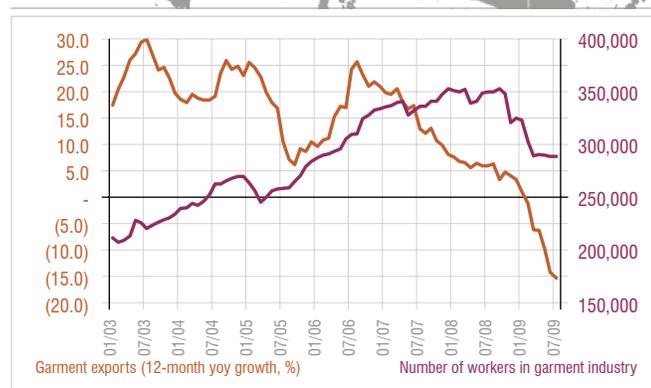
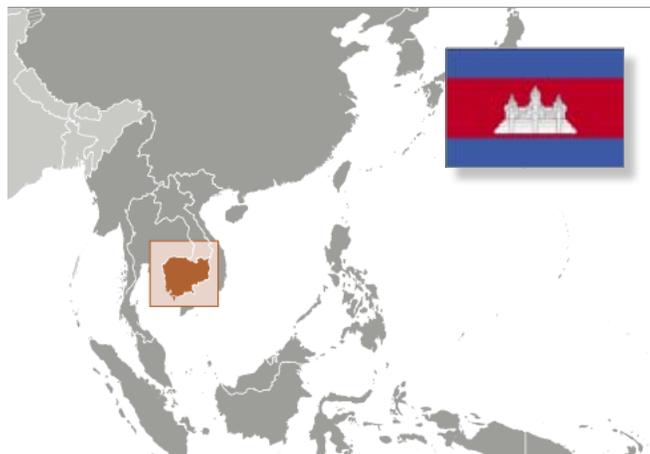


## COUNTRY SECTIONS

## CAMBODIA

|                   |                |
|-------------------|----------------|
| Population        | 14 million     |
| Population growth | 1.7 percent    |
| Surface area      | 181,000 sq.km. |
| Capital           | Phnom Penh     |



Cambodia's economy is contracting in 2009 and is expected to recover slowly in 2010. Through large trade flows – mainly in garments and services – and large inflows of foreign investment, Cambodia was very exposed to the global economic crisis. Although the country had a sound fiscal position and built international reserves, weak revenue mobilization and pervasive dollarization have constrained the policy reaction to the external shocks. Fiscal loosening in 2009 is supporting the economy, although it is creating tensions for macroeconomic management. Intensive bank supervision is also critical, as the banking sector faces the negative consequences of lower economic growth and much lower real estate prices.

Real GDP is projected to contract 2 percent in 2009 from nearly 7 percent in 2008 and four years of double digit growth before that. Agriculture, accounting for 27 percent of GDP, is the bright spot, with continued improvement in paddy rice production despite irregular rains in 2009. Exports of garments – which account for the bulk of shipments abroad and are almost all directed to the U.S. market - fell 26 percent in the first six months of 2009 from a year earlier. The loss of market share in the U.S. market, from 3.2 last year to 2.8 percent in mid-2009 is an equally worrisome development, indicating competitiveness challenges. The other key sectors of the economy were also negatively affected. Tourism arrivals declined and construction projects approved dropped one-fourth from a year before in the first half of the year.

There are initial signs of recovery leading to 4 percent real GDP growth in 2010. Construction might be bottoming out, reflecting new capital inflows. Hotel bookings are also improving, although tentatively. There are, however, signs of corporate stress. Access to finance – from domestic banks or foreign investment – remains subdued. New firm registration has plummeted 40 percent from a year earlier in the first 6 months of 2009, and 18 percent of garment factories have closed (net of opening), with a number of others under severe liquidity. Household debt has also increased under the pressure of higher prices in 2008 and lower income in 2009. Such corporate and household vulnerability will weaken the pace of recovery.

The current account deficit is being reduced in 2009 but the accumulation of foreign exchange reserves has slowed. The fall in garment exports and tourism revenues has been more than offset by the fall in imports of inputs for garments and tourism and the lower price of petroleum products. As a result, the current account deficit (excluding official transfers) has decreased during the first six months from \$748 million to \$643 million in 2009, with a projected deficit of 9.9 percent of GDP in 2009. The financing of the deficit has correspondingly decreased, with foreign investment over the first six months decreasing from \$486 million to \$223 million. The current account deficit is projected to widen modestly in 2010, as a rebound in domestic demand and oil prices boosts imports.

Exchange market intervention by the central bank to limit depreciation of the domestic currency and maintain the riel around 4,100 per U.S. dollar has slowed growth in foreign exchange reserves this year. Still, reserves rose modestly from a year earlier to \$2.2 billion by the end of June 2009. Cambodia's real effective exchange rate appreciated 2-3 percent in June 2009 from a year earlier. Prices are down 4.9 percent in June from a year before, reflecting the sharp downward correction in food and fuel prices. Upward pressures on inflation might reemerge as international prices of commodities rebound and as depreciation pressures continue. The monetary policy has been appropriately eased early 2009.

Developments in the banking sector bear close watch. Very rapid growth over 2005-2008 has stretched the risk management and supervisory capacity. The liquidity situation has significantly improved since late 2008, but at the cost of high deposits rates to mobilize savings, putting pressure on bank profitability. The non-performing loans ratio has increased during the first six months of 2009 and will be under further pressure as the deceleration in the economy and the deflation of the real estate bubble impact loan performance. Credit to private sector remains weak, with year-on-year growth at only 10 percent at the end of June 2009. An overdraft facility has been created in early 2009 to address liquidity issues and new regulations have been passed to strengthen banking supervision.

The fiscal deficit is expected to expand to 6.7 percent of GDP, beyond the budget target of 4 percent, largely because of larger than budgeted spending. Despite the extension of tax cuts in response to the crisis and the sharper downturn, the annual revenue target is expected to be met. The larger increase in spending, meanwhile, reflects mainly a larger wage bill. While the mobilization of foreign assistance is on track, it is not sufficient to finance the wider deficit. The government, as a result, is drawing down its deposits (budget reserves built up over the past few years, thanks to progress in public financial management and prudent fiscal policy).

The government is facing difficult choices in drafting the 2010 budget. Sustaining high deficits that exceed available

external financing would put pressure on macroeconomic stability. Hence the government is trying to bring the fiscal deficit to a level that supports growth – which remains below potential – without compromising macroeconomic stability.

Beyond the policy mix (including fiscal measures), a number of policy reforms are being taken to respond to the global economic crisis. A number of trade and investment treaties have been signed, including through ASEAN. Cambodia now enjoys preferential access to “everything but arms” in the European Union. A National Arbitration Center will soon be established. Trade facilitation reforms and investment promotion efforts are ongoing.

The impact of the crisis on Cambodians' livelihoods is deemed significant but varies across the population. Only one-fifth of all households have a job in sectors directly affected by the crisis (garments, construction, and tourism). Urban households and richer households are more likely to be affected through these sectors, but the income impact is greatest amongst poorer and rural households, for whom these jobs, if present, account for a far larger share of income. Projections suggest that the crisis could add 1 to 4 percentage points to the poverty headcount between 2007 and 2010. The key challenge ahead is whether the economy can absorb new labor entrants as well as labor shed from crisis-affected sectors. Compounding these vulnerabilities are high levels of debt for a number of households and the fact that the slowdown comes on the heels of soaring food prices in 2007 (which had a major distributional impact, and probably adverse effects on poverty). There is currently limited data on human development outcomes, but preliminary indications and experience in other countries suggest that the impact will be a reversal of the very encouraging trends of the past decade.

## CHINA

|                   |                  |
|-------------------|------------------|
| Population        | 1,318 million    |
| Population growth | 0.6 percent      |
| Surface area      | 9,598,000 sq.km. |
| Capital           | Beijing          |

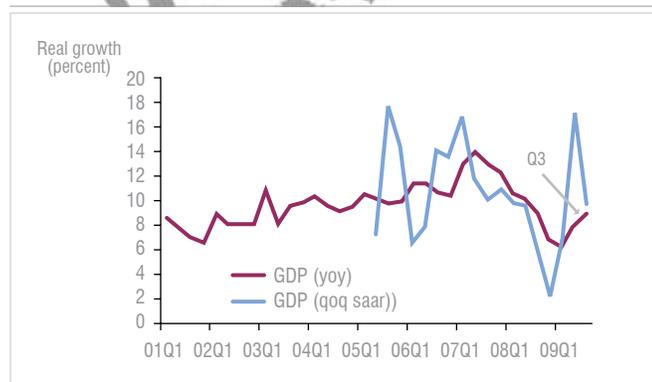


Figure 1 Growth is Recovering Strongly

Exceptionally large fiscal and monetary stimulus has supported a strong recovery in China's economy despite the large drag on growth from exports amidst the global recession. Reflecting a large increase in domestic demand, real GDP growth surged to 8.9 percent year-on-year in the third quarter from a low of 6.1 percent in the first. China's stimulus policies included a discretionary fiscal stimulus of perhaps 3.5 percent of GDP and a surge in bank lending that may reach 30 percent of GDP in 2009. Most of the stimulus has shown up in infrastructure-oriented government-influenced investment. However some of the stimulus has been consumption-oriented and the acceleration in domestic demand has been more broad-

based. Resurgent housing sales have started to feed through to construction activity. Consumption held up well, even as it lagged investment. However, other market based investment in several sectors, notably manufacturing, is affected by spare capacity. Export volumes fell 16 percent from a year earlier in the first three quarters of 2009. The fall in exports has been very broad-based, geographically and in terms of products. With net exports of goods and services subtracting the equivalent of 3.7 percentage points from GDP growth in January-September.

