East Asian Developments … A Case for Guarded Optimism?

STRONG GROWTH MOMENTUM UNDER CLOUDED SKIES

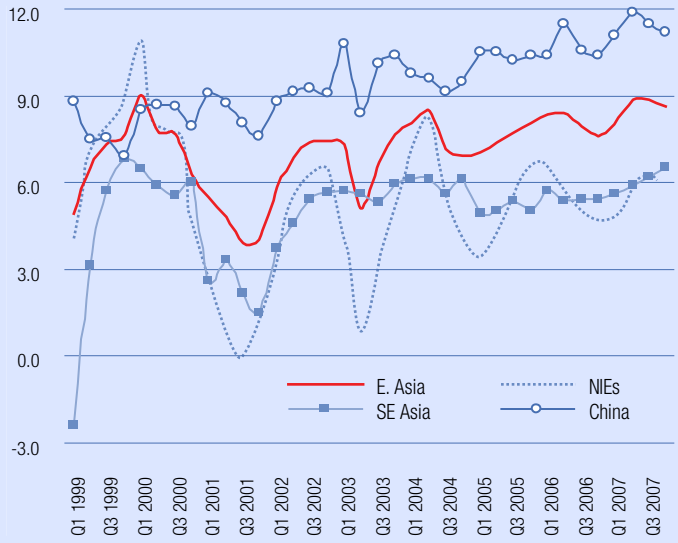
Developing East Asian GDP growth reached 10.2 percent in 2007, the highest since the early 1990s. Growth generally continued at strong rates in the third and fourth quarters of the year, despite growing concerns about the potential impacts of the financial turmoil in the United States. Growth in China exceeded 11 percent throughout the year, easing only gradually over the course of the year as moderating export growth was mostly offset by rising domestic investment and consumption growth. Low income economies such as Cambodia, Lao PDR, Mongolia and Vietnam also continued to see strong growth in a 7-10 percent range for the third or fourth year in succession.

Most middle income countries in South East Asia enjoyed an increase in the pace of output growth over the course of 2008 (Figure 3), generally on the basis of accelerating domestic demand. Rising remittances flows in the Philippines supported robust consumption growth, while recent improvements in the fiscal position allowed a strong increase in public infrastructure spending. Growth in Indonesia accelerated to a 10 year high of 6.3 percent, principally on the basis of booming private investment and consumption. Running counter to the regional trend, private consumption and investment in Thailand were generally weak for much of the year because of unsettled political conditions, but growth still came in at a respectable 4.8 percent because of resilient overall export growth, despite weaker exports to the US and a 9 percent appreciation of the baht against the dollar. Growth in Thailand accelerated to an unexpectedly strong 5.7 percent in the fourth quarter because of a late year surge in exports to Europe, Japan, the rest of East Asia and – reflecting a trend across East Asia – in exports to other developing regions and countries, especially those benefiting from high oil prices, such as the Middle East and Russia.

Growth in most of the high income Newly Industrialized Economies (NIEs) in the region also picked up to an average pace of around 6 percent in the second half of 2007, supported by robust consumption growth and unexpected strength in exports. Real growth in exports of goods and services in Taiwan (China) and Korea accelerated to 13 percent and 16 percent

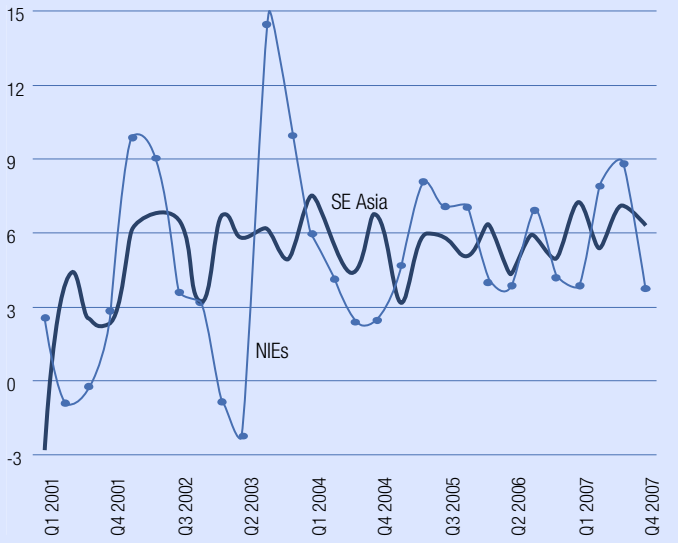
respectively in the fourth quarter, for example. Singapore however saw year on year GDP growth decelerate sharply from close to 10 percent in the third quarter to just over 5 percent in the fourth because of falling manufacturing sector growth. Fourth quarter output contracted at a seasonally adjusted annual rate of -4.8 percent from the third quarter, contributing to the downturn in quarter on quarter growth of NIEs as a group shown in Figure 4. Singapore's Ministry of Trade and Industry observed that the fall reflected a sharp decline in biomedical manufacturing rather than the impact of the slowing US economy.

Figure 3. East Asia – Quarterly GDP Growth (% Change Year Ago)



Source: World Bank data and staff estimates.

Figure 4. East Asia – Quarterly GDP Growth (% Change Quarter Ago, SAAR)

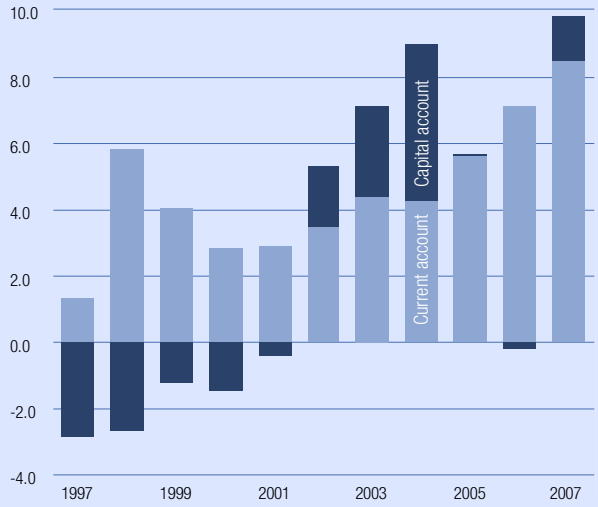


Source: World Bank data and staff estimates.

FINANCIAL LINKAGES: US TURMOIL AFFECTS EAST ASIAN SECURITIES MARKETS, NOT SO MUCH BANKS

The most obvious effects of the US financial turbulence on East Asia have been sharp declines in East Asian equity markets. Rising uncertainty and risk aversion have also pushed spreads on sovereign and private offshore borrowings higher. A number of economies experienced net portfolio outflows in the latter part of the year, a reversal of large inflows earlier in the year. A number of banks in the region have written off losses on US sub-prime mortgage-related assets, although the impact on overall banking system profits and balance sheets has so far been small. However, it remains to be seen what additional losses banks in the region may experience as the US credit market turmoil affects a widening array of assets.

