

EAST ASIA AND PACIFIC REGIONAL UPDATE

Summary

Growth in the Emerging East Asia region is expected to reach a little over 6 percent in 2005, down modestly from the exceptionally strong 7.2 percent pace of 2004.¹ With growth in China continuing to run at robust rates over 9 percent, the recent easing in growth has affected mainly the high income Newly Industrialized Economies and the middle income economies in South East Asia, primarily reflecting the impact of higher oil prices, higher dollar interest rates and slower demand growth in global high technology markets. Recent data suggests that the slowing may be relatively limited in scope, and that the pace of activity around the region was already reviving in the third quarter of the year. Among the developing economies in the region, growth of 7-8 percent this year will help secure a further robust reduction in the number of poor at the \$2 a day level by around 37 million in 2005, close to a 6 percent decline.

Looking forward, much attention is rightly being given to some key risks, including high oil prices, a weak outcome to the Doha trade talks, global macroeconomic imbalances and the specter of a human influenza pandemic. However it is worth observing that there are also solid positive developments that augur well for growth and development in the region. These include evidence of underlying resilience in domestic activity, improvements in some external trends, as well as mature and well-considered changes in domestic policies that should help countries better adapt to changing circumstances.

One of the clearly most fortunate developments of the last two years is the unexpectedly limited effect on economic growth of the more than doubling of *crude oil prices*. Some of the reasons for this are discussed later in this report. While a further large rise in oil prices would obviously have a more serious effect on growth, there is also evidence that markets are beginning to respond to the signal of high prices by fostering greater demand efficiency and expansion of supply capacity. Thus, barring dramatic new supply shocks, consensus forecasts envision that oil prices, while remaining high for the next 1-2 years, should be gradually easing from the dramatic levels reached during the 2005 U.S. hurricane season.

Meanwhile East Asian governments have also been taking actions to help economies better adapt to this period of high and volatile oil prices. In particular several governments have had the political confidence and

credibility with the public to implement politically sensitive cuts in or *removal of subsidies on fuel products*, allowing fuel users to respond more effectively to signals from world markets. In Indonesia the cuts have been combined with bold moves to alleviate the impact of the subsidy cuts on the poor through a new cash transfer program, combined with increased health, education and infrastructure spending. Central banks in the region have also been *tightening monetary policy* to prevent the rise in oil prices and headline inflation from becoming embedded in higher trend rates of core price and wage inflation. While the tightening cycle may tend to moderate the cyclical recovery in domestic demand in the region in the near term, it will, by helping ensure moderate inflation and macroeconomic stability, also help promote more sustainable growth in the medium term.

International trade has long been a great source of productivity gains and growth in East Asia. Last year's over 10 percent gain in world trade was paced by a 15-20 percent gain in East Asian real exports and imports. The first part of this year saw an easing in trade growth, in part because of a cyclical slowing in global high tech demand and a downturn in Chinese import growth. The *high tech cycle* this year has been relatively mild, with global orders and sales tending to reach a plateau rather than falling sharply, and starting to show signs of an upturn during the third quarter. In China some easing in domestic demand and a run down in inventories appear to have been the drivers for a significant slowing in import growth. However it appears that any slowing in the pace of *China's economic growth* is going to be gradual, with GDP growth now projected at over 9 percent in 2005 and close to 9 percent in 2006. Extended growth at these rates will undoubtedly be accompanied by further strong gains in imports, and there were already signs of an upturn in import growth in the third quarter. Finally, in one of the most positive recent developments for the East Asia region, there are increasing signs that, after a decade or more of stagnation, *Japan's economy* is achieving a robust and self-sustaining economic expansion. Over time, healthier growth in Japan will provide a basis for further trade and financial integration and engagement with Emerging East Asia.