The current account surplus has declined. Larger imports of raw materials—which made up almost one-half of non-processing imports in 2008—have been the key driver of import growth in 2009. Imports of machinery and equipment have also been robust. With overall imports holding up much better than exports, the trade surplus declined 25 percent in January-September from a year earlier in dollar terms and the current account surplus has declined from 9.8 percent of GDP in 2008 to 6.4 percent of GDP in the first half of 2009. Exchange market intervention has boosted foreign exchange reserves sharply higher this year to about \$2.3 trillion.

The slowdown has had a major impact on the labor market. Many jobs have been shed, particularly in export-oriented manufacturing sectors. The domestic economy has created new jobs at the same time, largely in services and the government sector, and overall conditions on the labor market are not as bad as feared earlier this year. Nonetheless, significant numbers of people have had to accept wage cuts. These labor market trends have put downward pressure on general wage growth, particularly in the more flexible segments of the labor market. Migrant wage income growth “per capita” slowed to 7.6 percent in January-June 2009 from a year earlier.

Real GDP growth in 2009 is likely to exceed the government target of 8 percent of GDP, and the pace of activity will probably strengthen in 2010. But the composition of growth will change in 2010, with the increase in exports likely to be significant, supported by strong fundamental competitiveness and the recent depreciation of the RMB in nominal effective terms (as the RMB was effectively pegged to the US dollar since mid-2008). Thus, net exports are likely to stop being

a drag on growth. Real estate investment is also bound to be stronger. However, the government stimulus is set to decline sharply next year. Market based investment is likely to continue to feel pressure from spare capacity, while consumption may feel some headwind from the weaker labor market situation. All in all, we expect GDP growth to rise somewhat in 2010, but a sharper acceleration is not likely until the global economy recovers more fully. In this climate, inflation pressures are expected to remain low.

China's external surplus is set to shrink sharply this year and remain broadly unchanged in 2010. We project a current account surplus of around 5.5 percent of GDP for 2009 as a whole. In 2010, with domestic demand expected to remain robust and processing trade recovering, overall imports should continue to grow solidly. With exports projected to grow at broadly the same pace as imports, and terms of trade likely to remain little changed after this year's improvement, the current account surplus will remain roughly unchanged. Over the medium term, with the gap between domestic growth in China and the rest of the world is likely to diminish, leading to further widening of the surplus even if China's pattern of growth is rebalanced successfully.

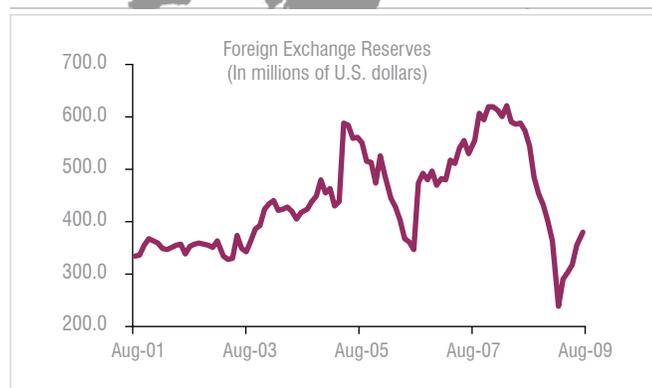
Looking ahead, the costs and risks of sustaining the current expansionary policy stance will increase over time. The government intends to keep the overall macroeconomic policy stance broadly unchanged for now. In our view, macroeconomic conditions in the real economy do indeed not call for a major tightening. However, risks of asset price bubbles and misallocation of resources amidst abundant liquidity need to be mitigated and monetary policy will have to be tightened sooner than in developed countries. In the fiscal area, significant additional stimulus does not seem warranted, although additional flexibility will be needed.

The recovery can only be sustained by successful rebalancing of the economy. Rebalancing and getting more growth out of the domestic economy call for more emphasis on consumption and services and less on investment and industry. Following on earlier initiatives, some steps have been taken in recent months to rebalance and boost domestic demand. Recent steps include increasing the presence of the government in

health, education, and social safety, including the rolling out of a rural pension program and implementing elements of the health care reform plan announced earlier this year; improving access to finance and SME development; and mitigating resource use and environmental damage, notably by coupling domestic fuel prices to the international oil price and increases in water prices and some electricity tariffs. Regionally, government-led investment has been emphasized in poorer regions away from the coastal areas. These are useful steps, although more policy measures will be needed to rebalance growth in China, given the underlying strong momentum of the existing pattern.

## FIJI

|                   |               |
|-------------------|---------------|
| Population        | 834 million   |
| Population growth | 0.5 percent   |
| Surface area      | 18,000 sq.km. |
| Capital           | Suva          |



Weaker demand abroad combined with the January floods have affected negatively economic activity. In January 2009, the biggest floods in forty years devastated the west coast of Fiji's main island and disrupted power supply, damaged crop fields and infrastructure, and limited tourist arrivals. Preliminary estimates suggest that the direct costs of the floods on the economy amount to about \$180 million (5¼ percent of GDP). The government projects output to contract 0.3 percent in 2009 after an expansion of 0.2 percent in 2008, but a larger decline is likely given the impact of natural disasters and the economic crisis.

The 20 percent devaluation of the currency is likely to help

narrow Fiji's current account deficit to 21 percent of GDP in 2009 from 26 percent in 2008 despite a 15 percent drop in tourist arrivals and reduced exports of garments and mineral water. Further improvements in the deficit may be constrained, however, should global demand for Fiji's exports remain weak, and domestic factors limit the supply of sugar and garments for export. In the first half of 2009, remittances were little changed in U.S. dollar terms from a year earlier, but were up 18 percent in local currency terms, helping support domestic consumption. Fiji's foreign exchange reserves declined to a low of \$336 million in February 2009 (equivalent to 2.7 months of imports) before recovering to US\$500 million in September 2009. Of the increase, \$95 million was accounted by the general allocation of SDRs by the IMF in August.

The pass-through of the devaluation of the currency into domestic prices, combined with a recent pickup in oil and food prices due to flood-related shortages, is likely to boost 12-month inflation to 9.5 percent by December 2009. Earlier, the decline in prices for imported food and fuel caused prices to drop year-on-year by June after a 10 percent increase in the twelve months through September 2008.

The Interim Administration's 2009 budget targets the fiscal deficit to widen to 4 percent of GDP in 2009 from 1.5 percent in 2008 because of measures to support domestic demand. The 2009 budget planned higher capital expenditure to be financed in part by a hike in import duties (from 27 percent to 32 percent on average), and improved revenue compliance and collection. After the floods and as the global crisis took its toll, however, tax receipts fell below budget targets. Government expenditure for the first half of 2009 was also lower than budgeted amid lagging execution of capital expenditures.

Looking ahead, Fiji's economy faces several challenges. Firstly, there are substantial downside risks should the global recovery sputter and prices for imported oil continue to increase. Secondly, the devaluation of the currency will likely increase the cost of servicing external debt and add further strains to the budget. Thirdly, Fiji relations with key external partners remain strained and restoration of full bilateral relations remains dependent on Fiji's return to democracy.

## INDONESIA

|                   |                   |
|-------------------|-------------------|
| Population        | 226 million       |
| Population growth | 1.2 percent       |
| Surface area      | 1,905,000 sq. km. |
| Capital           | Jakarta           |



In the first half of 2009, Indonesia's economy recovered solidly from the relatively weak second half of 2008. Seasonally adjusted real GDP growth has quickened since the start of 2009, with the trend of gradual recovery expected to continue through 2011.

Indonesia's recovery has been supported by an improved external environment. Second-quarter growth rates across the country's major export partners were better than expected, with most trading partners exited recession by mid-year. International prices of many of Indonesia's exports have also recovered in part since their drop from the 2008 peaks. These developments have supported Indonesia's economy, with exports recovering faster than imports.

Domestic consumption continued to contribute strongly to growth in the second quarter. In the first quarter, large amounts of spending by campaign teams for the parliamentary election lifted private consumption. Higher government consumption has been a key driver of growth in the second quarter, by contrast, as the government accelerated disbursement of its 2009 budget. Ongoing resilience in domestic consumption has supported the services sector, with output accelerating

compared with Q1. Most other indicators of domestic economic conditions have also strengthened from the start of the year, with consumer confidence at historical highs and rising, retail and vehicle sales improving, and industrial activity recovering from its downturn in late 2008.

Despite this resilience in the overall economy and the improving business environment, investors have remained cautious into the second half of 2009. Purchases of capital equipment continue to be cut, although investment growth in new buildings has remained buoyant. The slowdown in overall investment coincides with flat lending to firms for investment and working capital from late 2008, in contrast to the rapid lending growth in early 2008.

