



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

A Fine Balance



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Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
ASEAN-4	ASEAN members Indonesia, Malaysia, Philippines and Thailand
ASEAN-5	ASEAN members Indonesia, Malaysia, Philippines, Thailand and Vietnam
BIS	Bank for International Settlements
BOP	Balance of payments
CPI	Consumer price index
DECPG	Development Economics Prospects Group, of the World Bank
ECB	European Central Bank
e.g.	For example
EU	European Union
FAI	Fixed asset investment
FDI	Foreign direct investment
FY	Fiscal year
GDP	Gross development product
ICOR	Incremental capital output ratio
IMF	International Monetary Fund
IPO	Initial public offering
LIBOR	London inter-bank offer rate
LHS	Left-hand-side axis of the graph
MSCI	Morgan Stanley Capital International
MYR	Malaysian ringgit
NIEs	Newly-industrialized economies
OECD	Organization for Economic Cooperation and Development
PMI	Purchasing managers index
PPP	Purchasing power parity
qoq	Quarter-on-quarter
REER	Real effective exchange rate
RMB	Chinese renminbi
saar	Seasonally-adjusted annual rate
US	United States
US\$	United States dollar
WDI	World Development Indicators
WDR	World Development Report
WTO	World Trade Organization
RHS	Right-hand-side axis of the graph
SOEs	State-owned enterprises
TFP	Total factor productivity
yoy	Year-on-year

Countries

CHN	China
FJI	Fiji
HKG	Hong Kong, SAR China
IDN	Indonesia
KHM	Cambodia
KOR	Republic of Korea
LAO	Lao People's Democratic Republic (PDR)
MNG	Mongolia
MMR	Myanmar
MYS	Malaysia
PHL	The Philippines
PNG	Papua New Guinea
SLB	Solomon Islands
SGP	Singapore
THA	Thailand
TMP	Timor-Leste
TWN	Taiwan, China
VNM	Vietnam
AUS	Australia
CHL	Chile
NZL	New Zealand

Regions, World Bank classification

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

Preface and Acknowledgments

The *East Asia and Pacific Economic Update* was prepared by Antonio Ollero, Ekaterine Vashakmadze, and Jennifer Golan. The team worked under the guidance of Shubham Chaudhuri (Sector Manager, Poverty and Economic Management, East Asia and Pacific Region), Sudhir Shetty (Director, Poverty Reduction and Economic Management, East Asia and Pacific Region) and Bert Hofman (Chief Economist, East Asia and Pacific Region). Andrew Beath of the Chief Economist Office East Asia and Pacific coordinated the Office's contributions.

World Bank country economists throughout the East Asia and Pacific Region provided country write-ups and tables and assisted with the analysis. They include: Karlis Smits, Xiaofan Liu, Min Zhao, Xiaoli Wan, Ashley Taylor, Alex Sienaert, Magda Adriani, Fitria Fitriani, Frederico Gil Sander, Intan Nadia Jalil, Kai Kaiser, Karl Kenrick Tiu Chua, Marianne Juco, Paul Mariano, Kirida Bhaopichitr, Amornsak Mala, Nattaporn Triratanasirikul, Habib Rab, Viet Tuan Dinh, Enrique Aldaz-Carroll, Sodeth Ly, Genevieve Boyreau, Somneuk Davading, Keomanivone Phimmahasay, Tae Hyun Lee, Altantsetseg Shiilegmaa, Khwima Nthara, Douglas Addison, Virginia Horscroft, Tobias Hauqe, Lucy Pan, Timothy John Bulman, Hans Anand Beck, and Young Hwan Cha. The country economists worked under the supervision lead economists Chorching Goh, James Brumby, Mathew Verghis, Rogier J. E. Van Den Brink, Deepak Mishra, and Vivek Suri.

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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, 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, Philippines, Thailand and Malaysia.

Summary

The developing economies of East Asia and Pacific (EAP) remain resilient amidst a challenging global environment. Collectively, they grew by 7.5 percent in 2012, lower than the 8.3 percent growth recorded in 2011, but still higher than any other region. Because of weaker economic activity in the first half of the year due to depressed external demand and policy tightening as part of its rebalancing efforts, China's growth slowed to 7.8 percent in 2012 from 9.3 percent in 2011. But growth in the other developing economies of the region increased to 6.2 percent in 2012, up from 4.5 percent in 2011, due to strong domestic stimulus measures in the largest economies in EAP and reviving global demand in the second half of 2012.

Middle-income EAP—Indonesia, Malaysia, the Philippines, and Thailand—out-performed expectations, due to stronger than anticipated growth especially in the last quarter of 2012. Elsewhere in the region, growth impressed in the smaller states, but turned out mixed in the Pacific Island countries. Domestic demand supported growth across EAP with governments marshaling both fiscal and monetary policy to boost consumption and investment. External demand was a drag on growth in 2012 in most EAP economies. Consequently, current account surpluses deteriorated last year but international reserve positions remained strong, reflecting considerable capital inflows. Data in the first quarter of the year indicate that external weakness may be abating, while domestic demand remains resilient. Meanwhile, capital inflows continue to surge on loose monetary policies and deleveraging globally, while the region's financial markets remain solid.

Though the volatility leading up to the Cyprus bailout illustrates how fragile financial market confidence still is, and is likely to remain for considerable time to come, global financial market conditions have greatly improved since mid-last year. Although weak, there are signs of a turnaround in real activity in the high income countries. Our baseline projections for global growth are for a modest expansion of 2.4 percent in 2013, gradually strengthening to 3.1 percent in 2014, virtually unchanged from the outlook in December last year.

Within the region, available data in the first quarter of the year indicate that external weakness may be abating, while domestic demand remains resilient. The expectation of some stabilization in external demand, coupled with still resilient domestic activity, may be showing in the industrial production and Purchasing Managers Index numbers, which are generally positive. After declining through much of 2012, inflation has ticked up in a number of countries in the region in the first months of 2013.

Our growth forecasts for EAP for 2013 and 2014 remain roughly similar to those of December last year. We expect that with improving external conditions and strong domestic demand, regional growth will rise moderately to 7.8 percent in 2013 and then adjust back to 7.6 percent in 2014 and 2015, reflecting continued rebalancing in China. Policy-induced movements in some high-income currencies, in particular the yen, are likely to affect the dynamics of trade in manufactures in the EAP region in the short-term and will likely help cut trade deficits with Japan, developing EAP's largest import source and fourth largest export market.

Both the global and regional outlooks are subject to several risks, most of which are by now familiar. The likelihood of a serious crisis of confidence in the Euro Area has declined significantly since mid-last year,

but remains a factor to consider as does policy uncertainty in the United States, where possible fiscal deadlock could yet affect the US and the global economy. And while a progressive decline in China's unusually high investment rate is expected over the medium-term, an unexpectedly rapid disorderly unwinding could have significant consequences, particularly for developing commodity exporters and for the EAP region.

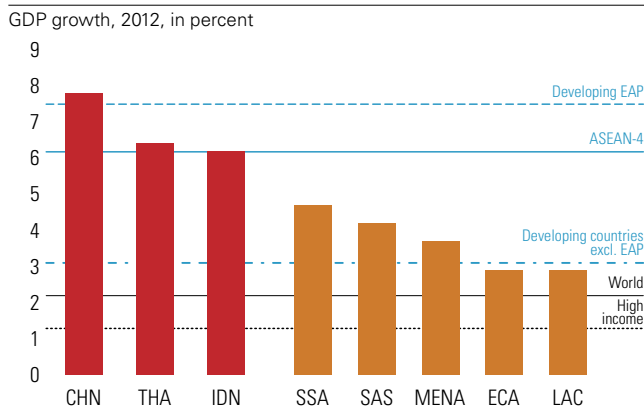
Though the developing economies of East Asia are generally well-prepared to absorb external shocks, an emerging concern is the risk of over-heating in some of the larger economies in the region. The latest numbers suggest that if global demand continues to revive and the recovery in the global economy is more robust than expected, these economies may be reaching the limits of their productive capacity. Continued demand-boosting measures, which have helped sustain growth, may now risk stoking inflationary pressures and amplifying the credit and asset price risks that are emerging in the context of a strong rebound in capital inflows.

Policy makers in developing EAP should strive to strike the right balance between managing the near-term risks, and sustaining and increasing inclusive growth in the medium-term by enhancing the underlying productive capacity—human and physical—of these economies. That means, above all, investing in infrastructure and in the skills of the growing labor force. Middle-income EAP countries have to raise levels of investment, as these remain below the median for middle-income countries globally, and have to improve on the quality of investment, as investment efficiency has declined in most. Moreover, developing EAP must strive to improve productivity, the growth of which has stagnated since mid-last decade.

