East Asia and Pacific Regional Update

Summary

Growth in Emerging East Asia accelerated to reach 8.1 percent in 2006 [1] (Table 1). This was the strongest pace of economic expansion in the last ten years and a fitting commemoration of the decade that has passed since the start of the Asian financial crisis in 1997. The region's accomplishments in grappling with and overcoming the crisis and in returning to solid growth are varied and impressive – a doubling in the dollar value of regional output from pre-crisis levels, the emergence of China into the front rank of global economic powers, a halving in poverty rates, accumulation of over $2 trillion in foreign reserves. But even as the region celebrates recovery, new challenges are arising, which could slow or even derail growth if not properly handled. The report looks at these issues in a section on "Ten Years After the Crisis."

Another challenge of staggering proportions that lies ahead is East Asian urbanization: The region's population will rise by around 17 percent between 2000 and 2025 but its urban population will jump by 65 percent or 500 million. The Special Focus in this report on "Sustainable Development in East Asia's Urban Fringe" looks at the issues.

Table 1. East Asia Economic Growth

	2005	2006	2007	2008
Emerging East Asia	7.6	8.1	7.3	7.0
Develop. E. Asia	9.0	9.5	8.7	8.1
S.E. Asia	5.1	5.4	5.5	5.7
Indonesia	5.7	5.5	6.3	6.5
Malaysia	5.2	5.9	5.6	5.8
Philippines	5.0	5.4	5.6	6.0
Thailand	4.5	5.0	4.3	4.5
Transition Econ.				
China	10.2	10.7	9.6	8.7
Vietnam	8.5	8.2	8.0	8.0
Small Economies	7.6	7.2	5.9	4.9
Newly Ind. Econ.	4.8	5.4	4.5	4.9
Korea	4.0	5.0	4.4	4.9
3 other NIEs	5.5	5.8	4.6	4.9
Japan	2.6	2.2	2.3	2.4

World Bank East Asia Region; March 2007. Consensus Forecasts for NIEs..

This year is also likely to be memorable for another reason, as the turning point in the global cycle, after 5 years of sustained and accelerating expansion, with the US economy slowing and a global tightening of monetary policies still underway. The base outlook remains for a 'soft landing' and continued expansion, but one that is weighted with more uncertainties and with greater volatility. The next two sections of the report explore the implications for East Asia.

East Asia Regional Outlook

- ***Growth***. The strong overall regional outcome for 2006 was dominated by China, which now comprises over half of Emerging East Asian GDP and where growth reached 10.7 percent, a fourth year of over 10 percent growth, driven by buoyant exports and investment. Activity also expanded at energetic 8-10 percent rates in low income economies such as Cambodia, Lao PDR, Mongolia and Vietnam. In Vietnam, across-the-board strength in exports, consumption and investment was buttressed by a surge in foreign direct investment before the economy's accession to the WTO this January. The larger middle and high income economies of the region also continued to expand at more moderate but still healthy rates of 4-6 percent. Some slowing in regional activity became apparent in the latter part of the year, with growth easing to 7.6 percent (y-o-y) in the fourth quarter. In China this mainly reflected a moderation of investment spending following policy tightening by the authorities. Elsewhere, though, the slowing trend reflected lower export growth, especially to the US. And the emerging US downturn and slowing export growth are also the main factors behind the forecast easing in Emerging East Asian growth to 7.3 percent in 2007. The extent of the US slowdown is one important risk in the outlook, but continued growth in Japan and Europe should provide some balance, together with continued growth in China's imports of components and other inputs from the rest of Asia (although recent trends suggest growing competition in the China import market as the country deepens its domestic supply chain for export goods). Another area of uncertainty is the extent to which domestic demand in the East Asian economies outside China will be able to pick up slack from slowing exports.

