

Financial sector trends and issues

Commercial banks in the larger economies of the region generally closed 2006 with further improvements in asset quality, including lower non performing loan ratios and rising or stable capital adequacy ratios (Exhibit 25). Economies continue to implement significant financial sector reforms, as the following country notes indicate.

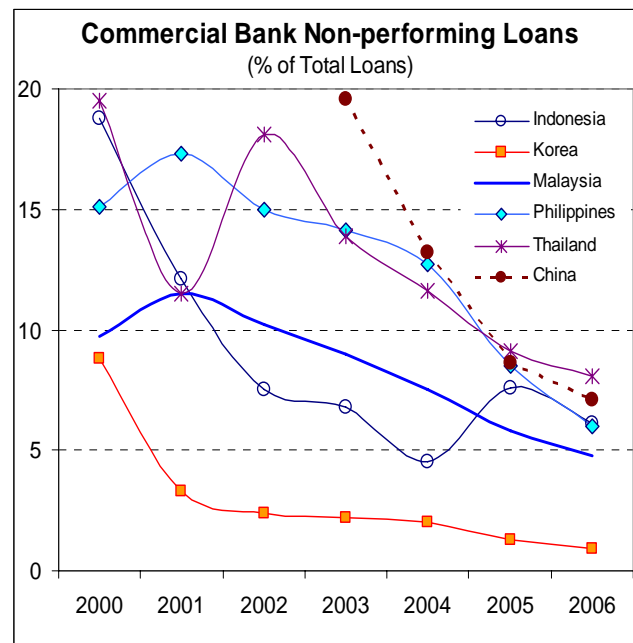
In **China** the third national financial work conference held in January set out directions for major financial sector reform. Key reforms discussed were in rural finance, foreign exchange management, and policy banks. On rural finance, it was decided to reduce the access thresholds for financial institutions to attract a more diverse set of providers and to continue the reforms of the Agricultural Bank of China. Looking ahead, rural finance would also benefit from interest rate liberalization and further reforms in existing providers. On foreign exchange reserve management, the meeting decided to explore ways to more actively manage the country's foreign exchange reserves.

Banking indicators for **Indonesia** generally improved in 2006. The capital adequacy ratio rose to over 20 percent with net interest margins remaining close to 6 percent. However, the return on equity (ROE) fell to a little over 17 percent from 18 percent in 2005, reflecting charges to cover an increase in non-performing loans in the earlier part of the year (due in part to a change in rules for loan classification). However the NPL ratio fell sharply in late 2006 due to a pick up in intermediation and total loans outstanding, as well as a regulatory change by which state-owned banks could write-down NPLs according to the same procedures as private banks. The government's financial sector reform package issued in early July 2006 however strengthened regulatory powers to resolve problem debts at state banks more speedily. More broadly, the July reform package covers key areas such as financial stability, the banking sector, non bank financial institutions (NBFI), capital market development, export financing and privatization of SOEs. Implementation of the package is continuing. Bank Indonesia announced eight initiatives in January 2007 with a focus on improving banking intermediation, not only for large firms but also for SMEs and micro enterprises.

In **Korea** the average non-performing loan ratio of the commercial banks fell to a record low of 0.8 percent at the end of 2006. In the non-bank sector, the six credit card companies have continued to improve financial health, with asset quality and capital ratios improving significantly. The companies have recorded positive net income for six consecutive quarters since the second quarter of 2005. A continuous drop in bad loans drove up their net income in the first three quarter of 2006 by 12.5 percent over the previous three quarters. Average credit card delinquency ratios have continued to fall, reaching 7.1 percent at end-September 2006, down from 10.1 percent at the end of

2005. The capital adequacy ratio rose of the credit card companies rose to 24.5 percent at end-September.

Exhibit 25



In the **Philippines** the banking sector has continued to reduce balance sheet vulnerabilities. The NPL ratio for Universal and Commercial banks fell from 8.2 percent at end 2006 to 6 percent at end 2006. Improvements in asset quality are due in part to enactment of the Special Purpose Vehicle (SPV) Act, which was an important catalyst in reducing banking sector vulnerabilities via the take out of non-performing loans and assets from commercial bank balance sheets. About P97 billion worth of non performing assets (NPAs) were sold through transactions under the SPV Act by end 2005, reducing by about 19 percent the stock of NPAs in the banking system. In early 2006, the SPV Act was extended by a period of another two years. This enabled (mainly) universal and commercial banks to reduce their stock of NPAs by another 18 percent in 2006.

East Asia: Ten years after the crisis

A decade after the financial crisis that devastated East Asia in 1997-98, the region is far wealthier, has fewer poor people and a larger global role than ever before. Led by continued strong growth in China, Emerging East Asia now has an aggregate output of over \$5 trillion, double the dollar value just before the crisis. Real per capita incomes in the previously crisis affected economies¹³ have significantly exceeded pre-crisis levels. For Emerging East Asia as a whole they are some 75 percent higher. The poverty rate at the \$2 a day level has fallen from 50 percent

¹³ Indonesia, Korea, Malaysia, Philippines and Thailand.

of the population to 29 percent today. When Vietnam reaches middle income status (defined as annual per capita income of about \$900), which could happen as soon as 2010, more than 9 out of ten East Asians will live in a middle income economy.

But even as the region celebrates recovery, new challenges loom, which could slow or even derail growth if not properly handled – economies could find themselves in a ‘middle income trap’ and struggle to climb onwards to higher income levels. A recent World Bank report notes the strategies that economies need to make the transition from low income to middle income are different from those needed to transition from middle income to high income status.¹⁴ Among other things, countries that are successfully making a transition towards high income status begin to specialize in selected areas where they are able to achieve economies of scale and technological leadership. Accompanying this change are a whole host of complex transitions, for example, substantial increases in the proportion of people with tertiary education and specialized skills, the transition from economies that largely absorb knowledge from abroad to ones that are also a source of innovation, the development of deep financial systems that provide a diverse range of services, the movement of much of the population into livable cities, among many others. At the socio-political level, successfully transitioning countries are able to maintain a certain level of social cohesion, avoiding the emergence of deep inequities of the kind that fuel social conflict and political instability and stall growth. Clean government and rule of law become the norm, while corruption becomes the exception.

Economic history has many examples of economies that succeeded in getting to middle income status – often quite quickly – but have then stalled, unable to manage all of the complex economic, social cohesion and political challenges needed to make the high income transition. Many economies in Latin America and the Middle East have remained at middle income level for decades, for example. Ten years after confronting the reforms needed to rebound from the financial crisis, East Asia is confronting reform challenges at least as complex. The fact that other economies in the region like Japan, Hong Kong (China), Korea, Singapore and Taiwan (China) have already escaped the ‘middle income trap’ shows that it is possible. But the task will not be simple.

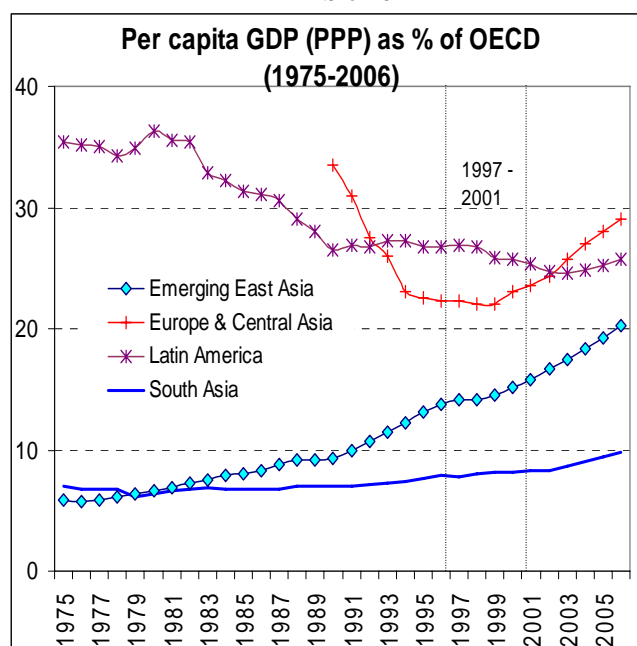
This section does not attempt to survey all of the challenges facing East Asia in transitioning from middle income towards high income status. Instead it looks at the region’s experience and some lessons learnt over the decade since the crisis in three key areas: maintaining high growth in a sustainable way, addressing the problem of growing inequality and managing economic and financial vulnerability, to reduce the risk of future crises.