Indonesia's banking sector has remained in good health overall. Non-performing loan ratios are stable, contrary to concerns at the beginning of 2009 that they would rise as borrowers affected by the weaker economy would be unable to meet their commitments. In September 2009, the central bank left its policy interest rate unchanged, following an easing of 300 basis points over the previous 9 months. Only a limited proportion of the cuts in the policy rate have been passed onto the lending rates of commercial banks, however, leading the central bank in late August to ask the 14 largest banks in the country to progressively lower their savings deposit rates to no more than 150 bps above the key policy rate. The central bank hopes that this will reduce the cost of funds for banks, allowing them to lend more and at lower interest rates.

Indonesia's financial markets have continued to strengthen, generally by more than markets elsewhere in the region. The rupiah has appreciated against the weakening U.S. dollar to about 9,000 per U.S. dollar by October. The equity market has also performed strongly, rising by one-third from late May to October. By mid-June, yields on government rupiah-denominated bonds had returned to their levels of early 2008. These improved market conditions have allowed the government to continue financing its budget through the domestic bond market, in addition to the two issues of dollar-denominated bonds, accessing funds at longer maturities and at lower yields.

Improved financial market conditions have coincided with somewhat less volatile flows on Indonesia's capital accounts, rendering Indonesia's external position in September 2009 more robust than at the start of the year. The overall balance of payments remained in surplus in the second quarter, although by less than in the first one. The current account surplus increased slightly, as the improved external environment lifted exports more than imports. While non-resident investors returned as net purchasers of Indonesian financial assets, overall the capital account switched to deficit, largely due to slower net foreign direct investment following several quarters of record inflows. Indonesia's scheduled external debt was largely rolled over through the first half of 2009, countering concerns early in the year that roll-over rates may be low and that the amount of debt due may be greater than officially reported. Foreign reserves had recovered to \$62 billion, near the peak of mid-2008.

After remaining subdued for longer than expected, inflation started to pick up from July and August. Twelve-month headline inflation amounted to 2.8 percent, while core inflation excluding prices for food and energy was 4.8 percent. All in all, Indonesia's inflation fell faster than in most of its trading partners, but remains higher than in almost all of them.

Employment grew faster than the working age population in the year to February, helping reduce the unemployment rate. However, most new jobs are in the informal sector, especially for women. Higher employment, low inflation and the final tranches of the government's unconditional cash transfer program (BLT), have helped reduce the poverty rate to 14.2 percent by March 2009, or by 1.2 percentage points from a year earlier.

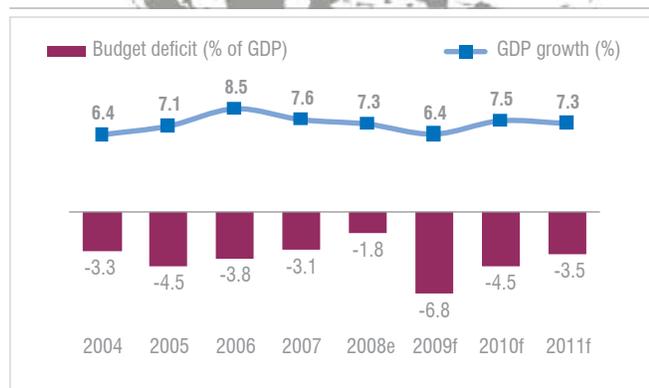
Public finances have provided a larger stimulus to the economy in 2009 than in recent years. Through July, the government budget overall was in larger deficit than in previous years, thanks to lower revenues due to tax cuts under the fiscal stimulus package and weaker profits as a result of lower commodity prices and weaker external demand. Government spending on its core programs was broadly unchanged in nominal terms compared with 2008, but lower subsidies for energy resulted in lower overall outlays. After a very slow

start, disbursement of the spending measures under the government's stimulus package accelerated from mid-July. For the year as a whole, the fiscal deficit is likely to widen to about 2.2 percent of GDP, somewhat less than under the 2009 budget. For 2010, the draft budget targets a deficit of 1.6 percent of GDP. The government's conservative nominal GDP growth and oil price assumptions, however, suggest that there may be room for larger spending than budgeted within the overall deficit projection.

Economic recovery is likely to continue. Real GDP growth is expected to rise gradually further towards its potential of a little over 6 percent by 2011. Domestic demand is likely to remain the main driver of growth, helped by the fiscal stimulus this year and by the recovery in investor confidence in 2010. Net exports should not subtract greatly from growth once global recovery is on a firmer recovery path, perhaps by 2011. With a weakening trade surplus and recovery in commodity prices, the current account is likely to move closer to balance or even to a small deficit by 2011.

## LAO PDR

|                   |                |
|-------------------|----------------|
| Population        | 5.9 million    |
| Population growth | 1.7 percent    |
| Surface area      | 237,000 sq.km. |
| Capital           | Vientiane      |



The economy of Lao PDR has performed relatively well in the midst of the global financial crisis. Real GDP is projected to grow at 6.4 percent in 2009, slightly lower than the 7.3 percent in 2008. This projection has been revised upwards from 5 percent earlier in the year because most sectors, including mining, manufacturing (garment, food and beverages, cement and metal industries), construction, agriculture and services have been performing better than expected due to the recent recovery of commodity prices (copper and gold), increased public expenditures and recovery in regional demand (especially from China). The mining sector (mostly copper and gold) contributes about 2.5 percentage points to growth this year; manufacturing and construction together, and

agriculture about 1 percentage points, and services account for the remainder.

With the expected global recovery, real GDP growth in Lao PDR will strengthen over the medium-term although the recovery remains subject to global commodity price changes (mainly metals and agriculture). The economy is projected to benefit from the recovery of tourism, implementation of large hydropower projects under construction and in the pipeline and projected increase in demand from the neighboring countries (especially Thailand, China and Vietnam); and to the European Union.

Prices have been falling year-on-year since May, reaching a drop of 2.3 percent by August due to the decline in food and energy prices. Core inflation excluding food and energy fell to 0.9 percent year-on-year in August. Average inflation is projected to decline from 7.6 percent in 2008 to just about 1 percent this year, but should increase slowly over the medium term as prices for oil and food recover.

Pressure from the global crisis combined with commitments to host a series of major events led to significant expansion of public outlays in 2009. As a result, the budget deficit is estimated to increase sharply from 1.8 percent in 2008 to 6.8 percent in 2009. Public spending has noticeably increased on capital expenditure and the wage bill (the increase in public servants wages and allowances was approved by parliament before the crisis). There was an increase in quasi-fiscal expenditure, as the central bank lent in support of local infrastructure projects and preparation for two important events, the South-East Asian (SEA) Games and the 450 year Vientiane Anniversary. After three years of exceeding budget targets, revenues are expected to fall short of target this year by about 8 percent. While Lao PDR has made progress in reducing its external and public debt burden, it still faces a high risk of debt. Nevertheless, public debt service remains manageable as much of the debt is contracted on concessional terms.

In dollar terms, Lao PDR's exports and imports are expected to fall this year due to lower commodity prices, smaller imports for large infrastructure projects and weaker global

demand. Exports are projected to drop by about 10 percent while imports would decline slightly more by 11 percent. The current account deficit is projected to narrow to about 8 percent in 2009, with foreign exchange reserves down to \$586 million or about 4.9 months of non-resource imports.

The kip has remained little changed against the U.S. dollar during the first eight months of 2009 and risen modestly by 2.4 percent against the Thai baht. This followed a larger appreciation in 2008.

Credit has continued to grow rapidly, with 12-month credit growth up to 98 percent by the end of June from 78 percent in December 2008. The sharp increase in lending against the background of poor capacity to screen borrowers raises concerns about an increase in contingent liabilities and possible deterioration of bank balance sheets. This fast expansion takes place however from a very low base, with credit amounting to 12 percent of GDP at the end of 2008.

Reforms have shown some progress. Most importantly, the government has committed to returning to a more sustainable macroeconomic path and a phasing out of quasi-fiscal activities. Public finance management reforms include completing the provincial level centralization of the Treasury, Customs and Tax this year and the full extent by next year. Consolidation of revenue accounts with the National Treasury is also in progress, as is the revision and implementation of various laws and decrees, including the VAT law, the tax law, the executive decrees on minerals and royalties, and on the civil service administration. The government is also moving ahead with the elimination of the tax exemption on motor vehicle imports. A new decree on new import and export licensing procedures has also been approved, as have been the mineral law and the new unified law on investment promotion.

## MALAYSIA

Population 27 million

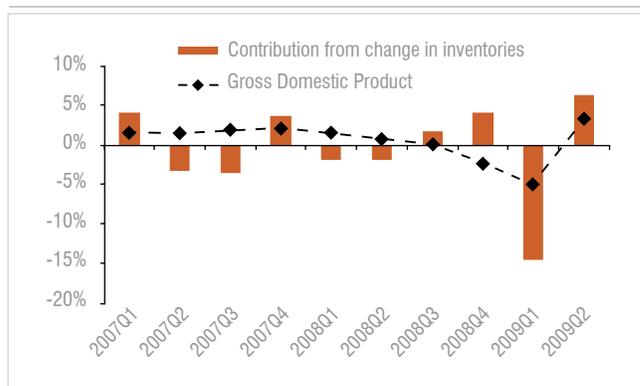
Population growth 1.7 percent

Surface area 330,000 sq.km.

