

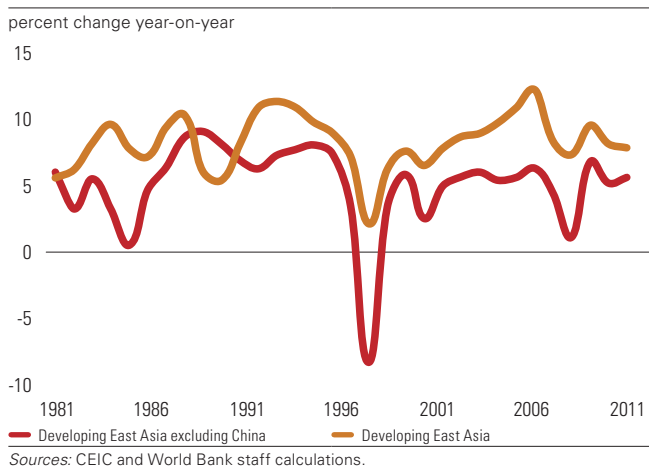
## I. RECOVERY FIRMLY ON TRACK

The region's recovery is firmly on track, with real GDP, industrial production and exports above pre-crisis levels. But employment in manufacturing—which typically pays higher wages than jobs in other sectors—has lagged, suggesting employers are still cautious about the durability of global growth. Sluggish manufacturing growth, combined with the negative impact of rising food and fuel prices, could slow progress reducing poverty across the region this year.

### Growth surprises on the upside

Output growth throughout developing East Asia moderated in the second half of 2010 but was still surprisingly strong. This positive outcome reflected sustained monetary and fiscal stimulus measures and stronger growth in demand abroad, both of which partly offset the return of capacity utilization to pre-crisis levels. Real GDP growth in developing East Asia and Pacific amounted to 9.6 percent for 2010 as a whole (Figure 1 and Table 1), 0.7 percentage points higher than our estimate in November 2010 (see our East Asia update from November 2010, Robust Recovery, Rising Risks). Estimates for growth among the G-3 (the U.S., the EU, and Japan) were also revised up by a similar amount, thanks largely to a markedly better outcomes in the eurozone and Japan.

**Figure 1.** Real GDP growth moderated...



**Table 1.** ...but for the full year 2010 was close to pre-crisis levels and East Asia remains the fastest growing global region

	2008	2009	2010e
Developing East Asia	8.5	7.4	9.6
Excluding China	4.7	1.2	6.9
Europe and Central Asia	3.9	-6.6	4.7
Latin America and Caribbean	4.0	-2.2	5.7
Middle East and North Africa	4.2	3.1	3.3
South Asia	4.8	7.0	8.7
Excluding India	3.7	4.3	5.1
Sub-Saharan Africa	5.2	1.7	4.7
High Income Countries	0.2	-3.4	2.8

Source: World Bank Global Economic Prospects 2011.

**Growth in 2010 was broad-based.** Seven countries in developing East Asia grew by 7 percent or more last year, including Thailand and Malaysia, the only middle-income countries in the region whose economies had contracted in 2009. Real GDP grew 7.8 percent in both countries in 2010, driven equally by domestic and external demand and accommodative policies. In the Philippines, a surge in consumer and business optimism in part due to the presidential elections, and stronger and more robust remittance growth were additional factors that underpinned the country's fastest growth in more than three decades.

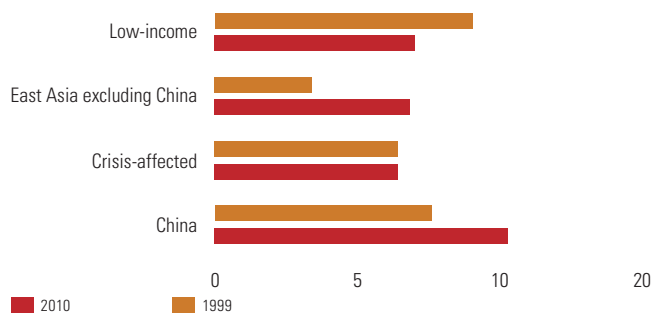
The post-crisis rebound in 2010 was faster than the recovery from previous crisis episodes, including after the 1997-98 Asian financial crisis. Much of this rebound reflected the solid macroeconomic foundations that existed before the crisis, plentiful fiscal space, low external and government debt, and the strong balance sheets

**Box 1. Then and now: the 1997-98 Asian financial crisis and the global economic crisis**

What a difference a decade makes. The “noughties” began with the region emerging from one crisis and ended with another. In 1999, output in developing East Asia excluding China rose by 3.4 percent, after contractions in 1998 of 13 percent in Indonesia and 7 percent or more in Thailand, Malaysia, and Korea. In 2010, output in seven countries in developing East Asia expanded by more than 7 percent, after contractions of about 2 percent in Malaysia and Thailand in 2009 and a modest slowdown in Indonesia. The greatest economic and financial crisis in more than half a century had a temporary impact on the region which governments, companies, and households took in their stride. And with large parts of the developed world still tackling the consequences of excessive debts and with banks rebuilding their balance sheets, East Asia remains the fastest-growing region in the world.