Recent Developments

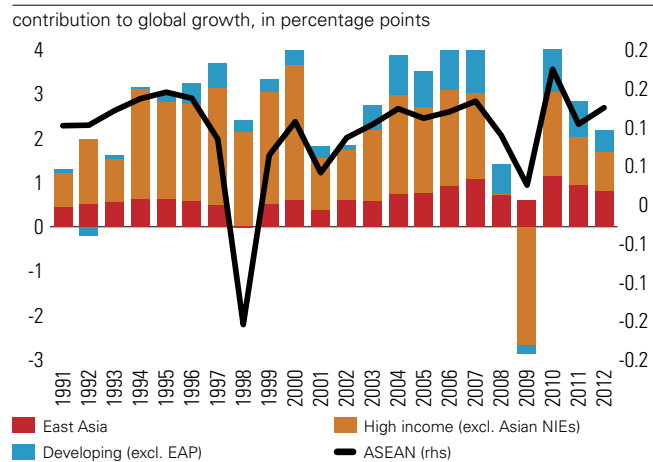
The developing economies of the East Asia and Pacific region grew by 7.5 percent in 2012, lower than the 8.3 percent growth recorded in 2011, but still higher than that of any other region. Because of weaker economic activity in the first half of 2012 due to depressed external demand and policy tightening as part of its rebalancing efforts, China's growth slowed down to 7.8 percent in 2012 from 9.3 percent in 2011. But growth in the other developing economies of the region increased to 6.2 percent in 2012, up from 4.5 percent in 2011, due to strong domestic stimulus measures in the largest economies and reviving global demand in the second half of 2012 (Figure 1). Specifically, growth in the ASEAN countries increased to 5.4 percent in 2012, up from 4.5 percent in 2011. And the region as a whole continued to be an engine of global growth, contributing around 40 percent of global growth in 2012 (Figure 2).

Figure 1. East Asia remained the fastest growing developing region in the world...



Source: World Bank staff estimates.

Figure 2. ...and an engine of global growth during the global turmoil



Source: World Bank staff estimates.

Middle-income EAP—Indonesia, Malaysia, the Philippines, and Thailand—outperformed expectations, due to stronger than anticipated growth in the second half and especially the last quarter of 2012. The Philippines led the ASEAN-4, accelerating from 3.9 percent GDP growth in 2011 to 6.6 percent in 2012, spurred by robust private consumption, a recovery in government spending, strong performance of the construction sector and of exports. Thailand rebounded strongly from the devastating floods of 2011, posting a historic 18.9 percent growth in the fourth quarter last year, a performance slightly exaggerated by base effects, but V-shape sharp nevertheless. GDP growth in Thailand was 6.4 percent for the full year, compared with 0.1 percent the year before. Malaysia's GDP growth rose a half percentage point higher than baseline expectations, chalking up a 5.6 percent growth rate on strong investment activity buoyed by election spending. Indonesia stayed resilient, with 6.2 percent growth in 2012, slightly lower than the 6.5 percent growth in 2011, but the same as in 2010. China slowed down as it moved to rebalance internally from an overdependence on investment to a greater reliance on consumer demand. Policymakers engineered a soft landing, countering global headwinds with looser monetary conditions that benefited investment, notably in property, a central government stimulus that boosted construction and manufacturing, and a surge in local government investment. Vietnam slowed

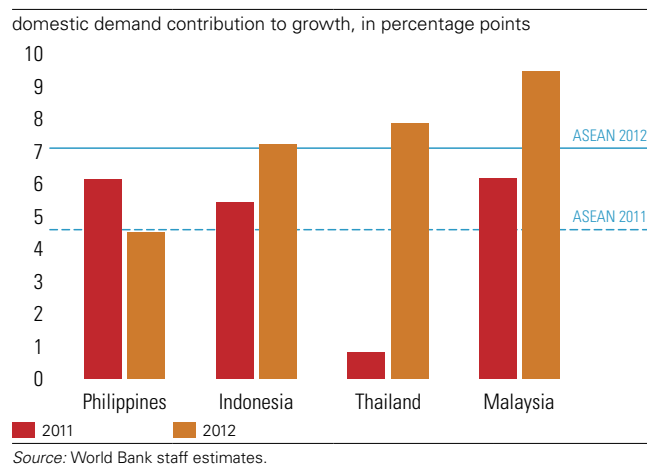
to a thirteen-year low 5.0 percent growth. Stabilization policies helped avert a macroeconomic crisis, reducing inflation, strengthening the fiscal and external accounts, stabilizing the exchange rate, but lowering growth.

Elsewhere in the region, growth impressed in the smaller states, turned out mixed in the Pacific Island countries. Cambodia grew faster than expected, at 7.3 percent, bolstered by the strong performance of agriculture, construction and tourism and a recovery in garments. Lao grew faster than last year, at 8.3 percent, driven by robust investment in the non-resource sectors and a notable rise in mining output in the fourth quarter (reflecting the completion of a new gold mine). Mongolia was one of the fastest growing economies globally, expanding 12.3 percent, following the first-phase development of the Oyu Tolgoi mine project, a revival in agriculture, and steady growth in construction. Backed by political and economic reforms, growth accelerated in Myanmar to 5.5 percent in 2011/12 and an estimated 6.25 percent in 2012/13. In the Pacific Island economies, where growth has averaged 2.0 percent in the past twenty years, the performance was mixed. The Marshall Islands, supported by rising fisheries exports, stayed on this average at 2.0 percent. Samoa, struck by a major cyclone, grew only at an estimated 0.9 percent.

Domestic demand supported growth across the region (Figure 3).

Consumption rose on the back of higher household income in China, government cash transfers and pay increases in Malaysia, strong remittances in the Philippines, and government social spending in Thailand. Real disposable income of urban households rose by more than 9 percent in China in 2012, supporting final consumption. Private consumption expanded 7.7 percent in Malaysia, bolstered by salary increases and bonuses for civil servants and MYR 2.34 billion of cash transfers that were distributed to almost 70 percent of all households. Remittances grew 6.3 percent in the Philippines in 2012, sustaining private consumption, which expanded 6.1 percent. The country reported an expanding base of remittances, with the number of workers deployed overseas increasing to 1.8 million in 2012 from 1.68 million in 2011. In Thailand, household incomes received a boost from the introduction of a new minimum wage in six provinces in 2012. Other policy measures, including incentives for auto purchases, also boosted consumer spending. Private consumption rose 3.4 percent in the year, from 0.5 percent in 2011.

Figure 3. Growth was supported by strong domestic demand



Investment strengthened significantly in most of middle-income EAP. Investment was boosted by FDI in Indonesia, catalytic public enterprise investment and infrastructure spending in Malaysia, and post-flood reconstruction in Thailand. FDI continued to flow at a rapid pace in Indonesia, topping 2.3 percent of GDP on a gross basis, and 1.6 percent in net terms, in 2012. Fixed investment grew 9.8 percent in Indonesia last year, contributing 2.4 percentage points to overall GDP growth of 6.2 percent. In Malaysia, large investments by non-financial public enterprises, especially Petronas, catalyzed private investments in the oil and gas and real estate sectors, complementing a pick-up in infrastructure investments funded by the budget and through government guarantees. Fixed investment surged 19.9 percent in Malaysia last year and contributed 4.7 percentage points to GDP growth of 5.6 percent. Post-flood reconstruction efforts jump-started investment activity in Thailand in 2012. Some ambitious water management projects are still to be launched and progress on these should keep investment activity on a high gear in the near to medium term. Fixed investment grew by 13.3 percent in

Thailand last year and contributed 2.9 percentage points to GDP growth of 6.4 percent. In both Malaysia and Thailand, gross investment boosted growth proportionately more than consumption did.

Governments marshaled both fiscal and monetary policy to boost consumption and investment. Fiscal support came from central government deficits and more — off-budget spending, state-owned enterprise activity, and local government investment. Accommodative monetary conditions spurred credit growth, and not just from depository institutions but from the shadow banking system as well.

Fiscal policy remained supportive of domestic demand, with most governments adopting expansionary fiscal policies in the year. Fiscal deficits (in percentage of GDP) generally increased last year from their levels in 2011 (Figure 4), although the size of the deficits remained a fraction of those at the height of the global financial crisis in 2009. In China, where the central government fiscal deficit was held to 1.5 percent of GDP, versus 1.8 percent of GDP in 2011, fiscal support came from higher local government spending. In Indonesia, the actual fiscal deficit, 1.8 percent of GDP, was narrower than the planned 2.2 percent of GDP. But energy subsidies rose to almost a third of total central government spending, reaching 3.7 percent of GDP in the year, from 3.4 percent in 2011. In Malaysia, fuel subsidies were also a major contributor to government spending in Malaysia at 2.7 percent of GDP. The fiscal deficit was 4.5 percent of GDP, only slightly lower than the 4.8 percent of GDP in 2011. In Thailand, spending on measures to boost consumption increased the fiscal deficit to 3.2 percent of GDP in 2012. The government's rice pledging scheme, by which it buys rice from farmers at prices higher than the world market, has its costs: it could help push government debt toward the 60 percent-of-GDP statutory ceiling.

