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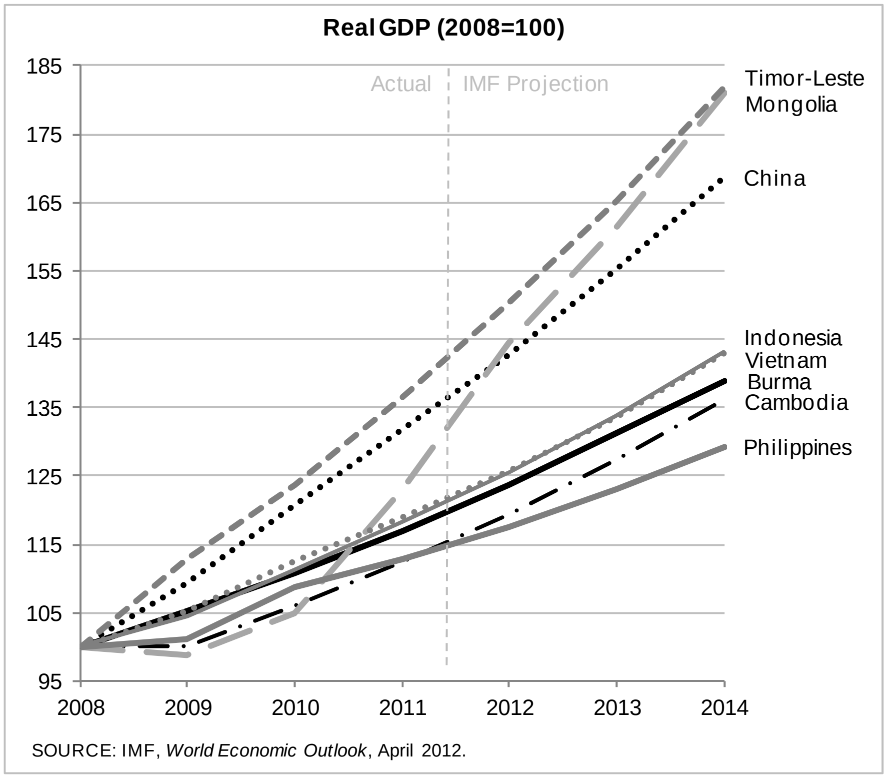
EADS Economic Trends Report
East Asia

May 2012

Economic Overview



SOURCE: IMF, *World Economic Outlook*, April 2012.

Evidence of softening external demand has trimmed the economic growth forecasts for East Asian economies, but the pace of expansion remains strong. Chinese domestic demand powers the region's economy, most countries have scope for some policy easing, and Asian banks have the capacity to increase lending. In five out of the eight East Asian countries covered in this report, the IMF has reduced the real GDP forecast for 2012 from its September 2011 report. The typical growth rates, however, remain faster than in any other region of the world.

The fastest growing East Asian economy is Mongolia, with the IMF now expecting real GDP to rise by more than 17 percent in 2012 and 12 percent in 2013. The Mongolian economy remains heavily reliant on mineral exports and when prices rise, the economy surges at a rapid pace. The present double-digit growth rates reflect large infrastructure spending in the mining sector and higher government spending. Gross capital formation, for example, was up by about 60 percent in 2011. One side effect of the galloping growth rate is double-digit inflation and one major risk is the lack of fiscal reserves to cushion a downturn in commodity prices. Mongolia's export growth has been heavily dependent on Chinese demand, pointing to another vulnerability in the economic outlook.

China's economic growth will remain among the fastest in East Asia through 2014, supported by strong corporate profits and rapidly growing household incomes. A transition from export-led growth to a pattern of strong investment (both domestic and foreign), rising government expenditures, and resilient domestic consumption is well underway.

By contrast, the export sector remains the key growth factor for the Cambodian economy. A soft outlook for economic growth in Europe and the United States implies that Cambodia's economic growth will be limited during the next few years.

