II. FIGHTING INFLATION HAS BECOME A KEY SHORT-TERM PRIORITY

Despite buoyant growth last year and the resumption of strong private-sector-led expansion, governments in East Asia have moved only gradually away from their emergency monetary and fiscal measures and back to their pre-crisis policies. This has been complicated by the unprecedented high levels of capital inflows to the region, the rapid increase in food and commodity prices, and an increase in consumer price inflation. Given concerns that higher policy interest rates would encourage interest-sensitive inflows and, by helping to appreciate currencies, hurt competitiveness, the monetary authorities in most countries in the region were willing to wait for more evidence that increases in food and commodity prices were permanent. As a result, there was only modest monetary policy tightening in many countries, which contributed to substantially higher inflation rates and inflation expectations. Evidence that price shocks are not temporary is now plentiful. Tighter monetary policies, including higher policy rates, are needed across the region in varying degrees to pre-empt the recent rise in food and other prices from exacerbating inflation expectations. At the same time, governments need to allow their discretionary fiscal stimulus packages to lapse. Those countries whose governments have underinvested in public infrastructure will need to reverse this by reallocating spending, often away from untargeted subsidies for food and fuel, by improving revenue collection, or by encouraging the private sector to develop public infrastructure.

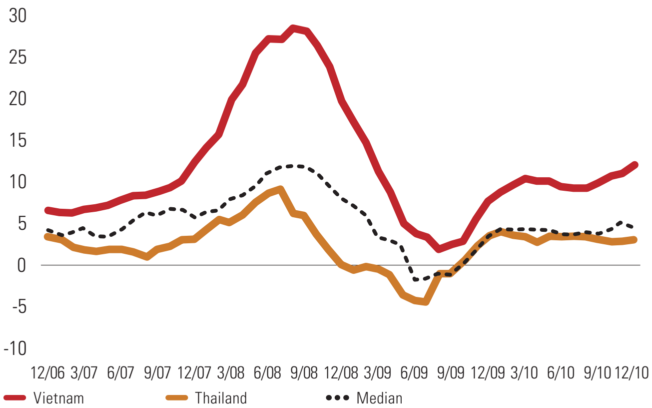
Inflation is on the rise

Consumer price inflation has risen faster than expected since late 2010 due to the surge in food and commodity prices, robust domestic demand, and limited monetary tightening. Inflation is above targets or official projections in China, Indonesia, and Korea and is above the government's comfort level in several other countries. Overheating contributed to a surge in inflation to double digits in Mongolia and Vietnam, as did a cumulative 18 percent devaluation against the U.S. dollar in the latter country since November 2009. Twelve-month inflation surged also in Indonesia to 7 percent, due to large increases in prices for rice amplified by only timid policy actions to withdraw monetary accommodation. Inflation has risen in the rest of the region to almost mid-single digits, including in China and the Philippines, but growth above potential makes further increases likely.

Food prices—a key driver of inflation throughout the region—have risen significantly because of higher international prices for cereals and oil, booming domestic demand, and a range of local factors. The pace of increases in food prices quickened in most countries during 2010, with the 12-month increase in food prices up by 10 percentage points or more in Mongolia, Indonesia, Vietnam, and China. In Cambodia and the Philippines, by contrast, food prices have been well-contained, thanks to a strong rice harvest in the former and much larger than expected rice stocks in the latter. Meanwhile, global food prices have surged since mid-2010, leaving them 10 percent higher for the year on average than in 2009. Maize and wheat prices are up by 84 percent and 67 percent respectively since the middle of 2010 and are near their 2008 peak. While rice prices fell by 12 percent on average in 2010, recent increases have meant that prices are now more than double the level that prevailed in the first seven years of the 2000s. Moreover, an increasing concern is that worsening prospects for wheat as a result of a drought in key wheat-growing provinces in China will have a substantial ripple effect on rice prices. With over 50 percent of global rice supplies coming from Thailand and Vietnam while Indonesia and the Philippines have a high risk of contingent imports, the rice market remains highly exposed. Further increases in rice and other food prices could have severe negative effects on vulnerable populations in several countries in East Asia.

