

EAST ASIA AND PACIFIC UPDATE

1. Summary

*Growth in Emerging East Asia is expected to exceed 8 percent in 2007 for a second year in succession and to moderate only slightly in 2008.*¹ (Table 1). Our projections for regional growth in 2007 and 2008 have been substantially increased compared to six months ago, mainly due to the unexpected and large domestic-demand-led acceleration of growth in China. Growth also picked up in most of the other larger economies of the region, again a result of more buoyant investment and consumption spending. Concerns about the impact of the US sub-prime crisis and the renewed surge in oil prices have clearly increased downside risks. Nevertheless we expect that the stronger growth momentum in the region will carry through 2008. There are as yet few signs of a significant pick-up in underlying core inflation pressures or of other domestic constraints or imbalances that would require a marked slowing of growth. And it is worth noting that this year's pick-up in East Asia has occurred despite an already substantial decline in US import growth, and some (more modest) slowing in the region's own exports. Consensus forecasts are still for overall OECD growth in 2008 to continue at the same modest pace as in 2007 – around 2.2 to 2.3 percent. It seems reasonable to expect that East Asia could also sustain its recent pattern of growth through next year.

Downside risks to the outlook have also increased. There is a significant probability that the sub-prime crisis, the associated credit squeeze and rising oil prices could force a more substantial downturn in the developed world, in particular in the US. This would lead to a more significant cyclical slowdown in East Asia. But a review of the region's performance in previous global downturns suggests that the impact on East Asia is unlikely to be especially severe or protracted, given the region's strong macroeconomic fundamentals and in the absence of a major downturn in global high tech demand such as occurred in 2001.

The region's ability to weather near term global volatility allows countries to remain focused on advancing long term development goals. Poverty in East Asia continues to fall, but, as the Special Focus in this Update on "Agriculture for Development in East Asia" explains, it is also now a largely rural problem. A widening urban-rural income divide is also contributing to rising inequality. This is one reason why governments in countries like China are renewing their focus on rural and agricultural development issues. At the same time it has

been East Asia's rapid growth that has been primarily responsible for its remarkable success in lowering poverty. Maintaining this growth remains key and to this end continued improvements in the investment climate, financial systems, public service delivery, and education and innovation systems remain priorities in much of the region.

Table 1. East Asia Economic Growth

	2005	2006	2007	2008
Emerging East Asia	7.7	8.3	8.4	8.2
Develop. E. Asia	9.2	9.8	10.1	9.7
S.E. Asia	5.1	5.4	5.7	5.8
Indonesia	5.7	5.5	6.3	6.4
Malaysia	5.0	5.9	5.7	5.9
Philippines	4.9	5.4	6.7	6.2
Thailand	4.5	5.0	4.3	4.6
Transition Econ.				
China	10.4	11.1	11.3	10.8
Vietnam	8.4	8.2	8.3	8.2
Small Economies	7.8	7.2	6.4	6.2
Newly Ind. Econ.	4.9	5.5	5.1	5.1
Korea	4.2	5.0	4.8	5.1
3 other NIEs	5.5	5.9	5.4	5.1
Japan	1.9	2.2	2.0	1.8

World Bank East Asia Region; October 2007. Consensus Forecasts for NIEs. Regional averages are GDP weighted.

East Asia Regional Outlook

East Asian growth accelerated in 2007, led by domestic demand. Economic growth in Emerging East Asia accelerated to 8.4 percent in the first half of 2007, up from 7.8 percent in the latter part of 2006, exceeding earlier expectations by a wide margin. The acceleration in the first half of 2007 was especially sharp in China, with growth averaging 11.5 percent, up from around 10.5 percent in the latter part of 2006, mainly due to faster domestic demand growth, in particular investment. Growth also continued to run at solid 7-10 percent rates in several low income economies of the region such as Cambodia, Lao PDR, Mongolia and Vietnam, powered by across-the-board strength in exports and domestic demand. Growth also picked up in several middle income economies in South East Asia, notably Indonesia and the Philippines, where first half growth picked up to 6.1 percent and 7.3 percent respectively, while continuing to run in a 5 ½-6 percent range in Malaysia.

The outbreak of the US sub-prime crisis has had little adverse impact on East Asia so far. Preliminary assessments suggest that direct exposures of East Asian financial institutions to sub-prime risks are

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).

relatively limited, although risks may increase if the global instability and tightening of credit markets intensifies and leads to further declines in prices of various other structured assets held by banks. The main transmission channels to East Asia and other emerging markets in the immediate aftermath of the sub-prime crisis were instead heightened uncertainty and a reassessment of risk, reflected in stock market declines, depreciation of currencies and widening sovereign bond spreads. The initial pullback from emerging market assets proved temporary, with asset prices recovering their initial losses between mid August and mid October, as international investors took a more positive view of macroeconomic fundamentals in emerging markets and the potential for continued strong growth in these economies. Volatility again increased in early November as US financial institutions announced larger than expected losses on sub-prime related assets. Frequent and large reassessments of risk and high volatility in asset prices are likely to remain a part of the scene for some time.

The impact of the sub-prime crisis on East Asia through slower import growth in the developed countries should be modest.

