CHAPTER 4: THE OUTLOOK FOR EAST ASIA AND THE PACIFIC

The deterioration in the advanced economies since the writing of the Bank's last Regional Economic Update ("Navigating the Perfect Storm" issued on December 10, 2008), has meant a further downgrading in our growth forecasts for East Asia and Pacific. Indeed, overall, our projections indicate a decline of 1.4 percentage points in growth for developing East Asia for 2009 compared to our December forecasts, reflecting the worse-than-expected unfolding of the global economic and financial crisis. Real GDP in the G-3 is set to contract by 3.1 percent in 2009 (compared with a 0.4 percent decline forecast in December), global trade volumes are projected to fall for the first time in a quarter of a century at a pace of 6 percent that represents the greatest contraction since World War II. Excess capacity – most of it geared for export-oriented production in many countries in the region, notably but not only China – will keep exerting downward pressure on manufacturing prices, increasing the short-term risks of deflation. Global capital flows are set to slow substantially further, with global private flows likely to fall to a fifth or less their levels a few years ago, reflecting weakened bank lending and subdued portfolio flows, and reduction in direct investments amid delays in new investment projects.

Despite this dire global environment, determined monetary easing across the region, facilitated by a sharp decline in inflation, has helped limit the impact of the financial crisis on domestic liquidity. There is scope for further interest rate cuts in several countries in the region, although the limits of what monetary policy alone can accomplish have probably been reached already, given heightened risk aversion and tight credit conditions globally. Some countries, moreover, have little room for further monetary easing because of investors' concerns that further global rate cuts may add to downward pressures on currencies and a sharp pickup in inflation. And countries that entered the crisis with overheated economies and rapid credit growth, such as Mongolia and Cambodia, have the dual challenge of tightening monetary conditions at a time when the economies are experiencing a sharp downturn.

The authorities in the region are likely to be more engaged to help handle the emergence of bad loans in the portfolios of banks that will result from the deterioration of economic activity. Efforts to ensure credit markets remain unclogged will be successful to the extent the authorities and banks succeed in ensuring that these losses can be absorbed or new capital raised quickly. Confidence that credit and financial markets will continue to function properly will be crucial for economic activity to recover, even though output has tended to strengthen before credit in previous global downturns, the Great Depression and the 1997-98 Asian financial crisis.

Recovery in the region will be supported by fiscal easing, including through implementation of fiscal stimulus packages in the region's middle-income countries and NIEs. The size of the fiscal stimulus may be increased in some countries with available fiscal space, notably China and Thailand, provided additional spending is well targeted, effective and easily reversible. However, there are limits to how much stimulus geared toward infrastructure can accomplish and the adverse consequences of the downturn on employment would be more efficiently addressed by targeted social safety spending. In all countries, moreover, there will be scope for the authorities to revise stimulus packages to improve their impact while aligning them better with longer-term priorities. This realignment will reflect efforts to ensure that the stimulus is channeled into areas that address critical bottlenecks (including in power generation, transportation, environment-related investment), and does not add to already abundant capacity (such as in export-oriented manufacturing). Fiscal stimulus is also likely to be more effective if it allows firms to adjust to the new patterns of domestic and global demand, rather than protect activities and jobs that need to be scaled back. Increased emphasis on maintenance – which is typically neglected in good times - could be a viable option for countries lacking investment projects ready to be implemented, as would be efforts to properly fund or set up social safety nets. In addition to helping cushion the impact of the crisis on the most vulnerable and providing an important element of countercyclical fiscal policy, social safety nets will give the authorities the confidence to allow more complete labor and business adjustments that will ultimately help economies gain competitive advantage over others with less advanced adjustment. Supporting SME financing is also likely to be

a highly effective use of stimulus funds, given the importance of these enterprises in supporting employment and trade.

For the low-income countries, the key avenue for boosting fiscal room is by reallocating resources from low- to high-priority projects and programs, increasing donor aid, and by accelerating the disbursement of projects with the greatest impact on domestic demand. The recent G20 Summit recognized once again the urgent need to mobilize resources for multilateral institutions and put these to best use in helping the world's poorest. Efforts to rationalize existing spending would also help, including through a detailed review of budgets to identify possible cuts of unproductive expenditures.