¹⁴ Indermit Gill and Homi Kharas. “An East Asian Renaissance: Ideas for Economic Growth”, The World Bank, 2007 forthcoming.

Growth – facing a middle income challenge?

Emerging East Asia has come a long way since the financial crises of 1997-98. By 2006 real per capita income for the region as a whole had increased by over 75 percent compared to 1996, the last pre-crisis year. As Exhibit 26 indicates, the region’s real per capita income (measured in purchasing power parity terms) continued to increase relative to incomes in high income OECD economies, rising from a little under 14 percent in 1996 to over 19 percent in 2005. Further, this increase in relative per-capita income levels was the same as in the previous decade, 1986-96, showing no diminution in the pace of ‘catch-up’ to high income country levels.

Exhibit 26



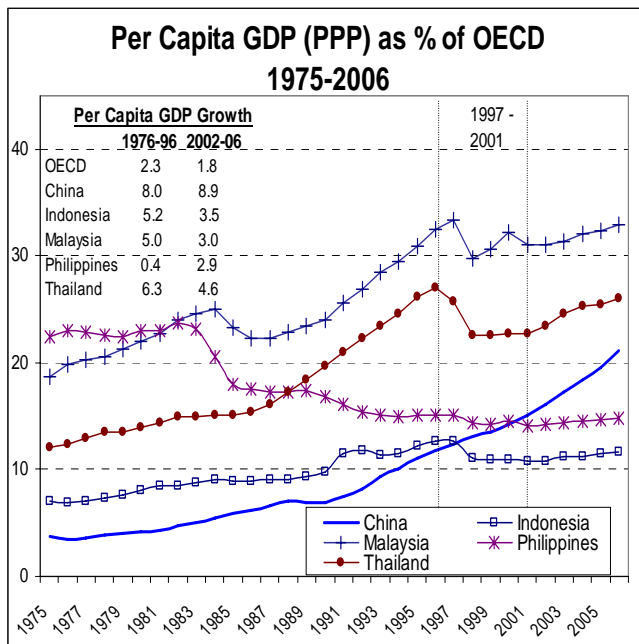
It of course true that a large part of the region’s strong performance over the last decade is due to China, where real per capita income growth averaged 8.1 percent. Growth in several low income economies like Vietnam, Cambodia and Lao PDR has also accelerated to rates above pre-crisis performance. Nevertheless the crisis affected economies have also displayed a robust performance in many respects. For one thing, all returned to positive growth quite quickly after the severe recessions of late 1997 and 1998. Korea, Malaysia and Philippines promptly regained or exceeded their pre-crisis level of per-capita income in 1999, while this took longer, till 2003, in Indonesia and Thailand. Taking 2002-06 as the period of sustained post-crisis expansion¹⁵, economies such as

¹⁵ It is not straightforward to assess the underlying growth performance of the crisis affected countries in the period after the crisis, because, for one thing, these economies were also soon hit by a second shock, the severe recession in the global high tech industry in 2001, which led sharp downturns in exports and output growth in much of East Asia. Thus for the purpose of this

Indonesia, Malaysia and Philippines have achieved real per capita income growth of 3-3.5 percent, with per-capita growth in Korea and Thailand averaging 4-4.5 percent.

Per-capita growth rates in the 3-4.5 percent range are certainly healthy enough compared to the per capita growth rate of the world as a whole over (say) the last quarter century, which was 1.8 percent. But there are also less flattering comparisons. First, recent growth in most of the post-crisis economies is running at around 2 percentage points less than in the two decades before the crisis. (The only exception is the Philippines, whose recent per capita growth of 2.9 percent is much higher than its negligible 0.5 percent performance in 1976-96.) Second, other emerging regions are growing substantially faster in recent years, so that the bar for comparison is now higher than in the past. For example the Europe and Central Asia region and the South Asia region experienced aggregate per-capita growth of 5-6 percent in 2002-06. Third, at their current growth rates it will take longer for the East Asian post-crisis economies to close the gap with the developed world. Exhibit 27 shows how the previous rise in East Asian per-capita incomes relative to the developed economies has tended to flatten out among post-crisis economies in recent years compared to previous decades.

Exhibit 27



Evidently there is not one but at least two sets of “middle income country challenges” facing economies in the region today. In China this means new strategies to tackle the severe environmental and other stresses and imbalances that have arisen during the last 20 years of very rapid growth. Elsewhere, among the formerly crisis affected economies, the challenge is different, to build on

discussion we take the 2002-2006 as the representing the period of sustained post-crisis expansion.

their recovery from the crisis and boost growth to higher rates. In the rest of this section we first look briefly at the challenges facing China. We next consider the dramatic changes in international trade patterns that have affected the region over the last decade, in particular the rapid increase in economic integration between China and the rest of the region. Lastly we look at growth challenges in middle income East Asia outside of China, focusing in particular on investment.

Economic Rebalancing in China

China’s rapid growth over the last 20 years has reduced poverty and improved living standards on a scale and at a pace unequalled in history. Inevitably growth at such a rate has also led to an accumulation of interlinked stresses and imbalances that could affect China’s onward development if left unchecked. Environmental stresses are the most apparent. China today contains 20 of the world’s 30 most polluted cities, due largely to high use of coal and cars. Serious erosion, acid rain and polluted waterways also affect the lives of millions.¹⁶ On the supply side, the growth rate and share of industry is unusually high relative to services, which also contributes to pollution and high energy and natural resources consumption. On the demand side, investment (and saving) is high and rising relative to consumption, raising concerns about inefficient use of capital and a potential build up of overcapacity in specific sectors, which could also contribute to bad debts in the banking system. A rising rural-urban income gap, in part driven by the capital intensive, manufacturing-led pattern of growth, has contributed to a sharp rise in overall income inequality.

The broad long-term challenge of improving the quality of economic growth, rebalancing the pattern of growth and striving for a harmonious society was put firmly on the government’s agenda with the approval of the 11th five year plan in March last year and reconfirmed during the sixth plenum of the Communist Party of China (CPC) central committee in October 2006. It means a relative shift in production from industry towards services, more reliance on domestic demand, more equally shared growth and more environmentally sustainable growth. Besides being desirable in their own right, measures that support rebalancing are

¹⁶ A forthcoming multi-year multi-sector study estimates the physical and economic cost of air and water pollution in China as reflected in the pollution-related disease burden, pollution-exacerbated water scarcity, wastewater irrigation, fisheries loss, crop loss, and material damage. Building upon willingness-to-pay surveys for reducing health risks from pollution among households in Shanghai and Chongqing municipalities, the study finds that the health costs of air and water pollution amount to about 4.3 percent of GDP in China. By adding the non-health impacts of pollution, which are estimated to be about 1.5 percent of GDP, the study indicates that the total cost of air and water pollution in China is about 5.8 percent of GDP. (“Call for a Green China”).

also likely to address the surging trade surplus, China's main short term macro challenge.

A shift towards services relative to industry and, on the demand side, a larger role for consumption relative to investment and exports would address many concerns. It would make growth less intensive in energy, raw materials, and resources and less tough on the environment. It would also make growth less capital intensive, allowing China to grow with lower saving. Moreover, it would mean more labor intensive growth, with more urban employment creation. Urban job creation is the key to reducing excess labor in agriculture and the related poverty and urban-rural inequality. Finally, it would ameliorate the pressures for overproduction of goods and current account surpluses.

The World Bank's November 2006 China Quarterly discusses policies that will help economic rebalancing, many of which are already in the pipeline.¹⁷ Several macroeconomic measures can help stimulate consumption, reduce saving and encourage services growth. These include shifting public spending from investment to education, health and social security, speeding up financial sector opening and reform to improve the efficiency of the allocation of capital, and establishing a dividend policy for State Owned Enterprises (SOEs) and improving corporate governance, to remove an over-investment bias.

