.7	0.8	0.5	0.9	
Real wages (% change yoy) 1/	7.2	19.6				16.6	17.2	13.7		10.4			
Consumer price index (% change yoy)	3.8	3.0	2.6	2.8	3.0	2.9	3.2	3.1	2.3	2.3	2.3	2.0	1.6
Public Sector													
Government revenues (% GDP)	18.0	18.3	17.4			19.2	16.9	15.9	21.9	17.3	35.0		
Government expenditures (% GDP) 2/	21.0	21.5	19.9			20.2	26.8	19.8	16.6	14.0	17.2		
Government balance (% GDP) 2/	-2.9	-3.3	-2.5			-1.0	-9.8	-3.9	5.3	3.4	17.9		
Total public sector debt (% GDP)	40.8	43.6	45.0			43.4	43.6	43.7	44.6	44.2	44.6		
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 3/	17.0	6.0	1.8	0.7	-1.7	4.5	0.1	-0.3	-0.5	0.5	0.6	0.3	
Exports of goods (billions US$)	219.1	225.9	231.5	243.1	265.0	59.0	56.4	56.2	55.6	19.5	18.8	18.8	
(% change yoy)	14.3	3.1	2.5	5.0	9.0	-3.4	18.2	4.5	-1.9	-5.1	-3.5	-1.6	
Key export (% change yoy) 4/	-7.3	3.4				-10.6	34.3	0.0	-13.8	-18.6	-13.5	0.5	
Imports of goods (billions US$)	202.1	219.9	229.8	242.4	266.6	54.5	56.3	56.5	56.1	19.0	18.2	18.6	
(% change yoy)	24.9	8.8	4.5	5.5	10.0	-2.1	16.4	6.4	0.2	-6.3	0.9	0.0	
Current account balance (billions US$)	5.9	0.2	-6.2	-7.3	-8.7	2.2	0.2	1.3	-5.1	-1.1	-0.7	-0.7	
(% GDP)	1.7	0.0	-1.6	-1.7	-1.9	2.5	0.2	1.3	-5.1	-3.3	-2.1	-2.2	
Foreign direct investment (billions US$) 5/	7.8	7.2				2.0	1.0	1.4	0.6	0.9	-1.9		
External debt (billions US$)	434.0	363.6				126.1	133.2	140.4		140.7			
(% GDP)	125.5	99.2				34.4	36.4	36.4		14.2			
Short-term debt (billions US$)	214.1	174.0				57.5	60.6	62.1		62.3			
Debt service ratio (% exports of g&s)	3.5	3.2				4.4	4.0	4.8					
Foreign exchange reserves, gross (billions US$)	165.2	171.1				172.7	171.1	167.7	162.5	166.2	162.5	163.5	159.7
(months of imports of g&s)	7.8	7.5				7.7	7.3						
Financial Markets													
Domestic credit (% change yoy) 6/	11.6	15.3				12.4	15.3	15.8	15.3	14.3	15.3	12.7	
Short-term interest rate (% p.a.) 7/	2.98	2.94				3.00	2.75	2.75	2.58	2.50	2.50	2.50	2.50
Exchange rate (B/US$, monthly average)	30.47	31.05	30.50	30.50	30.20	31.32	30.66	29.78	29.88	29.76	30.82	31.13	31.61
Real effective exchange rate (2007=100) 8/	102.0	102.3				102.3	103.8	108.9	111.1	112.33	107.79	107.22	
(% change yoy)	-0.8	0.3				0.3	2.5	7.7	8.7	9.9	5.5	5.0	
Stock market index (January 1, 1975=100) 9/	1,025	1,392				1,299	1,392	1,561	1,452	1,562	1,452	1,423	1,294
Memo: Nominal GDP (billions US$)	345.9	366.4	395.0	421.0	457.5	89.5	96.7	100.7	98.8				

Sources: CEIC, World Bank staff estimates.

f = forecast.

1/ Average monthly wage. 2/ Cash balance of central government, including off-budget expenditure. 3/ Balance of goods. 4/ Electronics. 5/ Nonbank FDI.

6/ Bank of Thailand (BoT), end-of-period. 7/ Policy rate, average. 8/ Trade-weighted broad index (23 major trading partners), average (Source: BoT).