Figure 4. Fiscal policy has been expansionary, including through SOEs and off-budgets

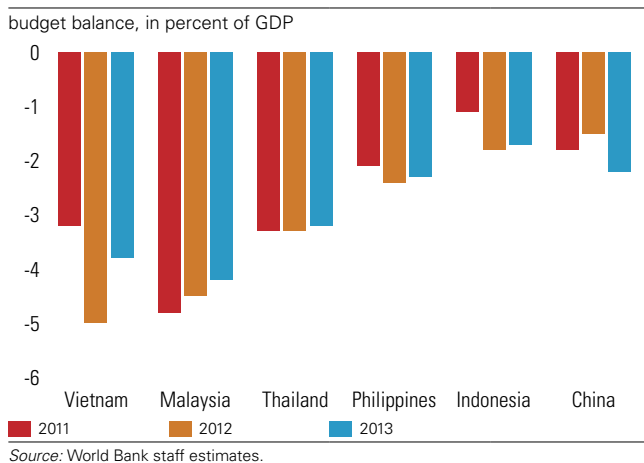
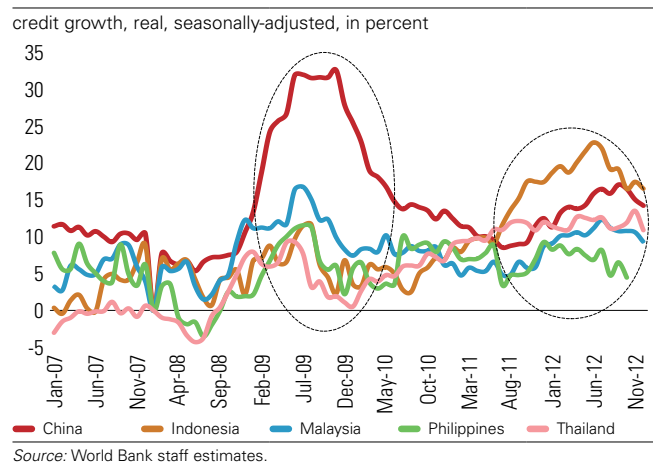


Figure 5. Credit growth has been strong



Monetary policy continued to be accommodative. Most central banks cut policy rates in the year. Malaysia was the exception, staying on hold as robust domestic demand and strong credit growth offset concerns about external weakness. Vietnam cut rates the most, by 600 basis points between March and December. Bank credit remained anemic in Vietnam, however, barely growing 9 percent in the year, versus a target of 15 percent, spurring the central bank to slash rates another 100 basis points in March this year. Elsewhere, however, bank credit expanded robustly, particularly in China and Indonesia (Figure 5). In China, bank loans did not breach the RMB8.5 billion target for the year, but “social financing,” or off-balance sheet bank lending expanded. Inflation remained generally under control in the region, decelerating on an annual basis in 2012 to half the rates the year before in China, Malaysia and Vietnam. Recently, though, prices have started to crawl

back up, with headline inflation higher in the fourth quarter last year than in the third and higher in February than in January. In Indonesia, headline inflation accelerated to 5.9 percent in March. Although some of the recent increase in prices, which has been driven by a handful of food items, is expected to fade, inflation in 2013 may remain close to the top end of the central Bank's 3.5–5.5% target band due to higher minimum wages, pass-through from currency movements, and reforms in some administered prices, principally electricity.

External demand was a drag on growth in 2012 in most EAP economies, with the exception of the Philippines. Global imports by the European Union fell, from \$2.4 to \$2.3 trillion, while those by the United States and Japan remained essentially flat, at \$2.3 and \$0.9 trillion respectively. Imports by China, the world's third largest importer after the European Union and the United States, rose the least (at 4.4 percent) in the three years since the global financial crisis, adding to global trade woes. Across the region, export growth rates fell to single-digits and net exports posted negative contributions to growth (Figure 6). In Malaysia's open economy (with an export to GDP ratio exceeding 100 percent in most years), net exports deducted 3.8 percentage points from overall growth last year. In Indonesia, whose share of exports in GDP (25 percent) is much lower, but two thirds of that is commodities or commodity-based manufacturing, net exports deducted 1.5 percentage point from 2012 growth. The numbers confirm that the downturn in trade last year was broad, affecting both manufactures and commodities.

Figure 6. Net exports deducted a few percentage points from growth, except for the Philippines

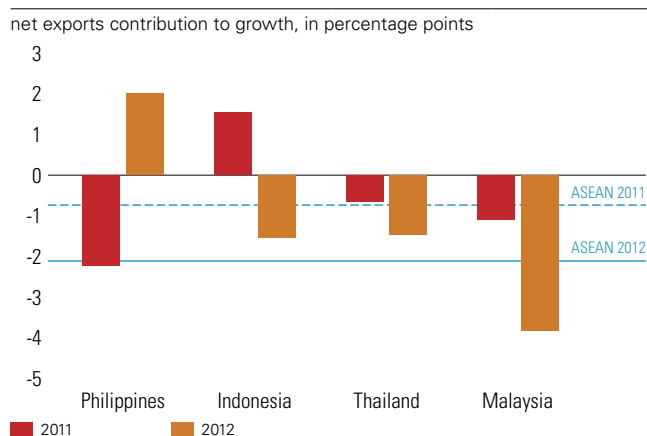
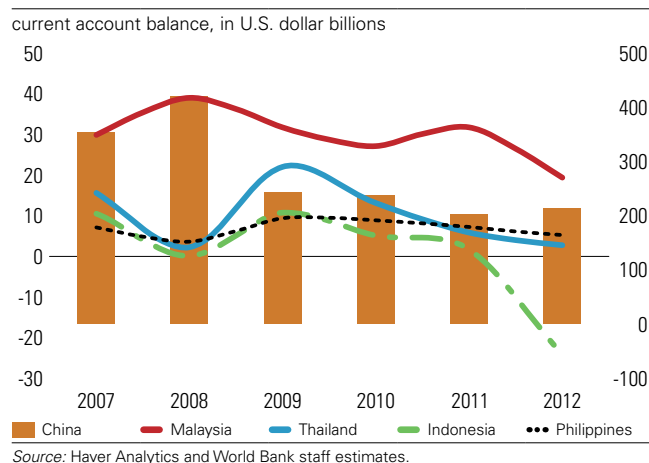


Figure 7. Current account surpluses have declined, and Indonesia recorded a deficit



Current account surpluses fell in the region last year, the result of a weak external environment and strong domestic demand growth in the ASEAN-4 countries. The combined current account surplus in the ASEAN-4 contracted by \$40 billion, or by 70 percent, in 2012 compared to 2011 (Figure 7). Most of this decline consisted of a \$26 billion, or 3.0 percent of GDP, adjustment in Indonesia, reflecting a record trade deficit of \$1.7 billion on weak external demand for the country's coal, tin and palm oil commodity exports and strong growth of fuel imports supported by price subsidies. Among the region's small economies, Mongolia's current account deficit was a large 31 percent of GDP because of high foreign investments in mining, Lao's was 16 percent, and Cambodia's was 11.5 percent. In China, the current account surplus stabilized at 2.6 percent of GDP last year, following the sharp decline from a 2007 peak of 10.1 percent of GDP to 2.8 percent of GDP in 2011. The adjustment was largely due to a lower trade surplus and reflected the combined effect of weak external demand, strong domestic investment (which lifted imports), worse terms of trade, and a stronger real exchange rate.

International reserve positions remained strong across the region, reflecting considerable capital inflows. Net FDI flows amounted to 1.6 percent of GDP in Indonesia. Net portfolio investment more than doubled to 6.4 percent of GDP in Malaysia and 1.0 percent of GDP Indonesia and increased by a third to 1.3 percent of GDP in Thailand. Net bank flows reversed to net inflow of 2.6 percent of GDP in Thailand from a net outflow of 2.2 percent of GDP the year before. China upped its international reserves by \$128 billion; Malaysia, the Philippines and Thailand, by \$6 billion each; and, Indonesia, by \$3 billion. The reserves continue to serve as buffers against a possible deterioration in the external environment.