Capital Kuala Lumpur



GDP growth: the power of inventories  
Real GDP growth (seasonally adjusted, percent) and contribution from inventories



Source: Bank Negara Malaysia.

After a period of strong growth, Malaysia's economy has been hit hard by the global economic downturn. The deterioration in economic conditions first became apparent in the manufacturing sector towards the end of 2008, when both private investment and exports contracted sharply. Real GDP growth slowed to 4.8 percent in 2008, as a result, from 5.8 percent on average in the previous three years. In early 2009, the manufacturing-led downturn intensified and spread more widely through the economy, from the tradable into the non-tradable sector and from corporate into household demand.

This resulted in a sizeable drop in output during the first two quarters of 2009, with manufacturing down 13 percent from a year earlier.

Economic activity showed signs of improvement in the second quarter of 2009. In seasonally adjusted terms, consumption, fixed investment, and exports all expanded in the second quarter. The services sector also improved. Conditions in the electrical and electronics (E&E) industry, which accounted for an important part of the contraction, improved in line with these general developments. Aggregate capital utilization increased as well, and so did consumer and business confidence.

Malaysia's export performance tells an important part of the story. Exports fell by some 31 percent year-on-year during January-July. Since April, exports have grown at an average monthly rate of 4 percent (seasonally adjusted) on the back of stronger demand from the U.S. and several countries in East Asia. Shipments to the EU and Japan remain weak, however, highlighting the fragile nature of the recovery. Good sequential growth was observed in exports of E&E goods, chemical products, and palm oil, even though on a yearly basis levels are still much below last year's.

Other external indicators improved as well. Malaysia's financial account of the balance of payments registered a deficit of \$38.3 billion in the second half of 2008 compared to a surplus of \$4.8 billion in the first half because of a sharp decline of foreign direct investment (FDI) and the large net outflows of portfolio and other private investment, as investors rushed to boost liquidity in their home markets. Portfolio outflows moderated this year, helping reduce the deficit on the financial account to \$15 billion in the first half of 2009. The current account surplus meanwhile stabilized at about 18 percent of GDP. Foreign exchange reserves fell from \$126 billion in the middle of 2008 to \$94 billion in September 2009, but are still four times larger than short-term external debt.

Corporate sector and labor market indicators suggest a mixed picture. On the positive side, the number of newly registered companies rebounded in recent months after a sharp slowdown

between August 2008 and February 2009. The current level (around 4,000 new firms per month) is now similar to that of July last year. But the number of bankruptcies is still rising. The July-August average (1,420 firms per month) is 13 percent higher than the average in the first half of the year. Job retrenchments were recorded at 12,590 positions in the first quarter of 2009 compared to 13,851 for 2008 as a whole, with actual job losses likely to have been much higher. The unemployment rate rose to 4 percent by March, the highest since mid-2003. The labor market has stabilized somewhat thereafter, with employment both in the manufacturing and service sector on the rise.

The banking sector remained in good health, thanks to conservative prudential standards, adequate capitalization, and limited linkages to toxic securities and troubled financial institutions in industrial economies. The capital adequacy ratio of the banking system averaged at a comfortable 14.6 percent as of August and nonperforming loans amounted to 2.1 percent of total loans, with credit risks being concentrated in the manufacturing sector.

Overall poverty remained unchanged in 2008, but rural poverty worsened. Despite a sharp economic slowdown in the final quarter, Malaysia's poverty incidence last year remained unchanged from 2007 at 3.6 percent of all households. Contrary to expectations, urban poverty decreased slightly, as lower manufacturing employment in late-2008 did not have an immediate poverty impact. Rural poverty, however, rose to 7.4 percent from 7.1 percent. In 2009, an overall increase in poverty is possible given the decline in economic growth for the year as a whole.

The near-term outlook argues for a slow process of recovery. Real GDP is projected to contract 2.3 percent in 2009 before increasing 4.1 percent in 2010. Consumption and fixed investment growth will remain relatively subdued, due to uncertainties about the global outlook, the efforts of fiscal consolidation, and still-low levels of capacity utilization. The turnaround in the inventory cycle is expected to be a main driver of growth. Import growth should continue to outpace export growth in the coming quarters, resulting in a smaller trade surplus. The current account balance is expected to

decline to 12.3 percent of GDP in 2009 and further to 12.1 percent in 2010.

Fiscal and monetary policies helped contain the negative impact of the crisis on domestic demand. The fiscal packages announced in November 2008 and March 2009 (SP1 and SP2), amounted to RM7 billion (1 percent of GDP) and RM60 billion (9 percent). Under the SP2, the actual fiscal injection amount to RM15 billion to be spent in 2009 and 2010, with the rest accounted for measures without a direct fiscal impact. Despite higher revenues, government expenditures expanded much faster in the first half of 2009, leading to the largest first-half deficit in decades. The deficit is likely to widen from 4.8 percent of GDP in 2008 to 7.8 percent in 2009. Fiscal consolidation efforts have been announced recently and should help narrow the deficit to 6.4 percent of GDP in 2010. Monetary policy has been accommodative after a 150 basis point reduction in the overnight policy in three steps to 2 percent and the required reserve ratio by 300 basis points to 1 percent during late-2008 and early-2009. Both rates currently stand at historically low levels.

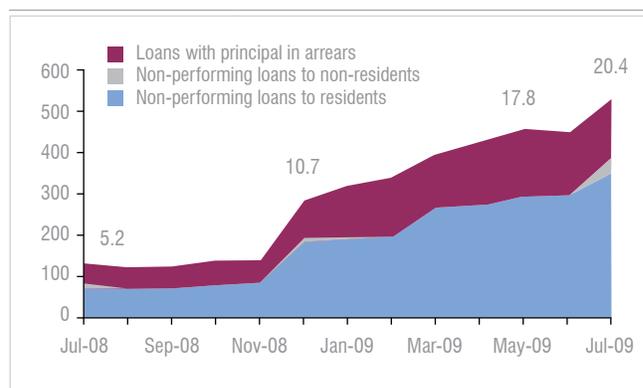
The crisis has not detracted attention from the underlying weaknesses which the authorities are addressing under the umbrella of a new economic model. Malaysia's economy has been trapped at upper-middle income levels for some time now. The authorities aim to revitalize growth with an integrated strategy focused on the specialization of the economy into new niches and the upgrading of the skill base of its workforce. Efforts in formulating a new economic model are under way and will build further on the important steps that have been already introduced to improve the dynamism of the service sector.

## MONGOLIA

|                   |                  |
|-------------------|------------------|
| Population        | 2.6 million      |
| Population growth | 0.9 percent      |
| Surface area      | 1,567,000 sq.km. |
| Capital           | Ulan Batar       |



Figure 6. NPLs and loans in arrears have risen strongly, as key sectors in the economy slowed down  
MNT billion



Note: number in boxes is sum of NPLs to residents and non-residents and loans with principal in arrears as a percent of total loans outstanding.  
Source: Bank of Mongolia, World Bank

Mongolia has been one of the countries in East Asia hardest hit by the financial crisis, although unlike others, the crisis was transmitted via the commodity channel. The collapse in copper prices that began in July 2008 hit Mongolia harder than the other major copper producers (Chile, Peru, Papua New Guinea and Zambia), because of the country's particular combination of expansive fiscal and monetary policies, a fixed exchange rate and – at that time - an overheating

financial sector.

The government took strong actions to address the economic downturn from the start of 2009, supported by programs with the IMF, the World Bank, the ADB and Japan. These have led to a stabilization of the external sector, the exchange rate and the budget. The trade balance has improved, but this is in part caused by the sharper contraction in imports than exports due to the economic downturn itself. Attention now is shifting to tackling the strains in the financial sector and ameliorating the effects of the downturn on the real economy, unemployment, and poverty.

The latest developments show that the budget remains under pressure, as revenues have continue to drop, whereas expenditures remain little changed. During the boom years of 2003-07, the government ran modest fiscal surpluses, but these turned out to be insufficient to absorb the fiscal shock caused by the collapse of the mineral prices and spending plans based on these prices remaining high. Moreover, the fiscal shock was made worse by government policies during the boom years to shift the fiscal burden away from the non-mining sector, leaving the budget increasingly dependent on revenues from mining.

The global downturn also aggravated problems in the financial sector which had been overheating during the boom years. During the boom, very high inflation (33.7 percent year-on-year in August 2008, the highest in East Asia) and loose monetary policies led to a credit boom that masked growth in non-performing loans (NPLs). High inflation also led to negative real interest rates on local currency deposits, resulting in flight of local currency savings into foreign exchange deposits, where interest rates were as high as 12-18 percent in some banks. As a result the successful policy actions by the central bank – including interest rate hikes and auctioning of foreign exchange - deposits have now recovered. However, non-performing loans have continued to increase, and bank lending to the private sector has come to a virtual standstill, as banks prefer to invest in central bank bills instead.