9/ Stock Exchange of Thailand (SET) index, end-of-period.

TIMOR-LESTE

Population	1.2 million
Population growth	2.9 percent
GDP (PPP, int'l US$) 1/	2.1 billion
GDP per capita (PPP, int'l US$) 2/	1,709
Surface area	14,870 sq. km.
Capital	Dili

Source: World Development Indicators.
1/ The equivalent in 2011 nonoil GDP at current market prices is US$1.128 billion.
2/ The equivalent in 2011 nonoil GDP at current market prices is US$1,007.

Summary

Timor-Leste's nonoil economy continues to grow at pace. Slowing growth in public spending and a gradual pickup in private sector activity may moderate medium-term forecasts. Inflation remains in the double digits in relation to last year, likely due to continued demand pressures against supply bottlenecks. Despite unseasonally high coffee exports, the first-half trade balance is significantly wider than last year. But petroleum revenues support a large current account surplus. Structural reforms continue, including a recent one-stop shop for business registration, a draft mining law, and progress on the land and procurement laws.

Recent Economic Developments

The government first proposed an FY14 fiscal envelope of US$1.3 billion, following an FY13 budget of US$1.65 billion, in an attempt to ease aggregate demand pressures and inflation and improve budget credibility. Despite smaller budgets, budget execution has slowed. Lower-than-budgeted expenditure will likely lead to downward revisions of the 2012 and 2013 estimated real growth in nonoil GDP from 10.6 and 10.4 percent, respectively. An International Finance Corporation (IFC)-supported one-stop shop for business registration, and the possible demonstration effect from the planned airport and port public-private partnerships, have the potential to lift private sector activity, but will only partially offset the decline in public sector activity, given its dominance in the economy. Despite falling global food prices, and an appreciation of the U.S. dollar (Timor's currency), inflation has risen rapidly again to 13 percent year-on-year in June, reflecting continued demand pressures and supply bottlenecks.

In June, the government's first estimate of 2012 nominal nonoil GDP (Timor-Leste's preferred measure of economic activity) was US$1.293 million, up from actual US$1.128 million in 2011, published in the May 2000–2011 National Accounts. The 2012 actual, and hence the real growth estimate of 10.6 percent, is, however, likely to be revised lower, as 2012 budget execution and agricultural sector growth appear slower than initially estimated. This lowers the base against which 2013 real growth occurs, and the strong rise in proxies such as electricity consumption and vehicle purchases in Q1 2013 also provide some upside opportunities. However, downside risks around falling budget execution rates and a long wet season affecting agricultural production, may lead to a downward revision in the 2013 real growth estimate of 10.4 percent.

The FY13 budget was passed in February, later than usual due to the June 2012 elections and related changes to the structure of government. The budget was significant in several ways. First, the proposal to Parliament was flat in nominal terms in relation to the US$1.8 billion 2012 budget, following three years of roughly 40 percent annual nominal budget growth. Second, Parliament cut it by a further US$150 million as infrastructure projects were scaled back. Third, the government plans after several years to return to its de facto fiscal anchor (Estimated Sustainable Income from the Petroleum Fund, or ESI) and finance the budget without excess withdrawals,

instead fully using large unspent cash balances from 2012. Finally, the budget was supported by both government and the opposition.

Budget execution is slow relative to 2012, both in nominal terms and as a share of the budget, despite a smaller budget this year. Only 28 percent of the 2013 budget had been executed (not including obligations) at end-August compared with 39 percent at the same time in 2012, weighed down by low execution rates of capital and development and minor capital of just 18 percent and 9 percent, respectively. With the exception of salaries and wages, recurrent spending rates have also fallen. Reasons for overall lower spending may include the late budget approval, a settling-in period for the new government, a change in the profile of capital expenditure from lumpy investments like electricity generation and transmission to smaller critical infrastructure investments, thin capacity across the project cycle, and tightening of public investment management systems. The latter includes a new Supreme Audit Institution that at inception reviewed all contracts above US$500,000, though the threshold is now being raised to US$5 million.