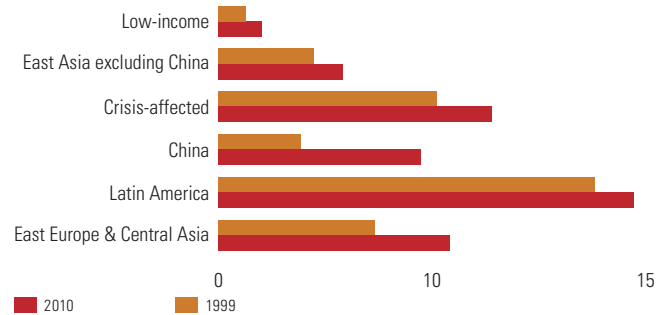
Growth moderated in China and most other middle-income countries after the 1997-98 Asian financial crisis, but picked up in Lao and Cambodia

percent change y-y, period average



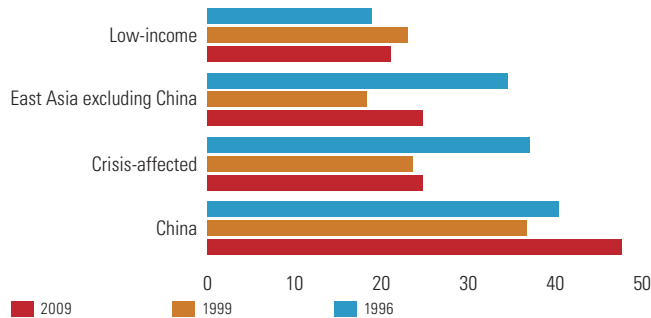
Per capita GDP relative to the OECD has risen throughout East Asia but markedly only in China...

percent relative to OECD, current prices



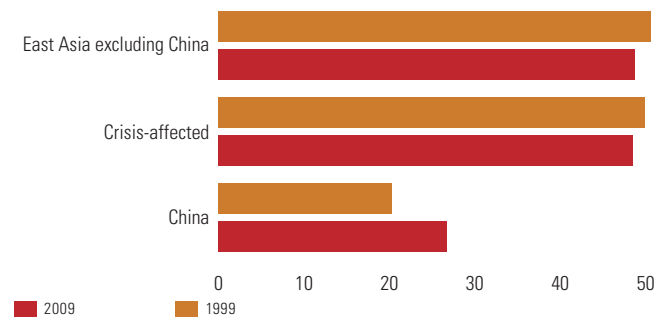
Investment declined after the 1997-98 crisis in most middle-income countries but rose in China, Vietnam and the low-income countries

in percent of GDP



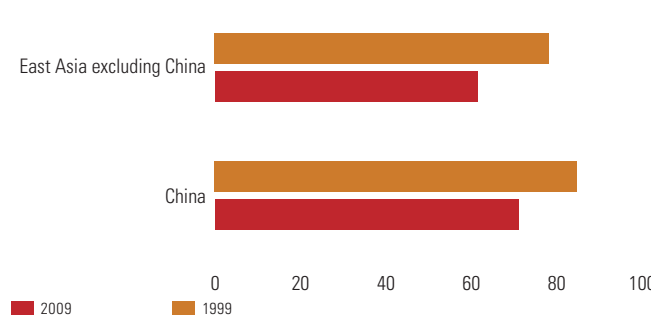
Exports have risen as a share of GDP only in China...

in percent of GDP



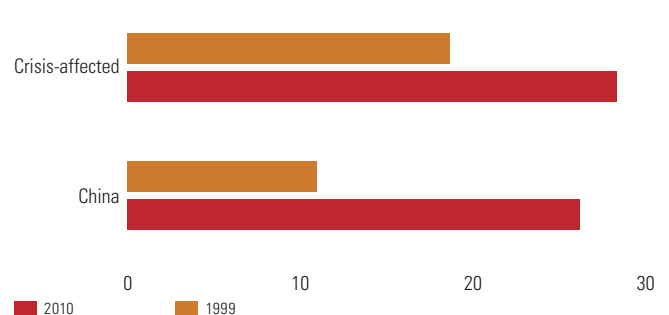
... but exports to the high-income economies fell as a share of total exports, as final demand within East Asia and in other developing regions has surged

exports to high-income economies as percent of total



Countries added to foreign exchange reserves, led by China

foreign exchange reserves in percent of broad money



Sources: CEIC, Haver, national authorities, and World Bank staff estimates.  
 Note: Crisis-affected: Indonesia, Korea, Malaysia, Philippines, and Thailand.

of companies and commercial banks. An increasingly diversified global customer base also helped (Box 1). The emergence of China as a major source of final demand in the region and globally has been equally crucial, a topic to which we will return in Chapter IV.

**Thanks to continued strong growth, China became the second largest economy in the world measured at market exchange rates.<sup>1</sup>** Despite efforts by the authorities to cool the pace of expansion, growth has remained firm since mid-2010 and amounted to 10.3 percent for the year as a whole, up from 9 percent in 2009. Net exports made a small positive contribution to growth according to official estimates in contrast with the substantially negative contribution of 4 percent in 2009. In the near term, China's rapid expansion and its rising inflation rate presents a growing risk for the region, given the moderate expansion in activity in high-income economies and the much increased final demand in China for goods produced in the region. Over the medium term, however, China will continue to present a unique opportunity that the countries in the region must seize, a topic to which we will return in later sections (Box 2).

