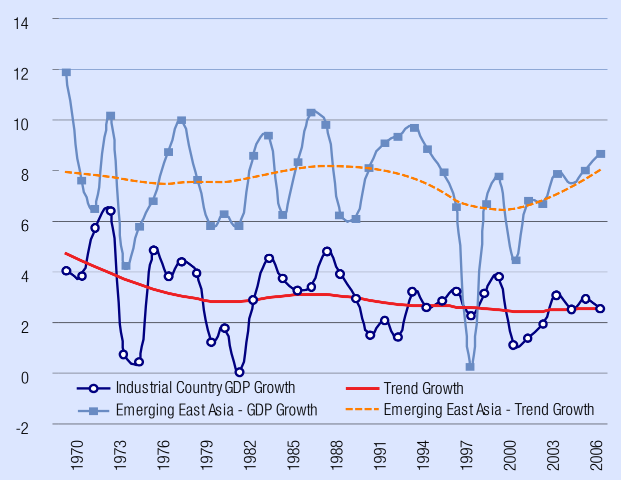
East Asian Outlook

East Asian economies will face testing times in 2008. Most analysts now expect the US economy to see either near zero or negative growth in the first half of the year, followed by a mild recovery in the second half of the year, accompanied by slower growth in Japan and Europe. In the scenario supporting this forecast US growth is expected to lie in a range of 0.5–1.4 percent in 2008, (down from 2.2 percent in 2007), followed by a mild recovery in the 1-2 percent range in 2009. Overall OECD growth in this scenario would fall from 2.5 percent in 2007 to perhaps 1.1-1.6 percent in 2008. World trade volume growth is assumed to dip to around 4-5 percent in 2008, down from 7.5 percent in 2007. Substantially higher world oil and food prices will further erode incomes in the bulk of the East Asian region, the latter particularly hurting the poor.

Developing East Asian economic growth in this global slowdown scenario is expected to fall to 8.6 percent in 2008, the lowest since 2002, down from 10.2 percent in 2007. (Table 1 earlier). China's growth is expected to finally dip below 10 percent, after five years at 10 percent plus rates, mainly due to lower export growth, although the decline likely will be welcomed by the government, which is seeking to avert economic overheating and to moderate inflationary pressures. Elsewhere growth is expected to ease more modestly to the 5-6 percent range for middle income economies like Indonesia, Malaysia and Philippines. In Thailand, for example, improved consumer and investor confidence, clearer policy direction and expanded public development spending after the December 2007 elections are expected to result in growth increasing modestly to 5 percent in 2008.

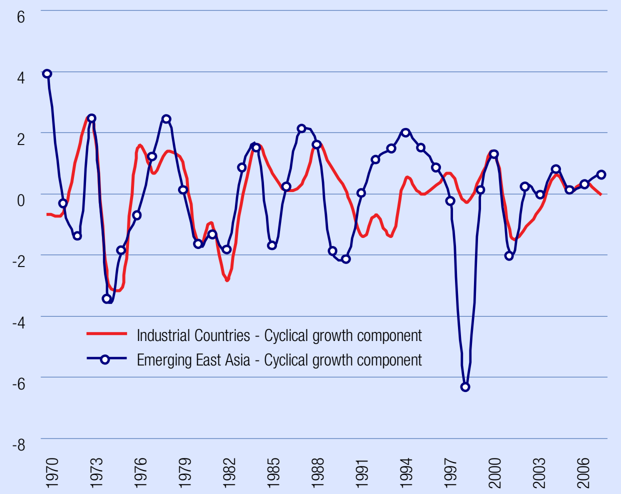
The overall picture of a cyclical slowing combined with a relatively high underlying trend rate of growth is fairly typical for East Asia. The trend rate of growth in Emerging East Asia has been 4-5 ½ percentage points higher than in the industrial countries over the last four decades (figure 23). High trend growth has been driven by fundamental factors such as robust productivity gains, ability to absorb knowledge from abroad, high savings, and growing education and skills. These fundamentals are unlikely to be displaced by the present financial turmoil and cyclical slowdown. At the same time, as figure 24 shows, East Asian business cycles around its high long run trend growth are often, through not always, correlated with cycles in industrial country growth. The present, then, is expected to be one of the times when the business cycle in East Asia reflects a downswing in the industrial country business cycle, although it will be a cycle around its high long run trend.

Figure 23. Growth Trends 1970 - 2007



Source: World Bank data and staff estimates.

Figure 24. Growth Cycles 1970 - 2007



Source: World Bank data and staff estimates.

