

## EAST ASIA AND PACIFIC REGIONAL UPDATE

### Summary

Growth in Emerging East Asia eased modestly from 7.5 percent in 2004 to 6.8 percent in 2005.<sup>1</sup> The slower pace of activity was most clear in the Newly Industrialized Economies and in some of the middle income economies of South East Asia. But it was not universal. Growth accelerated in Indonesia and Vietnam, and continued at very high rates in China. In addition, while the moderation in activity in the NIEs and South East Asia occurred in the first part of 2005, activity was generally rebounding in the latter part of the year. Indeed growth for 2005 as a whole generally turned out higher than we had expected six months ago. The prospects for 2006 also look reasonably firm, with aggregate regional growth expected to exceed 6.5 percent for a third year in a row. (Table 1).

While it is true that most of the risks to the outlook discussed in previous reports remain, recent evidence suggests that some have at least moderated over the last six months. In other words, the outlook is a bit brighter, at least in the near term. Large and rising global macroeconomic imbalances continue to loom as a potential source of instability and a risk to future growth. But, in the near term at least, growth in the US remains robust, while it is picking up in Europe and has rebounded quite strongly in Japan - this last of particular relevance for the rest of East Asia. Similarly, while authorities in China continue to watch for signs of economic overheating and over-capacity, the threat of a sharp cyclical downturn in China has receded, at least in the near term. Growth in China continues at high rates, and has even accelerated in recent months, while inflation remains subdued. Global high tech demand slowed in late 2004 and early 2005, causing a downturn in tech-reliant East Asian export growth, but then rebounded strongly in the second half of the year.

High oil prices clearly played a large role in moderating growth in 2005. While the report assumes that oil prices have now peaked, they are still expected to average 10 percent higher in 2006 than in 2005, so that some of the adverse impact is still likely to be playing out in 2006. Nevertheless, the real surprise has been that the highest real oil prices in more than 25 years did not inflict more serious economic damage, with growth not falling below 4 percent in any of the main economies of the region. At the same time, several economies in the region have taken action to reduce costly and regressive subsidies on fuel, which will strengthen government fiscal

positions, while also encouraging consumers and firms to adapt to a world of more costly oil prices, both of which should be good for macroeconomic stability and growth in the medium term.

Many East Asian economies began tightening monetary policy last year, which should help forestall the danger of rising oil prices becoming embedded in a sustained rise in core inflation. That too should help underpin the conditions for growth in the medium-longer term. Lastly, 2005 also saw a sharp downturn in some types of capital inflows to East Asia, in particular in loans and short term capital inflows, which had risen dramatically in 2004. This seems to have occurred as the spread between East Asian and US interest rates narrowed, and as a move towards modestly greater exchange rate flexibility in China and Malaysia discouraged short term speculative capital inflows that had been banking on large capital gains from revaluation of these currencies. Perhaps a little counter-intuitively, the downturn in these kinds of short term flows is also a likely net positive, as it may help avert the emergence of euphoria, excessive risk taking and speculative 'bubbles' in domestic financial markets, of the sort that accompanied sustained and large capital inflows in the run-up to the 1997-98 financial crises.

**Table 1. East Asia Economic Growth**

	2004	2005	2006	2007
Emerging East Asia	7.5	6.8	6.6	6.3
Develop. E. Asia	8.5	8.2	7.8	7.5
S.E. Asia	5.9	5.1	5.3	5.7
Indonesia	4.9	5.6	5.5	6.2
Malaysia	7.1	5.3	5.5	5.7
Philippines	6.0	5.1	5.3	5.6
Thailand	6.2	4.5	5.0	5.2
Transition Econ.				
China	10.1	9.9	9.2	8.5
Vietnam	7.7	8.4	8.0	7.5
Small Economies	5.7	5.2	5.1	4.9
Newly Ind. Econ.	6.1	4.8	4.9	4.6
Korea	4.6	4.0	5.0	4.8
3 other NIEs	7.3	5.4	4.8	4.4
Japan	2.3	2.8	2.8	2.1

World Bank East Asia Region; March 2006. Consensus  
Forecasts for NIEs other than Korea.