### Box 2. The rise of China

The most populous country in the world and the richest country until the early 19th century is now:

- **The world's second largest economy** after the U.S. at market exchange rates since 2010. In per capita terms, China's GDP is just one-tenth that of Japan. Adjusting for purchasing power parity, China's GDP per capita is one-fifth that of Japan and 14 percent of the level in the U.S..
- **The largest exporter** after overtaking Germany in 2009.
- **The largest manufacturer** followed by the U.S. in value added measured in current prices.
- **The world's largest steel producer since 2009**, producing about 10 million tons more than each of the OECD countries combined and the rest of the world.
- **The largest consumer of refined metals** (41 percent of the world), more than the OECD combined.
- **The largest global energy user** after surpassing the U.S. in 2010. Ten years ago, China's energy consumption was half that of the U.S. Per capita energy consumption in China is just one-fourth of that in the U.S., but U.S. oil consumption is double that of China.
- **The country with the largest installed wind energy capacity.**
- **The second largest recipient of FDI after the U.S.** with about \$100 billion in 2010.
- **Sovereign risk rated on par with Japan** after Standard and Poors downgraded Japan to BB- on January 27, 2011.

**Rapid expansion also returned to Cambodia and Mongolia, whose economies contracted in 2009.** In Cambodia, the recovery in garment exports and in tourist arrivals contributed to an estimated real growth rate of about 6.7 percent in 2010 after the first contraction in almost three decades. In Mongolia, resurgent foreign investment in the extractive industries supported by thus far prudent fiscal policy and renewed progress on structural reforms, led to an estimated 6 percent expansion despite severe weather-related losses in the livestock sector.

**More generally, the rebound among the region's resource-rich economies reflected the rapid increase in global demand for commodities.** This strong demand is transforming the economies of Lao, Mongolia, PNG, Timor-Leste, and the commodity-producing regions in Indonesia, Malaysia, and Vietnam. For most of these countries, resource riches have helped boost living standards this decade. But whether this abundance will ultimately elevate

<sup>1</sup> In purchasing power parity (PPP) that adjusts for the different purchasing power of the dollar across countries, China became the world's second largest economy in 2002.

countries to high-income status is yet to be seen in the region. Prudent fiscal management of windfalls and incentives that create genuine alternative industries and sources of income will ultimately be crucial for ensuring that commodity riches do not become a curse.

**Last year's growth outcome in developing East Asia was surprisingly positive, but the outcome in 2011 is likely to be more subdued.** Throughout East Asia, the rise in inflation at varying speeds and the volatility of commodity prices, exchange rates, and capital inflows will likely require more determined policy actions this year, including more monetary tightening than most projections call for. In the high-income countries, the recovery is firming up but is more likely than not to continue at a sluggish pace, albeit a bit faster than was expected earlier due to the new fiscal stimulus package in the U.S. and Japan.

**However, several key risks remain in the high-income economies, including those resulting from persistent banking and sovereign stress in the peripheral eurozone and still unresolved issues with residential real estate in the U.S..** Developments in the Middle East of late have contributed to substantially higher oil prices and still have the potential of further

disruption on commodity price volatility than is currently appreciated. And given the links between energy and food prices, these developments in the Middle East could have implications that extend well beyond energy.

**We project growth in China to slow to about 9 percent this year from 10.3 percent in 2010 and about 11 percent on average during 2000–2007 as measures to cool the property market and contain inflation, combined with efforts to rebalance the pattern of investment and growth, take firmer hold.** In the rest of developing East Asia, real GDP growth is likely to amount to about 5.3 percent, little changed from the pace during 2000–2007 but down from 7 percent in 2010 and 7.5 percent in the decade before the 1997–98 Asian financial crisis. Returning to a more buoyant growth path in the middle-income countries other than China remains a key priority for governments, one that they must achieve to enable a transition to high-income status in the foreseeable future, rather than stagnation in their current middle-income status.

### *Industrial employment and wages are picking up*

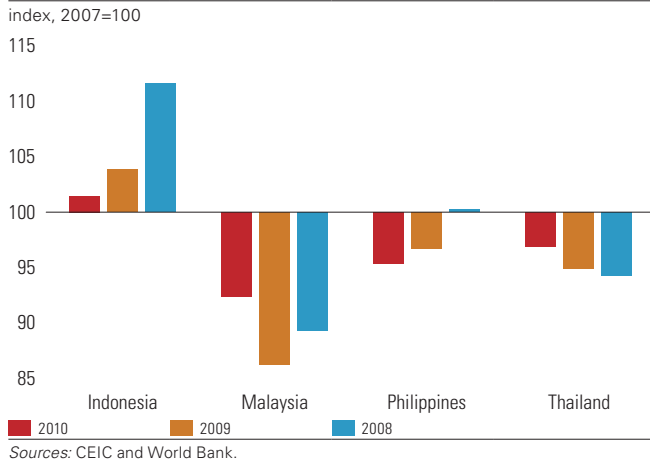
**Industrial employment has begun to pick up in most middle-income countries in the region, albeit unevenly and at a slower pace than output.** Since many manufacturers in Malaysia and Thailand are part of regional or global production networks that are dependent on demand from the high-income economies, hiring has been tepid and has yet to reach pre-crisis levels (Figure 2). In contrast, industrial employment in Indonesia and Philippines has recovered, driven by domestic demand (and by remittances in the latter country). The uptick in industrial employment together with increased hiring in services has helped to reduce open unemployment rates across the region (Figure 3).