Available data in the first quarter of the year indicate that external weakness may be abating, while domestic demand remains resilient. Recent trade data (Figure 8 and Figure 9), hold out some hope that the downturn in exports may have bottomed out. Caution remains warranted, though, in part because data for the first two months of the year reflect lunar year effects in East Asia with spikes in January and washouts in February. Countries in the region which are more deeply integrated in regional and global supply chains will gain the most from a rebound in global trade (Box 1). Meanwhile, indicators of domestic consumption and investment remain generally firm. In China, retail sales rose 10.4 percent year-on-year in the first two months of the year. Retail sales picked up 13.9 percent year-on-year in February in Indonesia from 8.2 percent in January. Retail sales averaged 21.7 percent growth in January-February this year in Thailand from 8.3 percent in the same period a year ago. Growth in car sales has cycled down in Thailand as the effects of the first car buyer incentive program—which spurred sales to an 80.9 percent growth last year—wind down. In contrast, car sales remain strong in the Philippines, with a 48 percent year-on-year growth in January and December, and in Indonesia, with 26.5 percent year-on-year growth in January and 19.4 percent in February. In China, fixed asset investment grew faster in January and February than in December last year. And construction investment is still growing, around 20 percent year-on-year in Thailand and the Philippines in January and 8 percent in Indonesia.

Figure 8. Exports are starting to rebound although the momentum is uneven

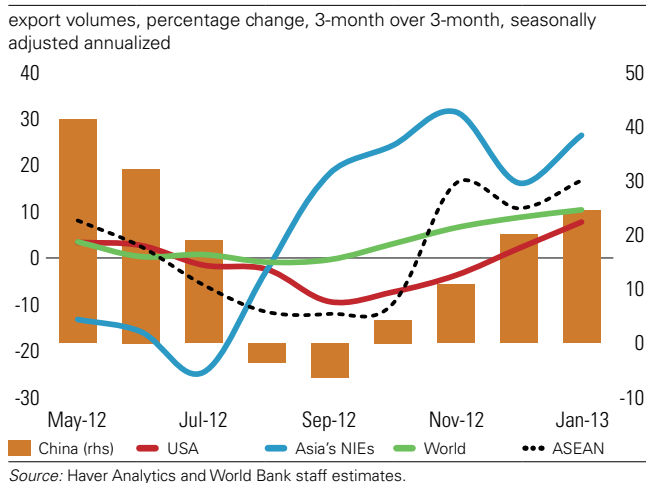
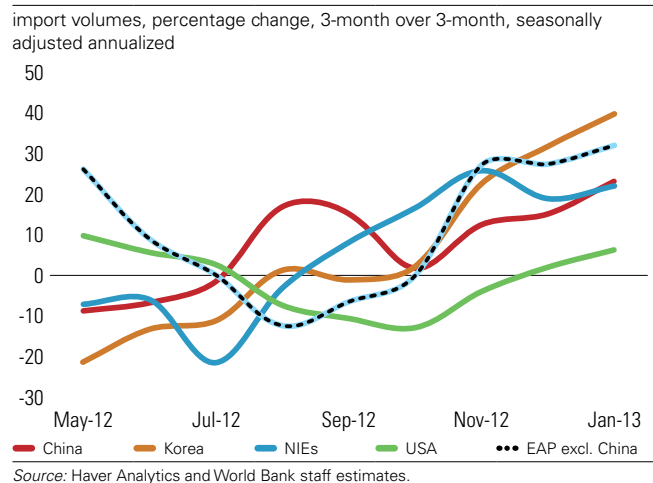


Figure 9. Imports are rapidly rising on the back of strong domestic demand



Overall, the industrial production and Purchasing Managers Index (PMI) numbers—indicators of output and sentiment respectively—are generally positive. An uptick in external demand, or at least the signs of some stabilization in external demand, coupled with still-resilient domestic activity, may be showing up in the industrial production and Purchasing Managers Index (PMI) numbers. Industrial production rose 2.8 percent in January from December on a month-on-month seasonally-adjusted basis in the Philippines (an 18.5 percent

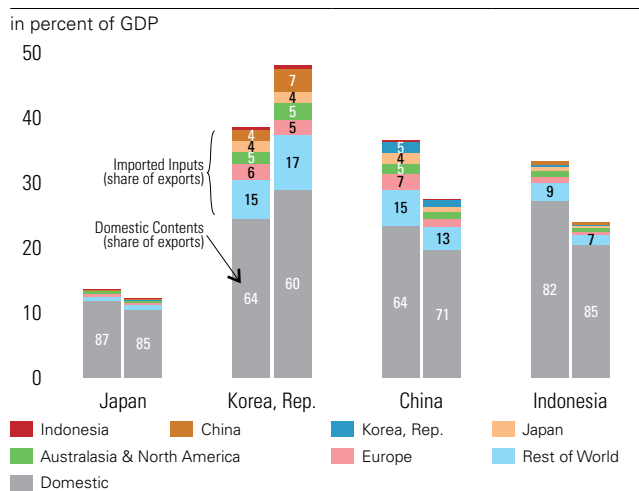
Box 1. Value Added in Trade

The recently-published OECD-WTO Trade in Value Added (TiVA) database allows the identification of origins of value added in country exports. Measuring trade flows in value-added terms provides a more accurate assessment of an economy's position in global supply chains by eliminating the over-counting that occurs with complex cross-border production processes and by quantifying the value-added of both domestic production and trade partners. For example, while China's gross export statistics record the full \$178.96 shipping price of an iPhone, domestic value added is only \$6.50, with the remainder accounted for intermediate goods and services imported from abroad.¹

The origins of value added in exports by Japan, South Korea, China, and Indonesia in 2005 and 2009 are shown in Box Figure 1. Of the four countries, China and South Korea exhibit relatively high exports to GDP ratios and relatively deep integration into global supply chains. Japan and Indonesia, on the other hand, are less integrated into global supply chains, but for different reasons: Japan possesses integrated domestic production processes, which accounts for the low imported component in exports, whereas Indonesia's exports is increasingly dominated by unprocessed or semi-processed commodities, which require little in terms of imported inputs. While the export share of GDP for Japan, China, and Indonesia fell between 2005 and 2009—potentially due to the effects of the global financial crisis—South Korea exhibited not just an increase in its export share, but also a deeper integration into global supply chains.

The analysis of sources of value added is a relatively new dimension to trade analysis, but is already providing some important insights. The analysis well underscores the links between import and export performance, by demonstrating the extent to which the exemplary export performance of economies such as China and South Korea is anchored in complex global supply chains. Countries that seek to curb imports of various commodities, thus, may be inadvertently limiting their export potential by discouraging the entry of firms into such global supply chains. And countries that have challenges in the logistics of import and exports may well exclude themselves from such global supply chains and therefore limit trade's contribution to growth.

Box Figure 1. Value Added in Exports, Select EAP Countries



Source: OECD and WTO.

1 Xing, Y. and Detert, N., 2010, "How the iPhone widens the United States trade deficit with the People's Republic of China", Asian Development Bank Institute Working Paper No. 257, December.

year-on-year rate) and 1.3 percent in Indonesia (an 11.5 percent year-on-year rate). The year-on-year gains are more modest but still positive in Malaysia (4.5 percent) and Thailand (10.2 percent), although the month-on-month outturns have reversed, an indication that the boost from last year's policy action is winding down (Figure 10). In China, the PMI, which fell to 50.4 in February (an index reading of 50 and above indicates expansion) from its two-year high of 52.4 percent in January, has bounced back 51.7 in March (Figure 11). In Indonesia, the

Figure 10. The real sector rebound follows different patterns across the region

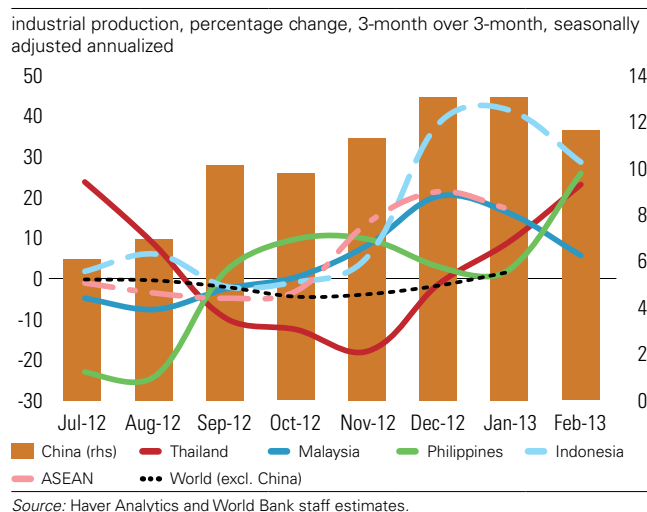
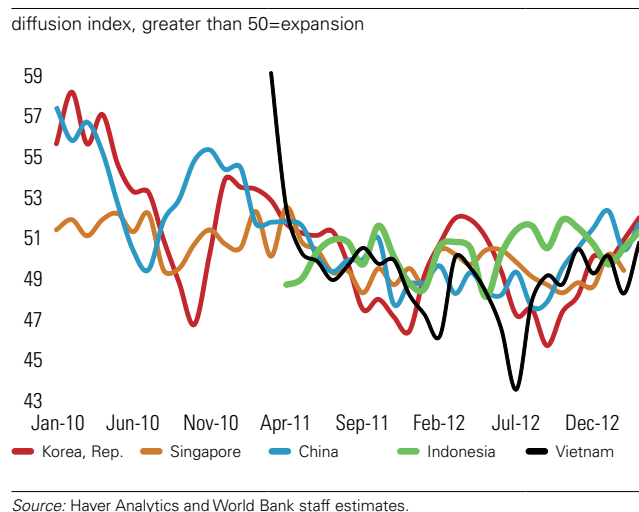


Figure 11. PMIs are on the uptick



PMI picked up to 50.5 in February from 49.7 in January. In Vietnam, the PMI slid to 48.3 in February from 50.1 in January.