The improvement in near term trends described in preceding paragraphs should not be taken as a reason to underplay the challenges and risks that persist. The World Bank's November 2004 *East Asia Update* noted the large number of successful political elections in the region that year, and the spread of representative government they evidenced. Recent sharp political

<sup>1</sup> Emerging East Asia comprises Developing East Asia (China, Indonesia, Malaysia, Philippines, Thailand, Vietnam and some smaller economies) and four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan, China).

tensions in Philippines and Thailand remind us that the consolidation of representative institutions in a climate of political stability is a task that will take persistent efforts over a long period to accomplish.

Emerging East Asia's exceptional economic openness has been one of the conditions for its great economic success. The region's exports exceed \$2 trillion and the share of its trade to GDP is now the highest in the world, exceeding even that of the European Union. But openness also makes the region ever more sensitive to broad global or cross-border trends, be these economic, political, environmental, health related or of some other type, requiring countries to confront many of these complex challenges simultaneously, fashioning responses in collaboration with many partners. This report touches on three of these challenges.

The first is successful multilateral trade liberalization under the Doha Round. East Asia is now a major constituent of the world trading system and is also the region that stands to gain the most from a successful round. Greater openness in services, could, in particular, provide a new engine for income and productivity gains in East Asia.

The second is the risk of avian influenza and a potential human influenza pandemic, which in a bad or worst case scenario could impose an enormous cost in human suffering and economic losses. Strong actions to delay or avert this threat are needed at national, regional and global levels.

The third is the problem of greenhouse gas emissions and the danger of global climate change. East Asia is an important emitter of greenhouse gases, and likely to become more of one over time, while at the same time one of the regions likely to be more affected by the potential ill effects that could flow from climate change. The Special Focus in this report on "*Climate Change and East Asia*" looks at possible implications of climate change for East Asia and at some national and international measures to adapt to and mitigate climate change in cost effective ways that governments in the region can pursue.

Finally, the report also touches on two areas of economic performance and social policy that are of growing importance in competitive open economies: technological innovation and social protection. The absorption, generation and application of knowledge is a crucial driver of productivity and development. The report looks at some empirical measures of knowledge creation in East Asia, emphasizing both its fast growth but also the diversity of experiences around the region. The discussion prefaces more detailed work on knowledge creation in East Asia that we plan to undertake in coming months.

Governments in East Asia are looking at ways to improve social protection, that is, at improving the methods available to people to better manage various kinds of risks. Better social protection can help households address new vulnerabilities in fast changing open economies, it can enhance productivity growth by facilitating more flexibility in labor markets, and it is central to strengthening old age security over coming decades, a time when most populations in the region will be aging quite quickly.

The rest of this summary provides some more information on the main cross-country trends and policy issues discussed in this report. Developments at the country level are discussed in the "Country Sections" at the back of the report, while fuller Country Briefs are available at the website associated with this report.<sup>2</sup>

## East Asia Regional Outlook

- **Growth.** After slowing in the first half of the year, growth rebounded in the second half of 2005 in much of East Asia. As so often in this region, recovery in the second half was mostly led by exports, supported by renewed strength in the high tech sector and also, to some extent, an upturn in the growth of China's imports from the region. Private consumption growth also gained momentum. A more worrying outcome, though, was a weakening in 2005 fixed investment growth in the economies outside China, dipping to only (a simple average) 3.4 percent from 8.5 percent in 2004. Fixed investment spending in the region outside China has been erratic and generally weak ever since the financial crises of 1997-98 and the dotcom crash of 2001, averaging zero growth in 2001-03, for example. The rebound in 2004 was thus encouraging as the first widespread, significant growth in investment in many years. In 2005, though, investment is likely to have been dampened by the impact of rising oil prices, heightened uncertainty about economic prospects and the start of monetary tightening. Several of these factors such as high oil prices and higher interest rates are likely to persist for a while. Carefully designed and sustained policy and institutional reforms to improve the investment climate are thus more important than ever.
- **Poverty.** Our most recent estimates suggest a stronger outcome for poverty reduction in East Asia in 2005 than had been expected six months ago. For the region as a whole, poverty at the \$1 a day level fell to 8 percent of the population in 2005, down from 9.1 percent in 2004. At the \$2 a day level, poverty is estimated to have fallen to a little over 31 percent in 2005, down from just over 34 percent in 2004. The number of poor at the \$2 level

<sup>2</sup> <http://www.worldbank.org/eapupdate/>.