**Table 2.** Growth in 2010 was broad-based

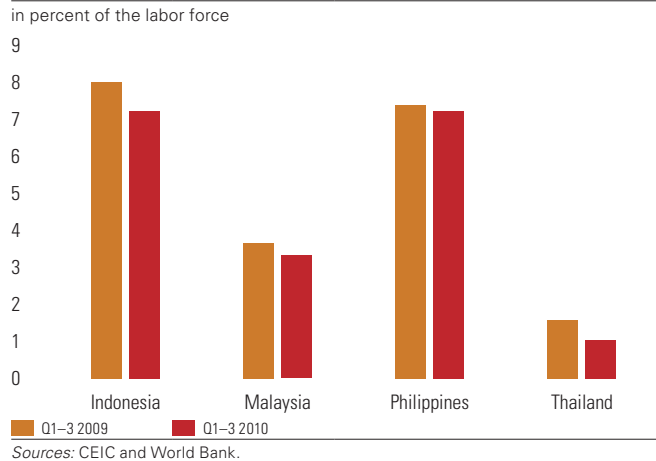
	percent change year-on-year			
		Estimate	Forecast	
	2009	2010	2011	2012
Developing East Asia	7.4	9.6	8.2	7.9
China	9.2	10.3	9.0	8.5
Indonesia	4.6	6.1	6.4	6.7
Malaysia	-1.7	7.2	4.8	5.7
Philippines	1.1	7.3	5.0	5.4
Thailand	-2.3	7.8	3.7	4.2
Vietnam	5.3	6.8	6.3	6.7
Cambodia	-2.0	6.7	6.5	6.5
Fiji	-3.0	0.1	1.3	0.7
Lao PDR	7.5	8.4	8.6	7.6
Mongolia	-1.3	6.1	10.3	7.6
Papua New Guinea	5.5	7.5	5.5	5.5
Developing East Asia excl China	1.2	6.9	5.3	5.7
<i>Memoranda</i>				
High-income countries	-3.4	2.8	2.4	2.7

Sources: CEIC and World Bank staff projections.

**Figure 2.** Industrial employment in Indonesia and Philippines reached pre-crisis levels

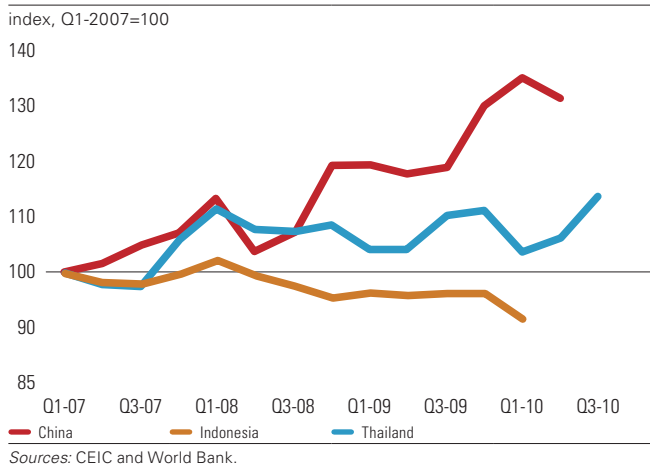


**Figure 3.** Unemployment has declined across the middle-income countries

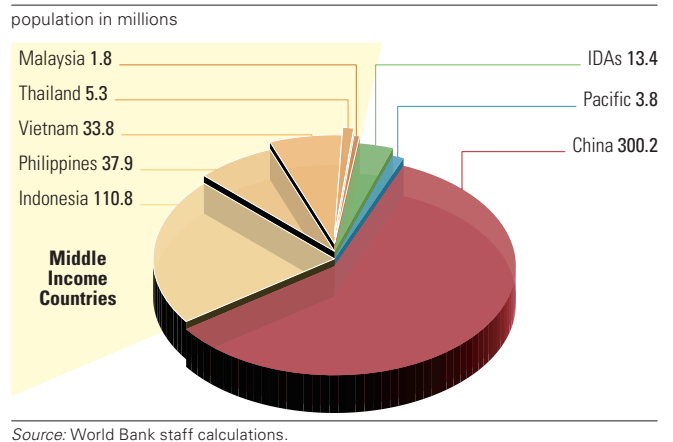


Real wages in industry have followed the same trend as real growth. The pace of increase has been the fastest in China, because of strong demand for labor and robust growth in productivity (Figure 4).