Several price and tax based measures would help adjust the attractiveness of manufacturing (tradables) production relative to services (non tradables). These include allowing the exchange rate to move more closely in response to underlying pressures, which at moment imply an appreciation and an increase in the profitability of non tradables. They also include adjusting the price of inputs into manufacturing—including land, energy, water, utilities, natural resources, and the environment—to better reflect relative scarcities and social preferences. In the area of energy, China has in recent decades had major success with using price increases to improve energy efficiency. Looking ahead, the resolution of the October plenum notes that "industrial policies, fiscal and taxation policies and pricing policies shall be amended to encourage environmental protection." The 11th Five Year Plan (2006-11) also sets a target of reducing energy consumption per unit of GDP by 20 percent and the total discharge of major pollutants by 10 percent.

Dramatic Changes in International Trade Patterns

Integration with international trade – exploiting the opportunities offered by global markets - has for decades been a key element of the 'East Asian miracle'. The last decade has seen further expansion and striking structural changes in the pattern of East Asian integration, associated in particular with the dramatic emergence of China as both a major competitor and a source of opportunities for the other economies of the region.

¹⁷ [World Bank China Quarterly, November 2006.](#)

Exhibit 28

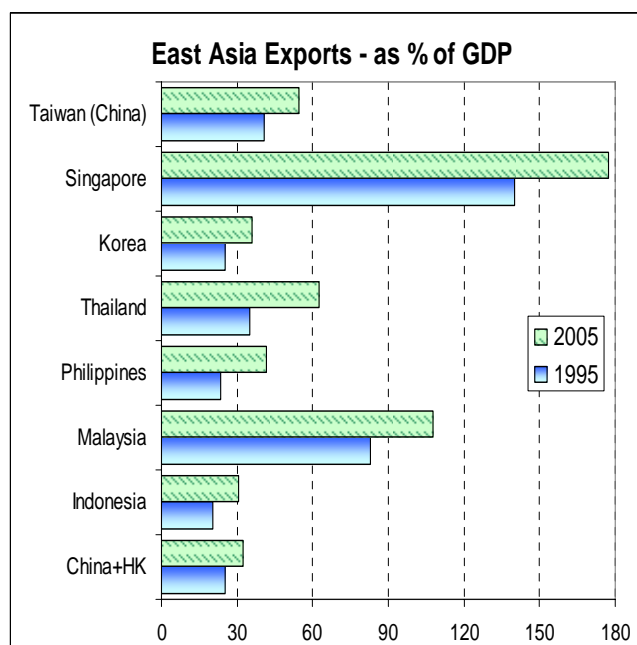
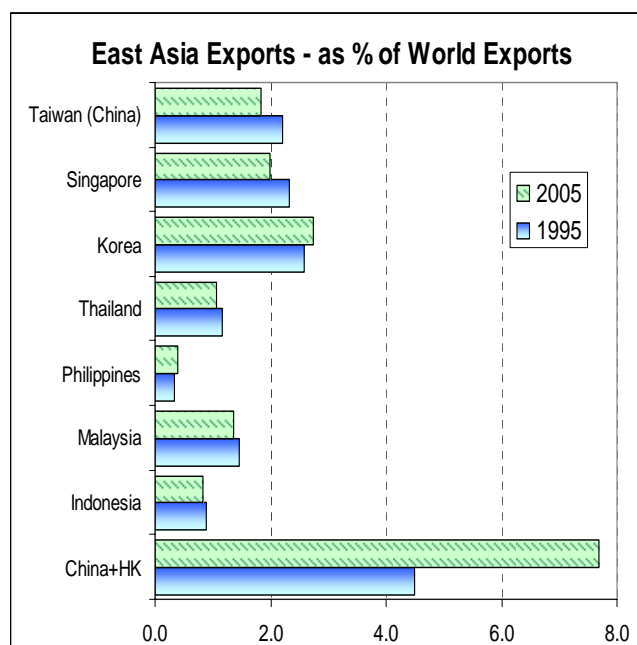


Exhibit 29



Emerging East Asian economies have continued to become more exposed to international trade over the last decade, with merchandise exports increasing from 34 percent of GDP in 1995 to 42 percent in 2005. As Exhibit 28 shows, trade to GDP ratios have risen in all of the major economies of the region. Emerging East Asia's overall share of world exports also continued to rise, picking up from 15.5 percent in 1995 to 17.9 percent in 2005. Here, though, we see more of the new trends that have emerged in the last 10 years. All of the increase in East Asia's world trade share came from China (taken together with Hong Kong because of the intense trade links between the two

economies), which increased from 4.5 to 7.7 percent of world trade. Exhibit 29 shows that world trade shares among the other main economies in the region either fell or increased only slightly over the last decade. This leveling out or decline in world trade shares among other East Asian economies represents a significant change from previous decades when these economies' trade shares also experienced steady increases.

There is little doubt that the emergence of China as an international trading power has had a major impact on the trade opportunities of other economies in the region, both as a competitor in world markets and as itself a new and dynamic market for these economies. Studies of the long run general equilibrium impact of the rapid growth of China on the rest of East Asia and the world stress the welfare gains that most economies are likely to derive from a growing China.¹⁸ But to exploit the new comparative advantages and secure the welfare gains created by the emergence of China is not an automatic process but will require significant restructuring and adaptation by firms in the other East Asian economies.

Ahearne, Fernald et al (2006) study the impact of China on trading patterns in the US market across 47 industry sectors between 1989 and 2005. China increased its market share in 41 of these sectors over this period, while, on the other hand, the market share of the East Asian NIEs fell in most sectors.¹⁹ Importantly, the pace of increase in China's market share in the US market increased dramatically in the most recent period 2001-05. Of particular note, the four middle income economies in South East Asia ("ASEAN 4") had also been increasing their market shares in many sectors through 2001. But in 2001-05 the ASEAN 4 economies also lost markets shares. Thus the post-crisis period 2001-05 appears to be the period when competitive pressure from China has increased most sharply. Exhibit 30 below illustrates how these trends played out in the largest sector of US-East Asian trade, computers, peripherals and semiconductors. More formally, Freund (2006) reports on an econometric investigation using bilateral trade data at the 4-digit SITC level from 1985 to 2004 to test how China's exports to a particular third country in a given product category affect East Asian exports, controlling for overall exporter supply growth. The study finds that on average other East Asian export growth to third markets in industrial products tends to be lower when Chinese exports in these same products are large and growing, with this effect being strongest in the most recent period, 2000-2004. The competitive impact has been strongest in North America, Japan and many developing

country markets. Viewed by the impact on exporters, the most significant impacts have been in Korea, Taiwan (China) and Singapore.²⁰

Exhibit 30

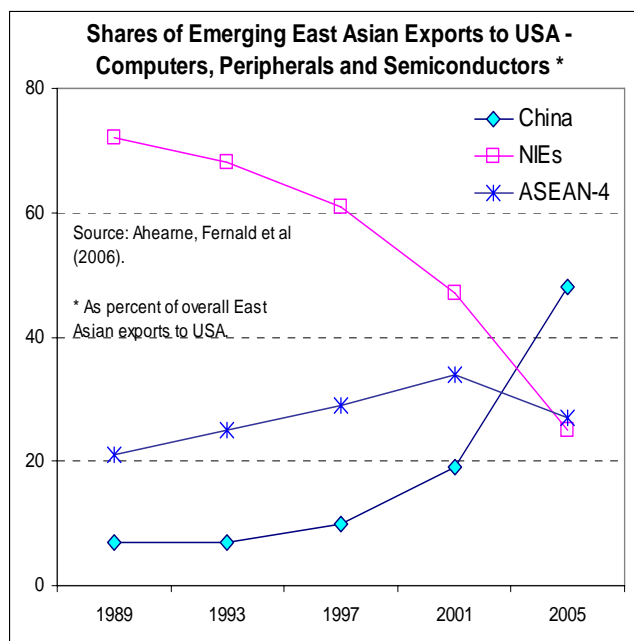


Table 7. Export Markets
(As % of Own Total Export)

| To | China & Hong Kong | | Other 7 EA Economies | |
|---------------|-------------------|------|----------------------|------|
| | 1995 | 2005 | 1995 | 2005 |
| USA | 27.4 | 26.3 | 19.8 | 14.7 |
| Japan | 17.1 | 12.5 | 13.1 | 9.9 |
| EU 25 | 20.5 | 23.3 | 14.1 | 13.4 |
| China & HK | | | 13.3 | 22.5 |
| Other 7 EA | 16.3 | 16.0 | 22.5 | 21.3 |
| Rest of World | 18.7 | 21.9 | 17.1 | 18.1 |

Not coincidentally, the increase in competitive pressures in third markets in recent years has also been associated with rapid growth in other East Asian exports to China, frequently in the very industry sectors that have felt the most competitive pressure in the US and other markets, for example in the computer, other office machinery and electronics sectors. However the character of this trade has changed – instead of exports of finished goods, exports from the other East Asian economies to China have been increasingly driven by exports of parts, components, capital equipment and other kinds of industrial inputs which are assembled or manufactured into finished goods in China for

¹⁸ See for example World Bank. (2006) "Dancing with Giants. China, India and the Global Economy". (Eds. L. Alan Winters and Shahid Yusuf).

