

East Asia: Testing Times Ahead



Contents

Executive Summary	1
Introduction	5
Global financial turmoil	7
East Asian developments . . . a case for guarded optimism?	11
Strong growth momentum under clouded skies	11
Financial linkages: US turmoil affects East Asian securities markets, not so much banks	13
Trade linkages: Weakening US demand offset by other markets—so far	18
Volatile commodity prices now at the forefront of policy makers attention	22
East Asian Outlook	29
Country Sections	33
Appendix Tables	53
Key Indicators Tables	67

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Executive Summary

Last year Developing East Asia recorded its highest growth rate in over a decade (10.2 percent), capping a decade of improvements following its home-grown financial crisis in 1998.¹ Yet this is hardly a time for celebration, but rather one for concern. The global economy is once again facing a testing time, with soaring fuel and food prices, on the one hand, and, on the other, an unfolding sub-prime crisis emanating in the United States and spreading to other countries and asset classes, bringing in its wake a plunging dollar and a slowdown in global trade and growth.

Although East Asia will undoubtedly be affected, it is reasonably well positioned to navigate this crisis without incurring significant damage to its prospects. True, much depends on how the crisis unfolds, and of course, some countries in the region will be affected more than others. But, broadly speaking, the region's investment in sound macroeconomic policies and structural reforms over the last decade has added economic resilience and flexibility that will help deal with these challenges over the next year or two. Foreign exchange reserves are at all time highs, non-performing loans of banks have been steadily lowered, external and public debt burdens are at acceptable levels, most governments have unused fiscal space, the real economy has momentum, and diversification of trade and financial flows provides some flexibility in adjusting to the impending global slowdown.

Yet the challenges ahead should not be underestimated. The crisis in the United States has deepened as asset prices struggle to find a new equilibrium and financial institutions go through a painful process of de-leveraging and recapitalization. Further surprises cannot be ruled out. Previous experiences of real estate price busts suggest they can last twice as long and twice as deep as equity price busts. And this is also the first financial crisis in the post-securitized world, in which most intermediation is done through securities markets not depositary institutions — which means it could take even longer to resolve. Fortunately, the authorities of the affected countries have responded speedily to the crisis, lowering interest rates aggressively, providing fiscal stimulus, and using innovative approaches to inject liquidity and rescue failing financial institutions. But even if these interventions help stabilize the financial system and prevent a downward spiral in asset prices and asset values on balance sheets, the impact of the financial turmoil on global growth, trade, and financial flows will

¹ Developing East Asia comprises all low and middle income economies in East Asia, including China, Indonesia, Malaysia, Philippines, Thailand, Vietnam and a number of smaller economies including Pacific Island economies. Emerging East Asia refers to Developing East Asia plus four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan, China).

undoubtedly be adverse, although the magnitude of the impending effects remains highly uncertain.

This heightened uncertainty makes forecasting the impact on East Asia a particularly challenging task at this time. The latest data from the region indicates that the momentum of output and trade remains strong, but this is hardly surprising. The impact of a slowing US economy will take time to feed through trading and financial channels and its full force may only be felt in the second half of this year. Yet even in the first couple of months of 2008, data indicate adjustments in trade patterns that are suggestive of emerging trends that may become more evident with time. For example, export growth is shifting from the United States to other markets in industrial and developing countries, encouraged by the depreciating dollar and by continued strong momentum in the developing world (including East Asia itself), as well as in Europe.

In addition, the underlying trend in East Asia's growth has long been much higher than the trend in industrial country growth, even as East Asian cycles around that trend have often been correlated with cycles in industrial countries, and may become more so as the region continues to integrate with the world economy. The region's strong long run growth trend is not driven by year to year fluctuations in world demand, but, rather, by improvements in productivity, innovation, quality control, education and skills. These underlying sources of trend growth are unlikely to be affected by the financial turmoil or by a slowing global market – suggesting that, with continued prudent economic management, East Asia, and especially China, can continue to emerge as a growth pole in the world economy, providing a possible counterweight to the slowing industrial economies.

While the sub-prime crisis in the United States has had relatively little direct impact on banks and financial institutions in East Asia, perhaps the most immediate and visible impact of the financial turmoil in the United States has been the steep decline in securities markets across East Asia, especially equity and, to a lesser extent, offshore bond markets. This decline has been driven not just by uncertainty and the liquidation of portfolio holdings of foreign financial institutions, but also by a more realistic revaluation of risk in global financial markets as a whole and an adjustment in expected returns of the underlying investments. At the same time domestic credit — supported by ample domestic savings — continues to provide resources for investment even as portfolio inflows and loans from international banks taper off. More worrying would be if the decline in stock prices had a contagion effect through the balance sheets of corporations and/or banks, one among the many financial sector issues that the authorities in East Asia will need to keep a sharp eye on.

Building on our analysis of expected trade and financial flows, and the future course of key economic variables, we project Developing East Asian growth could decline by 1-2 percentage points to around 8 ½ percent in 2008 compared to 2007. While such a decline in growth is a matter of concern, especially for the poor in these countries for whom every percentage point of growth counts, the resulting growth rate is still significant and considerably higher than in other regions of the developing world. Of course, the US financial turmoil could still take an unexpected turn that may affect this outlook — especially if the contagion were to spread to other industrial countries in a major way — and this may require further downward adjustments in the forecast. But in such a circumstance, the strong fiscal situation in most East Asian countries will allow them the space to soften the blow by stimulating domestic demand through tax and public expenditure policies.