**Figure 4.** Real wages have risen in most countries other than Indonesia



**Figure 5.** Poverty reduction has been impressive, but about 500 million people in East Asia still live on less than \$2/day



*Progress in reducing poverty is complicated by higher food and fuel prices*

The pace of poverty reduction in East Asia picked up in 2010 due to better-than-expected growth in many countries. Nearly 51 million people were lifted out of poverty in developing East Asia and Pacific during 2010, reducing the poverty headcount to 27 percent of the region’s population from 30 percent in 2009. The pace of poverty reduction almost doubled from 2008–09, although it was still slower than during 2000–07. The marked progress reducing poverty notwithstanding, the region remains home to about 500 million poor people (those living on less than \$2 per day), with the majority living in China and East Asia’s other large middle-income countries

The effects of higher global food and fuel prices continue to be significantly modified by domestic policies and these have a bearing on both the prevalence and severity of poverty. Both Indonesia and the Philippines

strictly control imports of rice and support domestic prices in order to promote domestic production. As a result, in both countries, rice prices are significantly higher than international prices and result in subsidizing net sellers at the expense of net buyers who are often the poorest. Although rice prices remained stable in the Philippines, domestic wholesale prices were more than 50 percent higher than global prices. In Indonesia, the gap between domestic and international prices increased further in 2010. And although many smallholders in Lao PDR and Cambodia produce rice in self-sufficient quantities, they frequently sell at harvest time (when prices are lower) because of lack of storage facilities or pressing needs, and buy rice later in the season when prices are higher. Though countries such as Philippines and Indonesia have cash or food subsidy programs for the needy, they are not necessarily targeted to the poorest. In the Philippines, for example, it is estimated that only a third of the total subsidized rice goes to the poorest quintile and as much as 41 percent of that leaks to non-poor households. Fuel subsidy programs are often characterized by similar if not higher leakage rates.

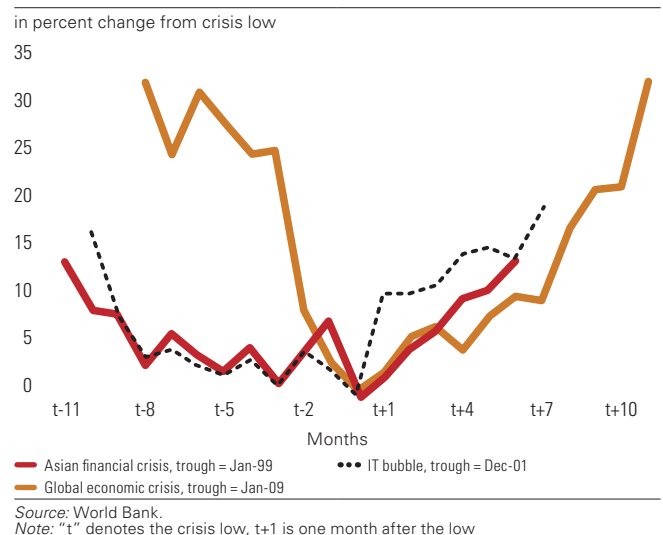
### *Exports are stabilizing at a faster pace than before the crisis*

The rapid expansion of East Asia as the world's export powerhouse was complemented by surging final demand within the region, notably in China. East Asia's share of global trade today is twice as large as two decades ago, and the crisis did little to halt that trend (Figure 6). Trade has also benefitted from stronger final demand for East Asian products.

**Figure 6.** Exports and imports from East Asia have surged as a share of global trade



**Figure 7.** Export volumes shrank during the global crisis, but have climbed strongly subsequently

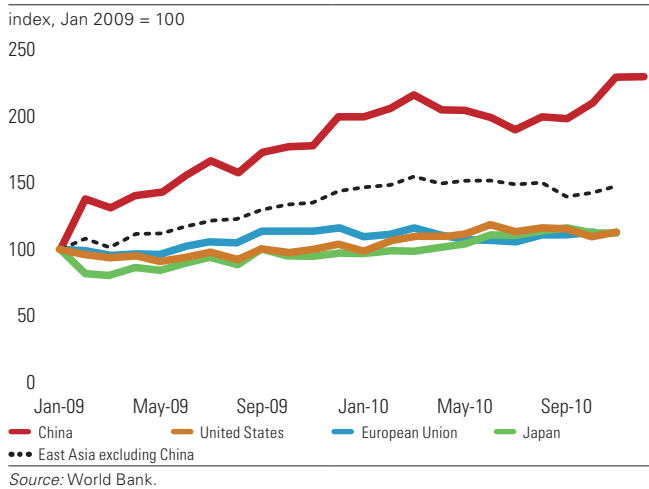


The rebound in trade from the crisis lows was dramatic. The trade contraction in the region during the global economic crisis was deeper and more protracted than during the 1997–98 Asian financial crisis or the “dot.com” implosion of 2000–01. But the subsequent recovery was equally strong, with exports picking up sharply after three quarters from the cyclical trough (Figure 7).