Meanwhile, capital inflows continue to surge on restored investor confidence and less bank deleveraging globally. Gross capital flows to the region rebounded strongly to \$46.8 billion in the first quarter of 2013, up 86.3 percent from a year ago (Figure 12 and Table 1). Equity flows more than doubled from \$5.6 billion in the first quarter of 2012 to \$13.2 billion in the first quarter of 2013. Banks loans increased 77.6 percent, including from the United Kingdom, France, the Netherlands and Germany as well as from China, Japan and the Asian NIEs, reflecting less intense deleveraging. Bond flows increased 67.5 percent, featuring public offerings in China and the ASEAN-4. Southeast Asia, including Malaysia, Indonesia and the Philippines, overtook North Asia in initial public offering (IPO) issuance in the first quarter on strong investor appetite for the rapidly expanding economies. On a monthly basis, capital flows to EAP eased in February and March to a monthly average \$11.7 billion after hitting a five-year record high \$23 billion in January, but the January number includes an extraordinary \$13 billion cumulative bond issuance.

Figure 12. Capital flows to the region are on the upsurge

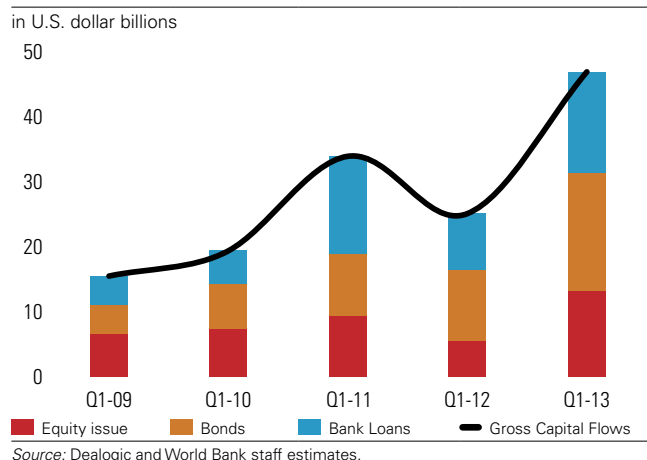


Table 1. East Asia and Pacific: Capital Flows

in U.S. dollar billions

	Gross Capital Flows	Equity Issues	Bond Issues	Bank Loans
2009	96.3	55.7	19.2	21.3
2010	144.3	87.3	26.3	30.7
2011	116.1	39.5	33.0	43.6
2012	139.9	49.5	49.6	40.9
Q1-09	15.5	6.5	4.5	4.4
Q1-10	19.4	7.4	6.8	5.2
Q1-11	33.9	9.4	9.5	14.9
Q1-12	25.1	5.6	10.8	8.7
Q1-13	46.8	13.2	18.1	15.5

Source: Dealogic and World Bank staff estimates.

The region's financial markets remain solid. The regional stock market composite, the MSCI AC Far East (excluding Japan) Index, slid 0.7 percent in the first quarter this year, but it remains 15.2 percent higher than its 2012 low of May last year. By contrast, the global emerging market benchmark, MSCI Emerging Market Index, has lost 2.6 percent year-to-date and is only 12.8 percent higher than in May last year. The performance varies across markets in the region, with the Philippines (up 19.0 percent from December), Vietnam (18.7 percent), Indonesia (15.1 percent), and Thailand (14.0 percent) posting the largest gains. Bonds in the region are more mixed, with the 10-year local-currency government issues rising in the Philippines and Vietnam but falling in Indonesia and Thailand. The benchmark 10-year government bond yield has dropped the most (125 basis year-to-date) in the Philippines, which earned its first investment-grade credit rating ever in March (the new "BBB-" credit rating from Fitch Ratings applies to the country's foreign currency -denominated long-term debt). The yield has also dropped in Vietnam, by 90 basis points year-to-date, on solid demand for government bonds from banks, which have slowed lending. Meanwhile, the yield has increased by 38.5 basis points year-to-date in Indonesia, where headline inflation topped 5.9 percent in March. Currency markets are relatively stable with most exchange rates appreciating or depreciating nominally against the U.S. dollar by an average 0.5 percent since the end of last year. The Thai baht has appreciated the most, by 4.1 percent since end-December. Inflows into Thailand's asset markets are quite large and continue to provide support to the currency.

Outlook and Risks

Global financial market conditions have greatly improved since mid-last year. Three policy factors have underpinned confidence in the financial markets: the extension of quantitative easing in the United States; the agreement on regional banking institutions in the European Union and the European Central Bank commitment to support the Euro; and the announcement of a higher inflation target in Japan. Gross capital flows to developing countries bounced back strongly in the second half last year, rising 17 percent from 2011 to a record \$530 billion in 2012. Developing country bond spreads have declined by 86 basis points since June and are now well below their long-term average. Additionally, developing country stock markets have increased 9.8 percent since mid-last year. Recently, though, volatility following the Euro Area finance ministers' decisions on support for Cyprus illustrates how fragile financial market confidence still is, and is likely to remain for considerable time to come, as developed countries reform their economies and financial systems.

Although economic activity in high income economies is still weak, there are signs of a turnaround in real activity. GDP declined in the fourth quarter in most of the G-7, dropping as much as -2.6 percent in the European Union, but the weakness appears to be easing. High-income country industrial production is now falling at a -2.2 percent annualized pace, compared to a 5.0 percent drop in the fourth quarter last year. Purchasing Managers Indices (PMIs) are on the rise and sentiment among German businesses reached an eleven-month high in February. Trade is also picking up in the high-income economies with exports expanding at a 5.6 annualized pace in January, including 7.2 percent in the European Union. Meanwhile, output and sentiment remain strong in the developing countries. Industrial production in developing countries outside of China strengthened to an annualized pace of 4.6 percent in the three months through January from zero percent in October. PMIs in developing countries outside of China have also been rising and are now at their highest levels since April 2011. Imports in developing countries outside of China are expanding at a 20.1 percent annualized pace in January.

Baseline projections for global growth are for a modest expansion of 2.4 percent in 2013, gradually strengthening to 3.1 percent in 2014, virtually unchanged from the outlook in December last year. For high-income countries, fiscal consolidation, high unemployment and still weak consumer and business confidence will continue to weigh in on activity in 2013, but growth should firm to 2.0 percent in 2014. For developing countries, improved financial conditions, a relaxation of monetary policy and somewhat stronger high-income growth will prompt an acceleration of growth to 5.4 percent this year and to 5.7 percent in 2014. The baseline outlook also envisions a recovery in global trade starting in 2013, with the volume of trade in goods and nonfactor services rising 5.8 percent in the year and 6.6 percent in 2014 from 3.1 percent in 2012.