For 2009, Mongolia is facing a major slowdown in real GDP growth to an estimated 0.5 percent from 8.9 percent

in 2008. Unemployment has been steadily increasing since the beginning of the year as a result of the contraction in the real sector. A recent survey of the informal urban sector and a recently commissioned study on the crisis implications for household in the informal sector found that the effects of the economic slowdown have a widespread social and poverty impact in Mongolia. Real effective income has fallen by about 60 percent in some informal urban labor markets, due to high inflation eroding real wages and due to reduced job availability. Employment conditions are also becoming less favorable for informal workers in the rural regions, and herders and informal mining workers are barely able to cope with the decreasing job availability, falling wages and increasing living expenses.

Recently, Parliament voted to approve four draft law amendments necessary for the conclusion of the Oyu Tolgoi (OT) investment agreement between the government and Ivanhoe Mines/Rio Tinto. If the deal is concluded, the Oyu Tolgoi copper and gold mine will make a substantial contribution to the economic growth of Mongolia in the near future.

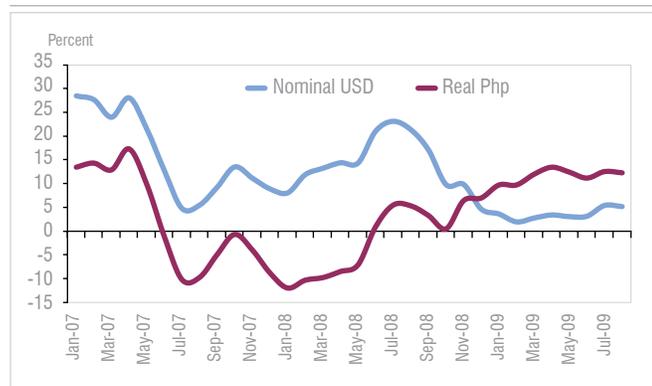
Going forward, it is important that the government focuses on implementing a fiscal responsibility framework to avoid a repeat of the boom-and-bust spending pattern that Mongolia has just experienced. It is also important to improve the planning and budgeting for public investments, and to prioritize the protection of infrastructure maintenance—critical during the downturn. Protecting the poor during this downturn is a challenge, but can be achieved by starting to target the currently untargeted social grants (in particular, the Child Money Program). In the financial sector, the authorities should ensure stability by intensifying supervision and taking decisive action in case of bank failures in order to retain confidence in the financial sector. In addition, a restructuring of the banking sector is envisaged after the completion of a series of loan portfolio audits. In the mining sector, the government can now use the recent experience gained during the negotiations of the OT investment agreement to improve the overall policy environment.

## PHILIPPINES

|                   |                |
|-------------------|----------------|
| Population        | 88 million     |
| Population growth | 1.9 percent    |
| Surface area      | 300,000 sq.km. |
| Capital           | Manila         |



Philippines: Remittance Growth (3mma), 2007-2009



Source: Bangko Sentral ng Pilipinas, World Bank staff estimates

The economy weathered the global crisis comparatively well, escaping a recession, thanks in large part to timely fiscal and monetary stimulus measures and the continued steady inflow of remittances. The authorities now face the challenge of balancing the need to avoid premature withdrawal of fiscal stimulus with ensuring medium-term fiscal consolidation.

After a brief but sharp contraction in early 2009, the economy rebounded moderately in the second quarter in line with consumer spending. Real GDP contracted 2.1 percent in the first quarter of 2009 in seasonally adjusted annualized

(SAAR) terms, before expanding 2.4 percent in the second quarter. The contraction in personal consumption expenditure during January-March was the first since the 1980s and underlies the extent of precaution households took when the crisis was in full swing. The recovery in consumption in the second quarter was mostly driven by remittance inflows, declining inflation, and an improving global outlook. Government consumption expanded sharply as well, due to the front loading of the government's fiscal stimulus. Capital formation, however, continued to contract, with sharp falls posted in private construction and durable equipment. Merchandise exports continued to contract on an annual basis in the second quarter, mostly due to smaller shipments of electronics. Export of services, however, expanded, mostly reflecting strong demand abroad for the business process outsourcing (BPO) industry.

The balance of payments surplus rose to \$3.3 billion during January-September, thanks to continued larger inflows of remittances and the BPO exports. The rapid growth of the BPO industry in the midst of a global recession stems from continued strong demand for back office, engineering and financial services as corporations across the world seek to optimize their cost structures. The balance of payments surplus boosted foreign exchange reserves to a record high \$42.3 billion by the end of September, equivalent to more than seven months of imports and more than three times the country's short-term external debt.

The remarkable resiliency of remittance flows to the Philippines has been surprising but welcome. Growth in monthly remittance flows measured in U.S. dollars slowed sharply during 2009 from double digit increases in 2008, but the expansion of 9.3 percent year-on-year in July compares with declines of 4-20 percent predicted by observers at the start of the year. In real peso terms, moreover, remittances rose by 12 percent year-on-year in January-August after contracting 2.9 percent in 2008. Strong deployment of workers abroad in 2008 and an extensive diversification of the overseas Filipino workers, whether by geographic location, skills, gender, or sectors of activity help explain the resiliency of remittances during the global crisis. Remittances are also expected to play a strong insurance role for families affected by the typhoons

that hit the Philippines. The former has severely impact the capital Manila, where most of overseas remittances are sent, and in particular the poor, near-poor and the middle class.

Financial markets have rebounded significantly while real estate prices are contracting moderately. Equity prices rose 46 percent from the start of the year, while spreads on foreign-currency denominated government bonds fell 177 basis points and are only 30 basis points higher than on September 15, 2008. Real estate prices, however, remain under pressure. Land prices in prime Manila locations contracted by 3.1 percent in the second quarter from the first, and given existing vacancies and the projected new supplies coming in the market, prices are expected to contract further over the next twelve months.

The fiscal deficit has widened substantially because of the fiscal stimulus package calling for frontloading of spending and noticeably weaker revenues. Spending grew by 15.2 percent from a year earlier in September driven primarily by larger capital spending, wages and transfers to local governments. Tax revenues contracted by 8.5 percent year-on-year in September. About two-thirds of the contraction reflects tax cuts implemented in 2008 and 2009.

Low inflation and a stable exchange rate helped the central bank cut its key policy rate by 200 basis points this year, but the pass-through to bank lending rates has been slow and partial. Inflation declined to 0.1 percent year-on-year in August from a peak of 12.5 percent a year earlier. Bank lending rates, meanwhile, fell only 120 basis points this year. Nonetheless, 12-month growth in bank credit (net of placements in the central bank) slowed to 5.9 percent by August from double digits that prevailed most of 2008.

The adverse impacts of the crisis on the social sector are easing, though the recent typhoons have likely led to renewed duress. As the economy started to recover, “green shoots” emerged in the labor market. The share of wage and salaried workers in total employment increased in July compared to April 2009, offset by a large decline in the number of workers in the informal sector. Hunger incidence also recently receded from its level during the height of the food and global financial

crises. Despite these improvements and measures under the government fiscal stimulus package, it is estimated that the global economic recession will leave an additional 1.4 million Filipinos in poverty by 2010 compared with a counterfactual scenario of no crisis. Damages and losses inflicted by the typhoons Ondoy and Pepeng are estimated to worsen poverty incidence even further.

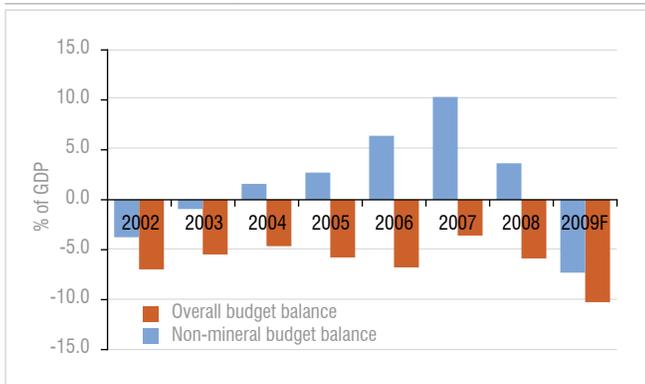
While the country weathered comparatively well the global crisis, important challenges exist for the country to generate inclusive sustainable growth. In particular, there is a need to balance the medium-term need for fiscal consolidation with the risk of a premature unwinding of the fiscal stimulus. Fiscal consolidation is needed to protect and increase priority spending in health, education, and infrastructure, and to help reduce government debt to levels that will open up more fiscal space for the future. Additionally, reaching a higher growth path will require increasing the share of investment in the economy, especially in infrastructure. Improving the business climate is key to achieving this objective. A higher intensity of investment would raise the potential growth rate of the economy and boost incomes, while helping rebalance the economy away from consumption as its key driving force.

## PAPUA NEW GUINEA

|                   |                |
|-------------------|----------------|
| Population        | 6.3 million    |
| Population growth | 2.0 percent    |
| Surface area      | 463,000 sq.km. |
| Capital           | Port Moresby   |



PNG: Fiscal Stance, 2002-09



PNG's economy is weathering well the impact of the global economic crisis. In 2009, real GDP growth is projected to slow only moderately to 4-5 percent from an average of 6.5 percent during 2007-08. This extends to 7 years the longest uninterrupted period of economic growth since PNG's independence in 1975. Growth remains broad-based, extending to both the extractive industry and the non-mining sectors, in particular construction and telecommunications. Some sectors such as construction appear to be operating at nearly full capacity. Although the share of formal sector employment in total employment is modest, it is growing rapidly.