¹⁹ Alan Ahearne, John Fernald, Prakash Loungani and John Schindler. (2006). "Flying Geese or Sitting Ducks: China's Impact on the Trading Fortunes of other Asian Economies." Board of Governors of the Federal Reserve System. International Finance Discussion Paper Number 667. (December).

²⁰ Caroline Freund. (2006). "The Effect of China's Exports on East Asian Trade with the World." Mimeo. World Bank..

export to the outside world. This kind of intra-industry trade has been closely associated with flows of FDI and the establishment of regional production networks. It is also at the heart of the rapid increase in intra-regional trade in the region in the decade since the crisis. As Table 7 indicates, the rise in intra-regional trade has been entirely due to an increase in the share of other East Asian economies' exports going to China (and Hong Kong), which surged from 13.3 percent in 1995 to 22.5 percent in 2005, reflecting the rise in exports of components and other inputs. (The share of these economies' exports to each other remained relatively flat, as did the share of China's exports to these other East Asian economies).

Investment weakness in other middle and high income Asia

The slower pace of output growth in several East Asian economies has been accompanied by much more pronounced differences in investment spending across economies. While investment spending growth in China has continued running at double digit rates, in many of the other middle and high income economies of the region the recovery of investment after the 1997-98 crisis and the 2001 slowdown has often been weak and erratic. This has led to very different policy concerns around the region. Unlike policy makers in China, who are concerned to ensure that the present investment boom there does not lead to overheating, policy makers in many of the NIEs and middle income South East Asian economies are concerned about the causes of continued relative weak investment. Table 8 indicates investment growth has averaged only around 3 percent or less in the four NIEs, Malaysia and Philippines in the post crisis recovery period 2002-06.

**Table 8. East Asia
Real Fixed Investment Growth**

| | 1980 -89 | 1990 -96 | 1997 -01 | 2002 -06 |
|------------------|-------------|-------------|-------------|-------------|
| China | 8.2 | 15.2 | 9.9 | 12.4 |
| South East Asia | | | | |
| Indonesia | 8.9 | 11.5 | -5.9 | 6.3 |
| Malaysia | 7.0 | 17.7 | -6.6 | 3.3 |
| Philippines | 0.4 | 5.3 | 0.2 | 1.0 |
| Thailand | 8.5 | 12.3 | -14.5 | 7.7 |
| NIEs | | | | |
| Hong Kong, China | 5.3 | 9.3 | -0.2 | 2.5 |
| Korea | 8.6 | 11.5 | -1.8 | 2.1 |
| Singapore | 6.3 | 13.1 | 0.6 | 3.0 |
| Taiwan (China) | 7.4 | 9.2 | 1.7 | 1.4 |

Source: World Bank. Compound annual average growth.

There is not yet a consensus about the causes of slower growth in investment among East Asian economies (ex-China) in the post-crisis period. Systematic econometric studies find it is not explained by economic fundamentals such as the fiscal balance, demographics,

financial development, financial openness, legal development, trade openness, terms of trade volatility, GDP growth, interest rates and credit flows.²¹ Up to a point, the cyclical "boom and bust" aspects of investment performance in the region can go some distance towards providing a useful explanation for the weakness of investment. In particular one can point to the high levels of spare capacity that were built up in the investment boom before the crisis, the huge negative demand shock released by the financial crisis and the further negative demand shock from the 2001 global high tech recession. Ballooning corporate sector debt, bad debt in the financial system and the need for painful corporate and financial sector restructuring also magnified and protracted the economic shock.

Nevertheless, these kinds of cyclical explanations become less plausible as the time elapsed since the crisis increases. For example, capacity utilization has been rising in most economies and is now near conventional definitions of full capacity in some. Corporate indebtedness has now fallen to levels similar to those in industrialized economies and should not be a constraint going forward. Over the last 5-6 years banks in the previously crisis-affected East Asian countries have also achieved substantial improvements in capital adequacy, asset quality and profitability. Although bank lending has remained sluggish in a number of economies, this now appears to be mainly a question of sluggishness in corporate demand for loans rather than in the capacity of banks to supply credit.

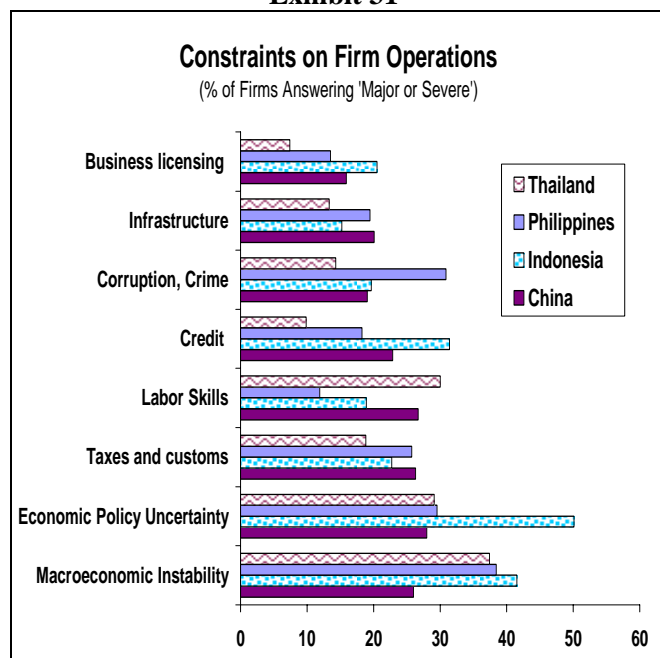
Other analysts have emphasized the role of *uncertainty* in checking new investment. They point for example to the high volatility of export earnings in a region that has become increasingly dependent on often highly cyclical electronics and high tech exports.²² One can add the possibility that uncertainty may also have increased because of the large and rapid changes in export market opportunities and comparative advantage experienced by East Asian firms over the past decade, and especially in the past five years, due in part to the rapid growth and intensification of competition from China (as discussed in the previous section). As a result many East Asian firms and economies are going through a period of structural adjustment, pulling back in a range of sectors and markets where they were previously competitive (an impact which may be felt immediately), while also having to invest time and resources (sunk costs) in seeking out the new sectors and market channels where there are investment opportunities created by the rise of China. Such a structural adjustment process may generate significant uncertainty, which may lead to new investment being delayed during an interim adjustment period during which firms try to learn

²¹ For example, M.D. Chinn and Hiro Ito. (2005). "Current Account Balances, Financial Development and Institutions: Assaying the World 'Savings Glut'". NBER Working Paper 11761. November 2005.

²² IMF. (2006). Asia and Pacific Regional Outlook. May 2006. Chapter V. "Asia's Investment Decline."

more about the new environment, although later it may also stimulate stronger investment, as firms become more familiar with new patterns of comparative advantage and market opportunities.