Figure 22. Inflation is trending up…

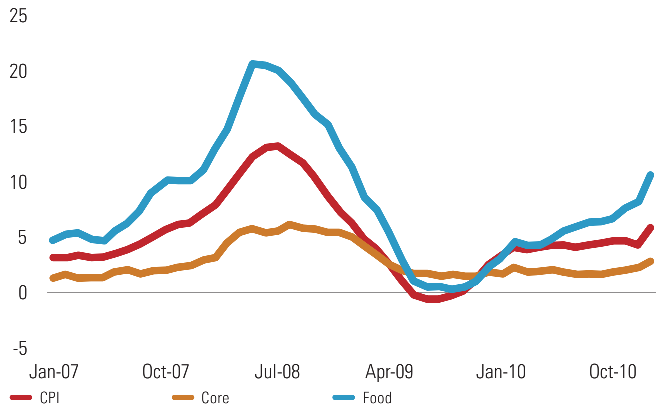
percent change y-y; dotted line plots median inflation



Sources: National sources, CEIC and Bank staff calculations.

Figure 23. …with food inflation leading and core inflation picking up since late 2010 …

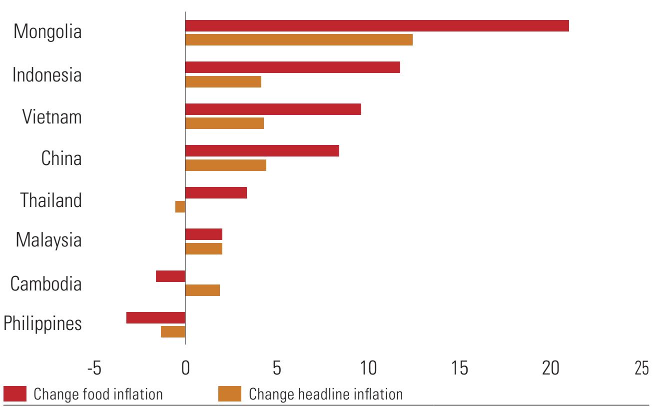
percent change year-on-year



Sources: National sources, CEIC and Bank staff calculations.

Figure 24. …but with substantial variation across countries

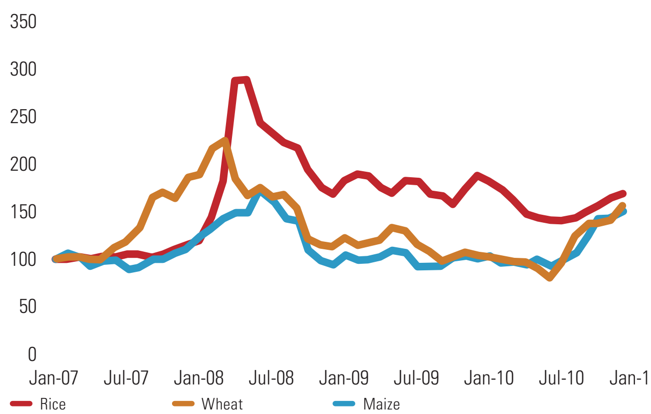
change in 12-month inflation between December 2010 and December 2009



Source: CEIC.

Figure 25. International prices for cereals have surged

international prices, in dollars per ton



Sources: National sources, CEIC and Bank staff calculations.

The country-specific factors that have been driving food prices have varied. In Mongolia, the 15 percent surge in food prices in December from a year earlier was largely due to the increase in meat prices after last year's devastating *dzud* (extreme winter weather) and an outbreak of foot and mouth disease. In Indonesia, ongoing weather problems caused local rice prices to increase by about 30 percent during 2010. In China, grain prices have risen strongly. But, vegetable prices were the main driver of food inflation in 2010 due to bad weather and supply bottlenecks before giving way to faster increases in meat and other food prices so far in 2011. And in Vietnam, the devaluation of the currency has increased the price of imported food (in other words, wheat, animal products, and sugar) and animal feed, as the increased prices for Vietnam's rice (up by about 7 percent during 2010), coffee (prices more than doubled during last year), and shrimp exports have also filtered through to the domestic market. Twelve-month food inflation amounted to 16 percent in December, up from 6.6 percent a year earlier.

In contrast, rice prices in Cambodia remained largely unchanged during 2010 because of high paddy production. The Pacific Islands—especially those that rely heavily on food imports—are most at risk. Since movements in global food prices affect Pacific retail prices with a three to six month lag, local prices have yet to move in any meaningful way. Kiribati, Samoa, Tonga, and Tuvalu were hardest hit by the 2008 food crisis and remain relatively more vulnerable today. Within the Pacific region, Fiji, Samoa, and Kiribati are most sensitive to rising wheat prices as wheat is a more important component of the diet in these countries than the rest of the Pacific.