Prudent macroeconomic management during the 2005-2008 commodity boom helped PNG build large buffers to cope with the global economic crisis. During the years preceding the crisis, the government prudently capped growth of government spending, saved windfall mineral revenues and paid off more expensive external debt. The non-mineral budget deficit, a key indicator of the fiscal stance in a resource rich economy, remained largely steady around 5-6 percent of GDP, close to the estimated long-term sustainable level. The overall budget was in a large surplus that peaked at 10 percent of GDP in 2007.

Care needs to be taken, however, in calibrating the fiscal response to the global economic crisis, given the already robust growth performance of the economy and the volatility of PNG's future mineral revenue stream. It is understood that one-fourth of the total savings in trust accounts, or 4 percent of GDP, were used to finance government spending in the first half of 2009. Assuming the expenditure trend from the first half continues, the non-mineral budget deficit may increase to 10-11 percent of GDP in 2009. Additional fiscal pressures may emerge over the medium term, including from government external borrowing to finance its stake in the PNG Liquefied Natural Gas (LNG) Project (see below) and meet substantial public investment commitments to landowners in conjunction with the project.

The prospect of a major extractive industry project – the PNG LNG Project – is also helping buoy PNG's economy. The project will be implemented by a consortium of international and domestic investors led by Exxon Mobil at an estimated cost of about \$17 billion, including finance charges, or more than twice PNG's annual GDP. The project is currently at the front-end engineering and design stage with the final investment decision expected by the end of 2009 and, assuming a positive decision, the start of production around 2014. The confidence boost to the private sector and consumer sentiment from the project combined with the inflow of substantial investment for design and early works have helped limit to an extent the negative impact of the global crisis on the PNG's economy.

The authorities responded well to the drop in external demand. The collapse of commodity prices in mid-2008

and the subsequent capital outflows reduced PNG's foreign exchange reserves from a high of \$2.7 billion in mid 2008 to less than US\$2 billion by early 2009. Following the tightening of monetary policy in late 2008 early 2009 and the somewhat delayed adjustment of the exchange rate, foreign exchange reserves have been stabilized and recovered to \$2.3 billion by September 2009. Tighter monetary policy also helped bring inflation under control after a peak of 13.5 percent year-on-year in the third quarter of 2008.

In the medium term, PNG is facing a significant volatility of its export and budget revenue base underscoring the need for continuing prudent fiscal management and expenditure smoothing as implemented in recent years. The PNG LNG project holds a major upside potential in terms of growth and revenues for the PNG economy, both during the construction stage (2010-13) and especially after production starts in 2014. As with other major natural resource projects, however, tax revenues from PNG LNG project are not expected to start flowing until the end of the next decade, several years after the start of production. Meanwhile, in the near term, PNG's revenues from existing extractive projects are projected to start declining. In particular, the Ok Tedi copper mine and South Highlands oil fields, which together currently account for more than a half of merchandise export earnings and government mineral revenue, are expected to come to natural depletion by around 2015.

Translating the strong macroeconomic performance and extractive industry revenues into a broad improvement in living standards remains a key challenge. Key policies need to include ensuring the integrity of the public financial management and adequate expenditures for sectoral service provision, improving efficiency of sectoral spending, strict control over the size and performance of the civil service, and transparency and accountability in budget management. Thinking also needs to start about setting up more robust institutional structures and mechanisms to save and use the windfalls from LNG and other commodities in the future.

Other structural reform priorities include stimulating private sector investment, particularly outside of the mining sector, increasing competitiveness and diversification. There has

been considerable progress in several areas of structural reform in PNG in recent years. In particular, opening markets in telecommunications and air transport in the past two years has produced major welfare gains for the population. Other priorities in the private sector development agenda are maintaining law and order, establishment of a level playing field and improvement in the business climate, especially through opening more markets to competition, commercializing parastatals, reducing the regulatory and licensing burden, clarifying property rights (especially for land). Developing infrastructure – electricity, telecommunications, road and other transport – through private sector involvement and greater efficiency of public investment – will also be important to support growth.

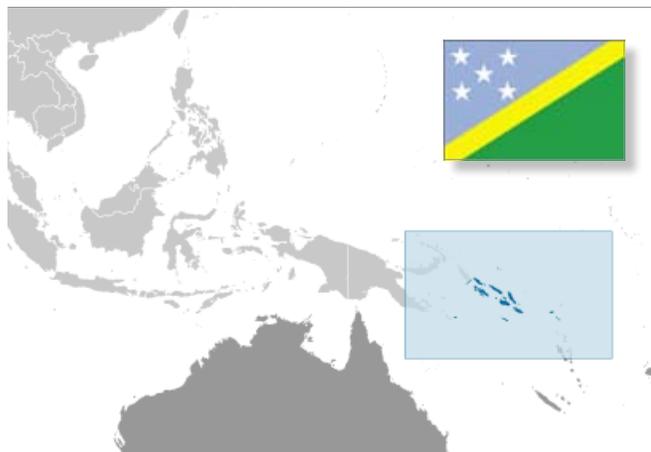
## SOLOMON ISLANDS

Population 495 thousand

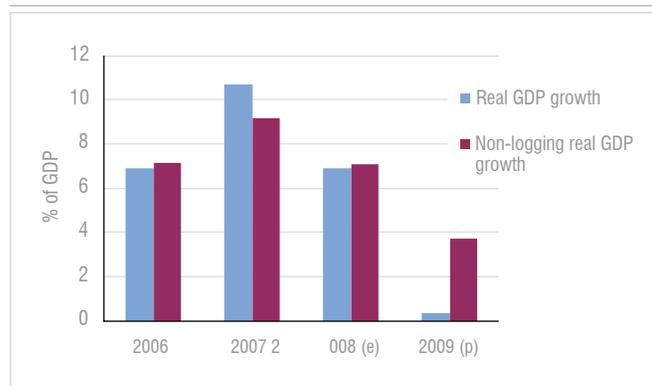
Population growth 2.3 percent

Surface Area 29,000 sq.km.

Capital Honiara



Solomon Islands: Sources of Growth (2006-09)



While the Solomon Islands (Sols) economy has proven relatively resilient over the past decade, weak external conditions along with declining timber production have dampened prospects for growth and export earnings. The relatively strong 2008 GDP growth of 6.9 percent was bolstered by a record harvest of logs, as well as strong demand and record prices for palm oil and copra. However, in 2009, growth is expected to reach only 0.4 percent, dragged heavily by a sharp contraction in the timber sector (the volume of timber exports fell by 32 percent year on year in the first seven months of the year); major floods which adversely affected agricultural production; a weak fisheries sector (the volume

of fish production fell by 17 percent year on year in the first seven months of 2009); and falls in commodity prices.

A supportive fiscal stance was targeted in 2009, but periodic cash shortages—in part caused by falling revenues—has at times impeded budget execution. The 2009 budget drawn up in late-2008 assumed that the government would finance an emerging deficit by drawing down its cash balances with the central bank to zero during this year. Unanticipated spending at the end of 2008, coupled with a shortfall in revenues in January, quickly reduced the government's cash reserves, leading the government to take measures over the past few months to conserve cash. These measures included a 10 percent cut in non-essential recurrent outlays, a freeze on civil service hires, an increase in selected import duties and excises, and a tightening of tax and customs exceptions. The fiscal balance is expected to slip into deficit of 0.4 percent of GDP compared to a surplus of 1.5 percent of GDP in 2008.

Growth is expected to recovery very modestly in 2010, but future prospects are damped by the imminent end of large-scale logging. Supported by improving conditions in Sols major East Asian trading partners as well as a rebound in palm oil and copra production, growth is expected to recover modestly to about 2.5 percent in 2010. However, with logging rates above sustainable levels since 1992, log exports are expected to fall by around 80 percent from present rates by 2013. This decline in logging activity is a significant drag on medium-term growth prospects. Mitigating sources of economic growth include the rehabilitation of the Goldridge gold mine, and prospects of nickel mining, from 2012 and 2015 respectively.

The current account is expected to remain under pressure, putting pressure on foreign reserves. Sols has seen a worsening trend in the external accounts where imports have almost doubled as a share of GDP from 27 percent in 2003 to almost 50 percent in 2008, and the current account has moved from broad balance in 2003 to a deficit 19 percent of GDP in 2008. Despite the effects of lower logging production, lower commodity prices have helped provide some cushion to the current account deficit, which is expected to narrow to 11 percent of GDP in 2009. Foreign exchange reserves have

been under pressure and fell below 3 months of import cover between October 2008 and March 2009. An uptick in exports in the second quarter (attributed to an increase in the value of log exports) combined with continued decline in imports (due to relatively low food and fuel prices, and lower freight prices) has provided some temporary relief. While reserves now provide over 4 months' import cover, risks remain on the downside.

Monetary conditions have tightened and banks have sharply curtailed credit growth due to declines in liquidity and increases in funding costs. Credit growth is projected to decline sharply from 26.5 percent in 2008 to 5 percent in 2009. Inflation is also expected to fall sharply from a peak of 25 percent year-on-year in mid-2008 to around 6 percent by the end of 2009 largely due to lower food and fuel prices.