Figure 5. East Asia balance of payments. 1997–2007



Source: World Bank data and staff estimates.

The macroeconomic effects of US and global financial volatility and associated financial sector losses in East Asia seem relatively limited. This assessment could change if the global credit market turmoil intensifies in coming months in ways that more severely affect domestic financial systems in East Asia. At the broad macro level, most of the region's larger economies are running large current account surpluses and have sharply reduced their net external liabilities over the last decade. East Asia is a large net supplier of funds to the global financial system rather than a borrower. In 2007 net current account surpluses totaled close to 9 percent of regional GDP (or a median 7.4 percent among the 9 largest economies), while net capital inflows were worth an additional percentage point of regional GDP (figure 5). In many economies, lower private capital inflows actually will reduce the monetary management and exchange rate appreciation pressures that their central banks have been grappling with. Most business investment in the region continues to be financed from internal earnings or domestic bank borrowing, where there is thus far little sign of a domestic credit crunch. This could change if banks suffer bigger losses on foreign mortgage-related assets than have been exposed thus far.

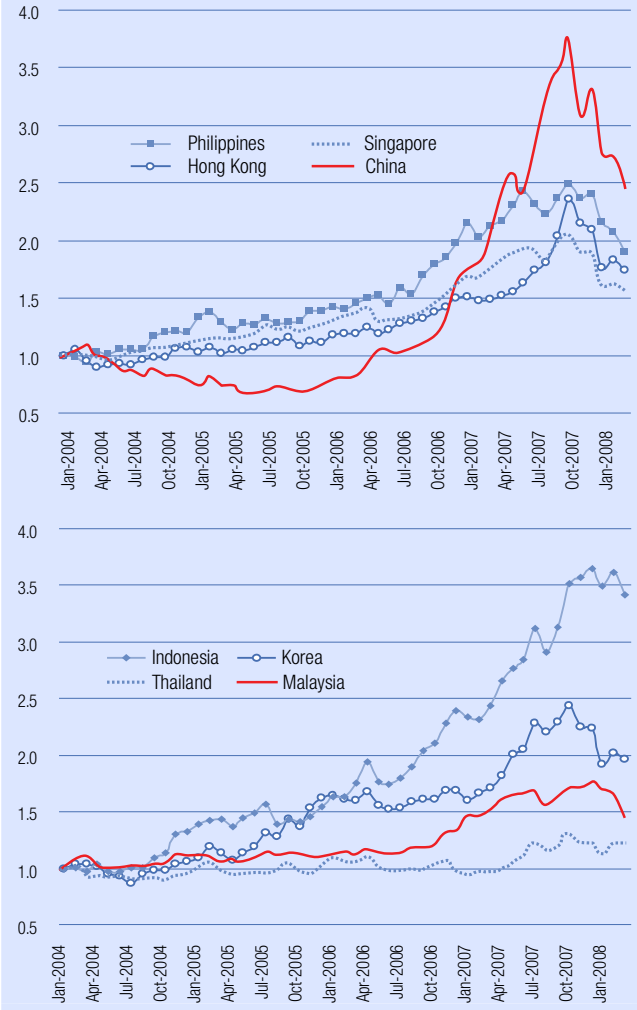
Equity markets sell off

Looking at some of these financial linkages and impacts in more detail, equity prices in the major economies have fallen a median 19 percent between their peak (generally October 2007) and early March 2008. The steepest falls were in China, Hong Kong, the Philippines, and Singapore, and smaller declines in Indonesia and Thailand (figure 6). The major factors behind the equity price declines are heightened uncertainty about the global economic outlook, rising risk aversion, and a significant pullback in portfolio equity and bond flows to emerging markets

after the start of the US financial turbulence in August 2007. In most cases, though, the recent price declines are but a partial reversal of previous large and probably unsustainable increases between the end of 2006 and October 2007. In some cases, price-earnings (PE) ratios have come down from probably excessive to more realistic levels. For example, the PE ratio on the IFC's China investible index fell from 43 in October 2007 to 28 in January 2008.

Initial public offerings (IPOs) in regional financial centers such as Hong Kong and Singapore have plummeted. IPOs in Singapore totaled only $24 million in the first 6 weeks of 2008, down from $283 million in the same period of 2007.[3] Equity markets play a significant role in corporate finance in the high-income economies of East Asia such as Hong Kong, Korea, and Singapore. However, equity markets are less important in most of the developing economies, for which internal corporate earnings and bank lending are more important sources of financing.

Figure 6. Equity Market Indexes
(Jan. 2004 (=1) to March 2007)



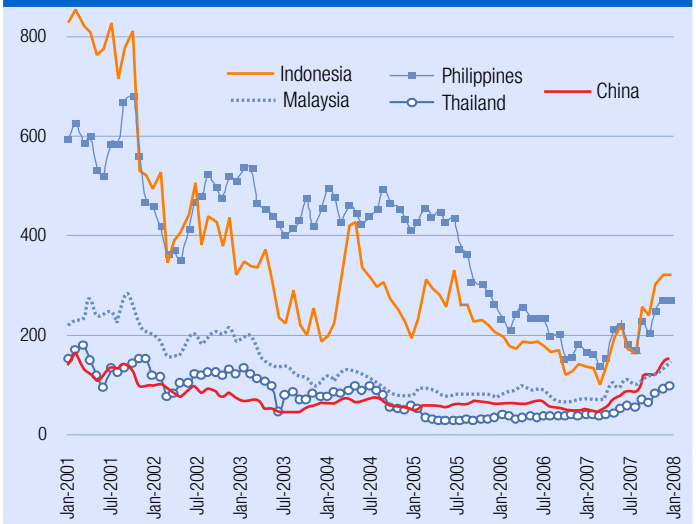
Source: Haver Analytics.

[3] *Business Week*, "Asia's IPOs Hit by a Drought," February 22, 2008.

Offshore bond financing costs rise

Spreads for offshore borrowing also have widened significantly for both sovereign and other borrowers (figure 7). Spreads moved from exceptionally low levels of approximately 140 basis points in mid-2007 to approximately 270 and 320 basis points by early March 2008 for Philippines and Indonesia, respectively. Nevertheless, the latter remain well below historical levels in the early-mid 2000s and also well below spreads in US high-yield debt markets. Spreads also have moved higher for China, Malaysia, and Thailand. However, appropriately for countries with much lower net external debt, ,at 100–150 basis points, their spreads remain considerably lower than those of Philippines and Indonesia.[4] The iTraxx Asia ex-Japan Credit Default Swap (CDS) Index measures how the cost of offshore financing has increased for a basket of issuers that includes East Asian banks and non-banks as well as governments (figure 8). The premium on such contracts surged almost 300 basis points between mid-2007 and early March 2008, a much larger move than for spreads on sovereigns alone.

Figure 7. Emerging Market Spreads (Jan. 2001 – March 200



Source: JP Morgan EMBI+; World Bank data.