Indonesia and the Philippines have been hit by weaker demand for their exports, but domestic demand remains relatively robust, so economic growth will remain in the 4–7 percent range in both 2013 and 2014. Indonesia's 6.5 percent growth rate in 2011 was a milestone of sorts, being the fastest growth rate since prior to the 1997–

East Asian countries included in this report are Burma, Cambodia, China, Indonesia, Mongolia, Philippines, Timor-Leste, and Vietnam. Because of limitations on data, not all countries are included in every graph or narrative section.

1998 Asian financial crisis. Growth would have been even faster, but food crop production (particularly paddy rice) was down for the year. In the Philippines, growth has been boosted by domestic consumption, which in turn has been strengthened by a rise in remittances from overseas workers.

Stronger exports are offsetting weaker domestic demand in Vietnam. Inflationary pressures eroded household incomes and the government has been cutting back on capital spending.

Burma's economy accelerated in 2011, boosted by investment spending in hydropower, natural gas, and oil, as well as by foreign tourism in the wake of political reforms. The growth factors offset lower agricultural output caused by flooding.

Timor-Leste's economy is hitting double-digit growth both in 2011 and in the projected rates for 2012 and 2013, thanks to fiscal stimulus as the government spends a large stream of oil revenues from offshore production.

World Bank Income Groups

Out of the eight East Asian countries covered in this report, only one is classified as upper-middle income (China) and five are lower-middle income (Indonesia, Mongolia, Philippines, Timor-Leste, and Vietnam). The remaining two (Burma and Cambodia) are low income countries.

As the IMF notes, a possible constraint on economic growth in East Asia and elsewhere will be the deleveraging by European banks, a process that will continue while the euro area rebuilds its fiscal and financial balance. Asian banks are generally in sound financial health and can take up the slack with European lending in decline. But European banks hold a large market share of Asian trade financing and are typically the leaders in complex project finance. There could be some economic hiccups as Asian banks step into new roles.

The IMF also warns that East Asia is vulnerable to another oil price spike, particularly if the impact exposes balance sheet vulnerability in the Chinese real estate sector. Any cutback in Chinese investment would quickly ripple through the region. With regard to higher oil prices, Timor-Leste is the counter-example to the rest of East Asia. Its economy could dangerously overheat from higher world prices for oil, but the pace of expansion would not be adversely affected in the short run.

In most East Asian economies, further work is needed to improve the conditions for private investment, enabling domestic demand to offset any weakness in world demand for the region's exports.

Fiscal Policy

Most fiscal policy stances in the East Asian region are expansionary in 2012, as noted by the IMF's *Fiscal Monitor: Balancing Fiscal Policy Risks* (April 2012). In China, the slowdown in economic growth prompted the government to defer fiscal consolidation planned for 2012 and resume a gradual adjustment in the fiscal balance starting again in 2013.

Vietnam's primary fiscal balance is projected to widen in 2012 despite higher revenues and a decline in capital spending by the government. Sharp rises in current expenditure will more than offset those two factors. The Philippines is expected to run a wider fiscal deficit in 2012. Measured as a percent of GDP, the IMF-estimated cyclically-adjusted overall general government deficit will be 2.6 percent in 2012, versus 2.1 percent in 2011.

Burma's consolidated fiscal deficit in 2011, at 5.5 percent of GDP, was little changed from 2010. Export taxes were cut in order to support the agricultural sector.

Mongolia's government amended its budget last year to boost both expenditures and revenues significantly over original targets. A heavy concentration of government spending in December fanned inflation. The deficit hit 3.6 percent of GDP in 2011 after a small surplus in 2010.

By contrast, Indonesia's deficit reduction and debt drawdown will continue in 2012 and 2013. Tax receipts have been buoyant and government capital expenditures have fallen short of targets.