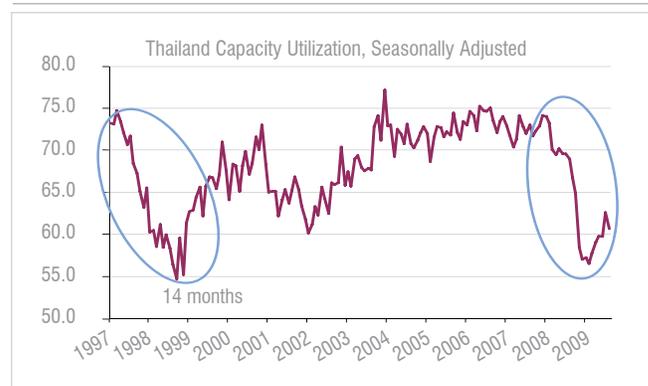
The imminent end of large scale logging will pose serious economic challenges for the nation and reforms which could generate sources of non-logging economic growth should be given priority. In addition, the government's cash position is under tremendous stress due to lower revenue than forecasted and weakness in cash management, which has resulted in spending in-arrears. Lastly, recent declines in foreign exchange reserves have highlighted the country's external vulnerability, which needs to be addressed in order to promote stability.

## THAILAND

|                   |                |
|-------------------|----------------|
| Population        | 64 million     |
| Population growth | 0.6 percent    |
| Surface area      | 513,000 sq.km. |
| Capital           | Bangkok        |



Thailand Capacity Utilization, Seasonally Adjusted



Thailand's economy is expected to contract by 2.7 percent in 2009, as recovery in the second half of the year helped partly offset the 6 percent decline in real GDP in the first half. Recovery from the impacts of the global economic and financial crisis began around midyear, when exports, industrial production and capacity utilization started a consistent upward trend after plunging in the first half of the year. The recovery is also evident in tighter labor market conditions, as firms have reported difficulties in quickly re-hiring the workers that were let go in the depths of the crisis. (Government policy may have partly contributed to this outcome, as some workers would rather take up government-

sponsored training or wait until their unemployment benefits run out). The recovery started later than in other countries in the region in part because of the relatively greater importance of the automotive sector, which has been more sluggish to recover, and in part due to a greater reliance on services exports, which have also lagged.

On the supply side, a contraction in manufacturing drove the large drop in real GDP since late 2008. Manufacturing represents 40 percent of value added, but has accounted for nearly 75 percent of the contraction in real GDP since the onset of the crisis. In just five months between October 2008 and February 2009, capacity utilization fell from about 70 percent to 55 percent (levels close to the troughs following the Asian Financial Crisis), while manufacturing production plummeted by 18 percent over the same period, more than the cumulative decline in 1997-98 over sixteen months. Capacity utilization and manufacturing production showed signs of rebounding starting in April, and by August both indicators were well above their lows, although still depressed compared to pre-crisis levels.

Household consumption grew by a seasonally adjusted 0.8 percent in the second quarter from the first and is likely to have quickened in the remainder of 2009 because of improved consumer sentiment. Household consumption, which is normally the least volatile item of GDP, contracted more than expected in the first half due to a combination of deteriorating employment prospects, declining prices of agricultural goods, and uncertainties from April's political turmoil. Since June, labor market prospects have improved, agricultural prices have stabilized, as did the political situation, thus supporting a pickup in consumption.

The outlook for private investment remains weak relative to the other components of expenditure. Capacity utilization is recovering, but at about 60 percent is still below the historical average of about 70 percent. Moreover, while business sentiment has risen from very low levels, recent results point toward more volatility. Inventories were drawn down substantially in the first half of 2009, but only modest restocking is projected to take place in the remainder of 2009.

Public investment surged in the second quarter, rising 11 percent in seasonally adjusted terms from the first, due to improved disbursements in public construction investments. Given the continued efforts to improve disbursements, as well as the ambitious public investment program under the government's second stimulus package, these large gains in the second quarter are likely to be maintained and public investment should continue to grow strongly in the remainder of 2009. Growth in public consumption should slow in the fourth quarter and into 2010, as the government switches the composition of the fiscal stimulus towards investment measures.

Exports of goods and services started recovering in May. Exports are expected to rise 7-8 percent a quarter in seasonally adjusted terms, mirroring the recorded monthly growth rates in July and August. Exports of services, mostly tourism, are recovering from a low base reflecting the airport closures in the fourth quarter of last year, but recovery is likely to remain subdued. Imports remain weak given only a modest pick-up in investment, consumption and exports. The authorities have limited appreciation of the baht against the dollar to the extent of the appreciation of other regional currencies, resulting in a very stable nominal effective exchange rate.

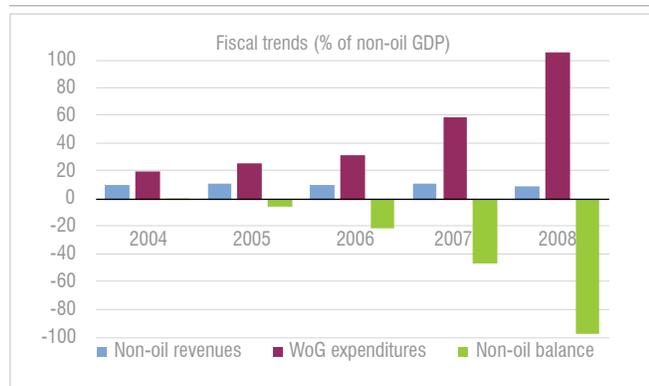
Substantial uncertainty remains for growth in 2010 given risks to the global outlook. Under the modest recovery in advanced economies assumed in this report, and assuming continued political stability in Thailand, real GDP growth should grow by about 3.5 percent in 2010. About 1-1.5 percentage points of the increase in output will be accounted by inventory accumulation, however. We continue to assume growth converges to potential by 2013, although export growth rates are lower than in recent years given the post-crisis outlook for the global economy.

## TIMOR LESTE

|                   |               |
|-------------------|---------------|
| Population        | 1.1 million   |
| Population growth | 3.1 percent   |
| Surface area      | 15,000 sq.km. |
| Capital           | Dili          |



Fiscal trends (% of non-oil GDP)



Source: Staff and Authorities' estimates

The global economic crisis has affected Timor-Leste largely through the reduction of oil and natural gas revenues. External linkages through non-energy trade, non-energy investment and financial markets are small. Economic activity remains buoyant on the back of government spending and the relatively large international donor and security presence. External and fiscal balances remain in surplus, although both are projected to narrow significantly in 2009 due to the drop in energy-related revenues and the rapid rise in government spending over the past two years. The deposits of the Petroleum Fund increased by more than 50 percent from a year earlier to \$5

billion in July 2009. This provides an important buffer against near-term shocks. The buffer has been supported by continued political stability, just as Timor-Leste celebrated ten years since its vote for independence on August 30. Challenges include ensuring the quality of public spending and improving competitiveness to attract much needed private investment in the non-oil economy.

Economic growth has been high over the past two years, reaching an estimated 12.8 percent in 2008. Data on economic output is limited but indications are that last year's buoyant growth was fuelled by increased private consumption and public investment in infrastructure. The value of imported capital goods (electrical machinery and other equipment used in construction) in the first two quarters of 2009 more than doubled from a year ago. Agricultural output rebounded in 2008 after a drought in 2007. Official statistics show that rice output in 2008 grew by 33 percent and maize output by 40 percent. Other than some limited growth in the tourism and services sector, private sector growth and investment remains constrained by a cycle of low skills, productivity and competitiveness.

Lending to the private sector has stagnated. Credit rose by 0.8 percent on average in the year to June 2009 to \$105 million. Total lending to the construction sector has dropped sharply by more than 50 percent since early 2008, but the decline has been offset by increased government construction spending. Lending to the tourism and services sector has increased by nearly 140 percent over the same period. Non-performing loans remain at a high level of about \$29 million since 2008. This does not pose a systemic risk because provisions are high; lending to the private sector is limited; the three commercial banks are all branches of foreign banks; and the domestic microfinance institution has capital adequacy well above the required minimum. The spread between lending and deposit rates has narrowed slightly but remains high at around 10 percentage points, reflecting private sector capacity constraints and associated risks.

Lower commodity prices and currency appreciation helped slow inflation from a high of 10.6 percent year-on-year in June 2008. According to official statistics, prices have fallen

by 3 percent in the year to June 2009, although the twelve-month average still shows a 5 percent increase. The real effective exchange rate (REER) appreciated sharply from mid-2008 to the first quarter of 2009 but has weakened more recently. The REER does not have a major impact on non-oil exports, which are small and constrained by other factors. Revenues from coffee exports – which account for nearly all non-energy shipments abroad – were up 36 percent from a year earlier, largely reflecting the increase in coffee prices. At the same time, imports of both consumer and capital goods have doubled in the first half of 2009 compared to the same period last year. As a result, the non-oil merchandise trade deficit has widened significantly to \$168 million in the first half of 2009 from \$92 million a year earlier.