Figure 8. iTraxx Asia ex-Japan CDS Index (Premium (bid) in basis points)

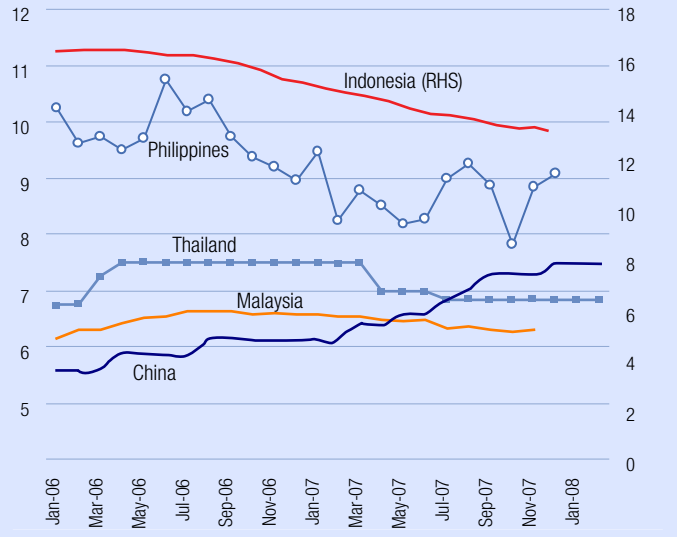
Source: Datastream.

[4] Indeed, foreign reserves held by China, Malaysia, and Thailand exceed their total stocks of external debt by significant margins. In Indonesia and Philippines, foreign reserves stand at 30 percent–40 percent of total external debt.

…but domestic credit conditions little affected

How fully rising offshore spreads are reflected in domestic borrowing costs remains to be seen. In Indonesia, yields for domestic government borrowing have risen from less than 9 percent in mid-2007 to over 10 percent in early 2008. As regards private sector borrowing, however, retained earnings and domestic bank borrowing remain the most important sources of external financing for firms in most of developing East Asia. Here it is difficult to see obvious signs of bank credit becoming more costly or harder to obtain. Average bank lending rates generally trended lower or were broadly flat through the end of 2007, tracking the trend of policy interest rates (figure 9). Bank lending rates trended higher in China, but again this reflected the government's policy of tightening monetary policy to avert the danger of economic overheating and higher inflation. Growth in bank credit to the private sector was accelerating strongly in China, Hong Kong, Indonesia, and Singapore in late 2007 or early 2008, while running in line with trends of recent years elsewhere (table 3).

Figure 9. Bank Lending Rates (%) (January 2006-February 2008)



Source: IMF IFS and World Bank data.

Table 3. Bank Credit to Private Sector (% change year ago)

	2003	2004	2005	2006	2007*
China	20.8	11.2	9.2	14.3	19.3
Indonesia	21.1	33.0	24.8	12.5	22.4
Malaysia	6.8	6.6	9.2	6.9	11.2
Philippines	1.1	9.3	-2.2	7.4	1.9
Thailand	-1.3	11.3	7.7	4.0	4.6
Hong Kong	-2.8	3.7	6.0	1.8	12.4
Korea	8.9	1.3	7.4	14.5	12.4
Singapore	5.4	4.4	2.0	4.9	17.6

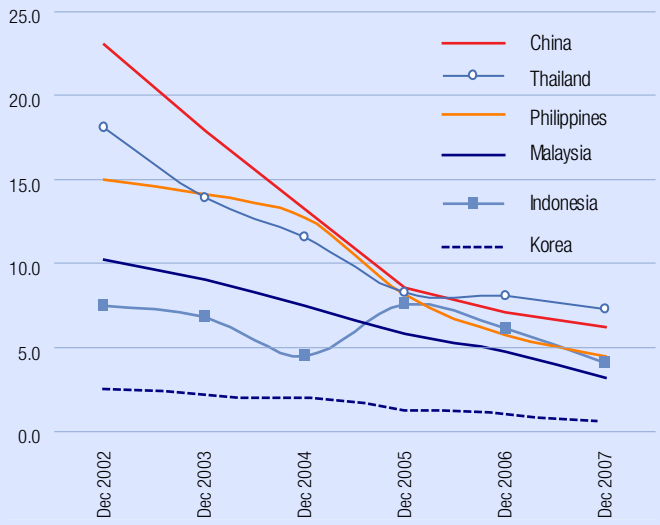
Source: IMF International Finance Statistics.
** Latest available in late 2007 or early 2008.*

Impact on East Asian bank balance sheets seems limited so far – but needs monitoring

How well East Asian banks continue to perform their intermediation and other key economic functions also will depend on the quality of their balance sheets. This introduces another potential channel through which the US credit market crisis could affect East Asian financial systems by damaging the quality of assets on bank balance sheets. Measures of non-performing loan ratios and capital adequacy in the larger economies generally continue to show improvements (figure 10). Nevertheless, past experience shows that underlying deterioration in bank asset quality can remain obscured during a period of fast growth such as East Asia has experienced in recent years.

Initial assessments by regulators, credit rating agencies, and investment banks suggested that emerging East Asian financial sector exposure to US sub-prime-related assets was relatively limited. Such exposure was concentrated in some more developed financial markets such as Korea and Singapore, as well as in China, and in a few institutions in each country: Woori Bank in Korea, DBS in Singapore, and Bank of China and Industrial and Commercial Bank of China. Indeed, China is the largest overseas holder of US mortgage-backed securities—approximately $260 billion—mostly through the central bank's international reserve holdings and also through holdings of commercial banks. However, most of these holdings are backed by US government agencies such as Fannie Mae and Freddie Mac. Among commercial banks, Bank of China disclosed an exposure of $7.95 billion in assets related to US sub-prime mortgages at the end of September 2007. At the end of December, these assets had been reduced to $4.99 billion, against which the bank booked charges of $1.3 billion. Nevertheless, Bank of China's net profits rose an unexpectedly strong 31 percent to 56.3 billion yuan ($7.99 billion) in 2007. This increase came despite the write-off on sub-prime assets driven by strong loan volume, higher interest margins, and surging fee and commission income (the latter driven by the rapid development of China's domestic capital market).

Figure 10. East Asia non-performing loan ratios, 2002–07



Source: World Bank data and staff estimates.