Our growth forecasts for EAP for 2013 and 2014 are roughly similar to those we made in December last year. We are lowering our forecasts for China and Indonesia but only very slightly—by a tenth of a percentage point in each country (Table 2). In Indonesia, the new forecast assumes continued strength in consumer spending but some moderation in real investment growth, from 9.6 percent in 2012 to 8.0 percent in 2013. We are upgrading our forecasts for Malaysia and Thailand, prompted by stronger outcomes in the fourth quarter last year in both countries. In Malaysia, a number of capital projects that contributed to the surge in investment in the first half of 2012 will continue to contribute a larger amount of value added to the economy in the near

Table 2. East Asia and Pacific: GDP Growth Projections

percent from a year earlier

				Forecast	Forecast	Changes from Dec-2012 forecast (in percentage points)	
	2010	2011	2012	2013	2014	2013	2014
East Asia	9.3	7.1	5.8	6.5	6.7	-0.1	+0.1
Developing East Asia	9.7	8.3	7.5	7.8	7.6	-0.1	0.0
China	10.4	9.3	7.8	8.3	8.0	-0.1	0.0
Indonesia	6.2	6.5	6.2	6.2	6.5	-0.1	-0.1
Malaysia	7.2	5.1	5.6	5.1	5.4	+0.1	+0.3
Philippines	7.6	3.9	6.6	6.2	6.4	0.0	0.0
Thailand	7.8	0.1	6.4	5.3	5.0	+0.3	+0.5
Vietnam	6.8	6.0	5.0	5.2	5.7	-0.3	0.0
Cambodia	6.0	7.1	7.3	7.0	7.0	+0.3	0.0
Fiji	0.1	1.9	2.1	2.2	2.3	0.0	0.0
Lao, PDR	8.5	8.0	8.3	7.6	7.7	+0.1	+0.2
Mongolia	6.4	17.5	12.3	13.0	11.5	-3.2	-0.7
Myanmar	5.3	5.5	6.3	6.5	6.6	0.0	0.0
Papua New Guinea	7.6	9.0	8.0	4.0	7.5	0.0	0.0
Solomon Islands	7.8	10.5	3.7	4.0	4.0	0.0	+0.7
Timor Leste	9.5	10.6	10.6	10.4	10.2	+0.4	+0.2
Memo: Dev. East Asia exc. China	7.0	4.5	6.2	5.7	6.0	0.0	+0.2
Memo: ASEAN	8.0	4.5	5.4	5.4	5.7		
Assumptions about the global environment							
World	4.0	2.8	2.3	2.4	3.1	-0.1	0.0
High-income countries	2.9	1.7	1.3	1.3	2.0	-0.2	0.0
Developing countries	7.5	6.0	4.9	5.4	5.7	-0.1	-0.1

Source: World Bank data and staff estimates.

term. In Thailand, the recovery last year from the historic floods in 2011 will continue into this year. We are keeping our outlook for the Philippines unchanged but reducing our forecast for Vietnam. In the Philippines, the fundamentals remain strong, policy responses have been appropriate so far, and reform efforts by the government appear sustainable. In Vietnam, growth is likely to remain moderate in the year given structural problems in the financial sector and in state-owned enterprises that have yet to be decisively addressed.

The prospects for the region's small economies have markedly improved, although last year's strong performance will not likely be matched this year. We are upgrading our forecasts made in December last year for Cambodia and Lao. Most output gains in mining would have been realized from the completion of the new gold mine project in Lao PDR last year, but the Nam Ngum 5 and the Theu Hinboun hydropower expansion projects will also start commercial operations this year, providing some lift to growth. In Cambodia, a likely stabilization in high-income country conditions should support further improvements in garment production and exports. Projections for Mongolia are more difficult to pin down, as recent growth has to a considerable extent been driven by the progress in major mining projects. The government forecast of an 18.5 percent growth this year will be hard to achieve, in light of the uncertainty surrounding the start date of production in the Oyu Tolgoi mine. In Myanmar, we expect the reform momentum and continued improvements in the international environment to drive growth gradually to 6.5 percent in 2013/14 and 6.6 percent in 2014/15. The government recently enacted a new foreign investment law, removed licensing requirements on imports and exports, and cleared the country's arrears with the ADB and the World Bank, resulting in the resumption of lending by the two institutions to Myanmar. We are upgrading our outlook for Timor-Leste for 2013 and 2014 to match the government projections. Public spending dominates growth, contributing 7 percentage points to

nonoil GDP growth of 9.5 percent in 2010, according to new national accounts data; and spending for 2012–16 has increased nearly 10 percent in real terms. Meanwhile, the outlook for the Pacific Island economies are not much changed from historical growth levels: Fiji, 2.2 percent in 2013; Kiribati, 2.5 percent; Marshall Islands, 2.0 percent; Samoa, 2.0 percent; and, Vanuatu, 3.2 percent.

Movements in some high-income currencies could affect trade and investment flows in the region in the short-term. Japan's policy effort to support growth—featuring the adoption of a higher inflation target last January and the switch toward an open-ended asset purchase program starting in 2014—has led to a depreciation of the Japanese yen by 19.7 percent in real effective terms from July last year to March. The weaker yen is mirrored in the region's currencies' strength, notably Thailand (8.8 percent real effective appreciation since July), Korea (6.7 percent), and Singapore (4.8 percent). Continued depreciation of the yen could affect the dynamics of trade in manufactures in the region in the short-term, as Japan is the region's largest source of imports and its fourth largest export market (Figure 13). Competitors of Japanese exporters in third markets, principally Korea (electronics, motor vehicles, and scientific equipment), may experience competitive pressures in the short term. On the other hand, suppliers of parts and components to Japan in regional production networks, like Thailand (motor vehicle parts) and to a lesser extent the Philippines (electronics and machinery parts), may benefit from advances made by Japanese exporters in global markets and gain even more from potentially larger Japanese FDI. More general, if Japan manages to escape its deflation and rekindle growth with the measures taken, all developing economies in the region would benefit through higher exports.

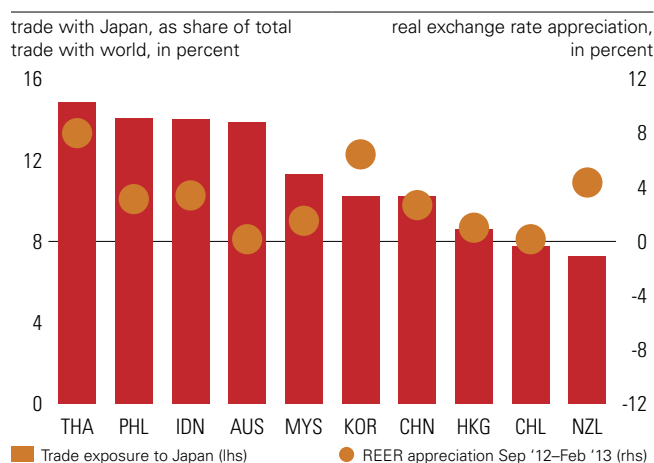
The external headline risks to the regional outlook are similar to those of the past few years, but the probability that the worst-case scenarios will materialize has declined. The likelihood of a serious crisis of confidence in the Euro area, which could trigger a freezing up of financial markets bloc-wide, has declined significantly. A series of national and European Union-wide efforts to reduce fiscal deficits, to initiate pan-European schemes for a banking union and foreign rescue funds and to strengthen regional institutions has helped reduce headline risks. Moreover, the European Central Bank's commitment to do whatever it takes to preserve the Euro has reduced chances on a worst-case outcomes. Fiscal policy uncertainty remains in the U.S., with a breach of the debt ceiling and full sequestration being clearly downside risks. But the worst case scenario—one involving a loss of confidence in the U.S. dollar—now seems unlikely.

Unconventional policy responses by the advanced economies to persistent bouts of economic weakness have, however, generated a set of subsidiary risks to emerging economies. Near zero interest rates and new and protracted rounds of quantitative easing in the United States, European Union, and Japan are inducing large capital inflows into emerging markets including in East Asia. Portfolio flows have close to tripled in Indonesia in the past year on a net inflow basis and have doubled in Malaysia, reaching as much as 6.4 percent of GDP in the latter. The risk of an asset boom in the markets, in which global liquidity spills over is emerging, with asset valuations moving ahead of fundamentals and possibly a correction down the road. Stock market indices have surged by 56 percent in the Philippines and by 48 percent in Thailand in the past 14 months alone. Large capital inflows are also exerting upward pressure on the region's currencies. Most policy responses to contain excessive inflows have drawbacks on macroeconomic and financial stability. Unsterilized intervention creates excessive liquidity and feeds inflation, whereas sterilization keeps interest rates high and attracts more inflows, while capital controls are leak-prone and distort capital flows.