The US sub-prime crisis and the associated tightening of global capital markets have led us to reduce projections for US and OECD growth in 2008 by 1 and ½ percentage points respectively compared to projections six months ago. OECD growth in 2008 is now projected at 2.2 percent, slightly down from 2.3 percent in 2007 - in other words a continuation of the more sluggish developed country conditions already seen in 2007, which however have not had much adverse impact on East Asia so far. US import growth has already fallen to near zero in real terms since the latter part of 2006 and East Asian export growth has also moderated. Nevertheless East Asian output growth accelerated in 2007 due to stronger domestic demand and the baseline forecast reflects a continuation of this pattern through 2008. A number of factors should continue to support resilience in domestic demand going forward. Capacity utilization is at much higher levels now than it was in the last global downturn in 2001 and profitability and balance sheets in the region's corporations are also stronger, providing a favorable footing for investment. Current account surpluses and very high levels of foreign reserves also mean that most economies are much less vulnerable to sudden volatility in capital flows.

New highs for oil prices will test the solidity of the East Asian and global economic expansions in 2008.

Crude oil prices have moved almost continuously higher over the course of 2007, from \$53.4 per barrel in January to over \$90 in early November (for an average of Brent, Dubai and West Texas intermediate crudes). The tightness in the oil market is underpinned by both demand and supply factors. Although rising prices have curbed

demand growth in developed countries, demand for oil in developing countries continues to grow by 3-4 percent year. The supply response to higher prices has also turned out to be more sluggish than expected due to rising input costs in oil capacity development and significant political and investment climate uncertainties in many producing countries.

Oil prices are likely to remain elevated and volatile over 2008-09.

Prices are currently assumed to average \$72 a barrel in 2008 and just under \$70 in 2009, although, given the tight market conditions, speculative demand and political risk factors, there is a significant risk that prices could remain above \$90 for a more extended period, adding to pressures for a global slowdown, especially in economies like the US already weakening for other reasons. However there is some comfort in the relatively limited impact on world growth of the more than doubling in oil prices over the last 3-4 years. One factor here is that the rise in prices has been spread out over several years, avoiding sudden shocks to consumer and business confidence. Many economies have also become more energy-efficient and more flexible in their ability to adjust to higher oil prices. We calculate that higher oil prices led to a loss of income in East Asia due to worse terms of trade of around 0.8 percent of GDP per year in 2004-06. But this did not prevent regional growth accelerating to 8 percent from around 6 percent in the preceding three years. We calculate that an average oil price of \$90 in 2008 would be associated with an income loss in East Asia of about 1.1 percent of GDP, which, while costly, would not be much larger than the annual losses already experienced over the last 3-4 years of fast growth.

Downside risks to the outlook have clearly increased. If a US recession were to materialize it would likely be accompanied by a significant but not severe decline in East Asian growth.

It is possible that the difficulties in credit markets may turn out to be deeper and take longer to resolve than expected in consensus forecasts. This, together with the risk of significantly higher oil prices, means that the likelihood of a more severe downturn or outright recession in the US economy has also increased. An event study shows that in the last three US recessions median East Asian growth fell on average by around 0.5 percentage points for every 1 percentage point decline in US growth. Thus a fall in US growth to, say, zero in 2008 (a 2 percentage point growth decline) might be accompanied by a 1 percentage point fall in median East Asian economy growth from around 6 percent to 5 percent - significant but no disaster. East Asian growth was more seriously affected during the US recession of 2001, which was accompanied by an extremely severe sector-specific cyclical contraction in global high tech demand, in the aftermath of the global high tech bubble of the late 1990s. However there are

few signs of such a cycle in global high tech at present; if anything high tech demand was rebounding quite smartly in the third quarter of 2007. East Asian policy makers should also have considerable room to undertake counter-cyclical easing of monetary and fiscal policies in the event of an unexpectedly severe downturn in exports. On the other hand, the impact of a developed world downturn could also be more severe than in the past if it were accompanied a rising protectionism.

A poverty milestone: the number of people living below \$2 a day in East Asia is estimated to have fallen below 500 million in 2007. The poverty headcount rate at the \$2 a day level is estimated to have fallen to about 27 percent, down from 29.5 percent in 2006 and 69 percent (over 1 billion people) in 1990. Strong economic growth is providing an essential underpinning for poverty reduction. But, as the review of individual country experiences in the report indicates, poverty in East Asia is now overwhelmingly a rural problem, with poverty reduction also tending to occur unevenly because particular social groups or geographical regions are doing less well than overall trends. And even as poverty falls, it is often the case that lower income groups experience slower income growth than higher income ones, resulting in widening income inequality. Governments in the region are therefore looking at policies that can foster poverty reduction in more targeted and cost effective ways. Concerns about a widening urban-rural income divide are one reason why governments in countries like China are renewing their focus on rural and agricultural development policies, while also exploring ways to strengthen the human capital development of the poor and to provide more effective insurance and income support mechanisms.