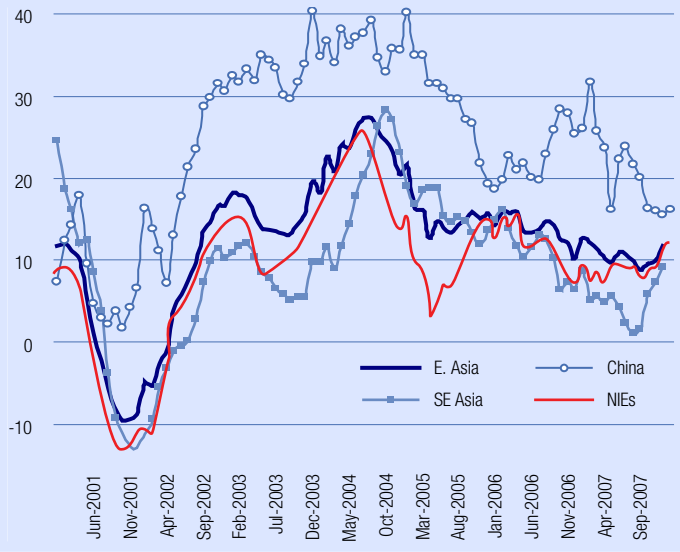
Finally, there is also a risk that banks in emerging markets could suffer liquidity or funding problems on the liability side of their balance sheets if the turmoil in global credit markets causes international banks suffering large losses on mortgage related assets to begin liquidating their loans to emerging market banks.[5] However, Bank for International Settlements (BIS) data suggest that external borrowings by banks in some of the main East Asian developing economies are considerably lower today than, for example, before the 1997 financial crisis. Thai bank liabilities to BIS reporting banks stood at approximately 9 percent of GDP in late 2007, for example, compared to 48 percent of GDP in June 1997. East Asian banks also have built up their own loans and deposits with international banks. Thus, for example, while Philippine banks' net borrowings from international banks were 8.4 percent of GDP in June 1997, they were -4.4 percent of GDP in September 2007, that is, a net credit position.

Overall, the initial assessment of relatively limited spillovers from the US credit market turmoil onto the East Asian financial sector appears to be holding in early 2008. However, it will need to be closely monitored and re-evaluated as the credit market turmoil intensifies and spreads from starting point of sub-prime mortgages to affect increasingly wider classes of assets.

TRADE LINKAGES: WEAKENING US DEMAND OFFSET BY OTHER MARKETS – SO FAR

Although exports from a number of economies were showing unexpected resilience and revival late in 2007 and early 2008, growth in East Asian exports as a whole eased lower over the course of 2007. In US$ terms, Emerging East Asian exports slowed from year-on-year growth of approximately 22 percent in January 2007 to 15 percent–16 percent in the third quarter. Export growth eased in China as well as in the South East Asian middle-income economies and the newly industrialized economies (NIEs) (figure 11). More recently, though, a rebound in export growth in South East Asian economies including Indonesia, Malaysia, and Thailand and in NIEs such as Korea and Taiwan (China) has pushed overall regional dollar export growth back up to 18 percent–19 percent.

Figure 11. East Asia Export Growth (US$ 3 mo. average - % change year ago. Jan.00-Jan 08)

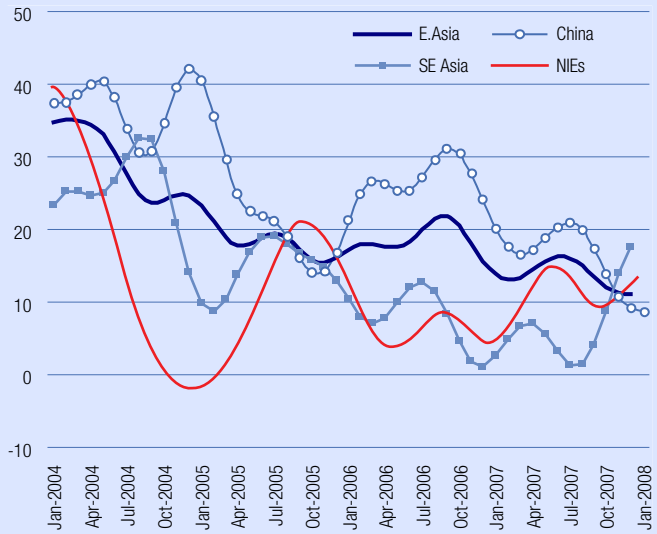


Source: World Bank data and staff estimates.

[5] The World Bank's forthcoming "Global Development Finance 2008" report studies this linkage in more detail.

Given the steep decline of the dollar in 2007, it also is worth looking at exports in local currency terms. And to get a more detailed view of export momentum, consider seasonally adjusted quarter-on-quarter growth in the rolling three-monthly average. The local currency export momentum for Emerging East Asia as a whole eased off from approximately 16 percent in the fourth quarter of 2006 to 11 percent in the fourth quarter of 2007 (figure 12). The analysis confirms that export momentum in South East Asia and the NIEs was rebounding in late 2007, while also suggesting that export momentum from China continued to gradually ease into late 2007 and early 2008. Interestingly, recent months are among the rare times when export growth in other main East Asian economies is running higher than in China.

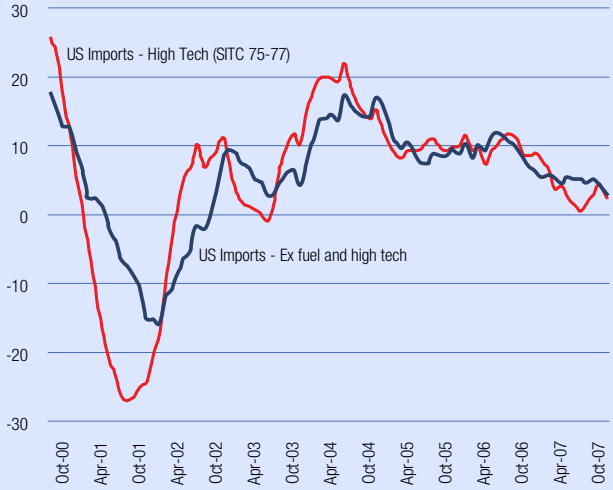
Figure 12. East Asia Export Momentum (Local currency. 3 mo/3mo - % change SAAR. Jan.04-Jan 08)



Source: World Bank data and staff estimates. Cencus X-12 trend-cycle component. Regional weights using 2000US$ exports

This pattern of a gradual easing in East Asian export growth, or even of export recovery during a global economic slowdown, is very different from the last major US downturn in 2001. At that time, East Asian local currency export momentum plunged from 25 percent to negative 10 percent over 12 months. But if the more recent pattern continues into 2009, it could help the region achieve more of a "soft landing" than a steep downturn or recession as experienced in 2001. Several factors explain the difference between the recent shallow descent of East Asian export growth compared to its sudden, steep plunge in 2001.

Figure 13. US Import Growth (% change year ago. Oct 2000-Jan 2008)



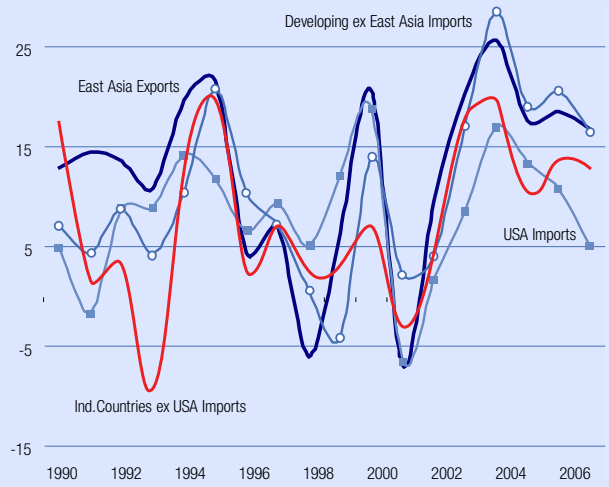
Source: World Bank data and staff estimates.