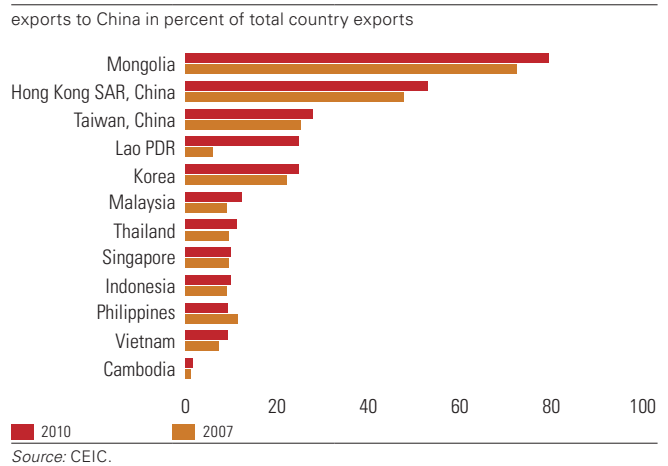
China's strong growth in output and import demand during the recovery provided crucial support to regional and global trade. While import volumes in the G-3 recovered only modestly and remain well-below pre-crisis levels, China's imports rose sharply during and after the global economic crisis (Figure 8). China accounts for 9 percent of world imports, up from 7 percent in 2007 and 3 percent in 1999. The growth in Chinese imports benefitted the

region significantly. Exports from the rest of developing East Asia to China grew faster than their exports to the rest of the world. Compared to 2007, exports to China now comprise a larger share of total exports in every economy in developing East Asia and the NIEs (Figure 9). But the story is not restricted to China. Import demand in the region excluding China also grew faster during the crisis than import demand in the G-3.

**Figure 8.** China's imports surged during the recovery...

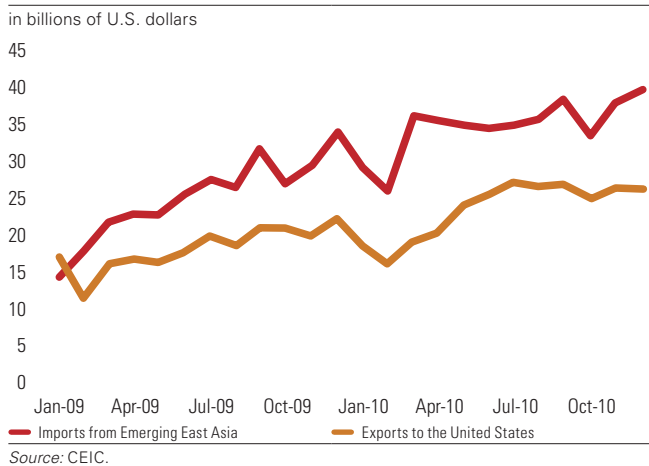


**Figure 9.** ...providing a strong impetus to regional trade

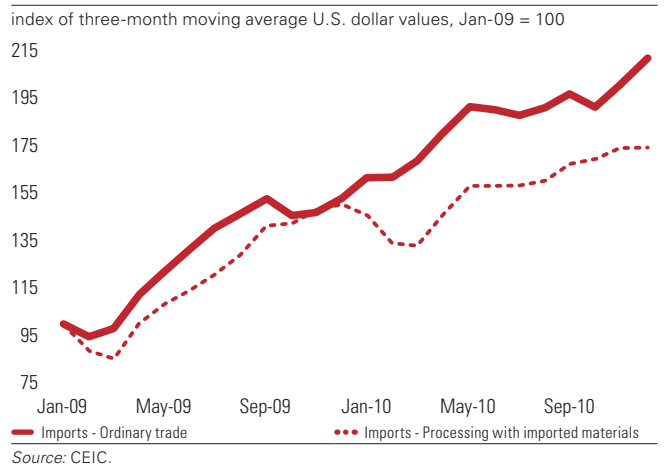


Final demand appears to have given a stronger lift to Chinese imports from the region than demand via international production networks. China's imports from emerging East Asia grew much faster than China's own exports to the high-income economies (Figure 10). Specifically, China's imports for processing trade grew much more slowly than "ordinary trade" imports (Figure 11). And, imports by foreign-invested enterprises in China—the workhorses of the global networks—also rose more slowly than imports by state and other local enterprises.

**Figure 10.** China's imports from East Asia are larger than its exports to the United States



**Figure 11.** Imports related to processing trade networks are lagging



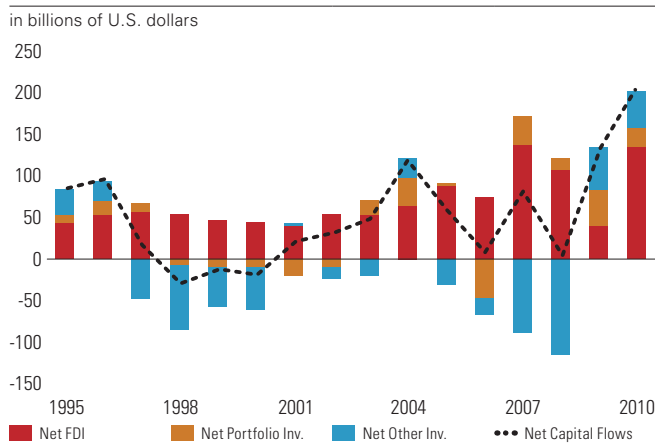
The impact of this buoyancy in Chinese imports on the region's economies was not uniform. Starting in mid-2010, the region's commodity exporters benefitted from increased demand for industrial raw materials and from higher international prices. In the Philippines (where electrical and electronic exports account for two-thirds of total

exports and 90 percent of the country's shipments to China) the contraction in the global electronics trade has meant that it did not benefit as much from the strength of Chinese imports as either Malaysia or Thailand.