The surge in international fuel prices has not fully translated into increases in domestic prices because of various price controls across the region. Several countries, including Indonesia, Malaysia, and Vietnam, subsidize domestic fuel prices. The government in Indonesia is considering whether to extend subsidies that are currently scheduled to be lifted by May 2011. While such measures temporarily relieve the pressure that higher international prices put on the poor, they ultimately create a persistent and much larger fiscal burden because these measures are poorly targeted and misused. Reducing and eliminating these subsidies, for example, by replacing them with a much smaller and targeted scheme of support, will be both less expensive and fairer.

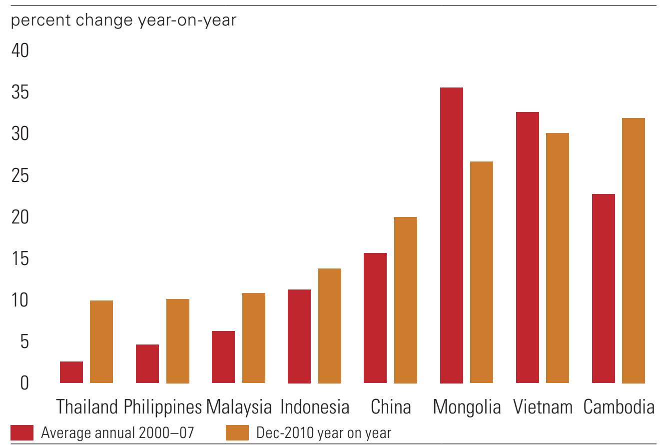
These short-term developments and considerations need not distract from tackling the longer term challenges of ensuring food security. Box 3 discusses this issue.

Monetary policy is tightened

Central banks have tightened their monetary policies gradually and at different speeds across the region, but in most countries the pace needs to accelerate. Thus far, central banks have proceeded gradually due to concerns that higher interest rates may stymie growth in credit and output while the outlook for the high-income economies is still fragile. Strong exchange rate appreciation during 2010 also helped to limit inflation pressures, albeit by hampering competitiveness. And with food and commodity prices having been well-contained through mid-2010 and overall inflation having been subdued in some countries, many policymakers considered this gradual approach to be appropriate. This meant that output gaps were closing faster than had earlier been predicted and inflation rose more quickly, leaving policy interest rates below current and projected inflation in the majority of countries.

There were signals during the summer of 2010 that inflation was picking up across the region and that global commodity prices were poised for sharp increases, and these are now a reality. Monetary policy in the G-3 has been loose for an extended period of time already and is adding to pressures on global prices. Turmoil in the Middle East is boosting already high oil prices, metal prices are at record highs, and food prices are only just below their 2008 highs. And commodity prices are likely to remain elevated this time around, even though the global economy will not be able to absorb much higher increases. Other factors that suggest monetary policy needs to be tightened across the region include stronger growth in credit than before the crisis in most countries in East Asia and sustained increases in asset prices (Figure 26).

Figure 26. Credit growth increased in most countries at a faster pace than the average during 2000–2007



Sources: IMF and Haver Analytics.

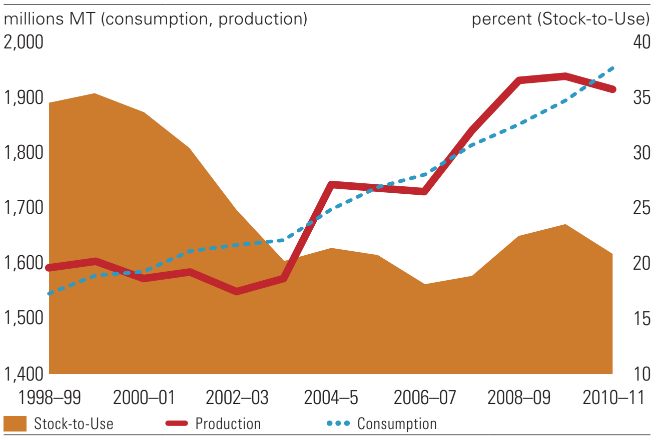
Other than in Vietnam after the recent hikes, central banks have yet to return their policy interest rates to pre-crisis levels. Since the start of 2010, central banks have hiked policy rates by 25 basis points (bps) in Indonesia, 75 bps in China and Malaysia, 120 bps in Thailand, and 300 bps in Vietnam. The central bank in

Box 3. The rising challenge of food security

International food prices are higher and more volatile. Volatility of international grain price was twice as high during 2005–2010 as during 1990–2005. Swings in prices affect producers, especially smallholders, for whom the debt burden rises when prices go down. Consumers, especially the poor, see their safety nets eroded during price peaks and find it increasingly difficult to prepare for future swings because of limited incomes and saving instruments. And even temporary shortages of food, especially of critical nutrients, can lead to permanent damages for children and young adults.