In Cambodia, fiscal policy had been expansionary since 2009, with deficits largely financed by external grants and concessional loans. During 2011 itself, the budget deficit was narrower than in 2010, but remains high at 7.6 percent of GDP. In February 2012, the IMF released a debt sustainability analysis of Cambodia, with the risk rating being changed from moderate to low risk. For now, external public debt appears manageable. For 2012, fiscal consolidation should continue and the deficit is projected to shrink by as many as two percentage points of GDP.

Monetary Policy

Many East Asian governments are tightening monetary policy in an attempt to offset the inflationary impact of expansionary fiscal stances or of higher world prices for food and energy. The State Bank of Vietnam tightened monetary policy in 2011 using a full arsenal of weapons: credit restrictions, tighter bank reserve requirements, higher interest rates, and conducting open-market operations. Both the repo and refinancing rates were raised by several hundred basis points in 2011.

The Chinese and Mongolian monetary authorities were working from similar playbooks in 2011. China's central bank raised the reserve requirements six times in 2011 and the Bank of Mongolia more than doubled its reserve requirement, from 5 to 11 percent. Chinese interest rates were raised three times while the Mongolian key interest rate was hiked four times. By December, with Chinese inflation retreating, a modest easing of monetary policy was implemented. For Mongolia, the monetary tightening was enough to keep the real effective exchange rate stable during the year, but not to curb inflationary pressures.

Indonesia's monetary policy has been somewhat out of step with the region. The key interest rate was hiked in February 2011, but since then has been lowered as inflationary pressures have eased.

Timor-Leste's economy is dollarized, leaving it without effective monetary policy instruments. A prudent fiscal policy is the key to curbing inflationary pressures.

Real GDP Growth, 2012 (IMF Projections)	East Asia 7.9%	Central Asia 6.2%	South Asia 5.8%

Inflation

In Vietnam, the year-on-year inflation rate hit a peak of 23 percent in August 2011, largely driven by sharply higher food prices. Monetary policy tightening during 2011 helped to cut the inflation rate to around 14 percent by March 2012.

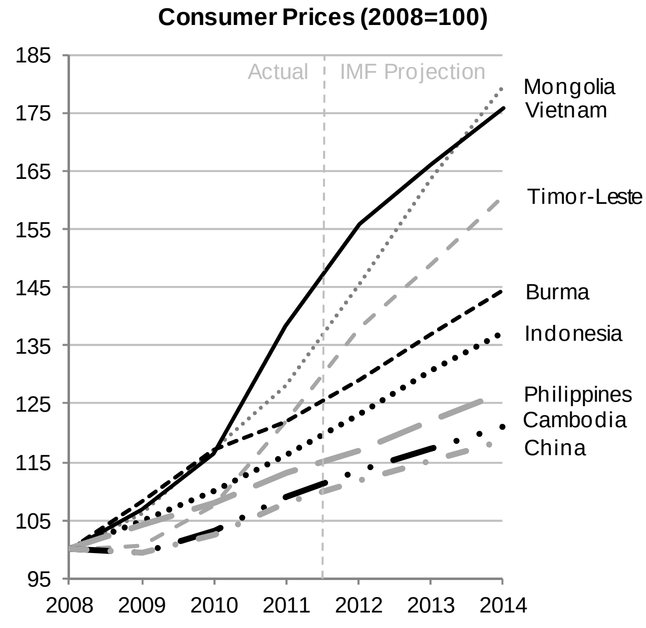
China's inflation rate last summer hit a three-year high at 6.5 percent, but had fallen back towards 4.0 percent by year's end. A favorable harvest last fall alleviated food price pressures and the economy generally responded to monetary tightening earlier in the year.

In Cambodia, higher world prices for food and fuel translated into a doubling of the annual inflation rate during the first half of 2011, to more than 7 percent. Despite flood-related rice price pressures, inflation eased in the second half of the year to under 6 percent.

Inflation trends in Mongolia are volatile, with food price swings obscuring the underlying core rate of inflation. In early 2011, government sales from the meat reserve lowered food price inflation. For the year as a whole, the non-food part of the CPI was up by around 10 percent, a sign of overheating in the economy.