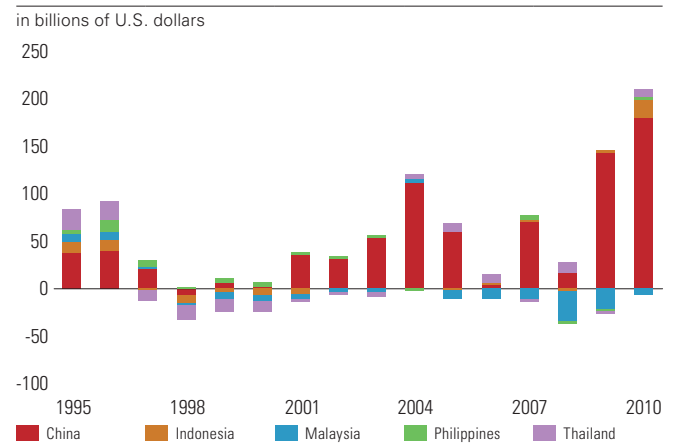
### Capital flows surge, volatility increases

After shrinking sharply in 2008, net capital inflows into developing East Asia surged to a record in 2010. Inflows were highly concentrated in China, Indonesia, Malaysia and Thailand (Figure 12 and Figure 13). Globally, nine countries received 95 percent of the portfolio equity, 50 percent of the portfolio debt and 74 percent of the short-term debt flows to all developing countries. East Asia's experience with capital flows during and after the global economic crisis contrasts with the period after the 1997–98 Asian financial crisis when the crash was more severe (although concentrated in three countries: Indonesia, Thailand and Korea) and the revival slower.

**Figure 12.** Net capital flows into developing East Asia surged to a record...



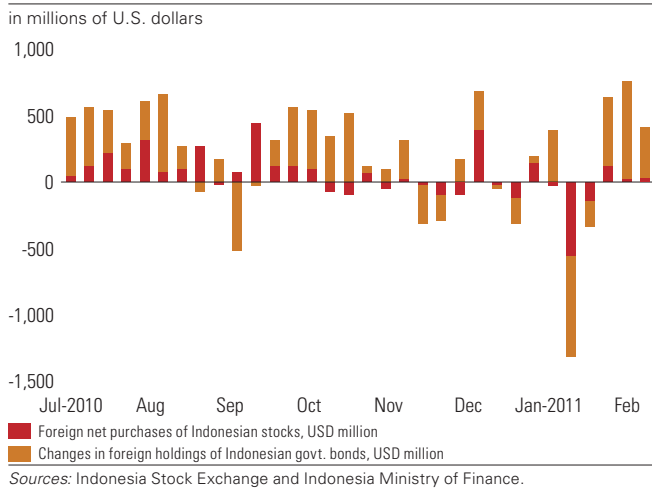
**Figure 13.** ...but are highly concentrated in a few countries, notably China



**Portfolio flows into the region's equities and bonds have been particularly volatile recently.** In Indonesia, foreign investors purchased \$2.2 billion worth of equities and \$9.6 billion of government bonds in 2010, but sold \$0.7 billion of the former and almost a \$1 billion of the latter in January 2011 alone (Figure 14). In the Philippines, the range in net monthly foreign purchases of securities widened considerably. Both the largest monthly purchase and sale have more than doubled from a year earlier in 2010 (Figure 15). The pattern of larger and more volatile flows is also evident in Korea where purchases of government bonds by non-residents fell from \$53 billion in April 2008 to \$28 billion in January 2009 before rebounding to \$65 billion at present

**Portfolio inflows have buoyed the region's asset markets, but increased recent volatility is a useful reminder how quickly such inflows can reverse.** As a result of large non-resident purchases of East Asian equities through most of 2010, the regional stock market index has outperformed the global index by 1.5 times and is currently at a level twice as high as its lowest point during the global financial crisis (Figure 16). Stock market capitalization for emerging East Asia also doubled to 110 percent of GDP in 2010 from 2003. As corporate fundamentals improved and as corporate and government issuers have taken advantage of the historically low yields to ramp up bond debt issuance, East Asia's bond markets have responded with a bond return index that is now three times higher than its level at the beginning of 2000 and a regional return index that is one and half times the global index (Figure 17).

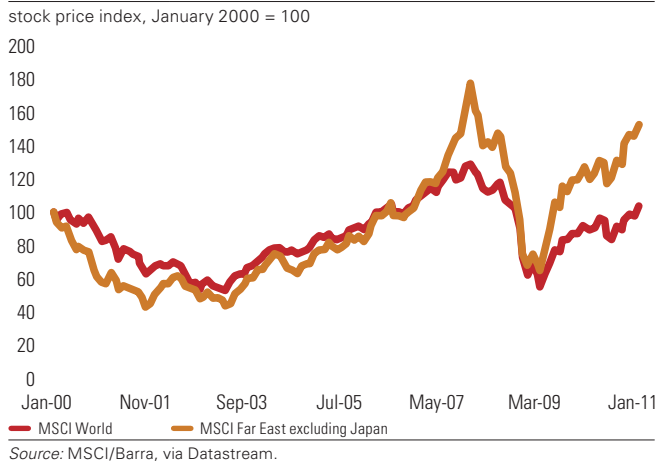
**Figure 14.** Weekly buying of Indonesian stocks and government bonds by nonresidents has become more volatile...