is estimated at some 585 million in 2005, down by 51 million from the previous year. Clearly, sustained strong economic growth has provided an indispensable foundation for the broad declines in poverty seen in most East Asian economies in recent years. But progress in poverty reduction at the broad national level sometimes occurs unevenly, with particular social groups or geographical regions doing less well than overall trends. Governments in the region are therefore pondering policies that can foster poverty reduction in more targeted and potentially cost effective ways. In China, for example, the new Five Year Plan reflects a significant shift in development priorities towards agriculture and the rural areas, where the vast majority of the poor live. In Vietnam, the five year planning process is accompanied by efforts to make resource allocation more pro-poor. In Indonesia the government has moved decisively towards abolishing fuel subsidies, a traditional but very costly and regressive approach to providing a measure of social protection for the poor, moving instead towards an approach of targeted cash transfers to help shield the poor from the impact of higher fuel prices. A later section of this report provides a more detailed look at social protection issues in East Asia.

- **The avian and human influenza threat.** Since our last November 2005 Update there have been outbreaks of the highly pathogenic avian influenza H5N1 virus (“bird flu”) in poultry and wild birds in another 31 countries. In East Asia there was a poultry outbreak in previously unaffected Myanmar, as well as further outbreaks in China and Indonesia. In Thailand and Vietnam, however, no new outbreaks have been reported since October-November 2005, a success attributed to aggressive action taken by these countries to stamp out the disease through culling and vaccination. There were also 42 confirmed new human cases of avian influenza reported to WHO worldwide so far in 2006, of which half were in East Asia, nearly all in China and Indonesia. The economic impact of bird flu in the affected East Asian economies has been fairly limited at the overall macroeconomic level, though of course more severe in agriculture, in rural communities and in the upstream and downstream industries to the poultry sector. However there remains great concern that genetic changes will allow the virus to achieve the capacity for sustained and efficient transmission from human to human, leading to a human influenza pandemic with much higher levels of illness, death and economic and social costs. A November 2005 global partners conference in Geneva identified key components of a global action plan to control avian influenza in animals and simultaneously limit the threat of a human influenza pandemic. These included a stress on country leadership based on integrated prevention and control plans, control of the epidemic at source among birds, strengthening of

surveillance, containment and preparedness and a transparent communications policy. A subsequent International Ministerial Pledging Conference in Beijing in January secured pledges of some \$1.9 billion in grants and credits to provide resources for technical agencies and developing countries in meeting the threat of avian and human pandemic influenza. With some progress having been made on mobilizing financial resources, a key focus is now on preparation, appraisal and implementation of integrated programs at the country level.

## The international and regional environment

- **Developed economies.** While the doubling of oil prices between 2003 and 2005 has undoubtedly slowed world growth, the extent of that impact has been surprisingly limited. Growth among the developed OECD countries eased from 3.1 percent in 2004 to a still healthy 2.7 percent in 2005, and is even expected to strengthen mildly to 2.9 percent in 2006, the result of a mild slowing in the U.S. being offset by recovery in Japan and Europe. In the United States fourth quarter growth was unusually low in the wake of Hurricanes Katrina and Rita, but monthly indicators in early 2006 for unemployment claims, new job creation, manufacturing orders and production were all strong. Corporate survey data suggest that business investment spending in particular should be a prominent driver for US growth in 2006, supported by high corporate profits, still relatively low longer-term borrowing costs and rising capacity utilization. GDP growth is expected to run at a robust 3.4 percent in 2006. In *Japan* growth picked up from 2.3 percent in 2004 to 2.8 percent in 2005, well above earlier consensus forecasts for the year, confirming assessments that the economy has finally emerged from its more than decade-long stagnation. Growth in Japan is also expected to run at close to 3 percent in 2006 with broad based support from consumers, business investment and exports.
- **China.** China’s economy grew 9.9 percent in 2005, down slightly from 10.1 percent in 2004, although growth was accelerating in the latter part of the year.<sup>3</sup> The composition of growth also changed over the course of the year, shifting from net exports to strengthening domestic demand. Net exports made a strong contribution to growth in the first half, reflected in the country’s trade surplus surging to over \$100 billion for the year as a whole. In the second half the contribution

---

<sup>3</sup> These growth rates use a new revised dataset for China’s national income accounts in recent years. The new data is discussed further in Box 2 below. On the old data GDP growth was an estimated 9.4 percent in 2005, and 9.5 percent in 2004.

of net exports shrank, however, as export growth slowed and imports revived, fueled in part by stronger domestic investment and consumption. Merchandise import growth rose from 12 percent in the first quarter to 22 percent in the fourth. Importantly for regional growth, China's imports from other East Asian economies also gathered momentum in the second half of 2005 after having dipped sharply in the first.