Exhibit 31



The quality of the *investment climate* in the region is also likely to play an important role. Regular firm-level investment climate surveys conducted by the World Bank in recent years provide a useful 'firm's eye view'. Exhibit 31 shows the proportion of firms in various economies that felt that a particular issue was a major constraint on their operations. In most economies shown the issues that concerned the largest number of firms as a major constraint on their operations are to do with uncertainty: *concerns about macroeconomic instability and about economic policy uncertainty*. For example, even though macroeconomic conditions have greatly improved since the 1997-98 financial crisis, some 42 percent of Indonesian firms in 2005 still cited concerns about macroeconomic instability as a major concern, although this proportion is down from 50 percent in 2003. These continued concerns may relate to firms' long memories of the crisis and also to occasional episodes of renewed volatility in exchange rates, interest rates and inflation that have occurred in the post crisis period, in particular in 2000/01 and in 2005. Firm concerns about macroeconomic instability have also been high in the Philippines, where the government's efforts to reduce a large fiscal deficit and high public debt have been at the center of attention. These examples underline the continued central importance of macroeconomic stability in firms' perception of the investment climate.

The investment climate surveys also highlight the importance of uncertainty about the content, interpretation

and implementation of rules and policies by government officials and in the courts. Some 50 percent of firms were concerned about this sort of policy uncertainty and arbitrariness in Indonesia in 2003, but it was also a concern for close to 30 percent of firms in China, Philippines and Thailand. On a related theme, concerns about corruption and crime are also particularly important for firms in the Philippines. In this connection, IMF (2006) also notes some deterioration in the World Bank's indicators of governance for East Asia over the last decade (Kaufman, Kraay and Mastruzzi, 2006), which may also suggest an increase in policy uncertainty.

Among other investment climate issues, concerns about the cost of and access to credit are prominent in Indonesia and, to a lesser extent, China (31 and 23 percent of firms respectively). Infrastructure, especially unreliable power supply, is flagged as a particular concern in the Philippines and China. Some 30 percent of firms in Thailand find the inadequate skills and education level of available workers to be a major constraint on their operations. The proportion is also relatively high in China, where over a quarter of firms find this to be a major constraint.

How important are investment climate variables for the operations of firms? To take just one example, econometric analysis shows that adverse investment climate variables in Indonesia have had a large and significant negative impact on firm level total factor productivity (TFP) and investment (measured here as the probability of undertaking a new investment). Total factor productivity is adversely affected by a wide range of investment climate conditions such as regulatory burden, policy uncertainty, poor financial market development, excessive labor disputes, and poor infrastructure. Since TFP is an important determinant of the return to capital, these factors can also be seen as having an indirect negative impact on investment. Among the factors having the largest direct negative impacts on investment are poor functioning of the judiciary (which has obvious negative implications for the security of property rights, for example), corruption, lack of security and lack of financial sector development. A one standard deviation improvement in security or financial development would increase the probability of a firm undertaking a new investment by almost one third, for example.²³

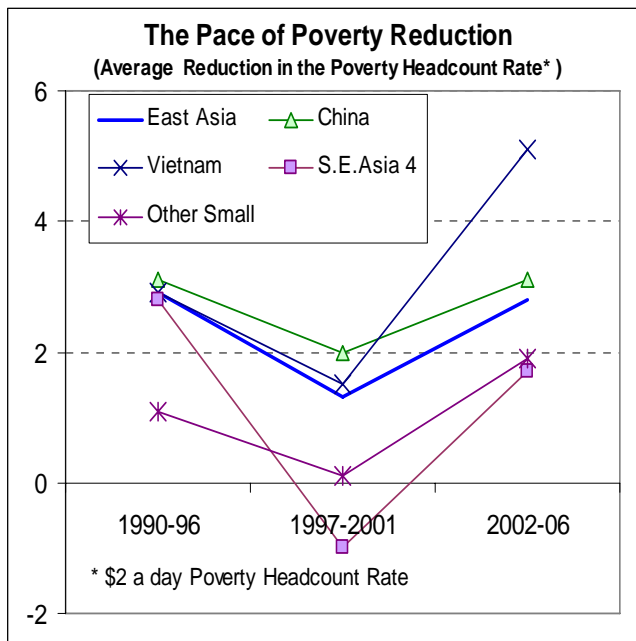
These results suggest that, although they are sometimes politically difficult and time consuming to implement, investment climate and governance reforms to reduce the scope for uncertainty about policies and laws and improve other aspects of the business climate can have significant payoffs for investment and growth. Such efforts are at the core of the agenda for revitalizing growth in the post crisis middle income economies.

²³ World Bank Indonesia Investment Climate Assessment 2003.

Poverty and Inequality - a 10 year perspective ²⁴

One of the distinctive features of the ‘East Asian Miracle’ of recent decades has been its ability to combine rapid growth with a relatively equitable distribution of the benefits of growth, reflected particularly in a rapid pace of poverty reduction. We find that for the region as a whole, the pace of poverty reduction in the period after the financial crisis has been just as rapid as before it. However the pace of poverty reduction is not equally robust everywhere. A still fairly large proportion of the region’s population continues to subsist at fairly low living standards. And inequality in income and consumption has risen significantly since the 1990s.

Exhibit 32



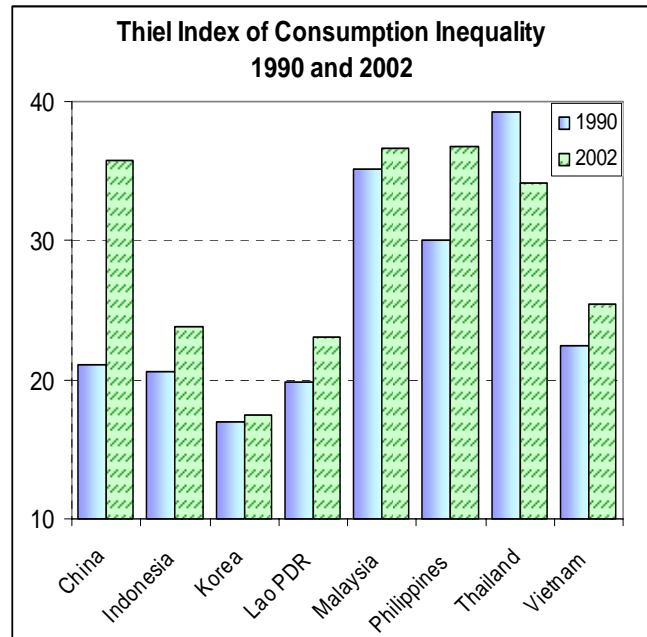
As Exhibit 32 indicates, the \$2-a-day poverty rate in East Asia was falling on average by close to 3 percentage points a year in the pre-crisis boom period 1990-96. The number of poor below this income line fell from 1.07 billion (two thirds of the population) in 1990 to 851 million (half the population) in 1996. The rate of poverty reduction slowed all over the region during the financial crisis. Poverty rates increased sharply in the crisis-affected middle income economies such as Indonesia, Philippines and Thailand. There was also a slowdown in the pace of poverty reduction elsewhere, even in economies that had not themselves fallen into crisis.

In the post-crisis period 2002-06, though, the pace of poverty reduction has once more picked up to close to 3 percentage points a year, bringing the \$2-a-day poverty headcount down further, from 43 percent in 2001 to 29 percent in 2006 (an estimated 552 million people). Within

²⁴ Recent developments in poverty reduction and human development are discussed on pages XX of this World Bank East Asia Update, while Appendix Tables 7 and 8 below provide detailed historical and forecast data on poverty.

the region, though, the revival of poverty reduction has been uneven and corresponds to differences in the pace of economic growth. In low income economies like Vietnam, Cambodia and Lao PDR economic growth and poverty reduction have both accelerated to exceed pre-crisis rates. In the previously crisis-affected middle income economies in South East Asia, though, both growth and the pace of poverty reduction have been somewhat lower than in the pre-crisis period.

Exhibit 33



While East Asian poverty continues to fall, a potentially more disquieting trend is that inequality of income and consumption has increased in most economies of the region. Exhibit 33 shows that the Thiel Index of within-country inequality increased markedly between 1990 and 2002 in China, Indonesia, Lao PDR, Philippines and Vietnam, and fell only in Thailand. A closer look at the increase in inequality in China finds that the largest part of the increase was contributed by an increased in inequality between urban and rural areas, with additional significant contributions from increased inequality within rural areas and within urban areas. Indeed the rural-urban divide is emerging as a key focal point of inequality in the region, with 75-80 percent or more of poverty at the \$1-a-day level being concentrated in rural areas.