The 2013 budget was in part reduced to bring it into line with absorptive capacity. However, at current rates, there may be, for the first time, a year-on-year nominal decline in spending. Close attention will need to be paid to the quality of spending in the remainder of the year, when spending traditionally picks up.

The 2013 budget includes US$146 million of domestic revenues, representing 10 percent of estimated nonoil GDP and 9 percent of the budget. By the end of July, 47 percent of this had been collected compared with 49 percent in 2012, suggesting that the 2013 projected nonoil fiscal deficit (domestic revenues less total spending) of US$1.5 billion, or 100 percent of nonoil GDP, can be met. The government made its first modest withdrawal from the petroleum fund in July, reflecting slow spending rates and the commitment to first use 2012 cash balances. Overperformance on petroleum revenues due to higher-than-forecast petroleum prices, could lift the fiscal surplus (including petroleum revenues), above the 54 percent of nonoil GDP forecast for 2013.

In a decisive move aimed at lowering inflation, greater fiscal sustainability, and enhancing budget credibility, the government in May proposed an FY14 fiscal envelope of US$1.3 billion although there has since been pressure to increase it. This represents a 29 percent reduction in relation to the FY13 budget and only around US$100 million more than was spent in FY12—effectively representing a reduction in real terms on current inflation estimates.

End-2012 inflation was 11.7 percent (headline inflation is year-on-year CPI in Dili), bringing the 2012 annual average to 10.9 percent. The government's 2013 headline inflation target is 7.6 percent. However, inflation has risen quickly this year to over 13 percent in June (year-on-year) largely driven by food prices, notably rice and meat. This has occurred despite global rice prices, notably from Vietnam and Thailand where Timor-Leste sources, falling by roughly 4 percent to June. Global meat prices, with the exception of chicken, have also fallen significantly in the first half of this year. Following an analysis of spending patterns, both the CPI basket and item weights were adjusted in January 2013. This has, for instance, raised the share of food slightly to just over 60 percent.

In a welcome development, the price of communications fell by over 12 percent in February relative to last year, and in a few months thereafter to June. This can be attributed to the opening of the monopoly telecoms market to two additional providers. Overall inflation should dampen, albeit with a lag, as the U.S. dollar, the official currency of Timor-Leste, appreciated over the period, relative to the currencies of Timor-Leste's major trading partners (Australia, Singapore, and Indonesia). An explanation for persistent inflation could therefore lie in continued rapid growth in aggregate demand, combined with supply bottlenecks, including at the

ports and border, and a prolonged rainy season that has dampened local rice production.

Net credit to the private sector grew by nearly 4 percent in the first half of 2013 to US$165.6 million, or 12.8 percent of estimated 2012 nonoil GDP. Agriculture (only 1 percent of overall credit), tourism and services (5 percent of overall credit), and trade and finance (25 percent of overall credit) grew the fastest, with loans to individuals (39 percent of overall credit) registering 3 percent growth.

Spreads widened, as lending rates rose from 12.13 percent in January 2013 to 12.59 percent in August, while deposit rates remained flat at 0.56 percent. The share of nonperforming loans, a legacy from the period around the 2006/7 security crisis, continues to decline, to 28 percent at end-June 2013 from 31 percent at end-2012. Loan loss provisions were US$59.7 million, or 131 percent of the value of nonperforming loans, effectively mitigating the risk to the banking system.

Official trade data showed first-half 2013 imports jumping to US$491 million—more than double the same period last year, due to unusually high imports of products related to the printing industry. Coffee, Timor-Leste's only significant nonoil export, was US$2.6 million, which is high compared to the value of US$300,000 exported last year in January–June, the low season, and given that global Arabica prices declined over 10 percent in the first half of the year. Despite this increase in coffee exports, the first-half trade deficit was more than twice the previous first-half high. However, first-half petroleum revenues of nearly US$1.7 billion, recorded as income on the current account, help transform the first-half trade deficit into a current account surplus of nearly US$1.2 billion, or roughly 100 percent of estimated 2012 nonoil GDP.