Since 2005, declining stocks and variable and lagging supply in the face of a steady increase of demand have been the main drivers of food price volatility. Global grain consumption increased by 26 percent since 1998/99, driven by population and income growth. But production only increased by 20 percent and was volatile due to erratic weather. Drawing down stocks compensated for production shortfalls at first, but the decline of stocks to about 20 percent of consumption today provides an inadequate cushion. Other factors, such as dollar depreciation, biofuel policies, export restrictions, and commodity speculation contributed to rising prices as well. Land and water shortages are the emerging factors that may further reduce the resilience of the food system to cope with short-term shocks and respond to the increased incentives from higher food prices.

Higher consumption, variable supply, and reductions in stocks have contributed to the grain price spikes



Source: World Bank, 2011.

Raising the level and stability of food production remain the main long-term solution. Use of existing agronomic practices and technologies could increase rice yields in East Asia by 25 to 80 percent, including through improved nitrogen and potassium management techniques, as well as increased irrigation efficiency, especially in smallholder rice production. At the national level, the composition of more spending on agriculture will be as important as its level: moving funds away from often inefficient price support towards investment in technology, land development, and irrigation will be helpful. A more widespread diffusion of advanced technologies could be fostered through a regional outreach initiative, the International Rice Research Institute (IRRI) and bilateral and international funding agencies. Other measures to adapt to increased volatility include development of flood-, heat-, and drought-resistant crops, better climate information, and weather-indexed insurance schemes. Targeted subsidies for insurance premiums may be considered, especially when they are less costly than ex post assistance. For the poorest consumers, cash transfers linked to prices could be cost-effective.

Increased supply must go hand in hand with strengthening trust in markets. When markets panic, excessive preemptive buying and hoarding exacerbates price swings and erodes trust in market-mediated global food security systems. Long-term measures to mitigate this include: improved information exchange on grain harvests and stocks, strengthened WTO regulations on export restrictions, and reliance on financial markets to transfer price risks. An example of a promising ingoing initiative is the ASEAN Integrated Food Security Framework and a Strategic Plan of Action on Food.

In the event of sustained price volatility, international organizations could support countries through various instruments. A food-based line of credit (deferred drawdown option) may be one such instrument. It could also be used by importing countries to finance hedging with option contracts to stabilize their food import bill. For such options to work, food markets in many countries must be better integrated with established commodity exchanges. The latter are also only poorly developed for rice. Overall, it will require a lot of learning by governments, but useful lessons could be learned from Mexico's recent experience.

Source: Prepared by Luc Christiaensen.

the Philippines has kept its policy rates unchanged since mid-2009, even while growth surged to a 30-year high, and the bank revised up its inflation projections. The central bank in China has supplemented increases in policy rates with seven increases in minimum required reserves to 19.5 percent of gross deposits, lifting the requirement to a level similar to that in Brazil where inflation is running at twice China's rate. The central bank in China also issued instructions in January 2011 to several large state-owned banks to stop lending, supplementing it with other micro-prudential regulations.

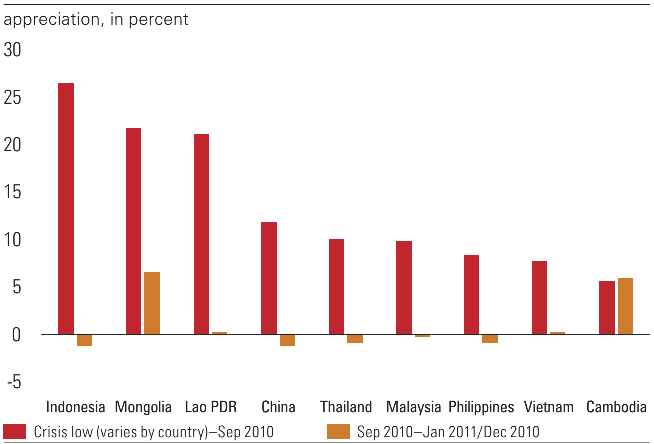
The modest extent of monetary tightening has done little to contain credit expansion so far. Credit growth has quickened since the start of 2010 compared with the average pace during 2000-2007 in most countries (Figure 26). At one extreme, in the Philippines, credit is rising at the fastest pace in a decade at about 10 percent a year. At the other extreme, in a clear sign of overheating, credit rose by 30 percent or more during 2010 in Vietnam and Mongolia, substantially faster than nominal GDP growth.