In the longer run, prospects for trade hinge to a significant degree on the maintenance and strengthening of an open, rules based trading system. A striking example of the gains from *global trade liberalization* has in fact been unfolding this very year, with the phase out of the Agreement on Textiles and Clothing. As was expected, exports of textiles and clothing from China to major markets have surged, accompanied by lower prices, substantial welfare gains for the world's consumers and increased growth for efficient producers. Importantly,

¹ Emerging East Asia comprises Developing East Asia (China, Indonesia, Malaysia, Philippines, Thailand, Vietnam and some smaller economies) and four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan, China).

textile and apparel exports from many low income countries (e.g. Cambodia) have also seen significant gains, while exports from higher cost producers (e.g. Korea) have declined. Such a move out of low cost segments by high and middle income economies is consistent with the longer term process of upgrading skills and productivity in these countries. Looking forward, much now depends on progress that members are able to make at the upcoming WTO Ministerial in Hong Kong on December 13-18, so as to achieve a successful conclusion to the Doha Round of multilateral talks. However, based on the very limited progress over the past year, there is a significant risk that only a limited outcome may emerge, something that would be far from in the long run interests of East Asian economies. The Special Focus in this Update on “What can East Asia Expect from the Doha Development Round?” looks in more detail at the issues at stake for the region.

Among broad issues facing the world and the region is the need to address the problem of growing *global macroeconomic imbalances*. The U.S. current account deficit will reach another record this year, matched by growing surpluses in oil exporting regions, as well as in East Asia, where China’s current account surplus has surged higher and foreign exchange reserves around the region mostly continue to rise. Addressing the problem of global imbalances entails collaborative efforts by many economies, including efforts to strengthen savings in the United States and policies to foster stronger domestic demand growth in areas such as the Euro area, Japan and Emerging East Asian economies other than China. While progress in addressing imbalances is decidedly mixed, there are also some clearly positive developments. The emerging recovery in Japan is based to a significant degree on stronger investment and consumption growth, and should, over time, establish a new growth pole in Asia, reducing the world economy’s over-dependence on U.S. demand growth in recent years. China’s move towards a more flexible exchange rate system this summer, while limited, is also clearly a step in the right direction. Elsewhere in East Asia reforms to improve the investment climate and expand infrastructure services are increasingly at the center of the policy agenda, while progress also continues to be made in strengthening the financial sector and capital markets, all of which are important priorities in achieving more robust investment growth.

Last but very far from least is the risk from *avian influenza*, which, if it expands to a widespread human influenza, could exact a dreadful toll in human life and economic losses both in Asia and around the world. The threat and the urgent policy responses that are needed are discussed later in this report.

The rest of this Summary highlights the cross-country trends and policy issues discussed in this Report.

Developments at the country level are discussed in the “Country Sections” at the back of the report, while fuller Country Briefs are available at the website associated with this report²

- **Growth.** Given that growth in China has shown hardly any deceleration from last year’s 9.5 percent pace, the recent easing in growth has occurred mainly among the region’s high income Newly Industrialized Economies (NIEs) and the middle income economies of South East Asia, driven, principally, by external factors. (Table 1). Exports in nominal dollar terms slowed from around 30 percent growth in mid 2004 to around 16-17 percent by mid 2005, driven in part by a cyclical downswing in global high technology markets, and by a temporary slowing in China’s import growth. The other main force behind the recent slowing in East Asian growth is the doubling in world oil prices over the last two years, which has generated terms of trade income losses of perhaps 0.7 percent of regional GDP in 2004 and 2005, although the impact on realized growth has likely been more muted. The recent flow of data suggests, however, that the slowing may be relatively limited in scope, and that the pace of export and domestic activity around the region was already reviving during the third quarter of the year. The package of monetary and fiscal policies should be broadly neutral with respect to growth, with a tightening of monetary policy offset by more expansionary public spending on infrastructure.