Table 7. Growth is slowing in developing East Asia, but will be higher than in all other world regions

(Percent change y-y)

	2007	2008f	2009f
Developing East Asia	11.4	8.0	5.3
Dev. East Asia excl. China	6.2	4.8	1.2
Europe and Central Asia	6.9	4.2	-2.0
Latin America and Caribbean	5.8	4.3	-0.6
Middle East and N. Africa	6.0	5.5	3.0
South Asia	8.4	5.6	3.7
Sub-Saharan Africa	6.0	4.9	2.5
OECD countries	2.5	0.7	-3.0

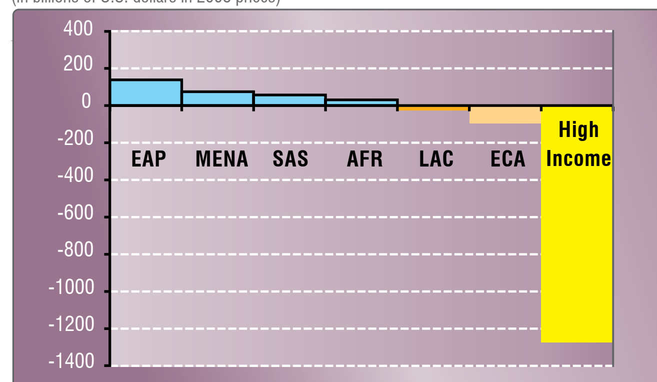
Source: DECPG (World Bank), and Bank staff projections.

Despite these determined efforts to boost activity in the region, we expect real GDP growth in developing East Asia to slow to 5.3 percent this year (1.4 percentage points lower than our forecast three months ago) from 8 percent in 2008. The slowdown in growth reflects both weaker exports and slower expansion in domestic demand in all countries. The latter is due to slower growth or declining investment spending by the private sector that is only partly offset by stronger government investment outlays in the middle-income countries, and more cautious private consumption amid rising unemployment, slower wage increases and stepped-up precautionary saving. A decline in remittances to developing East Asia, projected to fall 4.2-7.5 percent in 2009 (somewhat lower than the 5-8.2 percent forecast for developing countries as a whole), and return of migrants losing their jobs abroad, will also add to pressure to trim consumption.

Thanks to China, growth in developing East Asia and the Pacific will be the fastest among the world's regions (*Table 7*). The region's contribution to global GDP will remain the largest in the world, equal in dollar terms to the sum of the contributions from the other three regions with positive impact: South Asia, Middle East and North Africa, and Sub-Saharan Africa (*Figure 42*). Given that developing East Asia's nominal GDP is barely a tenth of global output, however, the region's contribution to incremental global GDP will offset only partially the collapse in output in developed countries. If China is excluded, however,

Figure 42. The contribution of developing East Asia to the change in global output in 2009 is the largest in the world

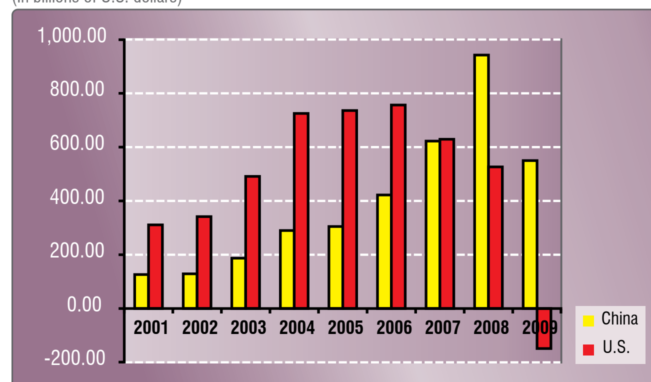
(In billions of U.S. dollars in 2008 prices)



Source: World Bank staff calculations.