China's internal rebalancing poses continued risk to the regional outlook. The government has set an indicative GDP growth rate target of 7.5 percent for the coming years. There are, however, domestic headwinds buffeting the government-managed slowdown: risks in the property sector, in the financial system, and in

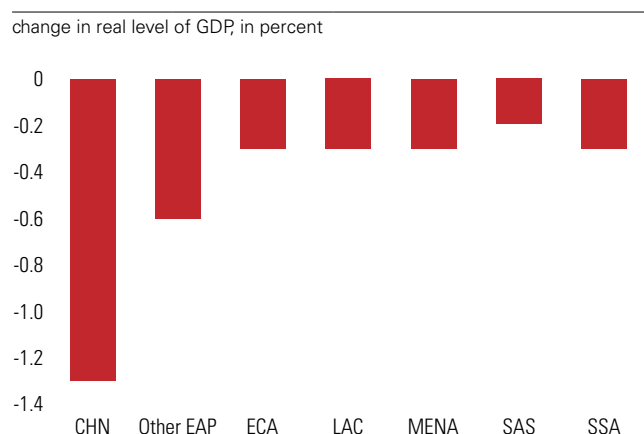
local government finances. A sharper than expected slowdown in China would affect East Asia in particular (Figure 14), reducing the region's aggregate GDP by 1.3 percent should the growth of investment in China drop by 5.0 percentage points. It would drag down exports in the rest of the region and would particularly affect commodity exporters—suppliers to China's investment-heavy growth model—through both lower Chinese commodity import volumes and softer international commodity prices. However, government-influenced investment and urbanization-related reforms are likely to keep growth in China above target in the next two years. Moreover, risks in the property sector, in the financial system, and in local government finances appear to be manageable. Strong credit growth will take some pressure off troubled property developers. The financial system is still strong enough overall to absorb potential losses, including in the shadow banking system. And, the central government has the fiscal buffers to assume ownership of problem assets of indebted local governments.

Figure 13. Countries supplying Japan with parts and components may benefit from a weakening Yen



Source: World Bank staff estimates.

Figure 14. Prospects are vulnerable to an abrupt decline in Chinese investment



Source: World Bank, Global Economic Prospects, January 2013.

Note: The simulations attempt to measure the effect on GDP of a precipitous 5 percentage point decline in investment by China.

Though the developing economies of East Asia are generally well-prepared to absorb external shocks, an emerging concern is the risk of over-heating in some of the larger economies. The latest numbers suggest that if global demand continues to revive, the major East Asian economies may be reaching the limits of their current productive capacity. Comparisons of actual against potential output indicate that the output gap—a measure of how much slack there is in the economy—has virtually been closed or has narrowed last year, although to varying degrees, in China, Indonesia, Malaysia and the Philippines (Table 3). Actual output will

Table 3. East Asia and Pacific: Output Gap

actual GDP minus potential GDP, in percent of potential GDP; - = slack

	China	Indonesia	Malaysia	Philippines	Thailand	Vietnam
2010	2.01	0.06	-0.81	0.52	0.52	-0.15
2011	1.94	0.73	-0.32	-0.36	-2.99	-0.29
2012 /e	0.74	1.19	-0.17	0.01	-2.22	-0.56
2012	0.65	1.19	0.24	0.48	-0.84	-0.81
2013 /f	0.06	1.40	0.77	0.73	0.75	-0.71
2014 /f	-0.48	1.70	0.85	0.97	1.81	-0.60

Source: World Bank staff estimates.

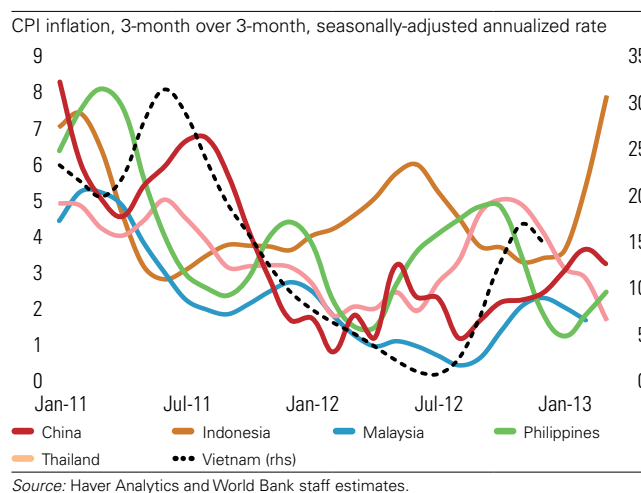
e = estimate, in December 2012

f = forecast, in April 2013

likely outpace potential in Thailand this year if the forecast GDP growth rate of 5.3 percent is achieved. This implies that governments may have overplayed fiscal and monetary policy last year.

Continued demand-boosting measures may now be counterproductive. Countercyclical demand policies have helped sustain growth, but they may now risk stoking inflationary pressures and amplifying the credit and asset price risks that are emerging in the context of strong capital inflows into the region. Inflation rates had fallen last year, until the third quarter in China, Thailand and Vietnam and until the fourth quarter in Indonesia, Malaysia and the Philippines, but, with the exception of Thailand, they are clearly all cycling up early this year (Figure 15). In China, although the headline rate remains under the central bank target of 3.5 percent, price pressures are mounting. The inflation momentum reached a 3.6 percent annualized rate in the three months to February, the highest since October 2011, and 3.3 percent in the three months to March. In Malaysia and Thailand, currency appreciation combined with broadly stable commodity prices has helped curb inflationary pressures so far, despite expansionary fiscal policies. In Indonesia, inflation has recently increased rapidly, with the headline rate reaching 5.9 percent year-on-year in March, and the inflation momentum accelerating to a 7.8 percent annualized rate in the three months to March. Much of this recent increase has been driven by a handful of food items which have been subjected to trade restrictions, alongside a rise in administered electricity prices. While these factors should prove temporary, with food price pressures in particular likely to abate following policy responses to the recent price increases and the beginning of the harvest season, there is a risk of second-round effects filtering into inflation from cost-push pressures due to the relatively weak Rupiah, higher minimum wages and the possibility of additional energy subsidy reforms. In Vietnam, inflation accelerated to double digit rates in the last months of 2012 following a significant fall-off earlier reflecting stabilization measures.

Figure 15. Inflation remains in check across the region but price pressures are building-up



Monetary easing and the fiscal stimulus since the global financial crisis, coupled with surging international capital flows from global liquidity, has resulted in the accumulation of debt in the region. General government debt has expanded from 41.2 percent of GDP in 2007 to 53 percent in 2012 in Malaysia, from 38.3 percent to 44.2 percent in Thailand, and from 19.6 percent to 22.2 percent in China. More significant than the growth of government debt has been the expansion in corporate and household debt (Figure 16). Combined non-financial corporate and household debt has grown from 113.6 percent of GDP in 2007 to 126.4 percent in 2012 in Malaysia. Non-financial corporate debt is now 126.4 percent of GDP in China, up from 113.6 percent five years ago. And household debt is now 63.4 percent of GDP in Thailand, up more than 15 percentage points from 2007, and 29.2 percent of GDP in China, up more than ten percentage points from 2007. Meanwhile, external debt is now relatively high for some of the region's small economies (Figure 17). This buildup in debt warrants careful monitoring of domestic credit creation and cross-border debt flows, and where appropriate, use of macro-prudential measures in the financial system.

Beyond the risks affecting the region as a whole, EAP economies face idiosyncratic risks. In Indonesia, an erosion of consumer real purchasing power through higher inflation, higher consumer and investor borrowing

Figure 16. The sum of general government, non-financial corporate and household debt now exceeds 150 percent of GDP in Malaysia, Thailand, and China

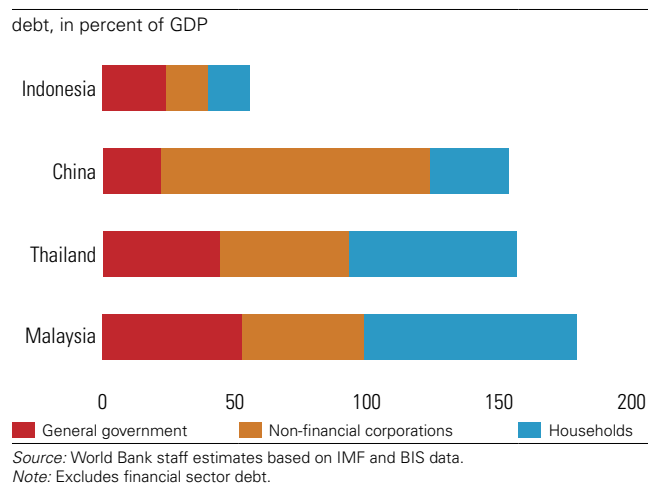
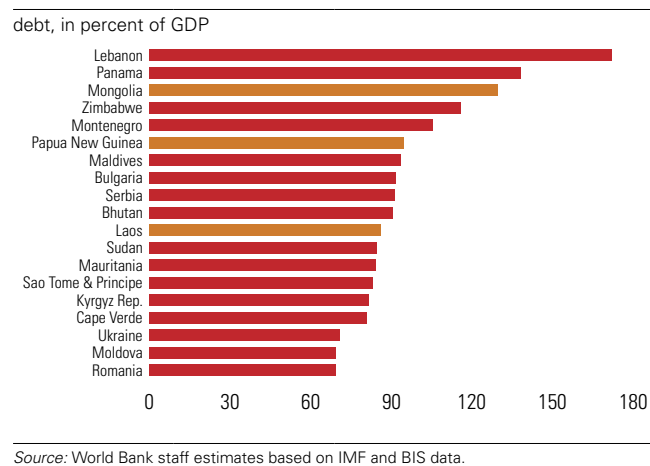


Figure 17. External debt is high in Mongolia, Papua New Guinea and Lao PDR



costs from tightened policy, weaker commodity markets, and regulatory uncertainties and uncertainties related with the 2014 elections may all negatively affect private investment spending. A halving of investment growth to 5.0 percent in 2013 would reduce GDP growth by one percentage point. In Malaysia, lower international commodity prices would reduce export earnings; and, post-election fiscal consolidation could disrupt the growth momentum. The Philippines is concerned with asset bubbles in the stock market and in the housing sector. Vietnam faces several downside risks: core inflation is still high at 11 percent; foreign reserves are still low by international standards; asset quality in credit institutions is worsening; public debt could rise sharply if some contingent liabilities in the banking sector and SOEs are realized; and delayed implementation of restructuring of banks, SOEs, and public investment will could affect investors' confidence.