Exchange rate appreciation slows

The region's policymakers have responded to the surge in capital inflows by a combination of exchange rate appreciation, exchange market intervention, and measures to deter inflows and encourage outflows. The region's currencies rose strongly last year, but the pace of appreciation for most of the recipients of the largest capital inflows has slowed since late 2010, as foreign long-term interest rates increased substantially and non-residents became concerned about higher inflation in East Asia. The currencies of the low-income countries continued to appreciate in real effective terms in part due to higher inflation, while there has been limited real depreciation in middle-income countries since September 2010 (Figure 27). In contrast with the other countries in the region, Vietnam's dong has weakened substantially in nominal terms because of four devaluations amounting to 18 percent cumulatively since November 2009 through February 2011.

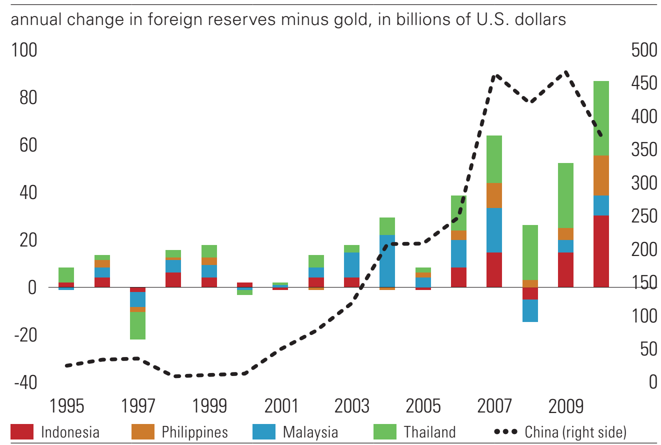
Increased exchange market intervention led to a surge in foreign exchange reserves. While foreign exchange reserves have increased the most in China, accumulation has also been rapid in other countries (Figure 28). In all countries in the region, reserves are now much higher than their pre-crisis levels. For developing East Asia on

Figure 27. Real effective exchange rates have appreciated since the crisis low, but this trend is easing or reversing



Sources: IMF and BIS.
Note: (+) denotes appreciation.

Figure 28. Foreign exchange reserves have soared reflecting central bank interventions



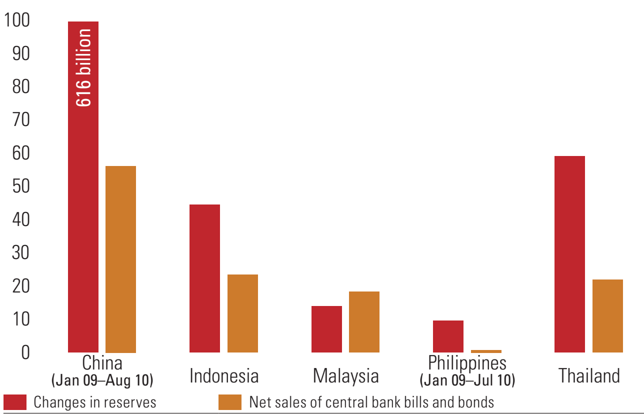
Source: World Bank staff calculations.

average, foreign exchange reserves amounted to one-half of GDP in 2010 (up from one-third in 2005) and 110 percent of gross external liabilities (up from 75 percent in 2005). But while China's reserve increase was slightly less in 2010 than in 2009, the change in reserves in 2010 in Indonesia and the Philippines was more than double that in 2009.

Central banks sterilized a modest share of exchange market interventions. Sales of central bank bills and bonds suggest the extent varied across the region (Figure 29). The use of forwards and swaps by central banks in sterilizing exchange purchases indicates that the scale of sterilization is somewhat larger. For the middle-income countries on average, given the surge in capital inflows, sterilization rose from 2.2 percent of GDP on average during 2000–2007 to 4.2 percent in 2009 before settling at 3.9 percent by the second quarter of 2010 (Figure 30). Since central banks started tightening monetary policy, interest rates have risen and so has the cost of sterilization.