- ***Poverty.*** We estimate that the number of poor people in East Asia at the $2 a day level fell to some 552 million in 2006 (or 29 percent of the region's population). Looking back, it is likely that the last five years of economic recovery and expansion have been among the most productive for poverty reduction in the history of East Asia. Since 2001 the number of people living below the $2 a day line has been reduced by some 228 million, an even bigger reduction in poverty than in the previous extended 'boom' of 1991-96. Those earlier

[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).

poverty reduction gains were also partially squandered during the subsequent 1997-98 financial crisis. If the region's policy reform efforts succeed in reducing macroeconomic and financial vulnerability while maintaining high growth, the payoffs for sustained poverty reduction would be large indeed. The Poverty section of the report also looks at new policy approaches that governments are taking to tackle poverty in a more comprehensive way. Thus China recently announced plans for a nationwide rural safety net or 'di bao' to tackle vulnerability to poverty (i.e. the fact that many more people are vulnerable to falling into poverty as a result of adverse shocks than are actually poor at a given time). Indonesia announced plans to scale up spending on poverty reduction through a National Community Empowerment Program that builds on the success of existing community development programs. These programs focus on improving local governance and service delivery through participatory planning, providing community block grants for productive assets such as rural infrastructure, education, and health.

The international and regional environment

- ***Developed economies***. After reaching 4 percent in 2006 (5.3 percent in PPP terms), global growth is at something of a turning point, projected to fall to 3.4 percent in 2007, led by a more than one percentage point fall in US growth to 2.1 percent. Growth in Japan and Europe has tended to surprise to the upside over the past year, however, and is expected to continue at rates similar to 2006. The rotation in the balance of growth from the US to the rest of the world should help stabilize and begin a gradual adjustment in global macroeconomic imbalances. Another key aspect of the turn in the global cycle is the continued gradual tightening of monetary policies in the developed world, most recently in Europe and Japan, which is bringing to an end an extended period of negative real interest rates. Tighter monetary policies are helping curb an incipient upturn in inflation in developed economies, and are also providing a check to the danger of bubbles in financial and other asset markets, a healthy development. Higher developed country interest rates are also likely to slow or partially reverse the surge in 'yield seeking' private capital flows to emerging markets underway since 2003. This development may actually ease macroeconomic management in many East Asian economies, which have been grappling with the exchange rate and monetary consequences of not only large current account surpluses, but also of significant capital inflows.

- ***China***. Growth in China decelerated mildly in the second half of 2006, easing from almost 11 percent in the first half of the year to around 10.5 percent in the second, the result mainly of policy tightening aimed at curbing excessive investment growth. Slower investment growth in the latter part of 2006 was partly offset by a further increase in the contribution of net trade to growth – export growth accelerated (at a time when US demand and other East Asian exports were waning), while import growth decelerated. Rising net trade also contributed to a surge in China's current account surplus to an estimated $230 billion in 2006, or a striking 8.7 percent of GDP, up from $161 billion in 2005. The large external surplus is complicating the authorities' efforts to establish an appropriately tight monetary policy by tending to feed more rapid growth in domestic credit. These circumstances point towards a continued focus on the authorities' policy of rebalancing the pattern of economic growth, orienting growth more towards domestic demand and consumption, towards more even distribution of the benefits of growth, and towards less intensive use of energy and natural resources. They also point to a continued focus on the role of greater exchange rate flexibility and a stronger exchange rate as instruments to bring about desirable expenditure switching and laying the basis for a more independent and flexible monetary policy.