First, US import growth itself eased lower gradually in 2007 (figure 13). Year-on-year US$ import growth will doubtless become negative as US economic growth slows further in 2008. Yet, the pace of decline may remain shallower than in 2001. One reason is that US electronics and high-technology imports,

especially important markets for East Asian exporters, have declined at about the same pace as overall non-fuel/non-high tech exports. This is quite unlike the 2001 recession, when the end of a high-tech spending boom led to a sudden and steep collapse in US high-tech imports, followed by a sharp fall in other imports. Recent data on high-tech equipment orders in G3 countries and on world semiconductor sales suggests that global high-tech demand indeed is waning in line with the broader downshift in domestic demand growth in developed countries. This decline is likely to be reflected in weaker East Asian export growth in the months ahead. However, there is little in the data so far to suggest a steep high-tech-led downturn of the 2001 type.

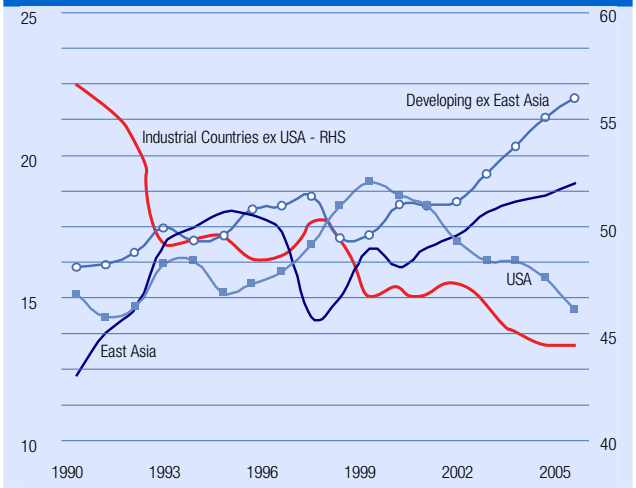
A second factor explaining the recent resilience of East Asian exports is that export markets other than the US have held up well, and East Asian exporters have nimbly made the most of the opportunity. Figure 14 shows that US$ import growth in non-US industrial countries ran at approximately 13 percent in 2007, well above the 5 percent import pace in the US. Imports by developing countries outside East Asia also grew by approximately 17 percent in 2007. Strong East Asian exports to booming developing country markets elsewhere—in particular to oil-rich markets in the Middle East and Russia—are one of the factors contributing to the unexpected strengthening of exports from many East Asian economies in late 2007 and early 2008.

Figure 14. East Asian Export and Global Import (% change 1990 - 2007)



Source: IMF IFS.

Figure 15. Share of World Import (percent, 1990 - 2007)



Source: IMF IFS.

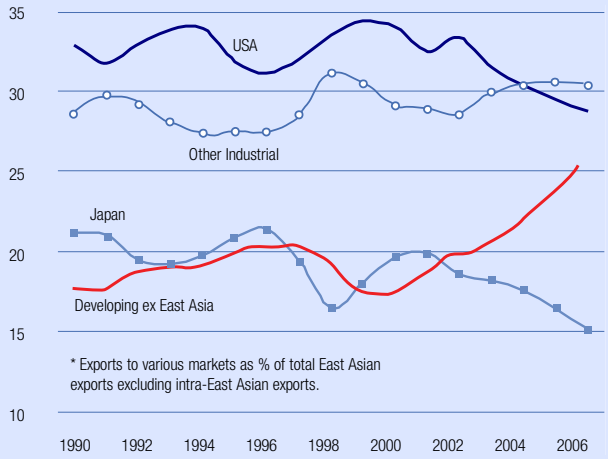
The growing importance and resilience of emerging countries as factors in world output and trade growth are 2 of the most important global economic developments over the last 5 years. In fact, while US imports have fallen from 19 percent in 2000 to less than 15 percent of total world imports, developing countries outside East Asia now comprise 22 percent of the total, and East Asia comprises another 19 percent (figure 15).

What about intra-East Asian trade, which comprises a little over 40 percent of overall East Asian exports? Can it help sustain East Asian growth during a US recession, in particular, through exports from the rest of East Asia to China? As many observers (including the authors of this report) have pointed out, a significant part of intra-East Asian exports, perhaps two-thirds, comprises

trade in intermediate products that are ultimately exported outside the region.[6] Thus, a significant slowdown in exports outside the region also would be reflected in slower intra-Asian exports within the region.

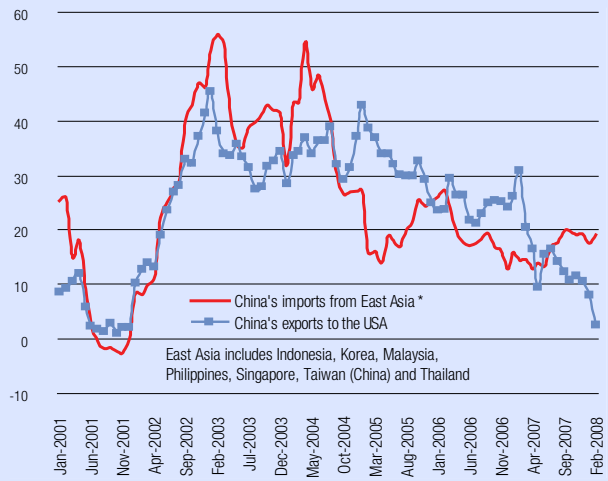
Two provisos could be added to this widely accepted story. First, the share of East Asian exports to the US is declining even after accounting for intra-Asian trade. A simple way to see this is to imagine East Asia as a single integrated economy, netting out all intra-East Asian trade. Exports to the US as a share of East Asia's purely extra-regional exports have fallen from 34 percent in 1999 to 29 percent in 2006 (figure 16). Meanwhile, the share of other developing countries surged from 17 percent in 1999 to 26 percent in 2006—almost as important as the US market.

Figure 16. Integrated East Asia's Export Markets *
(Percent of total exports; 1990-2006)



Source: IMF DOT and World Bank staff estimates.

Figure 17. China – Imports from East Asia
(US$. 3.mo. averages - % change year ago)



Source: World Bank data and staff estimates.