Quite apart from the challenge of growth, the East Asian countries also have to deal with current very high fuel and food prices. In virtually every East Asian country, inflation is climbing to uncomfortable levels due to these cost-push pressures, while monetary and credit growth is difficult to contain owing to substantial capital inflows. Some countries are resorting to price controls and other administrative measures to temporarily curb inflation, but these only distort market signals and encourage black markets over the longer term, and eventually have to be removed. In other countries, fuel subsidies have climbed to the point where they are becoming a large fiscal burden.

Dealing with high food and fuel prices probably constitutes a greater challenge to governments in East Asia than the financial turmoil in the United States and a slowing global economy. In the medium term, the answer clearly lies in greater fuel efficiency, stronger and more productive global agriculture and an open international trading system. But in the short term, the bigger concern is to alleviate the harsh burden this imposes on the poor. True, some economies in the region are net exporters of these commodities and so are enjoying gains in overall national income. And true, higher food prices do help farmers – although small farmers are usually net consumers of food and are thus hurt. But the non-farm poor living in rural and urban areas (and small farmers) – who devote between a third to two-thirds of their expenditures to food – are seeing their real incomes decline substantially as a result of the increase in food prices. Similarly, while higher fuel prices affect everyone, the poor are hurt disproportionately. Although this difficult problem has neither easy answers nor a one-size-fits-all solution, East Asia has faced these challenges before and adopted a variety of solutions in the past to fit different circumstances, ranging from targeted subsidies to conditional cash transfers to school lunch programs. These programs now need to be considered again and reintroduced before the problem becomes too acute.

Introduction

Despite falling growth in exports to the US, rising volatility in global financial markets, high and volatile international commodity prices, and an increasingly clouded outlook for the world economy, economic activity in most East Asian economies continued at strong rates through the end of 2007 and into early 2008. Fortunately, the countries of East Asia are generally better prepared than ever to deal with the vicissitudes of the global economy in this more uncertain time. Reflecting lessons learned from the East Asian financial crisis of a decade ago, today most economies in the region have strong external payments positions and large international reserves, prudent fiscal and monetary policies, better regulated banking systems, and profitable and competitive corporations. East Asia's trade and financial relations with the rest of the world have become steadily more diverse. The region is becoming more of a growth pole in the world economy, proving to be a force for stability at a time when the industrial economies are slowing.

This is not to say that East Asia is immune from developments elsewhere. On the contrary, its increased integration in the world's trading and financial system makes it sensitive to global economic conditions. Whether the unfolding turmoil in US and other financial markets will gather force or start to abate, and how large its impacts on world economic activity will be, is still uncertain. On balance, however, the financial turmoil has substantially increased the likelihood of a US recession and a significant slowdown in world growth in 2008, including in East Asia. Economic cycles in East Asia have indeed often been correlated with cycles in the industrial countries. But these have generally been cycles around an East Asian trend rate of economic growth that has for many decades run at 4–5.5 percentage points faster than trend growth in industrial countries. 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. And these fundamentals are unlikely to be displaced by the present financial turmoil and cyclical slowdown.

Looking forward, growth in Developing East Asia in 2008 is expected to come down from 2007's exceptional pace of over 10 percent by a hefty 1.5 percentage points. Nevertheless, that decline still would leave regional output expanding by a healthy 8.5 percent or so (table 1). Growth in China is expected to come down by 2 full percentage points to 9.4 percent. A further slowing in export growth will likely be a leading element in the impending East Asian slowdown. One of the striking features of the past six months has been how modestly East Asian exports have decelerated, as weaker exports to the US by have been offset by increasing exports to Europe, other East Asian economies, and—a notable development—surging exports to other developing regions, especially those benefiting from high oil prices. It is

Table 1. East Asia economic growth

	2006	2007	2008	2009
Emerging East Asia	8.4	8.7	7.3	7.4
Develop. E. Asia	9.8	10.2	8.6	8.5
S.E. Asia	5.5	6.1	5.6	6.0
Indonesia	5.5	6.3	6.0	6.4
Malaysia	5.9	6.3	5.5	5.9
Philippines	5.4	7.3	5.9	6.1
Thailand	5.1	4.8	5.0	5.4
Transition Econ.				
China	11.1	11.4	9.4	9.2
Vietnam	8.2	8.5	8.0	8.5
Small Economies	7.2	6.6	6.4	6.1
Newly Ind. Econ.	5.6	5.6	4.6	5.0
Korea	5.0	4.9	4.6	5.0
3 other NIEs	6.1	6.2	4.6	5.0
Japan	2.2	2.1	1.5	2.0

Source: World Bank East Asia Region; March 2008 Consensus Forecasts for NIEs.

impose a loss of income on East Asia of perhaps close to 1 percent of GDP. (Of course, the region contains a number of net commodity-exporting economies that will enjoy gains in national income due to higher commodity prices.) Rising food prices are exacerbating headline inflation and hurting the incomes of the poor. These developments could stall or even set back the progress made in reducing poverty over the last decade while heightening political tensions.

The task of macroeconomic management in this environment will not be an easy one, although policy-makers in most East Asian countries will be able to confront the problems from a relatively strong position.

Current account surpluses and large foreign reserves 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.

The role of monetary policy is likely to be especially challenging. 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. Countries also face difficult challenges in addressing the harmful distributional effects of higher food and fuel prices on the living standards of the poor. Well-targeted cash transfer schemes may be helpful, although they need to be considered within the context of the country's overall fiscal position.

nevertheless likely that exports will turn lower more distinctly in coming months, as US imports themselves begin to fall (rather than merely growing more slowly or stagnating), and as the US downturn and financial market turmoil begin to affect more decisively other regions that are East Asian export markets.

The US financial market turmoil has already led to increased volatility in East Asian equities markets and to rising offshore bond financing costs. However, given that lending by domestic banks—the main source of financing in the region—has been little affected so far, the impact of these developments on domestic activity may be limited. Rising oil, metals, and food prices will also