A recent analysis of rising inequality in East Asia argues that many of the same forces that are contributing to rapid growth and more global integration are also the forces that are shaping unevenness in growth.²⁵

- A key factor underlying the rise in inequality within the region has been an expansion in wage inequality. In particular, as in many countries around the

²⁵ The discussion of inequality in this section follows Gill and Kharas (2007) *op.cit.*, Chapter 6: ‘Cohesion.’

world, there has been a large increase in the wage premium paid to education and skills. For example the wage premium for college graduates over senior high school graduates in China increased from 12 percent in 1988 to 37 percent in 2001.

- Increased global integration has increased the relative demand for skilled labor, in particular as foreign direct investment (FDI) has concentrated in skill-intense sectors and has introduced new technologies. Relative wages for skilled labor have also tended to increase because of the less elastic supply of such labor.
- Enterprise reforms and downsizing of the state owned enterprise sector in economies like China and Vietnam has reduced the proportion of employment in the public sector. As workers move into private sector employment, their wages become more closely related to their skills, leading to more wage dispersion. Some former SOE workers drop out of the job market, accept lower wages (especially if they are older) or become employed in the urban informal sector.
- Spatial disparities between dynamic urban areas and lagging rural areas are exacerbated by so-called location and agglomeration effects. Coastal areas and cities with other good transport links to global markets attract the lion's share of FDI. Firms and workers in urban agglomerations benefit from their closeness to each other in various ways, enhancing their productivity and incomes and further attracting modern firms and FDI. About 80 percent of FDI in China in 1989-2003 was concentrated in the coastal provinces, which also enjoyed faster income growth than the rest of the country.
- The trend towards fiscal decentralization in much of East Asia during the 1990s has tended to increase disparities in the fiscal resources available to local governments and in their ability to provide public services of importance to the poor such as health and education services.
- Massive internal migration from rural areas to fast growing urban areas has been a powerful equalizing force through its effect on reducing wage and income differentials across regions and sectors. However workers may lack the minimum levels of assets, education, skills and information needed to migrate. Migration may also be impeded by policies that deny them access to public services in the cities they want to migrate to.

Should people in East Asia care about rising disparities? After all, some of the factors that have been responsible for rising disparities are also the ones contributing to growth. Arguably, as the modern sector continues to grow and absorb ever larger proportions of low-productivity labor from other sectors, the disparities will eventually decline. Values surveys show there is a fair degree of support among East Asians for disparities that provide incentives for effort. Nevertheless there are still reasons for concern about the growth of excessive

disparities in the region. Current inequalities may become entrenched through inequality of opportunity across generations. There is also growing evidence that inequality may hamper productive investments and growth: poor people without access to credit may be unable to exploit investment opportunities that would benefit society. Excessive disparities may also be a source of political instability and social unrest. The last section of this discussion looks at approaches that may be helpful in addressing inequality.

Managing Vulnerability

Are East Asian economies still vulnerable to capital market and financial crises? In many respects it is fair to say that they are much less vulnerable to the specific *kind* of crisis that hit these economies in the second half of 1997 and in 1998. But that is not to say that they are not subject to any risks.

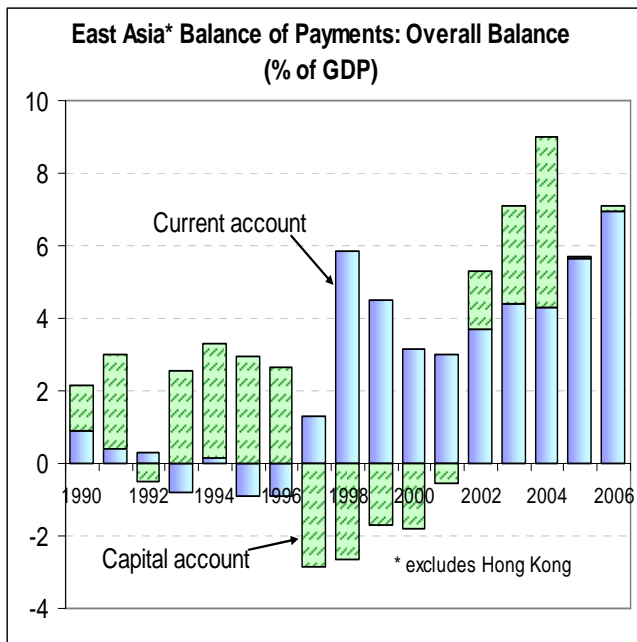
Here it may be worth briefly summarizing how East Asia got into trouble in the 1997-98 crisis. The lead up to the crisis involved growing private capital flows to emerging markets - an emerging markets boom - encouraged in part by the prevailing low interest rates in the developed world. In many instances governments had recently liberalized financial institutions, although without building up a sufficiently strong financial supervisory and regulatory capacity. These poorly regulated financial institutions took on excessive external debt, especially short term, foreign currency debt, which they intermediated to local borrowers (who also borrowed abroad directly), stimulating a surge in domestic credit, investment and asset prices. Strong asset prices and growth in turn attracted more foreign capital inflows. Vibrant domestic demand growth also led to the emergence of significant deficits on the balance of payments current account. The crisis began when a sharp change in foreign investor sentiment in mid 1997 led to a sudden stop in capital inflows, a severe liquidity squeeze, the emergence of massive bad debts, a collapse in investment and severe recession.

Economies in the region have pursued two broad strategies to manage vulnerability and reduce the risk of crisis. First, they have generally run current account surpluses and built up large foreign exchange reserves as a buffer or insurance policy against crises. Second, they have sought to strengthen fundamentals, for example by maintaining prudent macroeconomic policies and, in particular, by strengthening the financial sector.²⁶ Among the kinds of risks that might persist or new risks that might emerge are potential unwanted side-effects from the mix of policies used to support recovery after the crisis, or risks associated with only incomplete implementation of reforms.

²⁶ IMF (2006) "Country Insurance: The Role of Country Policies" presents a framework for analyzing the kinds of policies that countries can implement to protect themselves from adverse economic shocks.

Exhibit 34 shows the distinctive evolution of East Asia's overall balance of payment in the recent post crisis period, with large current surpluses being joined by significant capital account inflows, especially in 2002-04. (See the detailed discussion of recent balance of payments trends on pages 18-22 above). The Exhibit highlights the contrast with the period of the pre-crisis boom in the early-mid 1990s just described, when large net capital inflows to the middle income South East Asian economies and Korea were partly offset by significant current account deficits.²⁷

Exhibit 34



Exhibits 35 and 36 below show that the underlying forces driving large current account surpluses are very

different in China compared to the post-crisis economies of the region. In China the current account has surged despite very high levels of investment, due to a sharp increase in domestic savings. The largest part of the savings increase in China has derived from an increase in business profits and savings. Among the post-crisis economies, on the other hand, saving has been relatively stable but the current account surplus has surged due to the large decline in investment after the crisis.

Reserve Accumulation as Crisis Defense

As the earlier discussion of recent balance of payments argued, most economies in the region have resisted upward pressure on the exchange rate caused by large balance of payments surpluses by intervening in the foreign exchange market, resulting in the rapid build up of foreign reserves in recent years. For one thing, governments have been concerned about the potential adverse impact of exchange rate appreciation on competitiveness, exports and employment.