Policy Considerations

Policy makers in developing EAP have successfully navigated the global financial crisis and maintained high growth. There are, however, a number of short- and medium-term challenges that need to be addressed. Policy makers need to strike the right balance between managing the near-term risks and sustaining and increasing inclusive growth in the medium-term by enhancing the underlying productive capacity—human and physical—of these economies. For managing short-term risks, three areas of policy are relevant.

First, as the global economy recovers, countries where output gaps are closing, inflationary pressures are rising, asset markets are heating up, credit growth is surging, and debt is quickly building up, could gradually withdraw policy stimulus. For countries that show signs of inflationary pressures, it would be a good time for policy buffers.

Second, several countries in the East Asia region need to manage renewed strong capital inflows. Maintaining an appropriate macroeconomic stance and sufficient flexibility in the exchange rate and applying macroprudential measures to ensure these flows do not fuel asset bubbles are priorities. The bulk of capital flows into China and Indonesia are still in the form of FDI. But portfolio flows are sizable in Malaysia, comprising 6.4 percent of GDP in 2012 on a net basis, up from 2.9 percent of GDP in 2011, leaving the economy vulnerable to asset price risks and flow reversals. In Thailand, bank flows have expanded significantly, comprising 2.6 percent of GDP in 2012 in net terms, twice the size of portfolio flows into the country. Consequently, the Thai authorities would need to be aware of the risk of rapid credit expansion on the back of those flows.

Third, countries in the region have to remain prepared for possible disruptions in the global economy. Commodity export dependent countries, some of which are in East Asia, would in particular be well advised to prepare for possible disruptions in global growth. Rebuilding policy buffers for fiscal and monetary policy action when needed would pay off, notably for those countries that currently show some signs of overheating. A good example of that is the Philippines, where the government is gradually rebuilding the tax base through administrative reforms, which increased from 12.3 percent of GDP in 2011 to 12.9 percent last year. Recent passages of the long-awaited “sin tax” reforms will further strengthen revenues and increase the country’s fiscal space in case of need.

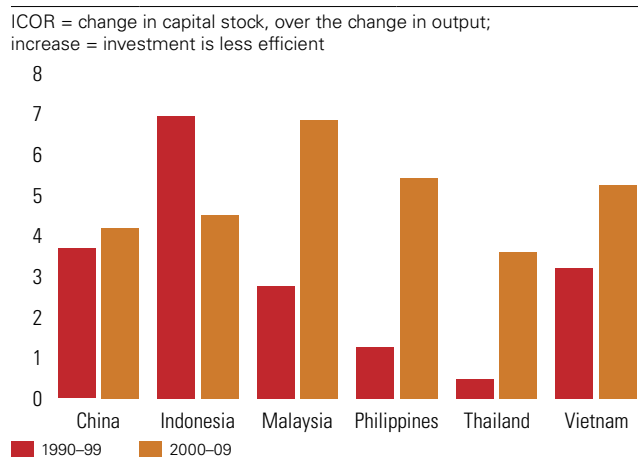
The challenge that the developing countries of East Asia face in the medium-term is to ensure that growth is sufficiently inclusive. In 2012, the number of people living under PPP\$2 a day was 512 million. A decade earlier in 2002, the number of poor was 959 million. This means that the number of poor (less than PPP\$2 per day) in the developing countries of EAP has gone down by about half a billion. While many of those who have risen out of poverty still remain vulnerable, nearly 600 million are now in what might be considered the lower middle-class and another 200 million are solidly in the middle class. Given the region’s growth dynamism, the middle class in East Asia is likely to grow dramatically in absolute terms in the coming decade, and it is likely to be largely urban. The challenge is to ensure that growth is sufficiently inclusive, so that inequality does not rise too fast, that lagging regions and segments of society share in the region’s increasing prosperity, and that the middle class grows equally as a share of the population.

For sustaining and increasing inclusive growth in the medium-term, the underlying productive capacity—human and physical—has to be increased, and that means, first and foremost, investments both in infrastructure and in skills. Since the Asian financial crisis, investment in physical capital has declined significantly in most of middle-income EAP. On average in the past decade, the levels of investment have remained below the median for all middle-income countries (27.6 percent of GDP in 2000–11) in the Philippines (20.4 percent of GDP), Malaysia (23 percent), Thailand (26 percent) and Indonesia (26.3 percent). In the Philippines, lagging infrastructure development is a long-standing impediment to private investment. And in Indonesia, where aggregate investment has now recovered to its levels in the mid-1990's, the public investment ratio remains among the lowest in the region and infrastructure gaps are cited in most business surveys as major constraints to greater private activity.

Raising the levels of investment would raise growth prospects in developing EAP. The focus differs across the middle-income economies. In Indonesia, an open investment and trade regime will make it more attractive to foreign investors. Malaysia is currently boosting investment through large-scale projects under the Economic Transformation Program. But wide ranging structural reforms remain necessary to sustain investment levels. In the Philippines, catching up on government infrastructure spending will provide the fiscal spark that is still missing in the country's growth path, although infrastructure spending is gearing up recently: in 2012 it was equivalent to 2.4 percent of GDP, up from 1.6 percent of GDP in 2011. In Thailand, rebuilding manufacturing facilities and public infrastructure, following recent disasters, is necessary to restore the country's productive base.

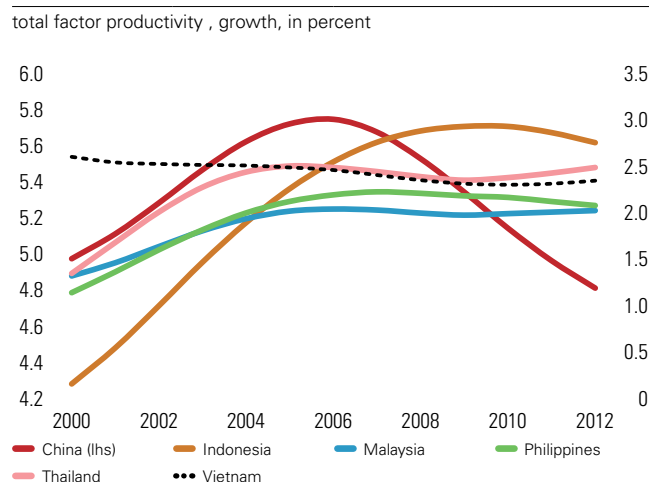
Pursuing productive investment is as important as raising the level of investment. Investment efficiency, measured in terms of the investments needed for an increase in GDP, has deteriorated in the last decade in Malaysia, the Philippines, Thailand and Vietnam (Figure 18). In all cases, countries have to emphasize quality investment. In China, measures of the efficiency of investment did not change markedly in the 2000s, but has deteriorated in recent years. The country's quality investment could well constitute the core of the internal rebalancing effort. As China's policymakers de-emphasize investment and seek a greater reliance on consumer demand for growth, they must ensure that the investment that is pursued is productive and efficient. In

Figure 18. Investment efficiency—measured by incremental capital output ratios (ICORs)—has deteriorated, except in Indonesia



Source: World Bank staff estimates.

Figure 19. Productivity growth has stagnated since mid-last decade



Source: World Bank staff estimates.

Vietnam, further rationalization of the state owned enterprises (SOE) sector should help improve investment project selectivity even if it scaled back aggregate investment spending.

Beyond raising the level and quality of investment, the region must regain its focus on improving productivity. Higher total factor productivity remains the most sustainable source of faster growth as the contributions of investment and higher labor participation eventually diminish. But productivity gains, which generally improved in middle-income EAP in the aftermath of the Asian financial crisis, have either declined or stagnated since the middle of the last decade (Figure 19). At its core, raising productivity will require continued reforms in the region's product and factor markets, improvements in governance and in the business climate, and investment in infrastructure and human development.

A Fine Balance