Timor-Leste's inflation has been running at double-digit rates and is projected to ease modestly in 2013. Food prices have been pushed higher by a cut in government subsidies and by poor harvests.

Inflation in the Philippines rose to 4.8 percent in 2011 as higher world prices for oil and food were only partially offset by a favorable domestic harvest. The higher rate remained within the central bank's 3-5 percent target range. Inflation is projected to average less than four percent during 2012–2013.



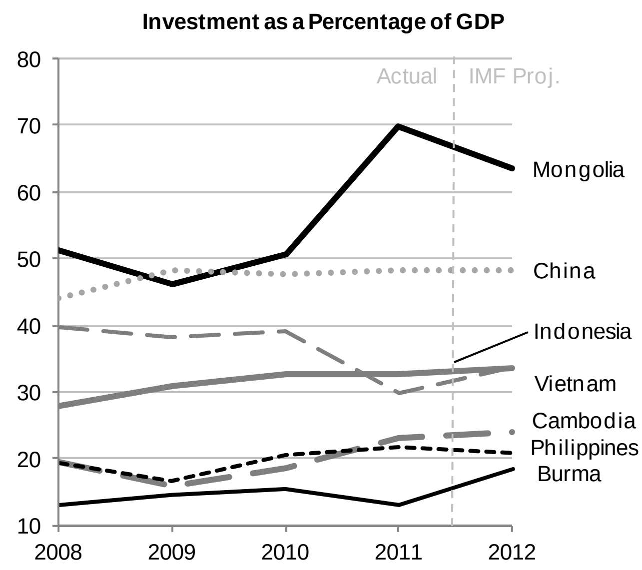
SOURCE: IMF, *World Economic Outlook*, April 2012.

CPI Inflation, 2012 (IMF Projections)	South Asia 8.8%	East Asia 7.7%	Central Asia 7.3%

Investment

Relatively high levels of investment spending as a percentage of GDP are typical for East Asian economies. Capital spending in the minerals sector is driving the Mongolian economy, where investment is above 50 percent of GDP. China's sustained investment spending partly explains its robust real GDP growth rates.

Vietnam's strong investment spending is being trimmed by monetary policy tightening and moves by the government to dampen public investment. Indonesia, by contrast, is seeing private investment rise sharply as spending on machinery and construction offset the cutbacks in the public sector.



SOURCE: IMF, *World Economic Outlook*, April 2012.

Cambodia, the Philippines, and Burma have low levels of investment in the context of East Asia, but for different reasons. In Cambodia, shortages of skilled workers are among the factors which keep potential foreign investors at bay. In addition, the immediate prospects for energy sector investment, and large inflows associated with that sector, are not bright.