The Petroleum Fund, Timor-Leste's Sovereign Wealth Fund, reached US$14 billion in value at the end of July 2013, over 10 times estimated 2012 nonoil GDP, and up from US$11.8 billion at end 2012. The government made its first 2013 drawdown (US$180 million) from the Fund to the Treasury in July. Revenue inflows to the Fund were US$1.7 billion, on track to meet the full-year estimate of US$2.3 billion. At the end of July, official reserves were US$620 million, or nearly eight months of imports. Import cover fell from nearly 15 months at end 2012, as average monthly imports picked up.

Outlook and Emerging Challenges

Timor-Leste and Australia have entered into arbitration over the maritime treaty governing the Greater Sunrise gas and condensate field, increasing uncertainty around revenue potential from oil and gas fields not currently under development. This may also have implications for the next exploration licensing round, due to be launched soon.

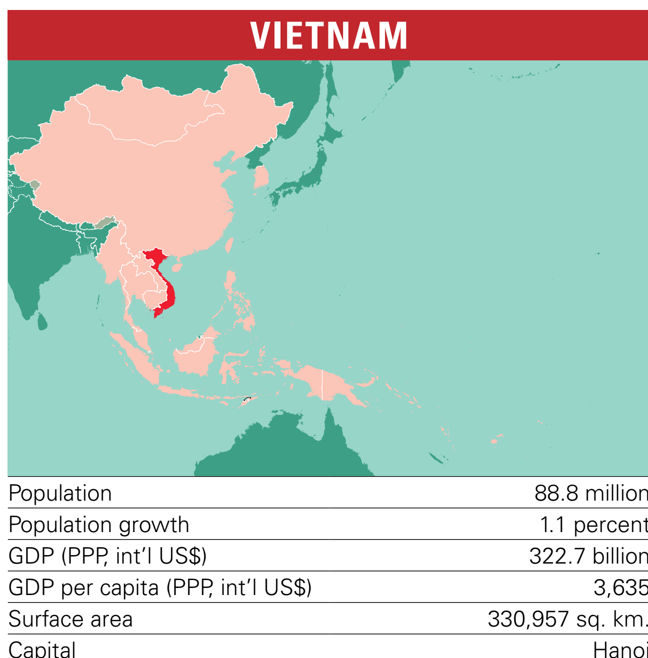
The public sector has been the key contributor to growth—accounting for up to three-quarters of nonoil growth in recent years. Private sector contributions are low and slowing, however, with contractions in agriculture and manufacturing.

Should projected public spending slow, and settle in the medium term at levels indicated by the 2014 fiscal envelope, then nonoil growth rates are likely to fall below double digits for a period. Much will depend on the prospects for an uptick in private sector activity that is not directly linked to government contracts. Recent progress has been made in this regard through a business registration one-stop-shop, preparation of the land law, and the recent public consultation on the mining law.

Timor-Leste: Key Indicators

No table accompanies the Timor-Leste entry because data were unavailable at time of publication.

VIETNAM



Population	88.8 million
Population growth	1.1 percent
GDP (PPP, int'l US$)	322.7 billion
GDP per capita (PPP, int'l US$)	3,635
Surface area	330,957 sq. km.
Capital	Hanoi

Source: World Development Indicators.

Summary

While macroeconomic performance improved in the last two years, growth slowed in the face of structural problems in the state-owned enterprise (SOE) and banking sectors. Headline inflation declined from more than 23 percent (year-on-year) in August 2011 to 7.3 in July 2013. The current account was in surplus with strong export growth. The exchange rate was stable and the level of international reserves increased. Growth is estimated at 5.2 percent in 2012—the lowest level since 1999. Growth is likely to remain moderate in the medium term in the absence of visible progress in addressing the problems confronting the financial and SOE sectors.

Recent Economic Developments

Vietnam's macroeconomic conditions continue to improve as its economy enters the third year of relative stability. Stabilization measures implemented in 2011 and 2012 helped Vietnam reduce inflation, strengthen fiscal and external accounts, and stabilize the exchange rate. Exports continue to grow rapidly, enabling Vietnam to post a surplus on its trade account in 2012 for the first time since 1992. The improved trade and current account balances have helped the State Bank of Vietnam to shore up foreign exchange reserves—from 1.6 months of import cover at end 2011 to about 2.8 months in the first quarter of 2013. Headline inflation has been falling in the last 24 months. In July 2013, headline inflation had fallen to 7.3 percent—largely attributed to the easing of food price and stabilization measures. Greater macroeconomic stability has helped Vietnam to regain confidence among investors.