Figure 29. Sales of central banks' bills and bonds suggest a large part of interventions are sterilized…

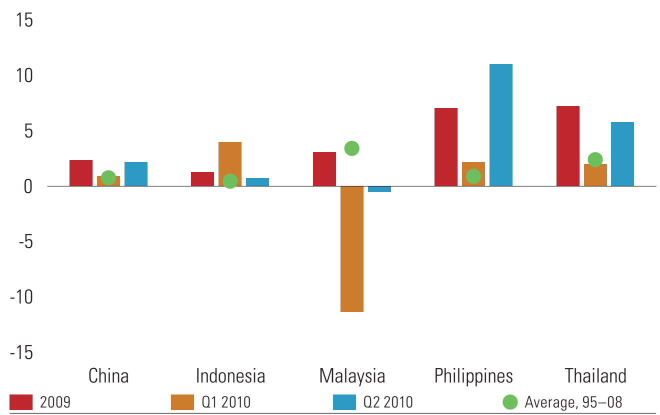
in billions of U.S. dollars, Jan 2009–Dec 2010 or as noted



Sources: CEIC and World Bank staff calculations.
Note: For Indonesia includes central bank deposit facilities.

Figure 30. …and the scale of sterilization operations has increased

in percent of GDP



Sources: CEIC and World Bank staff calculations.
Note: Sterilization indicator = Change in foreign reserves less change in base money, in percent of GDP.

The measures introduced by countries in developing East Asia to limit capital inflows have been few and modest. This outcome probably reflects policymakers' growing realization of the limits of such measures given the considerable integration of East Asian countries in the global economy and the great sensitivity of portfolio flows to policy announcements that markets may perceive as signs of weakness. In October, Thailand revoked a 15 percent withholding tax exemption previously granted to foreign investors, thus equalizing the tax treatment of resident and non-resident individual investors. Indonesia increased the holding period for Bank Indonesia Certificates (SBIs) and is planning to increase the required reserve ratio (RRR) on foreign exchange deposits held by all investors from 1 percent to 8 percent by June 2011, following the increase in the RRR on all deposits in September 2010. Korea adopted measures to strengthen the funding of the banking sector in November 2009, followed by the introduction of a ceiling on foreign currency derivative positions, tighter controls on domestic foreign currency lending, and a bank levy on the non-deposit foreign currency liabilities of financial institutions.

Measures to encourage outflows have continued in some countries but remain tentative. Thailand has relaxed regulations constraining outflows and has increased dollar limits on residents' transactions abroad and on the use of foreign currency deposits. The Philippines has increased the ceilings for residents' foreign exchange purchases and outward investments and has cut regulations that constrained or required government approval prior to the purchase of foreign currency, making an outward investments, or paying debt.

The efficacy of the measures continues to be mixed. Non-residents' share of Indonesian SBIs fell sharply by 13 percentage points when the one-month holding period on the SBIs was introduced in May 2010. Since then, foreign ownership of the bills has climbed by more than 10 percentage points. Meanwhile, the external debt of domestic and foreign banks in Korea remained under $120 billion in 2010 compared with a high of $160 billion before the global economic and financial crisis, but it is hard to attribute the outcome to the measures taken.

Currency appreciation—especially with the pause since late 2010—has not hampered the recovery, although exporters' margins have been affected. Exchange market intervention has limited the extent to which nominal exchange rates across the region have strengthened, but that has been largely offset by higher inflation. The result has been still substantial real appreciation compared with the level during the trough of the crisis. These developments are further affected by the different degrees to which countries have allowed nominal exchange rates to be flexible and the extent to which capital accounts are open. These issues need to be discussed in the context of ASEAN and ASEAN+6, in which member countries could fashion a common approach to these regional challenges. At home, countries might find it useful to adopt further prudential requirements to ensure that capital inflows do not unduly burden domestic banks. Smaller loan-to-value and loan-to-income ratios, increased reserve requirements, pro-cyclical capital adequacy ratios, enhanced rules for valuing real estate collateral, and other measures will help to sustain domestic financial and macroeconomic stability.