Figure 43. China's increase in nominal GDP has surpassed that of the U.S. since 2007 and is the largest in the world

(In billions of U.S. dollars)



Source: Datastream and World Bank staff calculations.

developing East Asia's performance is expected to be lackluster and trails well behind the World Bank's projections for Latin America, the Middle East and North Africa, and Sub-Saharan Africa. The reason lies in the openness of the economies in the East Asia region and the tight production networks organized to serve the markets in the U.S. (and to a lesser extent Japan). But just as these structural characteristics have pulled down the growth performance of these countries during the global downturn, they will serve to support their performance once global growth resumes.

Table 8. Growth is projected to slow further

(Percent change y-y unless indicated otherwise)

	2007	2009f	Difference, 2009-2007
Developing East Asia	11.4	5.3	-6.1
Indonesia	6.3	3.4	-2.9
Malaysia	6.3	-1.0	-7.3
Philippines	7.2	1.9	-5.3
Thailand	4.9	-2.7	-7.6
China	13.0	6.5	-6.5
Vietnam	8.5	5.5	-3.0
Cambodia	10.2	-1.0	-11.2
Lao PDR	7.5	5.0	-2.5
Mongolia	9.9	2.7	-7.2
Papua New Guinea	6.2	4.7	-1.5
Memoranda:			
Europe and Central Asia	6.9	-2.0	-8.9
Latin America and Caribbean	5.8	-0.6	-6.4
Middle East and N. Africa	6.0	3.0	-3.0
South Asia	8.4	3.7	-4.7
Sub-Saharan Africa	6.0	2.5	-3.5
OECD countries	2.5	-3.0	-5.5

Source: The World Bank; f=forecast

Developments in the region in 2009 will be influenced by China. The slump in global demand will cause China's exports to fall this year, the first decline in decades. Nonetheless, a large monetary and fiscal stimulus should help partly offset the decline in exports and contain the slowdown in growth to 6.5 percent for 2009 as a whole from 9 percent in 2008. With growth below potential, excess capacity is likely to restrain market-based investment and result in downward pressure on prices, following several months of month-on-month declines in the consumer price index. Even so, China will still grow faster than most other countries in the world in 2009, including all countries in developing East Asia. China's contribution to global incremental output has surpassed that of the U.S. since 2007 and is now the largest in the world, underpinning the country's role as a key pole of global growth during the current financial and economic crisis (*Figure 43*). There remains substantial uncertainty about the projected pace of expansion, reflecting concerns that prolonged external weakness will have a sustained negative impact on the export-oriented portion of China's economy, notably manufacturing. There are also concerns that the stimulus package may still be focused on limiting the slowdown in manufacturing at the expense of stimulating development of services such as health and education and encouraging domestic spending on non-tradables (construction, transport, finance, telecommunications, and domestic tourism). Rural spending, in particular, is coming under pressure from a slower increase in rural than urban incomes due to the disinflation led by food prices and the increase in returning migrants to rural areas that are left without employment.

In Malaysia and Thailand, among the region's other middle-income countries, output is projected to contract in 2009 due to a drop in exports and investment. In Malaysia, high and undiversified dependence on exports of electronics, oil and crude palm oil, all of which are falling sharply, coupled with its relatively small domestic market, underpins the projection of real GDP falling by 1 percent in 2009 (*Table 8*). Domestic demand is likely to slow considerably, as a sharp contraction in private investment offsets most of the continued strength in consumption and government investment. In Thailand, a slump in exports, exacerbated by heightened political uncertainty, is set to cause output to contract by twice as much following the slowest expansion in developing East Asia in 2008.