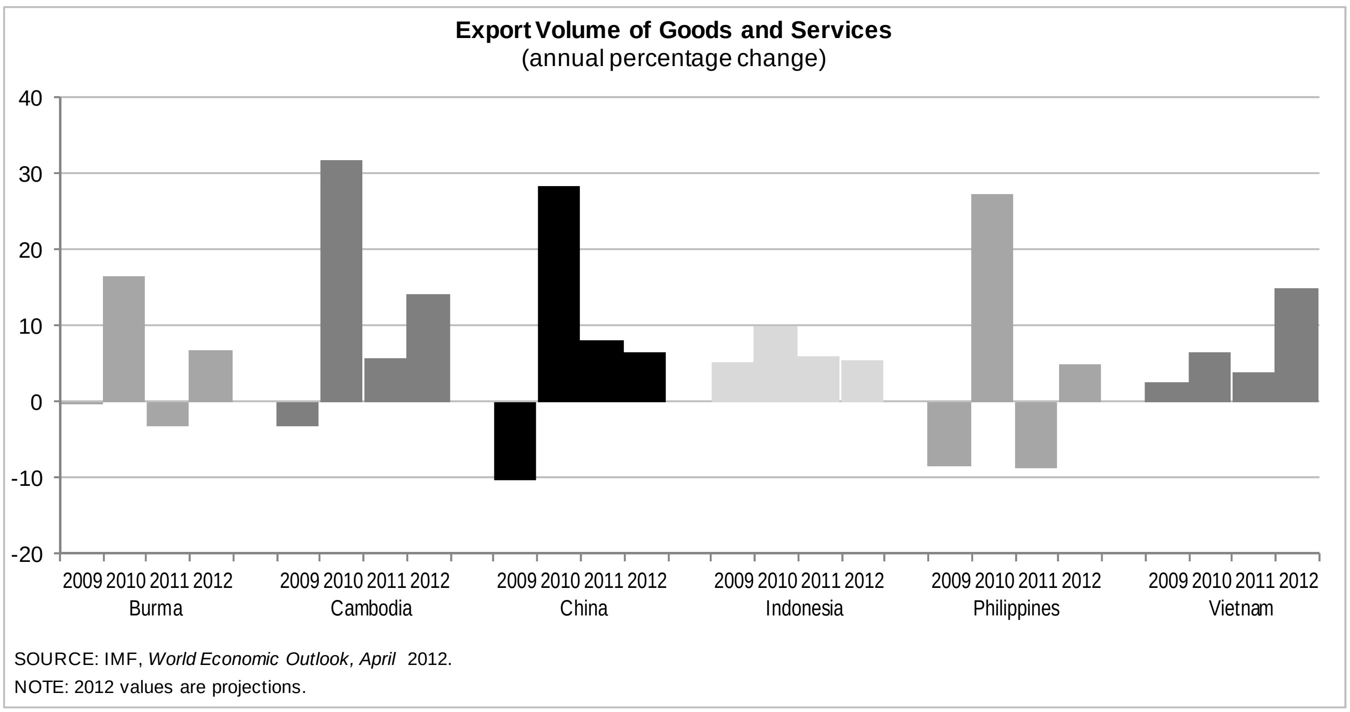
The Asian Development Bank has noted that the Philippines has not joined in the industrial transformation common elsewhere in Asia. The economy's failure to move into higher productivity sectors and the government's failure to improve the institutional framework are discouraging foreign investors.

In Burma, foreign investors are spending heavily in energy and hydropower. But barriers to investment and a weak business environment in other sectors keep investment levels to a minimum.

Total Investment, 2012 (as a % of GDP) (IMF Projections)	East Asia 34.6%	South Asia 28.0%	Central Asia 27.1%

Trade

Trade for East Asian countries has followed a similar path during the last few years. Exports for most economies posted large gains in 2010, either declined or grew more slowly in 2011, and are bouncing back in 2012.