The build up of record foreign reserves in East Asia can also be viewed as a form of precautionary saving, buffer or self-insurance against the risk of balance of payments crises. Exhibit 37 shows the large increase in the ratio of foreign reserves to short term foreign debt among the five crisis economies in the decade since the crisis. In all cases reserves stand well above the 100 percent ratio recommended by the so-called Greenspan-Guidotti rule of thumb for reserve management, in most cases 2 1/2 to 5 times above it. Jeanne and Ranciere (2006) present evidence that developing economies typically use reserves to smooth domestic demand and growth during a balance of payments crisis.²⁸ In addition to mitigating the impact of a crisis, high reserve levels might also serve to prevent crisis. Jeanne and

Exhibit 35

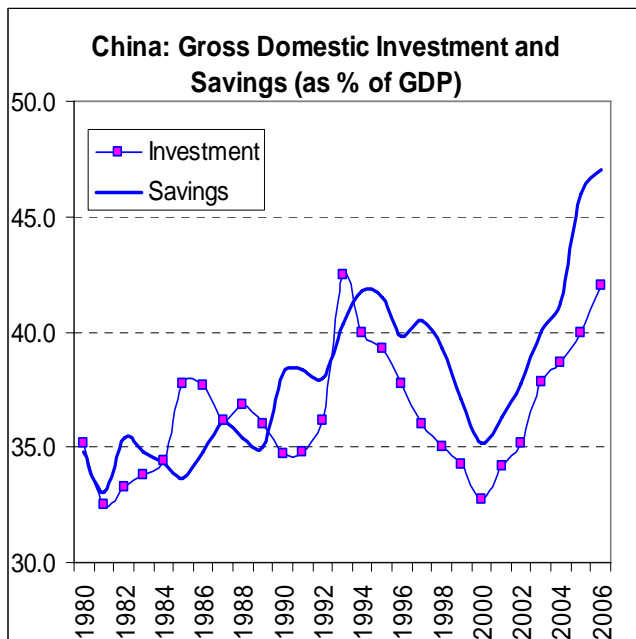
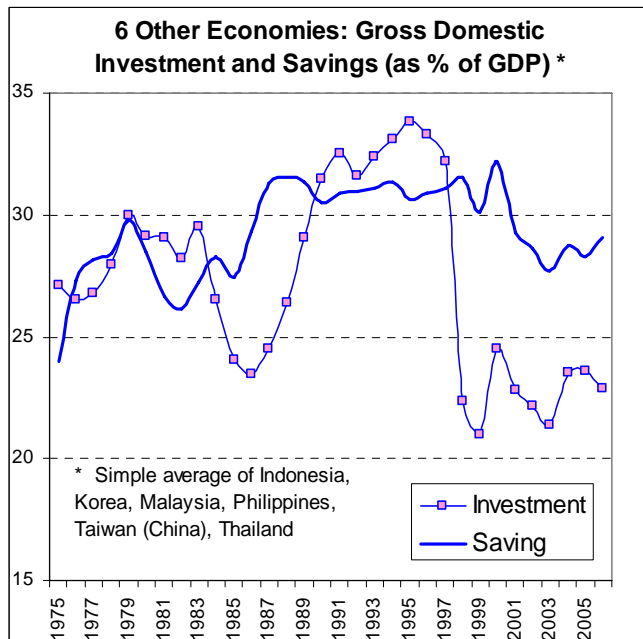
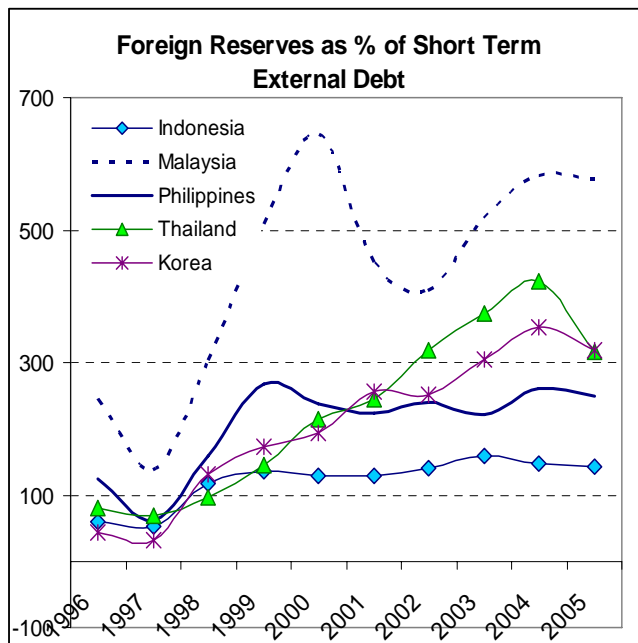


Exhibit 36



Ranciere develop a formal model to determine the optimal level of reserves. The optimal level increases with the probability of a ‘sudden stop’ in capital flows, which, in turn is found empirically to increase with the extent of financial integration, the ratio of public debt to GDP and the extent of real exchange rate appreciation. They find that the optimal level of reserves in Emerging Asia has indeed increased substantially over the last decade, principally due to the region’s growing financial integration, and is estimated to be about 25 percent of GDP in 2005. However, East Asian reserves actually averaged around 46 percent of GDP, exceeding the proposed optimal level by a wide margin.

Exhibit 37



The large build up of reserves can however create unwanted vulnerabilities or side-effects. Purchases of foreign exchange with local currency lead to an increase in domestic base money, which, if left untreated, can underpin a broader expansion of credit and aggregate demand, contributing to economic overheating, higher inflation and unwarranted euphoria or bubbles in asset markets, potentially compromising the central bank’s ability to pursue an independent monetary policy. To avert these consequences many East Asian governments have tried to mop up excessive liquidity (“sterilization”) through large bond issues, sometimes amounting to several percentage points of GDP, as well as increases in commercial bank reserve requirements. But these expedients can also have undesirable side effects (discussed in more detail in section on recent balance of payments developments earlier in the report).

Faced with these complications, policy makers in the region have been gradually moving towards greater exchange rate flexibility. China and Malaysia widened the band for their currencies in the middle of 2005, followed by

an appreciation of 7-8 percent since then. The Korean, Philippines and Thai currencies have also seen appreciable increases over this period. Continued movements towards greater flexibility would improve the ability of economies to adjust to external shocks more smoothly and would also allow central banks greater independence in the conduct of monetary policy.

Financial Sector Strengthening

The decade since the crisis has seen substantial changes in the size, diversity, efficiency and stability of financial systems in East Asia. If prior to the crisis the focus of attention was on mobilizing finance, now the it has shifted to the efficiency of resource allocation, diversification of supply, and improving the robustness of financial systems to withstand a range of shocks

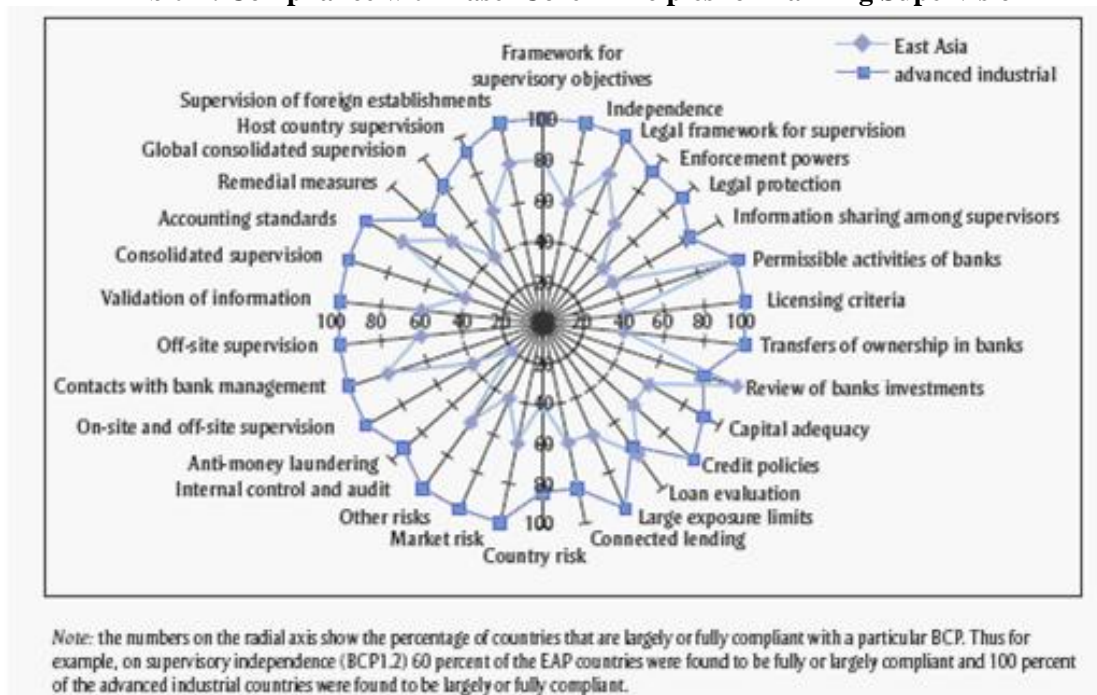
The assets of East Asian financial systems reached \$9.6 trillion in 2005, over one fifth the size of US markets and almost half the size of Japan’s.²⁹ Financial markets have also become more diversified. The importance of a more diversified financial system is that, given sufficient market depth, it can serve to enhance efficiency, since financial intermediaries and securities markets perform the core functions of resource mobilization, resource allocation and risk management in different specialized ways. By offering a wider array of risk-sharing mechanisms, diversification can also increase the overall risk-bearing capacity of the economy.

