EAST ASIA AND PACIFIC REGIONAL UPDATE

Summary

Growth in Emerging East Asia is expected to reach close to 8 percent in 2006, the second strongest pace in the five year long economic expansion underway in the region since 2001.[1] Among the developing economies of the region aggregate growth of 9.2 percent would indeed be the highest in the last five years.[2] (Table 1.) Poverty at the $2 a day level is estimated to have fallen by around 1 ½ percentage points to a little over 29 percent of the population. As in recent years, high aggregate GDP growth in the region is dominated by the fact that the region's largest economy, China, was also its fastest growing, reaching over 10 percent, while the other larger middle and high income economies of the region grew in a range of 4-6 percent. Strong export growth was a common factor sustaining growth throughout the region this year. But domestic demand performance was more varied, continuing strong in China and Vietnam, but easing in several of the South East Asian middle income economies and North Asian NIEs, reflecting adjustment to the impact of higher oil prices and higher domestic interest rates, among other factors.

Table 1. East Asia Economic Growth

	2004	2005	2006	2007
Emerging East Asia	8.0	7.5	7.8	7.3
Develop. E. Asia	9.1	9.0	9.2	8.7
S.E. Asia	6.0	5.1	5.2	5.6
Indonesia	5.1	5.6	5.5	6.2
Malaysia	7.2	5.2	5.5	5.5
Philippines	6.2	5.0	5.5	5.7
Thailand	6.2	4.5	4.5	4.6
Transition Econ.				
China	10.1	10.2	10.4	9.6
Vietnam	7.8	8.4	8.0	7.5
Small Economies	6.6	7.6	6.4	5.3
Newly Ind. Econ.	6.0	4.7	5.1	4.5
Korea	4.7	4.0	5.1	4.5
3 other NIEs	7.2	5.4	5.1	4.4
Japan	2.3	2.6	2.9	2.4

World Bank East Asia Region; October 2006. Consensus Forecasts for NIEs..

In some respects the forces expected to drive the outlook for 2007 are the converse of those that have driven outcomes in 2006, with exports expected to slow (rather than accelerating), and with domestic demand making a bigger contribution to growth than in 2006. Growth in Emerging East Asia is expected to slow by about half a percentage point in 2007 to a little over 7 percent, and in Developing East Asia to a little over 8½ percent, principally reflecting an expected weakening in US growth, and a consequent slowing in the region's export growth. It is true that intra-regional East Asian trade has grown strongly over the last decade (centered on exports by other East Asian economies to China). However, something like two thirds of intra-Asian exports are intermediate products used as inputs into exports whose final markets lie outside Asia. Thus the region remains intimately linked to extra-regional global markets. Nevertheless, the extent of the expected export slowdown should be limited if, as forecast, the US economy achieves a soft-landing, and slower US growth is accompanied by a rotation in relative growth momentum to other regions.

Even as exports slow, though, there are a number of factors that should support domestic consumption and investment. World oil prices have fallen substantially since their summer highs and are forecast to stabilize and then gradually decline over time, which should help bolster incomes in what is overall an oil importing region. Central banks in the region had tightened monetary policy since the middle of 2004 to curb a potential rise in inflation. With inflation stabilizing and turning lower during 2006, central banks in the region have stopped tightening or (as in Indonesia) started easing. By the second quarter average short term rates in East Asia were lower than in the US. Most central banks should have room to ease monetary policy in 2007, helping bolster domestic demand in case of a significant export led slowdown. In addition, fiscal balances have improved and government debt has generally declined over the course of the decade in most of the larger East Asian economies, thanks to fiscal consolidation efforts, relatively low interest rates and sustained economic growth since 2001. Except for the Philippines, central government debt levels are now generally less than 50 percent of GDP, leaving room for greater fiscal stimulus, should that be needed, particularly spending on needed infrastructure, which would also ease capacity bottlenecks and constraints. Stronger domestic demand growth is unlikely to face much of a balance of payments constraint in the larger economies of the region, given their current account surplus and strong foreign reserve positions. Improvements in the balance sheets and profitability of the region's corporations and banks, and lower levels of

[1] 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).

[2] Regional and sub-regional GDPs are the sum of national GDPs measured in 2000 US dollars. The resulting growth rates are higher than those shown in earlier editions of the East Asia Update (which used fixed GDP weights), principally because of a higher weight given to China.

spare capacity after several years of sustained growth in many economies should provide a more favorable environment for new investment spending.