**Figure 15.** ...and so have monthly nonresident purchases of Philippine equities



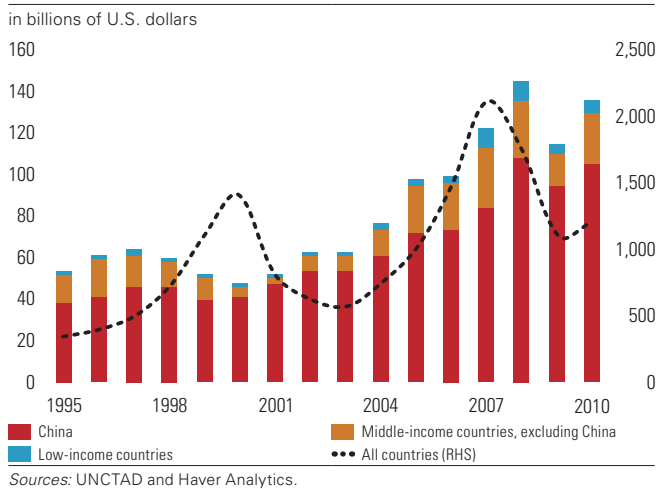
**Figure 16.** Regional shares have surged ahead of the global market...



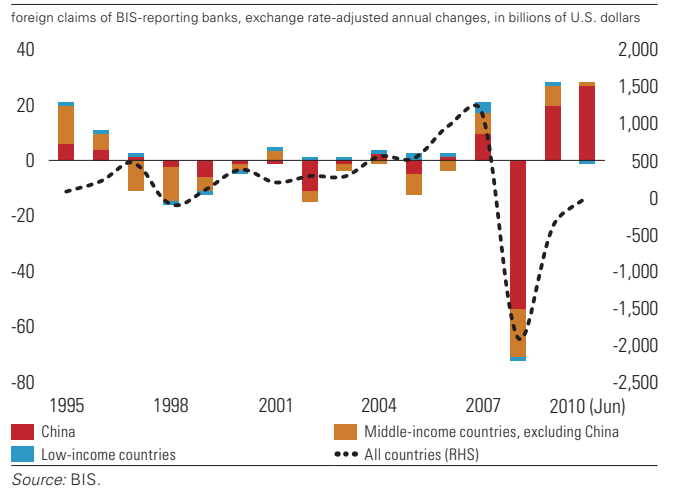
**Figure 17.** ...and regional bonds have performed better than their global benchmark



**Figure 18.** Inward FDI has recovered strongly in East Asia...



**Figure 19.** ...and so have inflows of bank credit



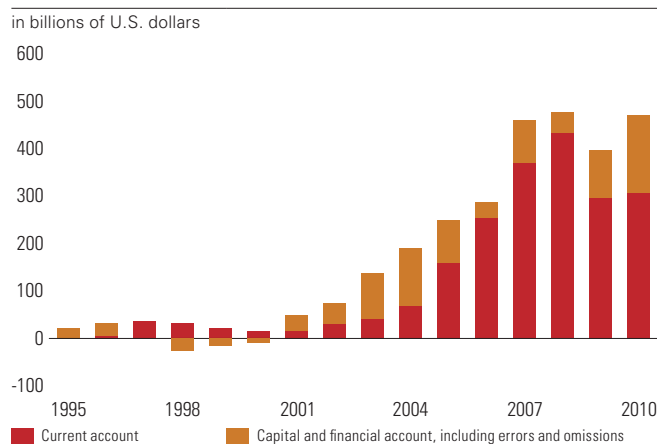
Recent equity market highs for the region on average are still below pre-crisis peaks, underscoring the high volatility of equity prices and capital inflows. The equity market has almost tripled since March 2009 though it is still below the peak reached in late 2007. In four years, the regional equity index fell 72 percent before rebounding by 220 percent, a degree of exceptional volatility driven in large part by capital inflows.

Inflows of foreign direct investment and bank flows have also recovered. FDI inflows to East Asia held up well during the crisis, declining in 2009 only to 2007 levels before recovering in 2010 (Figure 18). Cross-border credits from foreign banks have also returned, in particular to China and the middle-income countries (Figure 19). Foreign banks, which pulled back from the region at the onset of the global financial crisis and are still retrenching globally, have steadily rebuilt their assets in the region.

Outward investment by East Asian residents has also strengthened substantially. China, Malaysia, and Thailand have become significant sources of FDI in foreign markets. China ranked fifth among the world's top FDI investors in 2008, with FDI outflows of \$44 billion in 2009 and \$20 billion in the first half of 2010 (compared with \$75 billion by Japan, which ranks third globally). Malaysia and Thailand each invested \$4 billion a year abroad. As a result of sustained outward flows, net capital inflows into emerging East Asia were less than half of gross inflows at about 2 percent of regional GDP in 2009.

Net capital inflows are still dwarfed by current account surpluses across East Asia. The current account surplus accounts for the bulk of foreign currency liquidity into China (Figure 20). In the region's other middle-income countries, capital account deficits (including errors and omissions flows) in 2005-09 turned into a surplus in 2010 (Figure 21).

**Figure 20.** Capital inflows are an increasingly important source of exchange rate pressure in China...



**Figure 21.** ...and in the other middle-income countries of the region