Despite the rapidly growing trade deficit, the overall external balance remains strong, supported by the oil and gas sector. Total petroleum receipts for 2009 – that are recorded as service receipts on the balance of payments – are projected to decline due to the drop in oil prices. In 2008, petroleum revenues peaked at \$2.4 billion due to high international oil prices and a 15 percent rise in production volumes. Tax and royalty receipts in the second quarter of 2009 dropped by 30 percent compared to the previous quarter and by 35 percent year-on-year. Total revenue for 2009 is projected to amount to \$1.46 billion. Foreign direct investment (FDI) outside of the oil and gas sector remains very low. The final 2008 balance of payments statistics show a marked increase in inflows of foreign direct investment to \$38 million (7.6 percent of non-oil GDP) from \$8.7 million in 2007. Almost all of the increase is for an investment project in the oil and natural gas sector. The Portugal Telecom Group, majority shareholder in Timor Telecom, has indicated its intentions to invest \$54 million in 2009 to strengthen the telecommunications network.

Fiscal policy over the past three years has been expansionary, reflecting pressing needs and the government's objectives of promoting social stability and growth. Government expenditures rose from 32 percent of non-oil GDP in 2006 to 106 percent in 2008. Budget execution has improved significantly from 49 percent in 2006 to 80 percent in 2008, as has non-oil revenue collection. The latter remains low, however, at only about 11 percent of non-oil GDP. The

overall fiscal balance is in surplus, but is projected to narrow in line with rising spending. The non-oil deficit, meanwhile, is substantial, having increased from 46 percent of non-oil GDP in 2007 to 97 percent in 2008. Whilst this may not be an issue in the short-run, it may lead to less flexibility in the medium term to make fiscal adjustments if oil prices decline anew. Although budgeted spending for 2009 is above the Estimated Sustainable Income (ESI) from the Petroleum Fund, actual withdrawals to date have been within the ESI suggesting expenditure growth may be below the pace budgeted. The draft 2010 budget proposes a slight reduction in planned expenditure compared to 2008, partly through cuts in goods and services and minor capital, and intends to maintain withdrawals from the PF within the ESI.

Parliament recently approved an updated law on Budget and Financial Management. This includes a provision that would allow the government to borrow. Timor-Leste currently has no domestic or external debt. The fiscal deficit is financed entirely out of withdrawals from the Petroleum Fund. Borrowing at concessional rates may make sense if the cost is lower than the foregone income from the Petroleum Fund, taking account of the quality of proposed investments and debt management capacity. The government recently signed a Memorandum of Understanding with the Government of Portugal for a line of credit of up to €100 million per year, but actual borrowing is subject to parliamentary approval. The government is also implementing tax policy and administration reforms introduced in 2008, which contributed to a marked improvement in Timor-Leste's ranking in the 2010 Doing Business report (the country's overall ranking improved to 164th place from 173rd the previous year, but on the ease of paying taxes it surged to 19th place from 75th).

Maintaining fiscal discipline, ensuring the quality of public expenditure and improving productivity and competitiveness are the key challenges. The government has indicated its commitment to maintaining fiscal prudence. This is critical not only for fiscal sustainability, but also for ensuring the quality of spending given its rapid growth in a capacity constrained environment, which increases vulnerability to misuse. Without attention to the quality and prioritization of spending, continued fiscal expansion will have diminishing

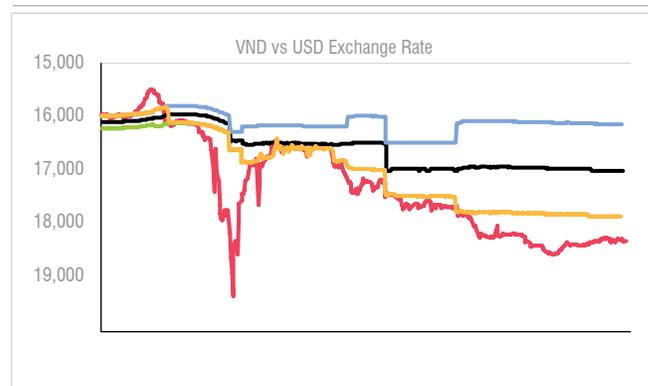
returns on economic growth. It may also impact adversely on productivity and competitiveness. In light of absorptive capacity constraints, the rise in public spending could create supply bottlenecks leading to inflationary pressures. Improving skills development, targeted investments in critical infrastructure and structural reforms such as liberalization of telecommunications will be important to promoting competitiveness and private investment.

## VIETNAM

|                   |                |
|-------------------|----------------|
| Population        | 85 million     |
| Population growth | 1.2 percent    |
| Surface area      | 329,000 sq.km. |
| Capital           | Hanoi          |



VND vs USD Exchange Rate



The global financial crisis and economic recession slowed economic growth in Vietnam. The international prices of commodities were on a declining trend since the third quarter of 2008, export orders for garments and other industrial products collapsed in the fourth quarter of 2008, and a slowdown in manufacturing became noticeable. The impact was apparent in the first quarter of 2009, when GDP increased only by 3.1 percent from a year earlier, or 4 percentage points below the average first-quarter growth for the last few years. However, positive signs of recovery have been emerging as a result of the government efforts to support economic activity. The government announced its stimulus package which

included various measures, from an interest rate subsidy, to tax breaks, and to additional capital spending. As a result, GDP grew by 4.5 percent in the second quarter and 5.8 percent in the third, raising real GDP growth to 4.6 percent year-on-year for January-September. While manufacturing sector is still facing tough challenges because of falling demand, the construction sector is a leading factor of the recovery, with value-added in the sector projected to reach a double-digit growth rate for the whole year. Domestic consumption is also an important factor of the recovery process, with retail sales increasing 9.3 percent in real terms during January-August from a year earlier. Even though the World Bank's forecasts a growth rate of 5.5 percent for 2009 as a whole, or more than 2 percentage points below the trend, we believe that Vietnam's economy navigated the crisis relatively well.

The global economic recession has had a significant impact on Vietnam's external sector. The main concern is the performance of exports that are equivalent to 70 percent of GDP. Over the first eight months of 2009, exports declined by 14.2 percent year-on-year in dollar terms. Export turnover is down across most items and most of Vietnam's traditional markets. This decline is less than in other developing countries, but could make 2009 the first year with declining exports since the beginning of Vietnam's economic reforms. The decline was even more dramatic for imports which fell 28.2 percent year-on-year in the first eight months of 2009. The relative decline in exports and imports helped narrow the trade deficit and the current account deficit. The latter is projected to be about 5 percent of the GDP in 2009, down from 11.9 percent in 2008. The actual level could be higher if the economy consolidates its current recovery. Although the projected current account deficit should be manageable, foreign exchange reserves declined from \$23 billion at the end of 2008 to about \$16.5 billion by August 2009. Most of the decline took place between May and July, when the central bank intervened in the exchange rate market to stabilize the currency.

The fiscal deficit is expected to widen to 9.4 percent of GDP in 2009, reflecting a decline in revenues and a significant increase in expenditures. Revenues are projected to fall in line with the slowdown in economic activity, lower oil prices

and various tax breaks included in the stimulus packages. Spending is up substantially because of stimulus expenditure measures and the government commitment to social spending to ensure social welfare provision. While Vietnam is able to call for some additional external financing, a sizeable financing gap remains and the government may need to reconsider its stimulus package to maintain the fiscal balance at a manageable level. However, it is noted that the main constraint to support the active fiscal stance of the government stems from short-term financing rather than from medium-term debt sustainability.

Monetary policy has been loosened substantially to support domestic demand after a period of tightening in 2008 to tackle overheating. The central bank cut its policy rate by half to 7 percent from mid-2008 to February 2009. The policy rate cut, together with the interest rate subsidy, has led to accelerated bank credit growth. Quantitative indicators of the quality of bank portfolios (based on days in arrears and rollovers) indicate that the fraction of non-performing loans (NPLs) is on the rise. Because the lending rate cannot exceed the policy rate by more than 50 percent, the margins of commercial banks are being seriously squeezed. Low interest rates also make it difficult for the government to issue bonds, and were associated with the reluctance of exporters to sell their foreign exchange. Recognizing emerging risks of the loosening monetary policy, the central bank recently asked largest commercial banks to cap their lending growth at 25 percent this year.

Poverty levels continued to fall in Vietnam, despite the sharp increase in food and fuel prices through the first half of 2008, followed by a period of sluggish growth in late 2008 and into 2009. While poverty fell in aggregate, the economic turbulence of the last two years highlighted a number of new vulnerabilities and continuing challenges. A Participatory Poverty Assessment (PPA) carried out in early 2008 in rural communities underscores Vietnam's considerable recent progress in rural development – PPA respondents noted substantial improvements in rural infrastructure, better access to services, rising agriculture productivity in many regions, and more opportunities to diversify rural income sources. The PPA and related studies also suggest some slow

recent progress in poorer regions with high concentrations of ethnic minorities. In addition, rapid assessments of the social impacts of the financial crisis carried out in February and April 2009 highlight growing vulnerabilities among specific populations, including Vietnam's high numbers of migrant workers, workers in the informal sector and household-based enterprises. Greater and more effective investment in education and the training of Vietnam's future workforce will help reduce vulnerabilities, as will the projected strong economic recovery and growing economic opportunities. However, Vietnam's social protection system remains underdeveloped in comparison to many other countries, a gap that will need to be addressed as the country moves forward.