- ***Commodity markets***. Oil prices remain extremely volatile and subject to political risks. Having fallen sharply from their peak of over $70 last August, crude oil prices averaged around $58 through much of the last six months, although they were moving sharply higher to the mid sixty dollar range by the end of March as a result of escalating political tensions in the Gulf. The report assumes a mild decline in oil prices from $64 in 2006 to $56 in 2007 as whole, which would provide a modest terms of trade based income gain for the region. Among fundamental factors favoring this stable to gradually declining price scenario is evidence that consumers in many places are adjusting to high prevailing prices by improving efficiency and cutting demand. Thus, even while demand from China continued strong in 2006, it fell in the OECD. On the supply side high prices are finally inducing significant increases in production capacity and output in non-OPEC suppliers. Given the significant fall in prices in the second half of 2006, OPEC has moved to stabilize prices by restricting output. That has also increased its margin of spare production capacity to the highest level in several years, which should be helpful in case of serious political disruptions to the market. Still, while it is hard to predict, a large politically driven spike in oil prices is well within the bounds of possibility. And that would constitute another significant risk in the East Asian outlook.

- ***Balance of payments and financial market developments.*** Emerging East Asian economies saw a record increase in their foreign exchange reserves (i.e. an overall balance of payments surplus) of $357 billion – worth 7 percent of GDP - in 2006. This was the fourth year when the increase in regional reserves exceeded

$200 billion. Foreign reserves for the region exceeded $2 trillion by the end of 2006, of which $1.06 trillion was held by China. Reserve accumulation was almost entirely driven by East Asia's current account surplus, an estimated $362 billion in 2006, another record. Almost two thirds of the regional imbalance occurred in China, where the current account surplus rose to an estimated $230 billion or 8.6 percent of GDP, both records by a significant margin. The other main economies in the region also ran current account surpluses in 2006, which in the majority of cases were also higher than in 2005. Wary of letting surpluses push up their exchange rates too far, for fear of hurting exports and employment, most governments have intervened, accumulated foreign reserves and then mopped up the resulting increases in domestic liquidity with fairly hefty bond issues. But the growing costliness and other inconveniences of this procedure have also led governments to consider other options. Thailand introduced controls on capital inflows in December, but rescinded a significant part of them following heightened uncertainty among investors. Overall though, the extraordinary scale of balance of payments inflows over the last 4-5 years is leading policy makers to put more emphasis on exchange rate flexibility. This is evidenced by China and Malaysia's adoption of a more flexible exchange rate framework in mid 2005, and an increased pace of appreciation among several other economies.

A sudden sell-off on the Shanghai stock market at the end of February set off a correction in stock markets around the world. While there was no single cause for the sell-off at the global level, the event does provide evidence for a heightened appreciation of risk among investors, more uncertainty about the outlook, for example about prospects for the US economy, as well as the impact of tightening global monetary policies. Asset markets in East Asia as elsewhere are likely to be more volatile in the coming period.

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. In per-capita terms real incomes are some 75 percent higher. The poverty rate at the $2 a day level has fallen from 50 percent of the population to 29 percent today. When Vietnam reaches middle income status (defined as annual pr 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. History shows that while many economies can reach middle income status – often quite quickly – few pass through it because the policy and institutional changes needed are more complex and more challenging technically, politically and socially. 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. We look at three key challenges: facing East Asia 10 years after the crisis, and at some policy perspectives that can help address them.

- ***Maintaining High Growth, Sustainably.*** While overall East Asian per-capita income growth in the post crisis period 2002-06 has been as strong as pre-crisis trends, this conceals two distinct stories. In China per capita growth of near 9 percent is somewhat faster than pre-crisis. But many other middle (and high) income economies in the region are growing at about 2 percentage points less than pre-crisis. There are thus at least two middle income growth challenges in East Asia.

In China rapid growth has led to an accumulation of 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. Industry is large relative to services, which adds to environmental pressure. On the demand side, the share of investment is large relative to consumption, raising concerns about inefficient use of capital and a potential build up of overcapacity in specific sectors. Rural-urban income gaps have widened. To address these problems the government is developing policies aimed at 'rebalancing the economy' and 'striving for a harmonious society'. While maintaining fast growth, the aim is to achieve a shift in production from industry towards services, more reliance on domestic demand, and growth that is more equally shared and more environmentally sustainable.