The rest of this summary provides further 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.[3] The Special Focus in this report is on "Investing in Young People in East Asia and the Pacific", a study of the lessons for East Asia from the World Bank's recent World Development Report 2007: *Development and the Next Generation.*

East Asia Regional Outlook

- ***Growth.*** Robust aggregate East Asian growth in 2006 has been underpinned by growth of over 10 percent in the region's largest economy, China, supported by strength in both exports and domestic demand. Growth has also been high in several low income transition countries, running at 7-9 percent in Vietnam, Cambodia, Lao PDR and Mongolia. The larger middle and high income economies of the region are however likely to see more modest growth in a 4-6 percent range. Robust export growth has been a common feature sustaining activity throughout the region, underpinned by above-trend growth of 3 percent in developed OECD economies, as well as by strong growth in China and continued expansion in global electronic and other high tech product markets. Domestic consumption and investment performance was much more varied, though. Both continued to run at strong rates in economies like China, Malaysia and Vietnam. On the other hand consumption growth was particularly weak in Taiwan, China, where, a credit card bust left over-indebted consumers cutting back spending, and was also slowing in Indonesia and Thailand in the first part of the year. Investment growth also slowed or became negative in the latter three economies, as well as in Korea and the Philippines. In addition to the adverse impact of higher oil prices and interest rates, domestic demand was affected by tightness in fiscal policies in some economies, as well as a series of country-specific factors such as political tensions and natural disasters.

- ***Poverty.*** Current estimates suggest that the number of East Asian poor at the $2 a day level is likely to have fallen to some 550 million (or 29.3 percent of the population) in 2006, a drop of some 25 million (or over 1 ½ percentage points) from 2005. The current estimates are a little higher than in the last (March 2006) East Asia Update, because of an unexpected up tick in poverty in Indonesia, the first since the financial crisis. Poverty at the national poverty line increased from 16 percent in February 2005 to 17.8 percent in March 2006. Most of the increase resulted from a sharp rise in domestic rice prices, partly due to shortages resulting from a ban on rice imports. In response the government reopened rice imports, helping stabilize prices. In much of the rest of the region, though, 2006 is likely to see further substantial declines in poverty. Poverty reduction has been occurring at exceptionally rapid rates in Vietnam. The current estimates now incorporate the results of Vietnam's 2004 Household Survey, which suggest a sharp acceleration in poverty reduction in 2002-04, almost all of it in rural areas, resulting from rapid productivity gains in agriculture, diversification to new crops and non-agricultural activities, hefty increases in international prices for key exported crops, more resources for targeted poverty reduction programs and a more pro-poor focus in public investment and other fiscal expenditure programs. With further buoyant growth, poverty rates in Vietnam are estimated to have now fallen below those in Indonesia and Philippines.

The international and regional environment

- ***Developed economies***. Growth in OECD developed economies is expected to have risen to 3 percent in 2006 from 2.6 percent in 2005, the result of an unexpectedly strong and broad based recovery in the Euro Area that should bring that region's growth up from 1.4 percent in 2005 to 2.3 percent in 2006. Second quarter Euro Area growth reached 3.8 percent, the strongest in six years. In the United States, on the other hand, growth decelerated from an exceptionally strong 5.6 percent in the first quarter of 2006 to 2.6 percent in the second and 1.6 percent in the third. Nine tenths of the slowdown in the third quarter reflected plunging residential investment and the ongoing slump in the housing sector. The sharp slowdown has led to consensus forecasts for US growth in 2007 being reduced by half a percentage point to around 2 ½ percent – still a 'soft-landing' scenario, although the likelihood of a 'hard-landing' or recession has undoubtedly increased, as has overall uncertainty about the outlook. Not all US data has been quite so negative as in housing. Employment and wage gains have been robust, as were consumption and business investment growth in the third quarter, adding some credibility to the consensus soft-landing view. In Japan an unexpected dip to only 1 percent GDP growth in the second quarter of 2006 has also raised concerns about the outlook for the recovery there. Worrying signs of weakness also emerged in Europe when French growth fell to zero in the third quarter. Overall OECD economy growth is expected to dip by over half a percentage point to under 2 ½ percent in 2007, with world trade growth expected to come down from 9.7 percent to 7.3 percent, one of the lower rates in recent years.

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[3] http://www.worldbank.org/eapupdate/.