Second, the character of intra-East Asian trade flows also is likely to undergo structural change over time. Observers have noted that China's increasingly sophisticated domestic production capacity is allowing it to source more of its input needs from within China. This has meant that imports have become increasingly delinked from exports in the last 2–3 years. The association of China's imports with its exports fell sharply in both size and statistical significance between 1994–99 and 2000–05, while the association with domestic demand increased just as dramatically.[7] If this trend continues and if other East Asian economies are able to exploit these new opportunities in China's domestic market, then, over time, China also is likely to become an increasingly important independent growth pole for the rest of East Asia. Figure 17 shows interesting differences in the pattern of China's imports from those of the rest

[6] World Bank East Asia Update, November 2006.

[7] Li Cui and Murtaza Syed, "The Shifting Structure of China's Trade and Production," IMF Working Paper WP/07/214, September 2007.

of East Asia between the 2001 recession and today. In 2001 China's imports from East Asia fell off rapidly in line with the fall in its own exports to the US. In contrast, in late 2007 and early 2008, China's imports from East Asia have grown steadily at 15 percent–20 percent a year while, on the other hand, China's exports to the US have fallen off almost as sharply as in 2001. Of course, the link between the two may well reassert itself if the US downturn intensifies. Nonetheless, this is an intriguing pattern.

VOLATILE COMMODITY PRICES NOW AT THE FOREFRONT OF POLICY MAKERS' ATTENTION

Since 2003, oil and non-oil commodity prices have respectively more than tripled and doubled. However, of greater immediate concern for policy makers is the surge in commodity prices over the last 6–9 months—especially for food—that has pushed headline inflation higher and sparked concerns about the adverse effect on the poor.

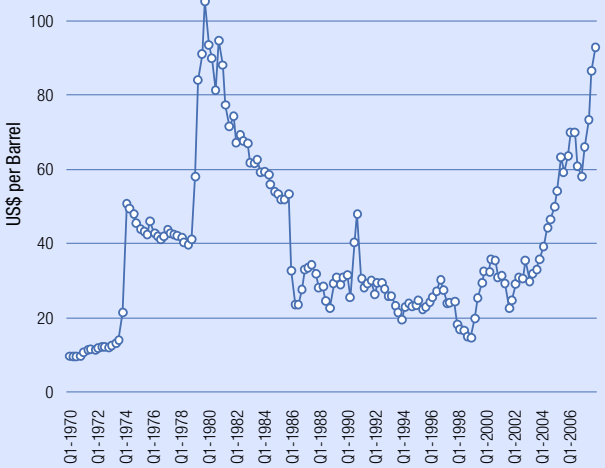
Oil prices return to 1979 high in real terms

Crude oil prices continued to move higher over almost all of 2007 and into 2008, from $53.4 per barrel in January 2007 to $89.4 in December, and on to an average $101.7 in 2008 (figure 18).[8] In inflation-adjusted terms, the oil price in March 2008 was barely 6 percent below the record of $105.7 per barrel (in 2007 US CPI inflation-adjusted prices) set in the fourth quarter of 1979 (figure 19).

Figure 18. Monthly Average Crude Oil Price ($/bbl - Jan 1990 - March 2008)

Source: World Bank data and staff estimates.

Figure 19. Average Real Oil Price (1970 Q1 - 2008 Q1. Constant 2007 $)



Source: World Bank data and staff estimates. Deflated by US CPI

[8] This reference price is an average of Brent, Dubai, and West Texas Intermediate (WTI) crudes. Through March 25 for March 2008 data.

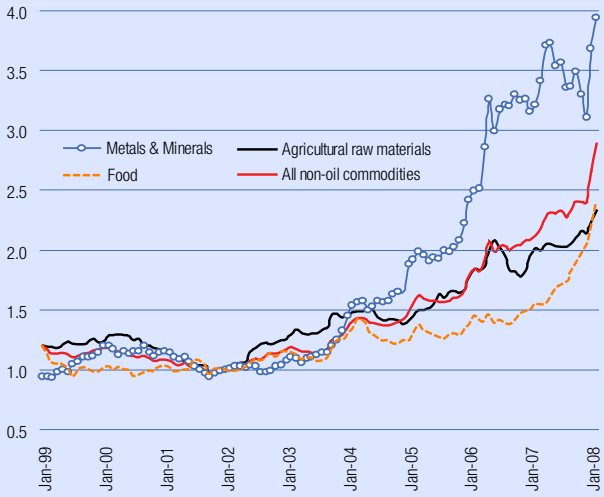
Factors supporting the latest surge in prices likely include increased investment demand as a hedge against the falling US dollar and inflation in the wake of the recent sharp relaxation in US monetary policy, itself provoked by the credit market crisis. While strong world demand had been a primary factor supporting much of the rise in oil prices since 2003, supply factors recently have become more important. OPEC reduced its production ceiling in late 2006 and in 2007, and OPEC oil ministers declined to increase production above the existing 29.67 mb/d production target at their meeting in early March 2008, citing concerns about the falling dollar and a weaker global economy. Non-OPEC supply prospects for the year also continue to be downgraded due to unexpected production outages, rising input costs and other problems in oil capacity development, and uncertainties about political conditions and the investment climate in a range of oil-producing developing economies. On the demand side, high prices have curbed consumption in OECD countries—which fell 1.1 percent in 2006 and a further 0.5 percent in 2007. However, demand in developing economies has continued to grow, increasing 4 percent in 2006 and 3.2 percent in 2007. These increases kept overall world demand rising by a little over 1 percent per year in 2006–07.

Oil prices are likely to remain high and volatile over 2008–09, although perhaps not at the levels of the recent spike. Oil prices are forecast to average in the $80-90 a barrel range in 2008 and 2009, easing from the average $95 per barrel average in the first quarter of 2008. The main factors supporting some easing from recent highs is lower expected demand due to the possible recession in the US economy and slowdown in overall OECD growth, as well as the projected moderation in China's growth toward its potential rate. Rising upstream investment in both OPEC and non-OPEC countries should also result in new capacity and gradually expanding supply potential. The implications for East Asia are taken up below.

Non oil commodities: continued increases in food and metals

Non-oil commodity prices increased 15 percent in dollar terms over 2007, a fifth year of solid dollar price gains. That was only a precursor to even more rapid 20 percent gains in just the first 2 months of 2008 (figure 20). Grains, edible oils, and metals prices have been especially buoyant in recent months, supported by strong investment and physical demand (the latter especially from developing countries) as well as by a variety of more specific factors on both the demand and supply sides of the markets. Low initial stocks; rising input costs (especially energy); competition for limited arable land; weather-related

Figure 20. Non-oil Commodity Prices U.S. Dollar Indexes (Jan.2002=1)