Vietnam's stock market rose nearly 18 percent in 2012 and about 19 percent in the first seven months of 2013 after declining two consecutive years in 2010 and 2011. Vietnam's sovereign spreads and country default swaps are hovering at their lowest levels since the onset of the global economic crisis.

At the same time, sluggish global growth and the slow pace of structural reforms has led to an economic slowdown. Vietnam's economy is experiencing its longest spell of modest growth since the onset of economic reforms in the late 1980s. GDP growth slowed to 5.2 percent in 2012 from 6.2 percent in 2011 and 6.4 percent in 2010. Nearly 29,000 businesses are reported to have closed, liquidated, or temporarily suspended their operations during the first half of 2013—a 10.5 percent increase compared to the same period of 2012, while newly registered enterprises amounted to around 39,000.

Recognizing the current economic difficulties, the government introduced a number of measures to support GDP growth. The State Bank of Vietnam has aggressively cut interest rates in response to the slowdown in growth and falling inflation. Key policy rates were cut by 600 basis points between March and December 2012, and by a further 200 basis points in March–April 2013. The Ministry of Finance also introduced several fiscal measures including reductions in tax rates and tax payment delays to assist struggling enterprises.

Despite the efforts of the government, the economy extended its slow growth into the first half of 2013,

registering a growth rate of 4.9 percent in the first quarter and 5 percent in the second quarter. Despite the lower borrowing cost, total credit to the economy from the banking system is estimated to have grown by only 5 percent (year-to-date) as of July 2013 compared to the annual target of 12 percent. Credit activity remains subdued as banks have become more reluctant to lend on account of impaired balance sheets, poor financial health of the SOEs, weak monitoring and reporting systems, and general lack of transparency in the policy-making process. At the same time, demand for credit has waned in light of weaker business prospects. Efforts to stimulate the economy through accommodative monetary policy and tax breaks appear to have reached their limits, while raising fiscal deficits and creating new contingent liabilities. Under such circumstances, further monetary easing is likely to have only limited impact on growth, but could add to concerns surrounding credit quality and negative consequences on macroeconomic instability. Authorities would do well by extending the measured approach of macroeconomic stabilization and deepening structural reforms, with a special focus on the SOE and banking sectors.

Vietnam's growth pessimism stands in sharp contrast with its strong export performance in recent years. Total export value (in nominal U.S. dollars) is estimated to have grown by 14 percent during the first seven months of 2013 after achieving a growth rate of 18 percent in 2012 and 34 percent in 2011. While earnings from commodity exports are declining due to falling global prices, Vietnam's traditional labor-intensive manufacturing exports such as garments, footwear, and furniture continue to sustain rapid growth. A noteworthy addition to the export composition has been the exports of hi-tech and high-value products (for example, cell phones and parts, computers, electronics and accessories, automobile parts), that have emerged as the largest and fastest-growing export items in 2013. The solid export performance is largely attributed to the foreign-invested sector, which now accounts for two third of Vietnam's total exports.

Booming exports, a sustained flow of external capital and remittances, and lackluster import performance have all helped Vietnam to turn around its external balances. In 2012, Vietnam posted its largest ever trade and current account surpluses. The trade balance (based on the balance-of-payments definition) was estimated to yield a record surplus of 6.5 percent of GDP in 2012. Similarly, the current account balance turned from a huge deficit of 11 percent of GDP in 2008 to a minor surplus of 0.2 percent of GDP in 2011 and a record surplus of about 5.9 percent in 2012. However, this performance may not last forever, because imports are expected to pick up once the economy regains strength.

Vietnam's public finances have come under stress during the last few years on account of slower growth, lower revenue buoyancy, and increased stimulus spending. During 2012, the fiscal deficit increased to 4.8 percent of GDP (under the Government Financial Statistics [GFS] definition) as the ratio of revenue collection to GDP fell to a record low of 22.8 percent and despite the government's effort to consolidate capital spending. As a result of higher deficits, government debt increased from 48 percent of GDP in 2011 to 52 percent in 2012. Despite the fact that Vietnam's public and external debt sustainability indicators are projected to remain below their applicable debt thresholds, the government will need to maintain its ongoing control over spending growth to ensure medium-term fiscal sustainability.