Fiscal deficits are declining

Fiscal deficits narrowed by nearly 1 percent on average in 2010 throughout developing East Asia, thanks to buoyant revenues and some spending restraint. Concerns about the strength of the global recovery, however, and adherence to earlier spending commitments have meant that policymakers have been withdrawing fiscal stimulus measures only very gradually. The median deficit in developing East Asia narrowed to 3.3 percent in 2010 as a result of these policies but was still double the level in 2007 (Figure 31). Compared with other countries, the 2010 deficit is similar to that in developing Latin America but is substantially lower than the deficit of 4.4 percent in the other developing regions and the 10 percent deficit in the U.S.

In most countries, the bulk of the adjustment in 2010 was due to more buoyant revenues helped by broad-based economic growth. In Malaysia, by contrast, revenues declined in line with oil-related receipts based, as is customary, on the average oil price during the previous year.[2] In the Philippines, structural weaknesses in the tax administration dampened revenue gains despite one of the fastest growth rates on record, resulting in only modest fiscal consolidation (Figure 32). Although all countries have begun reversing the fiscal stimulus measures introduced in 2008-2009, additional outlays have meant that spending in nominal terms has fallen only in Malaysia due to reductions in subsidies and in Korea.

Government debt is estimated to have declined in 2010 in most countries relative to output. Debt levels turned out to be lower than earlier expected as a result of favorable fiscal outcomes and strong growth (Figure 33). Fiscal sustainability risks are limited in most countries, but some countries have more challenges. Vietnam, for example, was downgraded by all ratings agencies in 2010 because of concerns about macroeconomic policies and developments. Debt in Malaysia jumped by 12 percentage points of GDP in 2009 but did not decline in 2010 despite

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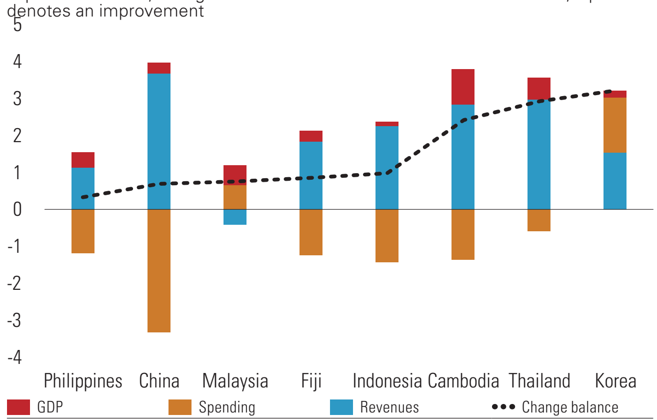
2 In Malaysia, oil revenues (including Petronas dividends) account for 40 percent of government revenues. Oil-related payments to the budget are based on the average oil price during the preceding year. Oil prices in 2009 were lower than in 2008 and in 2010 on average.

Figure 31. Fiscal balances improved throughout East Asia in 2010, largely due to stronger revenues

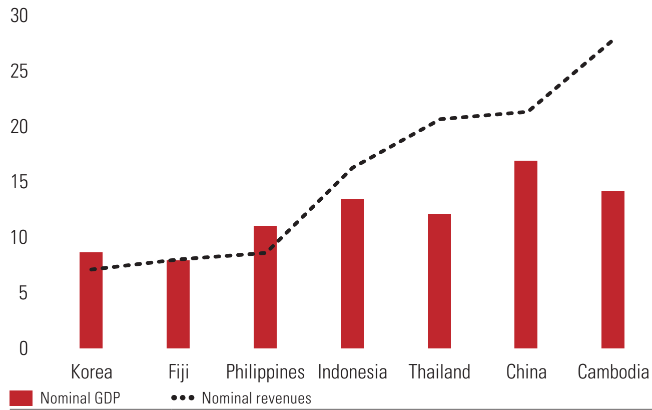
in percent of GDP; change in the fiscal balance in 2010 relative to 2009; a plus denotes an improvement



Sources: Datastream and World Bank staff calculations.