- ***China***. Growth in China accelerated to almost 11 percent in the first half of the year, reaching 11.3 percent in the second quarter, the highest in a decade, before decelerating modestly to 10.4 percent in the third quarter, following tightening measures aimed at reducing investment growth. Investment and export growth have been the principal drivers of growth in the year. The slowdown in investment growth in the third quarter was partly offset by rising export growth, which picked up from round 22 percent in US dollar terms in the last quarter of 2005 to 29 percent in the third quarter of 2006. With rising export growth outpacing imports by a growing margin, the contribution of net trade to GDP growth increased to almost 3 percentage points in the third quarter, after 1.2 percentage point in the first and 2.4 percentage points in the second. The trade surplus rose to US$110 billion in the first three quarters of the year from US$ 69 billion in the same 2005 period. China's current account surplus is forecast to rise to $223 billion in 2006 (8.5 percent of GDP) from $160 billion in 2005. From the perspective of its trading partners in Emerging East Asia, China's rapid growth continues to provide an important locomotive for the region as a whole. China's imports from the rest of emerging East Asia were up about 20 percent in the first three quarters of 2006, about the same pace as in 2005.

- ***'Decoupling', Intra and Extra-regional trade.*** The rapid growth of intra-East Asian trade over the last decade naturally raises the question how far such trade may protect East Asia from a downturn in exports to the US or other extra-regional markets. By 2005 32 percent of Emerging East Asian exports went to other economies in the region, while another 11 percent went to Japan. The first point to note is that it is East Asian economies other than China that have experienced the fastest growth in intra-regional exports, principally to China. China, on the other hand, has become the East Asian economy with the highest orientation to the US market, while its intra-Asian exports have remained steady at around 16 percent. The rising export-orientation of other East Asian economies towards China mainly reflects a changing regional division of labor over the last decade, with the emergence of China as a central assembler and exporter of finished manufactures to global markets outside Asia, and of other East Asian economies as suppliers of specialized capital goods, parts, components and other intermediates to China. China's demand for these inputs from the rest of East Asia is therefore driven to a large extent by demand for its exports to the major developed economy markets outside emerging East Asia. Something like two thirds of intra-Asian trade gets incorporated into exports shipped to extra-regional markets. As a result the growth on intra-Asian trade tends to be highly correlated with that of extra-regional trade. A rough calculation suggests that net of such intermediates trade East Asian intra-regional trade amounts to some 14 percent of the total, with Japan, the US and Europe respectively comprising 14, 25 and 22 percent of East Asian exports. A generalized decline in extra-regional markets would certainly have a strong impact on East Asian exports. The impact would however be considerably softened if there was a rotation of growth from the US towards Europe, Japan and East Asian domestic demand itself.

- ***Oil.*** Crude oil prices have been on a highly volatile path since our March 2006 East Asia Update, first running up to well over $70 in early August, before falling to below $60 in early October. This large retracement in prices bolsters confidence in the view that oil prices have seen their peak and are likely to decline further over the next several years, albeit at a gradual pace. Nevertheless the underlying demand and supply factors remain finely balanced, reflected in the unusually low level of spare production capacity in OPEC. Prices are currently projected to ease from $65 in 2006 to $60 in 2007, which would be higher than prices in early October 2006. On the supply side, high current prices are expected to induce further significant investments and gains in production, which are expected by the IEA to reach 1.8 mb/d in 2007, led by increases in the FSU, Africa and North America. On the other hand, continued world economic growth at relatively robust rates over 3 percent is expected to induce stronger demand gains than in the last two years. Thus the margin of spare production capacity is expected to widen only gradually, leaving prices vulnerable to unexpected supply disruptions and fears of disruptions.

- ***Balance of payments and financial market developments.*** Emerging East Asian foreign exchange reserves continue to accumulate at a solid pace, rising to $1938 billion by September 2006, of which $989 billion were held by China alone. As in 2005, much the greater part of the region's reserve accumulation continues to be financed by its rising current account surplus. Emerging East Asia's current account surplus in the year to the second quarter of 2006 rose to an estimated $302 billion - around 6 percent of GDP - up from $266 billion in 2005, headed by the sharp rise in China's surplus. Private capital inflows to and outflows from East Asia remain buoyant, reflecting the growing integration of the region into global financial markets. Net foreign direct investment inflows remain strong, totaling $101 billion in the year to the second quarter of 2006, compared to $112 billion in 2005. Gross financial capital inflows (mainly portfolio capital and bank lending) slackened somewhat during and after the global equity market correction in May-June of the year, but were reviving by September. East Asian equity prices also resumed moving higher in the third quarter. However, while gross financial capital inflows of portfolio capital and loans have remained healthy, one of the more notable balance of payments developments in East Asia in the last 1-2 years has been that on a net basis the region is now supporting large net *outflows* of these kinds of capital – residents are acquiring net foreign assets of portfolio and other financial assets. Such net outflows are estimated at $110 billion in the year to the second quarter of 2006. Among the main factors underpinning this change in net financial capital flows is that there has been more monetary policy tightening in the US than in East Asia. US short term interest rates were lower than average East Asian rates till recently; now they are higher.