Some of the low-income countries are the hardest hit by the crisis. In Cambodia and Mongolia, the crisis has helped cool economic activity that was overheating in early 2008. The decline in growth in Cambodia from 2007 to 2009, in particular, is projected to be the steepest in developing East Asia. The economy is affected by simultaneous declines in export orders for

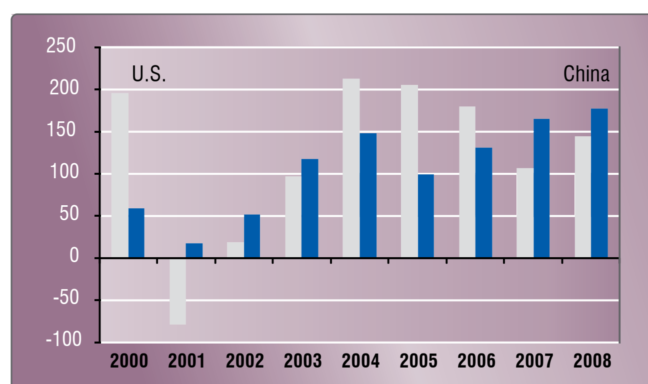
garments (which account for almost four-fifths of exports, and most of the shipments are to the U.S.), a drop in construction, a collapse in private capital inflows, and a sharp slowdown in tourist arrivals. Credit growth that helped fuel the earlier expansion, including in real estate, has slowed sharply from increases of 100 percent on an annual basis in early 2008. With the government lacking access to international or domestic credit markets, additional fiscal room can only be found in faster utilization of donor commitments and spending rationalization. Nonetheless, the small size of the public sector will limit the impact of fiscal easing on growth. The deceleration in growth in Mongolia has also been swift, as the collapse in commodity export prices exposed an unsustainable fiscal situation with little saving from the commodity boom in 2007/2008 and oversized and untargeted social transfers. Whereas other major commodity exporters let their currencies depreciate as terms of trade deteriorated, the Mongolian authorities defended the currency peg to the U.S. dollar, leading to a substantial loss of foreign exchange reserves that ultimately forced a sharp adjustment. In Vietnam, by contrast, decisive government measures helped slow activity early in 2008, leaving the economy in better shape to face the full force of the financial crisis when it hit in September.

Papua New Guinea and Timor-Leste are among the countries worst affected by the sharp decline in commodity prices. Gold, copper and oil account for 95 percent of PNG exports, leaving the country at the mercy of commodity price volatility. Unlike Mongolia, a country with a similar level of dependence on commodity exports, PNG's authorities prudently saved part of the mineral wealth over the last several years after running sizable fiscal surpluses during 2005-08. However, the savings were placed in LCU-denominated trust accounts creating a potential currency mismatch which limits the scope for using saved funds as it will create pressure on balance of payments. Timor-Leste, on the other hand, has accumulated surplus oil revenues in a petroleum fund, which has provided a substantial buffer to the current downturn in oil prices, and which is being drawn on to finance a significant part of the public investment program.

Looking beyond 2009, scope for faster recovery in the region will be helped by China, but will ultimately depend on the pace of recovery in the advanced economies. Even under the assumption that a pickup in growth in developed countries begins in 2010, a sizable output gap will remain for several years, including high unemployment and weak consumption and imports, sustaining downward pressure on prices for manufactured products. A pickup in 2010, moreover, is likely to be relatively subdued, as consumers in developed countries adjust to lower wealth levels and banks complete the deleveraging process. Prospects for lower global growth compared to the last decade increase the importance of China rebalancing its growth pattern by moving away from reliance on export-led manufacturing, boosting the role of services, and stimulating domestic consumption and, inevitably, imports. The change in China's imports has exceeded that of the U.S. since 2007, proving an impetus to global demand in challenging times (*Figure 44*). Most of the increase in imports is likely to be for raw materials, capital goods and increasingly sophisticated consumer products. Commodity exporters in the region are likely to benefit, as will producers of capital goods (largely limited to companies in the NIEs and the G3 for now). The other countries in East Asia, meanwhile, may benefit only to the extent they shift exports toward more sophisticated consumer products, a tall order in the short term. Exports of electronic and other components to China for assembly and shipment to the G3 are likely to remain slow, even more so given the success of some companies in China of late in reducing reliance

Figure 44. And the change in China's nominal imports exceeded that in the U.S. since 2007, 2000-2008