Table 1. East Asia Economic Growth

	2003	2004	2005	2006
Emerging East Asia	6.0	7.2	6.2	6.2
Develop. E. Asia	8.0	8.2	7.7	7.5
S.E. Asia	5.5	5.9	5.0	5.4
Indonesia	4.9	5.1	5.7	6.0
Malaysia	5.4	7.1	5.0	5.3
Philippines	4.5	6.0	4.8	5.0
Thailand	6.9	6.1	4.2	5.0
Transition Econ.				
China	9.5	9.5	9.3	8.7
Vietnam	7.3	7.7	7.5	7.5
Small Economies	4.8	5.6	4.9	4.9
Newly Ind. Econ.	3.0	5.9	4.0	4.4
Korea	3.1	4.6	3.8	4.6
3 other NIEs	2.9	6.9	4.3	4.3
Japan	1.4	2.6	2.3	1.8

World Bank East Asia Region; October 2005. Consensus Forecasts for NIEs other than Korea.

- **Poverty.** Poverty continues to fall in most parts of the East Asia region. For the region as a whole, poverty at

² <http://www.worldbank.org/eapupdate/>.

the \$2 a day level is estimated to have fallen to just less than 32 percent of regional population in 2005, down from just over 34 percent in 2004, or from 50 percent in 1996, just before the financial crisis. The number of poor at the \$2 level is estimated at some 596 million in 2005, down by 37 million from the previous year. A notable feature of recent developments is the success in reducing poverty among the region's transition economies. Recent evidence suggests that poverty reduction in Vietnam has been even more rapid than previously thought, while poverty reduction has also been more rapid in some economies where it had been previously thought sluggish, such as Cambodia and Mongolia. Another important trend is the explicit attention being given to issues of social protection in the formulation of overall development strategies. An example is Indonesia's recent initiative to alleviate the impact on the poor of its decision to remove subsidies on fuel. Fiscal savings will be used to establish a new cash transfer program for poor and near poor families, as well as expanded basic education, health and infrastructure programs aimed at benefiting low income families.

- ***The avian and human influenza threat.*** Since the spring, outbreaks of avian influenza A (H5N1) among wild birds and poultry have spread to Central Asia and Eastern Europe, while new outbreaks have also occurred this year in several East Asian countries. The confirmed number of human cases reported to the WHO since the end of 2003 has increased to 121, of whom just over half have died. While the bulk of human cases so far are thought to be the result of transmission of the virus from animals, there is great concern that genetic changes will allow the H5N1 virus to achieve the capacity for efficient and sustained transmission among humans, leading to a human influenza pandemic, with high levels of illness, death and other human, economic and social costs in East Asia and around the world. So far, the main economic impacts are occurring in the rural areas of several East Asian economies. At the overall macroeconomic level, costs so far have been fairly limited – on the order of 0.1-0.2 percent of GDP in Vietnam, for example - but could rise significantly going forward, and have already been high for specific sectors and communities. There are great uncertainties about the timing, virulence, and general scope of a future human flu pandemic but all agree it could lead to at least several million human deaths. The most immediate economic impacts of a pandemic might arise – as in SARS - not from actual death or sickness but from the uncoordinated efforts of private individuals to avoid becoming infected, as well as public policy actions like quarantines and travel restrictions, leading to severe demand shocks for services sectors such as tourism, mass transport, retail, hotels and restaurants etc, as well as supply shocks due to workplace disruption. A global flu pandemic would also entail a sizeable loss of potential world output

through a reduction in the size and productivity of the world labor force due to illness and death, as well as heavy medical and hospitalization costs. Policy makers everywhere need to give the influenza threat top political attention and priority, to avert, delay or mitigate what could be a major global disaster. At the political level an honest, transparent public information policy will be critical in winning the trust and confidence of the population, so as to minimize panic and disruption. The FAO, OIE and WHO have set out detailed recommendations on animal and human health policies and preparations that should be implemented at national and international levels. There is clearly a priority on curbing avian flu “at source”, in the agricultural sector, through implementation of strong animal and human health surveillance, disease control and mitigation measures, thereby reducing the probability of a far more costly human epidemic. Since in the present crisis animal and human health considerations are closely linked, the response to the influenza threat needs an integrated cross-sectoral approach that brings together agriculture, animal health, human health, finance and other key agencies and experts, with strong support and leadership at the highest political level.