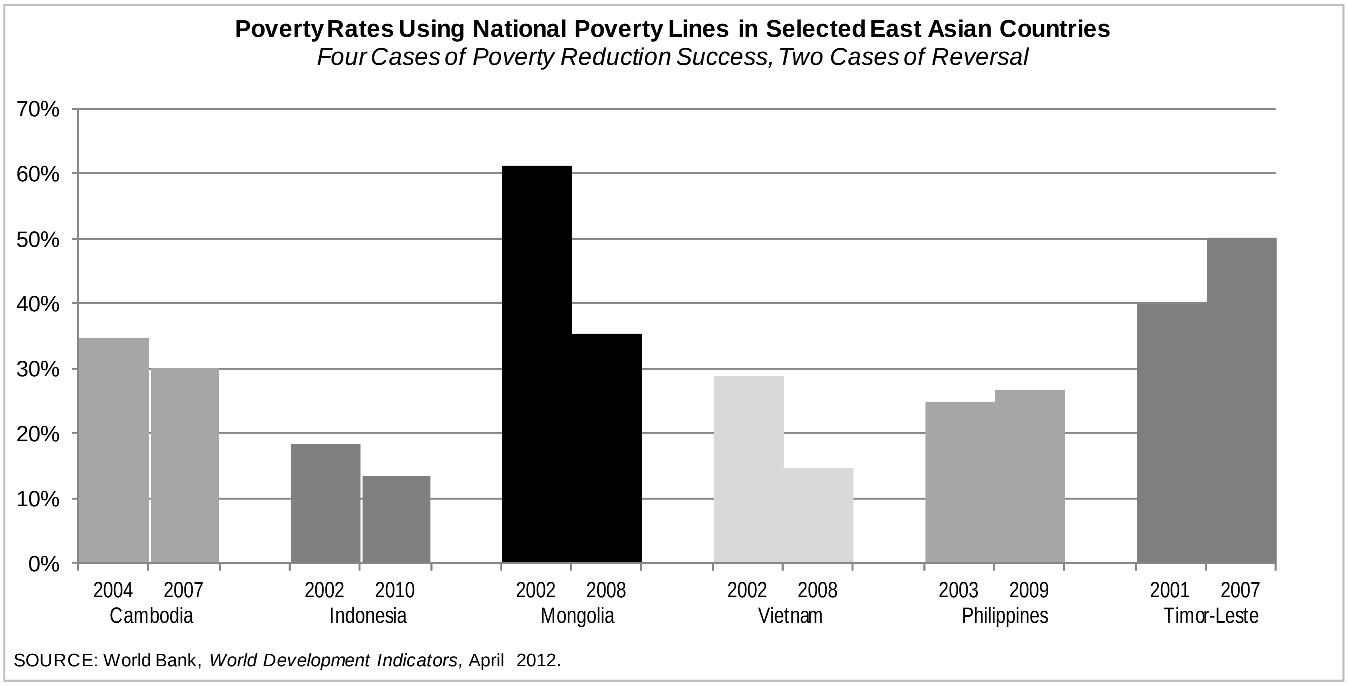
Vietnam's manufacturing sector is benefiting from strong export demand while favorable harvests are boosting export sales of high-quality rice. Cambodia's garment and footwear exports are rising sharply to the key European and American markets.

The pace of export growth in China has moderated since its torrid 2010 upswing, but exports do continue to expand. Transitioning the economy to a larger role for domestic demand so far has not involved a decline in exports.

The Philippines posted the weakest export performance of 2011 in East Asia, led by soft demand for electronic products and exacerbated by supply chain disruptions from earthquakes and tsunamis in other Asian countries.

Poverty Reduction

Years of consistently above average economic growth rates in East Asia establish a strong enabling environment for poverty reduction. The speed of poverty reduction in each country, as well the ability of a country to avert a reversal, has varied.



Indonesia's poverty rates increased in the immediate wake of the Asian financial crisis, but have steadily fallen in the more than a decade since that crisis. The low national poverty rate is second only to China's in the East Asian region.

The rise in poverty in the Philippines is a partial reversal of impressive gains scored during 1994–2003. Despite continued economic growth in the Philippines, rural poverty rates remain high even as urban poverty continues to decline.

The rise in poverty in Timor-Leste shown in the graph occurred prior to the recent surge in economic growth from oil revenues. Newer poverty data, when it is available, will test how effective the government has been at spurring widespread economic growth and creating strong incentives for employment.

Additional Information
For questions or more information, please contact the author, Michael Shea, at mshea@devtechsys.com. For country-specific data and additional information about the countries covered in this report, please visit the EADS Country Portal at http://esdb.eads.usaidallnet.gov/query/do?_program=/eads/esdb/countryPortal. Sources used in compiling this report include the semi-annual *World Economic Outlook* (April 2012) and the *Fiscal Monitor: Balancing Fiscal Policy Risks* (April 2012) from the International Monetary Fund (http://www.imf.org/), the *Global Economic Prospects* from the World Bank (http://www.worldbank.org/), and the annual *Asian Development Outlook* from the Asian Development Bank (http://www.adb.org/).