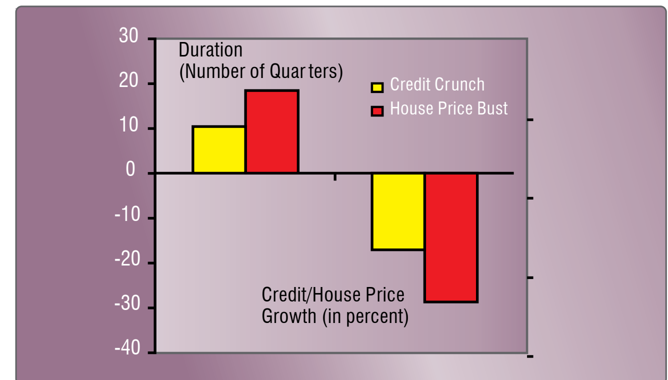
(In billions of U.S. dollars)



Source: Datastream and World Bank calculations.

on imported components for further processing. All in all, a sustained recovery in developing East Asia is likely only once growth in developed countries strengthens sufficiently for global demand to resume.

Figure 45. Recessions with crunches, housing and equity busts last longer



Source: Claessens, C., M.A. Kose, and M. E. Terrones (2008)

Over the medium term, the countries of East Asia and the Pacific can achieve high rates of economic expansion in a slowly growing world economy to the extent to which they are able to extract more growth from domestic demand, boost competitiveness, penetrate new markets, improve the environment for private investment, boost the performance of SMEs, and further improve the attractiveness of the region as a key destination for foreign investment. Convergence toward income levels in the developed countries will depend to an ever greater degree on the ability of firms to move closer to the technological frontier and be driven more by innovation than imitation. Innovative companies need different institutions and policies, including more openness to trade, fewer barriers to entry and exit, enhanced flexibility in labor and product markets, a better educated work force, and better developed private finance. Delivering on these institutions and policies will be an important component of the region's remarkable transformation into an ever more confident source of global growth and development.

In the near to medium term, slower growth and weaker remittances will reduce the pace of poverty reduction in the region. In some countries the absolute number of poor is expected to increase. Disparities across sub-national regions are also likely to worsen, at least in the short term in some countries, given the uneven distribution of economic activity and the sharp decline in manufacturing and mining, and the collapse in commodity prices. As the governments in the region focus on softening the impact of the crisis through mechanisms that often are only partially effective, it is important to heed the renewed urgency of introducing targeted and coherent social protection to ward off future adverse shocks. Strengthening social safety nets is also gaining importance as an instrument to allow households to ease high saving rates and enjoy a higher standard of living without jeopardizing the security of their families.

The projections outlined in this report are surrounded by extreme uncertainty. While recovery from most recessions has been relatively swift, an analysis of previous OECD recessions suggests that when accompanied by a credit crunch, housing crisis, and equity bust, they tend to last twice as long and are deeper than other "normal" recessions (*Figure 45*). Using these rough estimates and the fact that the average recession in the U.S. over the last three decades has lasted about a year, while the 1973 and 1981 recessions lasted a year and a half, there is a substantial risk that recovery in the U.S. – and in the world - may not materialize until late 2010. Further, while investment usually picked up strongly in past recoveries once inventories were exhausted, recovery from the current global recession may be more subdued due to the substantial destruction of wealth and ongoing deleveraging in financial systems around the world. Continued problems in commercial banks or even renewed financial market tensions could delay recovery further and lead to another year of stagnating or even contracting global growth. Finally, even when recovery begins, the pace of pickup is more likely to be subdued, as global imbalances are gradually resolved.

The April G20 Summit in London has reconfirmed the importance of speedy resolution of the financial crisis to break the negative feedback loop between financial tensions and economic activity, and stressed yet again the need for improved policy coordination and consultation across countries. Countries in East Asia are contributing substantially to the global solution of the crisis, while facing increasing challenges of sustaining critical expenditures on social safety nets, human developments and important

infrastructure. Enhanced regional cooperation should help, including through reaffirming the importance of free trade and regular sharing of information and consultation on key policy changes. The G20 has also underlined the need to expand assistance to developing countries to prevent erosion of progress in reducing poverty. Protecting the poor and those vulnerable to falling into poverty will help ensure that unemployment and partial employment do not spill into social tensions that test social cohesion.