Among other middle economies in the region, however, growth has been less than pre-crisis, with investment somewhat weak and erratic. Their overall shares in world trade have also been under pressure as they have adjusted to the rapid emergence of China on the world trade scene. China's emergence, while it is generating tremendous welfare gains for consumers around the world, is also creating intense competitive pressures for other East Asian economies in global markets (especially in the last 5 years). But China has also provided a fast growing market for components and other inputs from other East Asian economies. The result is a new division of labor, with pan-Asian production networks centered on China as a final integrator of products for export to the outside world, and a rapid rise in intra-regional trade in production inputs. World Bank Investment Climate Surveys find East Asian firms rating *uncertainty* as the biggest constraint on their operations. That is hardly surprising, given the wrenching competitive challenges and structural adjustments they are undergoing. Global competition is not going away. Efforts to strengthen the investment climate are key to creating an environment in which firms are able to more effectively seek out efficient investments and areas of global comparative advantage.

- ***Poverty and Inequality.*** At the same time as East Asian poverty has been falling, inequality of income and consumption has increased in many economies of the region, in some cases sharply. This matters. Inequality can hamper growth, as poor people without access to credit may be unable to exploit investment opportunities. It can be a source of political and social unrest. Research suggests 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. Among other factors, increased globalization has increased relative demand for skilled labor, pushing up wage premiums for education and skills, one of the key factors behind the rise in inequality. Spatial disparities between urban and rural areas are exacerbated by location and agglomeration effects that reward coastal areas and cities with good transport links to global markets, and firms and workers in cities who benefit from their closeness to each other in various ways. How might inequality be mitigated without killing the golden goose of productivity growth and wealth creation?

- ***Managing Vulnerability.*** The financial crises of 1997-98 highlighted the potential costs of mismanaging vulnerability. Economies in the region have pursued two broad strategies to reduce the risk of crisis. First, they have run current account surpluses and built up large foreign exchange reserves as an insurance policy against crises. Research suggests that reserves now far exceed optimal levels for precautionary purposes. Instead they can create unwanted side-effects of their own, for example by fueling excessive expansion of credit, economic overheating, higher inflation or speculative bubbles in asset markets, potentially compromising the central bank's ability to pursue an independent monetary policy. Second, economies have sought to strengthen fundamentals, in particular the financial sector. Progress in this area has been significant. Banks in the previously crisis-affected East Asian countries have improved capital adequacy, asset quality and profitability. Financial systems have become more diversified as equity and bond markets have grown. The region has improved 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. In terms of strengthening securities markets the focus needs to be on key factors that can help increase market liquidity and efficiency. These include improving the availability of information to price securities accurately, reducing transactions costs, and fostering growth in the size and heterogeneity of the investor base.

- ***Policy perspectives.*** The report highlights a number of policy areas in which progress could have multiple benefits across the three highlighted areas of concern.

✓ *Investment climate reforms* that reduce policy uncertainty and needless and costly regulations can help strengthen the competitiveness of not only formal sector firms but also entrepreneurial activity among the poor.

✓ *Deeper, more diversified capital markets* lessen vulnerability and enhance the growth potential of the economy by offering more specialized modes of resource mobilization and allocation, for example by supporting investment in new, more uncertain and innovative projects. Improving credit access for the poor removes a key impediment to their pursuing profitable investment opportunities.

✓ *Services trade liberalization,* an area where East Asia has lagged, would provide a boost to the productivity and competitiveness of services consuming sectors.

✓ *High quality infrastructure* is an increasingly important element of competitiveness. It is estimated that East Asia has infrastructure needs of approximately $200 billion annually over the next five years,

✓ *Meeting skilled labor shortages,* which are an important constraint on firm operations in the region's middle income economies. 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 fostering development of national innovation systems are an increasingly important part of the region's policy agenda. Policies that improve access to higher education will also promote a more equitable distribution of the benefits of growth.

✓ The importance of *prudent macroeconomic policies* cannot be overestimated. 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.