Figure 32. Revenues grew faster than output in most countries other than the Philippines and Fiji, 2010

growth in 2010 nominal GDP and revenues, in percent



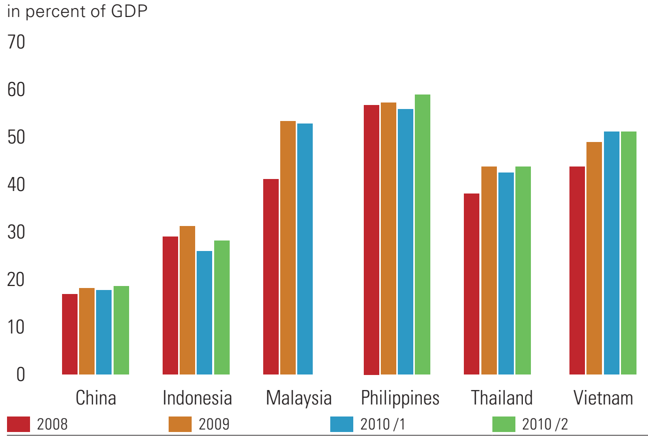
Sources: Datastream and World Bank staff calculations.

buoyant GDP growth. This underlines the need for Malaysia to promote fiscal adjustment not only through revenue growth as in the past but also through expenditure cuts in line with the government's plan to phase out several subsidies in 2011 and 2012.

National budgets for 2011 show that there is a continued cautious movement away from fiscal stimulus measures because of concerns about the pace of the global recovery and a renewed determination to increase government spending on infrastructure. At the time when the 2011 budgets were being prepared, policymakers were expecting weak import demand from the high-income economies. Meanwhile, thanks to their strong balance sheets and reinforced by better-than-expected revenues, the government in most countries opted to err on the side of caution. In some countries, moreover, governments have identified lagging investment in public infrastructure—in many cases below the levels that prevailed prior to the 1997-98 Asian financial crisis—as a critical constraint to growth. As a result, the governments of China, Indonesia, and Thailand have budgeted for larger fiscal deficits in 2011 (Figure 34).

Figure 33. Government debt burdens declined in most middle-income countries due to strong growth

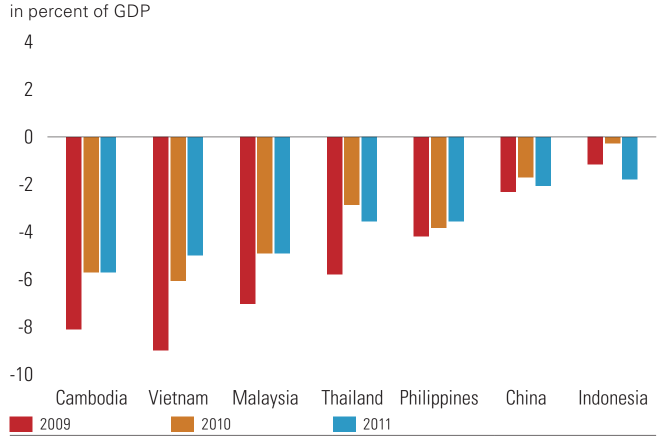
in percent of GDP



Sources: Datastream and World Bank staff calculations.
1/ 2010 actual; 2/ 2010 projection as of October 2010.

Figure 34. Fiscal deficits in 2011 are likely to be smaller or little changed in most countries, in contrast to budget plans that call for an increase

in percent of GDP



Sources: Datastream and World Bank staff calculations.

Past experience suggests some of the planned capital spending by governments is unlikely to materialize. Moreover, revenue projections in the 2011 budgets have also tended to be cautious. Fiscal deficits in 2011 are more likely to decline across most countries in the region, even in some of those that budget plans call for an increase. Thailand is an exception, where the favorable fiscal outcomes in 2010 and a possible election in the first half of 2011 have prompted the government to recently propose a supplementary budget to take advantage of higher-than-budgeted revenues. Nevertheless, the authorities remain committed to a primary surplus by 2016.

The increased use of subsidies to counter rising food and fuel prices presents an important risk to the fiscal outlook. Many East Asian governments have responded to higher food and energy prices by using fiscal policy as a buffer to protect consumers and firms. Thailand extended diesel subsidies and will continue to cap prices on liquefied petroleum gas for household and transport use (55 percent of total usage). China responded to the recent drought in major wheat-producing provinces with direct subsidies to farmers. The Korean government froze electricity and gas prices during the first half of 2011 among other measures. Indonesian policymakers do not intend to raise electricity tariffs in 2011 and there are talks to delay a plan approved last year to reduce the use of subsidized fuel starting in April. There is a risk that Malaysia may not raise domestic fuel prices further. Additional increases in food or fuel prices will not only exacerbate the cost of these policies but may also prompt governments to adopt new measures.