Domestic trends and policy issues

- ***Financial sector trends and issues***. Over the last 5-6 years banks in the previously crisis-affected East Asian countries have achieved substantial improvements in capital adequacy, asset quality and profitability. There was something of a pause or slowing in the process of clearing up bad debts during the first half of 2006, though. In Indonesia the rate of non-performing loan (NPL) rate at commercial banks picked up from 7.6 percent at the end of 2005 to 8.3 percent in June 2006 (and 8.4 percent in August), due in part to a change in rules for classification of assets at the two largest state owned banks. In Thailand the NPL rate at 8.2 percent in June 2006 was only slightly below the end-2005 rate. In both cases the authorities announced steps to further address NPL issues. Policy efforts to continue to address tasks of financial sector restructuring and consolidation left over from the financial crisis, as well as longer term financial sector strengthening and development remain important. NPL ratios in Emerging East Asia remain rather higher than in other developing regions such as Latin America and Emerging Europe.

- ***Towards a More Resilient, Diversified Financial Sector.*** [4] The importance of diversified financial systems is increasingly recognized in East Asia. Such systems can serve to enhance efficiency by providing specialized resource mobilization, allocation and risk management services. Although the region has traditionally had a bank-centered system, it has made much progress in developing securities markets in recent years. Equity markets in the region have tripled since the crisis—from a market capitalization of US$ 0.8 trillion in 1997 to almost US$ 2.9 trillion in 2005. The region's bond markets have also seen sizable growth over the past nine years, albeit with considerable variation across countries. For the region as a whole, bonds outstanding amounted to US$1.5 trillion in 2005—up from US$ 0.4 trillion in 1997. To foster further development of securities markets, a key constraint that needs to be addressed is limited liquidity. Investors are generally willing to invest in securities only if there is enough liquidity for them to sell and exit easily when needed. Three key factors affect liquidity and efficiency—and ultimately the role that securities markets play in the region: (i) the availability of good information to price securities accurately. East Asian economies have made good progress in establishing the legal framework for corporate governance, disclosure, accounting and auditing, but need to improve implementation; (ii) reducing transaction costs, in particular by fostering repo (repurchase) markets, securities lending, margin trading and derivatives, together with the strong regulatory and risk management frameworks needed for such markets; (iii) development of a more diversified and deeper institutional investor base, for example pension funds, insurance and mutual funds.

- ***Towards "An East Asian Renaissance".***[5] Healthy growth in the years since the financial crisis means that East Asia is increasingly a middle-income region. Once Vietnam reaches middle income country levels, which could happen as early as 2010, more than nine out of ten East Asians will inhabit a middle income country. Middle-income status poses new and quite specific development challenges. Research suggests that the sectoral pattern of growth changes as countries grow through middle-income. On the one hand, there is a demand for a greater variety of goods, many of which can be produced domestically, so there is a force towards sectoral diversification. On the other, countries only get richer if they specialize in what they do best. Although countries appear to initially diversify, at some point at middle income levels they begin to specialize, drawing on economies of large scale production and greater proficiency in innovation and knowledge based production. This is the challenge that confronts East Asian countries today, especially those in South East Asia. But this development strategy has distributional consequences at the country level which need to be managed. Inequality in much of developing East Asia has risen, not just in terms of income levels, but also in terms of schooling and access to basic services. Despite the huge differences in income per head between East Asian countries, more than three-quarters of the inequality of living standards of East Asian citizens comes from within-country inequality. In short, despite successful global integration and increasing regional integration, many East Asian countries are falling behind in domestic integration. Addressing the challenge of domestic integration must entail managing problems of rapid urbanization, service delivery, social cohesion and corruption.

[4] This section of the report draws on Ghosh: "East Asian Finance – the Road to Robust Markets." World Bank (2006).

[5] This section of the report draws on Gill and Kharas: "An East Asian Renaissance – Ideas for Economic Growth." World Bank (2006).