Reflecting increased diversification, 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. Despite the impressive (300 percent) growth in the securities markets over the past nine years, the banking sector, with US\$5.5 trillion in assets, still dominates. On average the banking sector accounts for almost 60 percent of total financial sector assets.

Significant structural changes have taken place in the banking sectors of crisis affected countries, as a result of policy efforts to address issues of capitalization, governance, risk management and operational efficiency. Banking sectors have generally become more consolidated, with a fall in the number of banks in most middle income countries, as well as an increase in their median size. Although banks have yet to reap the benefits of scale and scope, efficiency measures such as the ratio of operating costs to assets have improved and compare favorably to banks in other regions. As the earlier section in this report on recent financial sector trends discusses in more detail, banks in the previously crisis-affected East Asian countries

²⁹ Swati Ghosh: (2006). “East Asian Finance: The Road to Robust Markets.” World Bank.

Exhibit X. Compliance with Basel Core Principles for Banking Supervision



have achieved substantial improvements in capital adequacy, asset quality and profitability. Average NPLs in the five crisis countries fell from close to 30 percent in 1998 to only about 6 percent in 2006, although this remains higher than in some other developed and developing regions.

The region has undertaken significant efforts to improve prudential regulations and supervision to strengthen the stability of the banking system, but this is a work in progress and several areas still need to converge to international standards. Based on a review of the implementation of the Basel Core Principles for Banking Supervision (BCP), there are several areas in which fewer than 60 percent of the countries are compliant or largely compliant. Such areas, where more focus and policy effort is needed include:

- The independence, powers, and resources of banking supervisors;
- Criteria and processes for licensing banks;
- Prudential regulations and requirements, including rules for evaluating asset quality and the adequacy of loan-loss provisions and reserves; and systems to monitor, and control country risks and all other material risks;
- Remedial measures and exit which requires supervisors to have and promptly apply remedial measures when banks do not meet prudential requirements.

- Cross-border banking, which requires supervisors to apply global consolidated supervision over internationally active banks.

In terms of strengthening securities markets, the key constraints that need to be addressed in East Asian securities markets are limited liquidity and low efficiency. Three key factors affect liquidity and efficiency—and ultimately the role that securities markets play in the region, namely: the availability of information to price securities accurately, transactions costs, and the size and heterogeneity of the investor base

- The availability of good information to price securities accurately is affected by corporate governance and the degree and quality of disclosure. Countries in the region have made considerable progress in strengthening the legal and regulatory framework for corporate governance and disclosure requirements, and in strengthening accounting and auditing standards. But a stronger focus on implementation and enforcement are needed;
- Factors affecting transactions costs include withholding taxes and fees, the efficiency of intermediaries, market infrastructure and institutional arrangements. While the region fares quite well in market infrastructure with fairly advanced clearance and settlements systems, strengthening of the intermediaries and further development of the supporting markets and institutional arrangements such as repo markets, securities lending, and derivatives markets, is needed;
- A broader and more diversified investor base, will depend on further developing the domestic institutional

investor base—pension funds, insurance and mutual funds—as well as fostering greater regional financial integration. Securities markets have become more integrated both globally and within region over the past 10 years. However, in several economies, a sizable proportion of shares remains inaccessible to cross border investors. This, coupled with the fact that a significant proportion of shares is closely held, means that in some economies only a relatively small percentage of shares is freely available to potential investors. In turn this can significantly dampen liquidity and efficiency in the stock markets.

Some Policy Perspectives

The preceding discussion has touched on a variety of policies and ideas that may assist economies in East Asia maintain robust growth in a sustainable way, reduce poverty, strengthen equity and manage vulnerability. Bringing some of these points together:

- The importance of *prudent monetary and fiscal policies* to maintain or improve macroeconomic stability cannot be underestimated. Investment climate surveys show macro instability to be one of chief constraints on operations perceived by firms, and it is as well one of the chief sources of vulnerability to crises.
- *Governance reforms* to reduce arbitrariness and uncertainty in the formulation and implementation of policies and laws would also help address one of the major concerns of firms in the region. Grouped with this is the need for continued progress in combating corruption and crime, as well as regulatory reforms to reduce, simplify or eliminate needlessly burdensome and complex regulations, which add unnecessarily to the costs of doing business and are also important sources of uncertainty for firms. But reforms that reduce arbitrariness, corruption and needless red tape would perhaps be of even greater importance in accelerating poverty reduction and improving equity, for example by helping improve delivery of basic services for the poor, or in fostering entrepreneurial activity among the poor.
- *Financial sector and capital market development.* Economies in the region have made substantial progress in restoring the capital adequacy, asset quality and profitability of their banking sectors. The challenge now is to strengthen the corporate governance of financial institutions and further bring the quality of prudential regulation and supervision up to advanced standards. This will become increasingly important in ensuring that risk transfer among financial institutions through new financial instruments—which has been a major innovation globally—takes place appropriately. Also important is to continue to foster the development of deeper, more diversified capital markets. Such a development would not only reduce vulnerability to crises but would also enhance the efficiency, capacity for specialization and growth potential of the economy. Since financial intermediaries and markets perform the core functions of resource mobilization, resource allocation and risk management in different ways, they may each be better at certain aspects of these functions. A more diversified financial sector and capital market are especially important to support investment not just in well-known old lines of business, but especially investment in new, more uncertain, more innovative and long term projects. At the same time, the financial constraints faced by poor households are a key impediment to their taking advantage of income-generating opportunities. Improving access to credit and other financial services for the poor may be a major step in promoting a more equitable distribution of the benefits of economic growth
- Availability of *high quality infrastructure services* is increasingly important as a competitive element determining firms' investment decisions. It is estimated that East Asia has infrastructure needs of approximately \$200 billion annually over the next five years, 65 percent in new investment, with the remaining 35 percent channeled toward maintenance of existing assets. Government has a critical role to play in developing the long range vision for infrastructure, coordination between key players (public-private partnerships, central versus local government levels etc), developing the fiscal space for the appropriate public sector roles, enhancing competition and strengthening the quality of regulation.
- *Skilled labor shortages* are an increasingly important constraint on firm operations, especially in the region's middle income economies. While East Asia has made big strides in primary education over the last two decades, enrollments at the secondary and tertiary levels remain relatively low in many countries and there are large disparities within countries. Education and other forms of human capital development are a fundamental underpinning for both domestic innovation activity and the capacity of the economy to absorb knowledge from abroad. Strengthening quality and enrollment in secondary and tertiary education, improving labor force training capabilities and, more generally fostering development of national innovation systems are an increasingly important part of the region's policy agenda. Because imperfect access to credit and other impediments may prevent poor people from improving themselves through higher education, policies that improve access to higher education will also promote a more equitable distribution of the benefits of growth.
- *Facilitating internal migration* has the potential to become a major force for greater equity within

countries, in addition to its contribution to a more flexible business environment and to growth. Impediments that hamper migration include the low human capital base of potential migrants, de facto restrictions on the movement of people across regions, and the poor access to basic services (education of children, housing, and health) for migrants in destination areas.

- *The development of social protection systems.* Greater economic integration has tied the fate of people in East Asia to changes in the world and regional economies, thus exposing populations to new sources of vulnerability. The coverage of formal social protection systems is limited in most countries, while the demands on the systems have risen because of expanding urbanization and migration and the aging populations in several countries. Improving the coverage and performance of unemployment insurance, health insurance, and pension systems, as well as targeted income-transfer programs, is likely to assume more importance in the future.