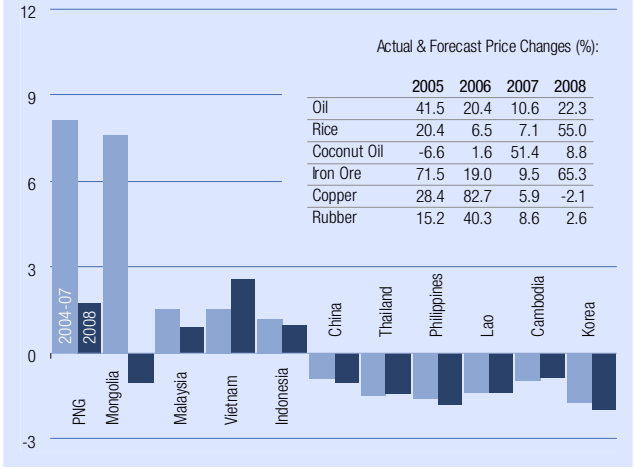
Source: World Bank data and staff estimates. Deflated by US CPI

production shortfalls; and strong demand for food, animal feeds, and bio-fuels have produced a surge in prices for corn, wheat, rice, and soybeans. Grain and edible oil prices rose 21 percent and 15 percent, respectively, in just the first 2 months of 2008. Metals prices gained 27 percent in the same period, led by iron ore, copper, lead, aluminum, and precious metals. China's consumption of the 6 main metals traded on the London Metal Exchange (LME) grew by nearly one-third, or 5.8 million tons, in 2007, up from an average 16 percent growth rate in the previous 7 years. Growth in Chinese demand alone more than offset lower 2007 consumption in the OECD. A 21 percent increase in China's steel production—the largest in the world—helped set the scene for a 65 percent increase in iron ore prices in early 2008.

Macro implications of high commodity prices: complicated terms of trade impacts

Higher primary commodity prices have generated a complicated pattern of national income gains and losses around the region. Overall, Emerging East Asia is estimated to have experienced income losses due to worse terms of trade worth approximately 0.9 percent of regional GDP per year on average in 2004–07. Within the region, net energy and non-energy primary commodity exporters such as Indonesia, Malaysia, and Vietnam are estimated to have received windfall terms of trade gains of 1–2 percent of GDP per year in 2004–07, rising to 8 percent of GDP in an economy such as Papua New Guinea, which benefited from higher oil, copper, and gold prices (figure 21). Mongolia also received net terms of trade gains worth 7 percent–8 percent of GDP per year, with large gains in metal prices overriding its higher import bill for oil. However, significant net oil importers including Korea, Lao PDR, Philippines, and Thailand are estimated to have experienced terms of trade losses of 1.5 percent–2 percent of GDP in 2004–07, while China saw more moderate income losses of approximately 0.9 percent of GDP per year.

Figure 21. Income gains/losses due to commodity price changes (As % of GDP)



The pattern of terms of trade losses and gains in 2008 should be qualitatively similar to that of the last four years, but with higher food prices adding a new twist. Higher food prices are expected to have relatively small effects at the level of national income—as distinct from possible distributional effects—in economies such as Cambodia, Indonesia, and Lao PDR. Economies such as China, Philippines, and Papua New Guinea could see somewhat larger net losses of approximately 0.5 percent of GDP. On the other hand, rice exporters such as Thailand and Vietnam likely will see substantial income gains because of high rice prices. Combining the effect of higher food prices with those of additional increases in oil and metals prices, the region could experience an aggregate income loss of approximately 1 percent of GDP in 2008. Income losses of this size perhaps could have been overlooked when the region's economy was growing very rapidly in 2006-07. However, they could have a more negative effect if the global credit market crisis results in significantly lower growth in East Asia.

Rising headline inflation – it's not just commodity prices

Inflation in developing countries has increased sharply as commodity prices have soared. East Asia is no exception, notwithstanding the repression of fuel and energy prices through price controls in some of the major economies.

In a few countries—China, Cambodia, Mongolia, and Vietnam–inflation, particularly food inflation, is generally higher than in other emerging markets (table 4). Headline inflation in Mongolia and Vietnam exceeds 15 percent, and has reached nearly 9 percent in China and 11 percent in Cambodia. Food inflation in each of these countries was running at or above 20 percent as of February 2008. In addition to higher imported food prices, specific factors in each country have contributed to higher prices. Examples are the outbreak of disease among pigs in China, tariff adjustments in Mongolia, and bad weather in Vietnam. Nonetheless, where inflation is highest, the common feature has been rapid monetary growth driven in large part by intervention to slow the appreciation of the local currency against the US dollar. The 3 clearest cases of excessive monetary growth are Cambodia (60 percent M2 growth), Vietnam (47 percent), and Mongolia (over 40 percent).[9] In each case, the local currency barely moved vis-à-vis the falling dollar in 2007, notwithstanding significant terms of trade gains in Mongolia and Vietnam (figure 22). Moreover, where monetary growth has been rapid and price controls are significant, bubbles have tended to develop in markets that are freer, such as in real estate and equities.

Table 4. East Asia: Consumer price inflation

	2006 Year	2007 Year	2007 Q3	2007 Q4	Latest Month	
"Headline" consumer price inflation						
China	1.5	4.8	6.2	6.7	8.7	Feb
Indonesia	13.1	6.4	6.5	6.7	7.4	Feb
Korea	2.2	2.5	2.3	3.4	3.6	Feb
Malaysia	3.6	2.0	1.8	2.2	2.7	Feb
Philippines	6.2	2.8	2.5	3.3	5.4	Feb
Thailand	4.6	2.2	1.6	2.9	5.4	Feb
Vietnam	7.4	8.3	8.6	10.7	15.7	Feb
"Food" consumer price inflation						
China	2.3	12.3	11.7	15.0	23.3	Feb
Indonesia	14.7	11.4	11.7	11.9	12.2	Feb
Korea	0.5	2.5	3.1	2.2	1.6	Feb
Malaysia	3.4	3.0	2.7	3.7	4.5	Feb
Philippines	5.5	3.3	2.9	4.1	6.8	Feb
Thailand	4.6	4.1	4.3	2.7	7.9	Feb
Vietnam	8.7	11.2	12.1	15.9	25.2	Feb
"Core" inflation						
China	0.8	0.9	0.8	1.0	1.1	Feb
Indonesia	8.8	5.9	5.8	6.2	7.3	Feb
Korea	1.8	2.3	2.3	2.4	2.8	Feb
Philippines	5.6	0.0	2.8	2.4	4.0	Feb
Thailand	2.3	1.0	0.7	1.1	1.5	Feb

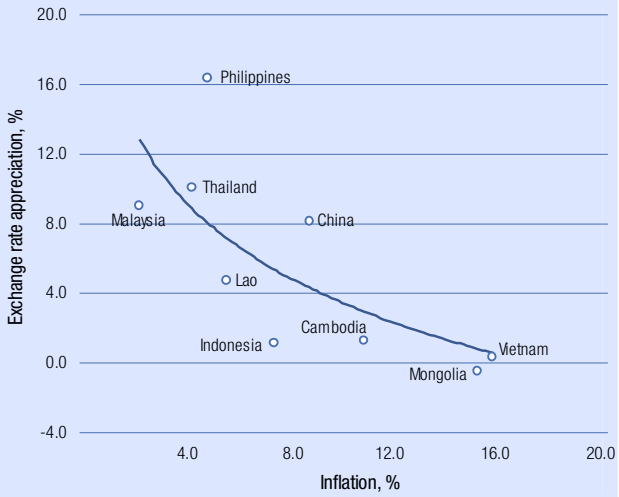
Source: World Bank data and staff estimates.