Looking at the outlook in a little more detail, somewhat lower export growth will be one of the main factors leading output growth lower. As the experience of late 2007 and early 2008 suggests, however, growth in exports to other developing regions, intra-regional exports and exports to Europe and Japan may provide some offset to falling exports to the US. The near term outlook for the region will depend to a large extent on the robustness of domestic demand in the face of slowing exports.

Many economies in the region ended 2007 growing more rapidly in the second half of the year than in the first, despite a sharp slowdown in US import growth mainly because exports to other markets and domestic demand remained strong. Private consumer spending accelerated in most economies, while business investment spending was particularly strong in economies like China, Indonesia and Vietnam. Looking forward, business investment spending will also likely slow in response to the export slowdown, but may prove more resilient than in the previous 2001 recession, due to higher levels of capacity utilization and stronger corporate balance sheets and profitability. Domestic banks appear to have suffered relatively minor exposure to sub-prime mortgage related assets and domestic credit flows have remained generally healthy despite volatility in equity markets and a rise in offshore bond financing costs. Current account surpluses and large foreign reserves should provide a buffer that will enable economies to accommodate volatility in international capital flows without forcing the kinds of sudden large adjustments in domestic demand that became inevitable during the 1997–98 financial crises.

Fiscal positions generally also have become stronger over recent years, creating the scope for more stimulative fiscal policies should an unexpected fall-off in private sector domestic make them desirable. Fiscal balances are generally restrained (in low deficits or surplus), while public sector debt to GDP ratios have fallen substantially over the course of this decade in most of the larger economies. (Table 6). The scope for fiscal measures will nevertheless need to be evaluated in line with the individual circumstances of each economy. In Thailand the government has run fiscal surpluses for several years and is in a strong position to undertake a proposed expansion of public infrastructure spending. In Indonesia careful fiscal management has contributed to a halving in the government debt to GDP ratio from over 70 percent in 2001 to 35 percent in 2007. Recently however rising world oil prices have caused a surge in fuel subsidies. Even with planned offsetting cuts in other spending, the fiscal deficit is expected to increase to a little over 2 percent of GDP in 2008 (providing a net stimulus to aggregate demand). In the Philippines the government recorded a 0.1 percent of GDP deficit, more than meeting its budget target for the year. The improved fiscal situation is allowing the government to expand much needed public infrastructure spending. Much of the improvement in 2007 came from one-time privatization revenues, however, so that there is still a need to put the fiscal improvement on a more sustainable basis, in particular by strengthening the tax effort.

Table 6. East Asia – Fiscal Indicators

	2005	2006	2007	2008 (f)
Fiscal balance (As % of GDP)				
China	-1.3	-1.0	-0.6	-0.9
Indonesia	-0.5	-0.9	-1.1	-2.2
Malaysia	-3.6	-3.3	-3.2	-3.2
Philippines	-2.7	-1.0	-0.1	0.0
Thailand	-0.6	1.1	1.7	2.0
Vietnam		-0.3	-1.0	-2.0
Government Debt (as % GDP)				
China	17.9	16.9	14.5	13.5
Indonesia	44.9	39.6	34.9	31.9
Malaysia	44.0	42.3	42.3	42.2
Philippines	71.5	63.8	56.5	52.0
Thailand	47.6	40.4	37.5	38.5
Vietnam		43.1	43.2	44.0

Source: World Bank data and staff estimates.

The role of monetary policy is likely to be especially challenging. Headline inflation rates are rising in most economies in the region, mostly as a result of sharp increases in food prices, reflecting recent major gains in international food prices, as well as, in some cases, domestic supply problems. Core inflation rates are generally much lower than headline rates, but are also beginning to move gradually higher in some economies. Inflation has risen sharply in countries like Cambodia, Mongolia and Vietnam, which are experiencing rapid domestic credit growth, due in large part to substantial balance of payments inflows under an exchange rate pegged to the US dollar. In principle, the rise in headline inflation caused by higher international commodity prices should be temporary, reflecting a change in relative prices that, by itself, does not call for action by the central bank. However, monetary policy will need to remain vigilant to ensure that the rise in fuel, food, and other commodity prices does not set off an inflationary spiral leading to rising core inflation rates, especially in economies already showing signs of domestic over-heating and excessively rapid credit growth. Continued movements toward greater exchange rate flexibility will provide countries greater flexibility in using monetary policies to meet inflation challenges.

Finally, as the more detailed discussion Section 2.4 suggests, governments also face difficult challenges in addressing the adverse distributional impact of rising food prices on the poor in ways that are fiscally sustainable and minimize the efficiency costs to the economy. Well targeted cash transfer schemes may provide a useful alternative here.