Outlook and Emerging Challenges

Vietnam's economy is projected to grow at a moderate pace of around 5.3 percent during 2013. The trade and current accounts are expected to remain in surplus in 2013, though by a smaller amount than in 2012. Some consolidation of the fiscal balance, and inflation remaining in the high single digits, could be expected during 2013.

Vietnam's gains on the macroeconomic front are, however, still fragile and face several downside risks. First, slower growth may intensify demand for further loosening of monetary and fiscal policies, with the risk of stoking inflationary pressures and reversing the recent gains in macroeconomic stability. Second, if the implementation of structural reforms is delayed further, investor confidence would be undermined, further worsening growth prospects.

Vietnam: Key Indicators

	2011	2012e	2013f	2014f	2015f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	6.2	5.2	5.3	5.4	5.4
Domestic demand (% change yoy)	0.7	4.3	4.5	5.2	5.5
Industrial Production Index 1/					
(% change yoy)	7.3	4.7	4.8	5.5	5.8
Unemployment (%) 2/	3.6	3.3	3.5	3.5	3.5
Consumer Price Index (% change yoy, period average)	18.6	9.1	8.8	7.4	7.7
Public Sector					
Government revenues (% GDP)	25.2	22.9	22.2	21.7	21.7
Government expenditures (% GDP)	28.1	27.7	26.2	25.7	25.1
Government balance, official (% GDP) 3/	-1.3	-3.2	-2.6	-2.6	-2.2
Government balance, general (% GDP) 4/	-2.9	-4.8	-4.0	-4.0	-3.4
Public sector debt (% GDP) 5/	47.9	51.3	50.4	50.5	49.8
Foreign Trade, BOP, and External Debt					
Trade balance (billions US$, BOP definition)	-0.5	9.9	11.8	7.9	4.8
Exports of goods (billions US$, fob)	97	115	132	146	160
(% change yoy)	34.2	18.2	15.6	9.9	10.2
Key export (% change yoy) 6/	45.9	13.6	-5.0	2.0	2.0
Imports of goods (billions US$, cif)	107	114	131	150	169
(% change yoy)	25.9	6.6	15.3	14.0	13.1
Current account balance (billions US$)	0.2	9.1	9.6	6.2	2.0
(% GDP)	0.2	5.9	5.6	3.3	1.0
Foreign direct investment (billions US$, net)	6.5	7.2	7.4	7.6	7.7
External debt (billions US$)/5	36.6	43.6	48.5	51.7	55.2
(% GDP)	27.2	28.5	28.5	27.6	27.0
Debt service ratio (% exports of g&s)	3.7	3.3	3.3	3.4	3.5
Foreign exchange reserves, gross (billions US$)	13.5	25.4			
(months of imports of g&s)	1.5	2.3			
Financial Markets					
Domestic credit (% change yoy)	14.3	8.9	10.0	15.0	15.0
Short-term interest rate (% p.a.) 7/	14.9	8.0	7.5		
Exchange rate (D/US$, eop) 8/	20,828	20,828	21,036		
Real effective exchange rate (2000=100)	122.7	122.0			
(% change yoy)	4.5	-0.6			
Stock market index (July 2000=100) /9	351.6	413.7	491.3		
Memo: Nominal GDP (billions US$)	134.6	152.8	170.0	187.0	204.6

Sources: General Statistics Office; State Bank of Vietnam; IMF; and World Bank staff estimates.
e = estimate.
f = forecast.
1/ The Industrial Production Index (IPI) is a new series replacing previous "industrial production value in constant 1994 prices."
2/ Urban areas.
3/ Excludes off-budgetary items.
4/ Includes off-budgetary items.
5/ Public and publicly guaranteed debt. Forecast by Debt Sustainability Analysis 2013.
6/ Crude oil (value).
7/ Three-month deposit, end-of-period.
8/ Central Bank's interbank exchange rate as of August 27, 2013.
9/ Ho Chi Minh Stock Index as of August 27, 2013.

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THE WORLD BANK