- **Trade Policy Developments.** The Sixth WTO Ministerial meeting in Hong Kong last December achieved only modest results, although it did set out a road map for the conclusion of the Doha round of global trade talks. Despite slow progress so far, WTO Director General Pascal Lamy is confident that a substantial agreement can indeed be reached in the limited time remaining. The key steps required are movement by the European Union on agricultural market access, by the United States on agricultural domestic support and by emerging market economies on industrial tariffs and services. Recent World Bank studies suggest that East Asian economies stand to secure substantial economic gains from services liberalization in particular. Liberalization of sectors such as retail and wholesale trade, logistics, the professions (a part of business services), air transport and electricity generation is expected to yield the largest gains, in particular because these services provide important inputs for production in the rest of the economy. Finally, recent news suggests that Vietnam's negotiations for accession to the WTO are progressing well, raising prospects for completion of the process this year.

- **Oil.** After climbing steadily for almost two years, world oil prices fluctuated in a range in the last quarter of 2005 and the first quarter of 2006. Oil prices are expected to gradually decline from current levels, averaging \$59 per barrel in 2006 and \$54 in 2007. (It is worth noting, though, that the forecast average price in 2006 would still be 10 percent higher than in 2005). While demand-supply factors are fairly evenly balanced at present, over time it is expected that growing supply capacity will gain the upper hand over demand. Nevertheless, given the unusually narrow margin of effective spare production capacity in OPEC at present, the market remains vulnerable to concerns about politically driven supply disruptions. World oil demand growth slowed sharply in 2005, falling to a little over 1 million barrels per day from a record 3 mb/d in 2004. Oil demand growth fell in China, where electricity generators were shifting to coal and hydro power capacity, and in South East Asia, where retail product prices have risen sharply in economies like Indonesia and Thailand which eliminated or reduced fuel subsidies during 2005. Higher oil prices are estimated to have generated an average income loss due to worse terms of trade of about around 0.5 percent a year in 2004-06.

Significant net oil importers like Cambodia, Korea, Lao PDR, Philippines and Thailand are estimated to have experienced even higher losses of 1-1.5 percent of GDP on average in this period. The ultimate impact on growth, while significant, is likely more muted than suggested by these first order terms of trade effects, since most economies are also able to support expenditures through some reductions in national savings rates, running down of current account surpluses, drawing on foreign reserves or access to foreign financing.

- **Balance of payments.** Foreign exchange reserves in emerging East Asia increased by \$241 billion, rather lower than the \$336 billion rise in 2004. Most of the accumulation occurred in China, where reserves increased by a little over \$200 billion, about the same as in 2004. In most of the other main economies of the region reserve accumulation fell sharply compared to 2004. The slowdown in reserve accumulation could not be attributed to changes in the region's current account surplus, which in fact increased substantially to an estimated \$235 billion in 2005 from \$183 billion in 2004, a change mainly due to a near doubling in China's current surplus. The main factor behind the slowdown in reserve accumulation was instead a sharp fall in net capital inflows to the region. Since net foreign direct investment (FDI) inflows to East Asia rose, while net portfolio capital flows were reasonably stable, the major swing occurred in the "other" category of the capital account, comprising instruments such as loans, short term deposits, trade credits and financial derivatives, among others. These other flows (together with errors and omissions) are estimated to have swung from net inflows of around \$118 billion in 2004 to a net outflow of perhaps \$60 billion in 2005. The outflow on the capital account appears to be related, first, to the narrowing or reversal of the spreads between East Asian and US interest rates, as a result of monetary tightening in the US. Second, the change in China and Malaysia from a pegged exchange rate regime to a 'crawling' appreciation against the dollar seems to have dissipated expectations of large capital gains to be made from a revaluation of those currencies, leading to a reversal of large earlier inflows of speculative short term capital.