The international and regional environment

Developed world growth has already slowed and could slow further. Growth in the OECD countries is forecast to slow from 2.8 percent growth in 2006 to 2.3 percent in 2007, led a by a one percentage point fall in US growth. Looking forward, growth projections for 2008 have been reduced for all the main developed regions, most emphatically for the US, where they have been cut from a forecast of 3 percent six months ago to only 2 percent now.. This hefty adjustment reflects the depressing effects of the sub-prime crisis and the associated tightening of credit markets that began in August, the unexpectedly deep recession in the US housing market and the impact of higher than previously forecast oil prices. But growth projections have also been tuned lower for the Euro area, which is also likely to feel the effects of the credit squeeze flowing from the sub-prime crisis, and Japan, where consumer spending has remained sluggish, belying earlier expectations of a revival (with both Europe and Japan also suffering from

the impact of higher oil prices). World trade volume growth is projected to dip from over 10 percent in 2006 to around 7 ½ percent in 2008.

China's growth is expected to remain strong.

Growth in China rebounded to an average 11.5 percent rate in the first three quarters of 2007, reversing the trend in the latter half of 2006 when growth had decelerated to 10.5 percent reflecting administrative tightening measures. A new acceleration in investment spending provided the main impulse for the rise in GDP growth in 2007, reflecting fundamental factors such as rapid profit growth, rising profit margins and still relatively low lending rates. Growth is expected to slow only modestly to 10.8 percent in 2008. Among domestic trends of concern to the authorities, headline inflation has picked up this year, although this seems to be mainly due to specific supply factors, including a sharp rise in food prices. The surge in China's trade surplus over the past three years has led to rapid growth in its foreign exchange reserves, which is contributing to liquidity expansion, which the authorities are obliged to mop up through bond issues, higher bank reserve requirements and higher interest rates. However, while these trends bear careful watching, none appears serious enough at present to derail the current momentum of growth, or to cause the authorities to make major policy changes that would lead to a marked slowing in the near term. China's growth has been little affected by past US recessions. Although the impact would be greater today because of the greater importance of exports, it is worth noting that exports in value-added terms are significantly lower than the gross numbers suggest, due to the importance of imported components. In addition, given China's strong macroeconomic position, domestic policies could also be eased to support domestic demand, should this be needed in the event of an export slowdown.

Domestic trends and policy challenges

Foreign exchange reserves in Emerging East Asia are likely increase by a record amount in 2007.

Foreign reserves for the 9 largest economies increased by \$451 billion in the 9 months to September 2007, reaching \$2.5 trillion. About four-fifths of this increase was in China, but reserves were also rising at solid rates in most other economies. The greater part of the overall surplus in the first half of 2007 (the period for which we have detailed balance of payments data) came from rising current account surpluses, which reached an aggregate \$322 billion or 8.9 percent of regional GDP. China's current account surplus reached \$163 billion, or close to 12 percent of GDP in the first half of 2007. Net capital inflows (inclusive of errors and omissions) made little contribution to the region's overall balance of payments surplus in 2005 or 2006, but they increased substantially in the first half of 2007. Official data suggests that China

in particular saw its capital account move from virtual balance in 2006 to a surplus of a little over \$100 billion in the first half of 2007 (although swap operations and other ad hoc transactions appear to have played a significant role in 2006 and the first half of 2007). Net capital inflows to economies such as Indonesia, Malaysia and Philippines also increased, principally because of higher portfolio capital inflows.

Economies face difficult policy tradeoffs in managing balance of payments inflows on this scale.

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 inflows on the present enormous and accelerating scale raise concerns about a potential loss of control over domestic monetary conditions at some point, which could then lead to problems of macroeconomic overheating, asset price bubbles and the emergence of vulnerabilities in the financial sector. Although the signs of such problems are limited at present, they could grow into significant concerns. Thus, for example, while there are few signs of any pickup in core inflation so far, previously existing spare capacity in the economies has now been largely used up, making the possibility of over-heating more of a concern for the future. Equity prices and price-earnings ratios have surged to historic highs in China, although in most other economies price-earnings ratios, while rising, are still significantly less than the levels reached in the run-up to the 1997-98 financial crises. Banks are also playing a much more

muted role in intermediating capital inflows than they were before the crisis. Still, with balance of payments inflows reached a striking 12.1 percent of regional GDP in the first half of 2007, policy makers are increasingly likely to rely on more exchange rate flexibility as a direct way of adjusting to these pressures.

Financial sector trends and issues. In recent years bank lending to the domestic private sector in the former crisis affected countries of East Asia has fallen in importance, while holdings of government or foreign assets have increased. This is likely to change if the recent strengthening of domestic demand in the region gathers pace, leading to stronger loan demand, especially from the business sector. In this context it will be important to ensure that faster loan growth is not accompanied by deterioration in loan quality and a build up of new vulnerabilities. Banking sector asset quality, profitability and capital adequacy in the region have indeed improved significantly in recent years. The average non-performing loan (NPL) ratio for the five formerly crisis affected countries has fallen from over 10 percent in 2002 to under 5 percent by the middle of 2007, although NPLs remain significantly higher than in developed economies or in some other developing regions, Latin America for example. The region has also 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 continued efforts are needed to converge to international standards.