China's case is less clear cut. China has maintained its controlled appreciation against the dollar and increased the pace of appreciation since October 2007. It also has been more successful in sterilizing capital inflows. As a result, money and credit have grown at about the pace of nominal GDP. Nevertheless, reserves have accumulated at a torrid pace, and allowing faster appreciation and a slower reserve build up would have moderated price increases from imports, dampening overall inflation. In the mean time sterilized intervention in the future will become more costly and less effective as US interest rates fall and Chinese rates rise.

[9] The Mongolia figure is August 2007. Domestic credit growth at end-2007 is estimated at over 90 percent. Latest available figures for other countries.

The Philippines provides a useful contrast. The peso appreciated by approximately 17 percent against the dollar even as reserves accumulated; growth accelerated to its highest pace in 30 years; monetary growth was contained; and inflation was held to below 5 percent in 2007. These results occurred despite the fact that the Philippines is a large food importer and the largest importer of rice in the world.

Figure 22. East Asia: Inflation and exchange rate appreciation



Source: World Bank data and staff estimates.

Rising food price inflation and distributional implications

The sharp rise in international food prices is likely to have a significant impact on the living standards of the poor throughout the developing world, posing one of the more urgent and difficult problems facing governments today. Food comprises a larger share of the consumption basket of the population in most developing East Asian economies than it does in developed countries. In the U.S. the share of food in the consumption basket of the average household is 15 percent, while in East Asia it ranges between 31 and 50 percent (31 percent in Malaysia, 34 percent in China, 36 percent in Thailand, 40 percent in Indonesia, 43 percent in Vietnam, and 50 percent in the Philippines). In Cambodia the share of food in total consumption is 59 percent in rural areas and 40 percent in urban. Internationally traded food products are also a large proportion of the food consumption of the poor – 56 percent in Cambodia for example, and 64 percent in Vietnam.

The impact of food price increases on the poor also depends on whether they are net food consumers whose real income will be reduced by higher food prices, or net producers of food, who will tend to benefit. The urban poor and landless rural workers are generally net food consumers as, typically, are a significant fraction of poor small landholders. In Cambodia these three types of poor households comprise 46 percent of the poor, with another 18 percent being small land holders who are self-sufficient but not net sellers of food. In Vietnam the proportion of net consumers among the poor is 47 percent, with another 19 percent being net self-sufficient. In Indonesia 76 percent of the poor are net rice buyers, including some 72 percent of the rural poor. Here it is estimated that every 10 percent increase in rice prices reduces the real value of the expenditure of poorest tenth of the population by 2 percent.

Other things being equal, the surge in food prices is therefore likely to increase poverty in the low and lower middle income countries of the region, although against that must be set the poverty reducing impact of continued robust economic growth. We estimate that every 1 percent increase in per capita consumption reduces the poverty rate for East Asia as a whole by around 1 percent (at the $1 a day level). In the slightly longer term there will also be a supply response as net food consumers move towards becoming net food producers in response to higher prices. What the net effect of these complex interactions on poverty rates in the region in 2008 will be is not yet clear. But it seems probable that, depending on how much food prices increase during the year, the pace of poverty reduction in the region will not

be as rapid as in the recent past and may even reverse. (Poverty rates at the $1 a day level fell by 11-12 percent a year in 2002-2007, while those at the $2 day level fell by 8-9 percent a year. See Appendix Table 5).

Rising food prices are quickly taking on a high profile around the region, eliciting a range of policy responses. Broadly speaking these have been designed to protect the poor through new or existing safety net programs or to moderate the rise in food prices by one means or another. The instruments applied are generally fiscal measures such as taxes and subsidies or administrative measures. Table 5 provides details of some responses for selected East Asian countries (China, Indonesia and Mongolia). In other countries, such as Vietnam, government strategy is to design and adopt safety net programs that are universal but where participation by the poor is fully subsidized and participation by the near poor is partially subsidized.

Table 5. East Asia: Policy Response to Recent Food Price Increases

Country (food share in CPI)	Fiscal	Administrative
China (34%)	1. School feeding program. 2. Cash transfer program for poor households. 3. Subsidies for grain and pig production.. 4. Export taxes on food grains.	1. Export ban on number of staple foods. 2. Export quotas for food grains. 3. Price controls on instant noodles and university cafeteria prices. 4. Large producers/wholesalers to seek consent of authorities prior to raising prices of basic necessities, including grain, edible oil, meat products, eggs and milk. 5. Increased supply of food grains using reserve stockpile. 6. Bilateral agreements on food grain imports to ease supply constraint.
Indonesia (40%)	1. Monthly quota of subsidized rice for poor households increased. 2. Program to provide subsidized cooking oil to poor households. 3. Price subsidy for small scale producers of processed soybean. 4. Import tariff on flour and soybeans removed 5. Export tax on palm oil increased. 6. Cooking oil exempted from VAT.	1.Increased supply of rice from government stocks. 2. Relaxed flour fortification standards.
Mongolia (42%)	1. Subsidy to wheat/grain farmers who sell to domestic flour mills. 2. Wheat flour imports exempted from VAT and import duty eliminated.	1. Voluntary price controls on flour during Lunar New Year. 2. Bilateral agreement with Russia to import 40,000 tons of wheat.

In general, administrative measures such as price controls may be helpful for managing expectations and could stabilize conditions for short periods but they suffer from serious drawbacks in the way they affect incentives in the medium to longer term. On the supply side price controls typically discourage supply and lead to a reduction of both quantity and quality. On the demand side, capping prices in the face of changing market conditions prevents both the reduction in demand and the substitution to other similar products that would normally allow markets to re-equilibrate. Administrative measures such as price controls are also difficult to enforce and encourage illegal activity such as black markets. Similarly, export bans create supply disincentives and encourage black markets.

Perhaps more useful may be targeted transfers to poor households such as feeding programs (particularly for vulnerable groups such as children and women), food for work programs and cash transfer programs, although these need to be evaluated also from the perspective of the government's fiscal position. In some limited settings, when other options are not available, subsidies on inferior food products consumed chiefly by the poor may also be considered, although broad or universal subsidies need to be avoided as they can quickly become fiscally ruinous. In some cases governments may also be in the position where removing policy distortions will help reduce the cost of food for the poor while also improving economic efficiency, for example by reducing or removing import restrictions on food imports. In the Philippines, for example, rice imports are subject to a 50 percent import tariff, as well as quantitative import controls. The efficiency cost of the Philippines' rice self-sufficiency policy is estimated to have cost an average 1.6 percent of GDP in 2000-2005.