- **Inflation and Interest Rates.** Short term interest rates in much of emerging East Asia have been rising over the course of the past one and a half years as central banks in the region have tightened monetary policy to avert both potential increases in core inflation and excessive exchange rate volatility. Headline consumer price inflation rates trended higher in several economies, fueled principally by higher oil prices and policy decisions to allow more pass through of fuel costs to consumers. Headline CPI inflation in Indonesia picked up to 17-18 percent at the end of 2005 and in early 2006, while in Thailand it rose to 5-6 percent during this

period. Year-on-year rates of core price inflation also picked up in these two economies. Monetary policy tightening is however expected to prevent a persistent or longer term increase in core inflation. By early 2006 the three month on three month rates of core inflation had eased in both economies.

### Domestic trends and policy issues

- **Financial sector trends and issues.** Most indicators of financial sector performance in East Asia also continued to improve over the course of 2005, including measures of asset quality, capital adequacy and bank profitability. Non-performing loans (NPLs) continued to move lower in most economies, supported by gradual improvements in corporate profitability in the region, as well as remaining financial and corporate restructuring activities. Bank interest margins, a key determinant of profitability, generally edged upwards in 2005, though less quickly than in 2004. The similar pattern held for capital adequacy.

- **Corporate sector trends and issues.** The financial health of East Asian corporations has continued to improve on several dimensions in recent years. Median debt-equity ratios and interest coverage ratios for listed companies have generally fallen significantly in the post crisis period (2001-04) compared to the period of the crisis and its immediate aftermath (1997-00), as a result of corporate debt restructuring, a significant paying down of debt by firms and strengthening exchange rates. Korea and Thailand have seen some the largest declines in corporate indebtedness. Corporate profitability as measured by median Return on Assets (ROA) has also been recovering from the sharp declines suffered in the crisis, but the pace of recovery has often been slow, with ROAs remaining below pre-crisis levels in the majority of cases. Overall, while corporate finances are moving in the right direction, there remain areas of vulnerability, for example still low interest coverage in economies like Indonesia and the Philippines, a still gradual pace in the improvement of corporate profitability and, linked to the latter, a continued hesitation in undertaking new business investment on a substantial and sustained scale. A focus on policy and institutional reforms to strengthen the investment climate clearly remains a priority for policy makers in the region. Governments are also increasingly interested in ways of efficiently fostering greater innovation, technological upgrading and absorption of knowledge from abroad.

- **Innovation in East Asia.** The generation and application of new technology is widely acknowledged to be a crucial driver of economic growth and

development. By various measures the level of technological development in East Asia now exceeds that in other developing regions by a wide margin, even though 15-20 years ago it was very similar. Patents provide one measure of the results or output of innovation. The number of patents registered at the US Patent Office by emerging East Asian economies increased from 197 per year in 1981-84 to 12135 in 2001-04, while those registered by selected Latin American countries increased from 101 to 228. At the same time there are also wide differences in technological development between East Asian economies. At the head of the league, Taiwan, China now produces some 30 patents per 100,000 people, about as many as Japan and the United States. Another group including Korea, Hong Kong and Singapore generates around 8-10 patents per capita per year, similar to the performance of the developed OECD countries in the mid 1980s, although only about half the average OECD level today. Economies such as China, Indonesia, Philippines and Thailand bring up the rear with patents per capita in the 0.01-0.07 range, (although patenting in China is rising very rapidly from a low base).

- **Social Protection in East Asia.** Governments in East Asia are looking at ways to improve social protection, that is, at improving the methods available to people to better manage various kinds of risks. There are several potential economic and social benefits. First, better social protection can be good for productivity growth, by facilitating job turnover and reallocation of labor to more efficient uses. Second, it can help reduce vulnerability to poverty: even as poverty continues to fall, a significant proportion of the population in East Asia remains vulnerable to the risk of becoming poor, as a result of factors such as unexpected health problems, large adjustments in labor markets due to industrial restructuring, or natural disasters. A third factor is that East Asia's population is rapidly aging. The question of old age security and putting in place effective pension systems will quickly grow in political importance. Clearly, East Asian economies need to look for home grown solutions that build on East Asian advantages such as relatively flexible labor markets and on traditions such as self reliance and family orientation. There are a variety of ideas that countries are experimenting with, drawing on experience –positive and negative- from within the region and from around the world. These include conditional cash transfer schemes, possible work related transfer programs, a range of options for expanding health insurance coverage, and ideas for strengthening old age security and funding pension coverage in financially sustainable ways.