The international and regional environment

- ***Developed economies.*** Projections for overall growth in developed economies are little changed from six months ago, suggesting a modest easing in OECD growth from 3 percent in 2004 to 2.4-2.5 percent in 2005-06, reflecting the impact of high oil prices and monetary tightening in the United States, among other factors. Within the OECD, 2005 projections for the hurricane-battered United States have been modestly lowered compared to six months ago, while those for the *Euro area* have also been shaved down to only 1.1 percent growth in 2005, due to unexpected weakness in domestic demand. Offsetting these downward revisions, projections for Japan have been boosted by 1 ½ percentage points compared to six months ago, as a stream of evidence strengthens expectations that a self-sustaining and robust Japanese economic recovery has finally arrived. Japanese recovery comprises one of the most important positive new developments for the East Asian regional outlook.
- ***China.*** Growth in the third quarter of 2005 was 9.4 percent, little changed from 9.5 percent in the first half of the year, or, indeed, from 9.5 percent in 2003 and 2004. Especially in the first half, growth was underpinned by a rise in the contribution of net exports, offsetting a softening in domestic demand. The third quarter saw some reversal of this pattern with stronger investment and imports. For the year as a whole, though, lower import growth combined with still strong exports has led

to a surge in China's trade surplus, likely totaling around \$100 billion, and continued fast growth in its foreign exchange reserves. Notwithstanding the modest upward revision of its exchange rate band this August, macroeconomic pressures for appreciation of China's currency remain strong. Policy discussions among the authorities are looking at how to move to a less capital and resource-intensive, more knowledge-driven, and more equally-shared pattern of growth. This could be achieved by rebalancing growth in the direction of sectors that require less capital, energy and resources but which generate more urban employment and use capital more efficiently. Such changes could be fostered by financial sector reform, better corporate governance, a larger role for private sector firms, less restrictions hindering the development of the services industry, and greater use of markets and taxes to determine prices of energy and resources, strengthening service delivery in education and health, and pension reform..

- **Textiles and Apparel Phase Out.** The phasing out of global quotas on textiles and clothing trade at the start of this year has already had a substantial impact on international markets for these products. U.S. imports of textiles and clothing from China increased by 64 percent (or \$6 billion) in the first 8 months of 2005, versus a 9.1 percent (or \$4.9 billion) increase in total imports of these products from the world. European Union imports of textiles and clothing from China rose 67 percent in the first six months of the year. Importantly, a range of other developing countries also managed to increase their market share under the new more open trade regime. US imports from Jordan, India and Bangladesh increased by 20 per cent or more in the first 8 months of 2005, while imports from Indonesia and Cambodia rose by around 15 percent. On the other hand, U.S. textile and clothing imports from higher income economies such as Hong Kong, Korea, Taiwan (China), Macao and Singapore fell by 20 percent or more. A similar situation occurred in the EU market, where imports from developing countries such as India, Sri Lanka, Turkey, Malaysia, Cambodia, Laos, Thailand and Vietnam have all increased. Both the US and EU have invoked 'safeguard' restrictions on selected clothing and textile imports from China, which may at least temporarily cushion the adjustment process for other producers.
- **Oil.** Crude oil prices have more than doubled since the end of 2003. Given a gradual pull back from current levels, oil prices are projected to average \$54 in 2005 and \$56 in 2006.³ Higher oil prices have generated terms of trade income losses in East Asia of perhaps 0.7 percent per year in 2004-05. Within the total, substantial net oil exporters like Malaysia, Vietnam and Papua New

Guinea have scored significant net income gains, while net importers like Korea, Philippines and Thailand have experienced significant income losses of 1-2 percent per year. The impact of terms of trade losses on growth has tended to be muted so far. Economies have been able to support domestic spending through some reduction in national savings rates and running down of current account surpluses, while in some cases fuel subsidies have shielded consumers from high world prices. However such subsidies have discouraged energy efficiency, while their fiscal cost has soared alongside oil prices. Countries such as Indonesia, Thailand and Malaysia have therefore acted to reduce or eliminate fuel subsidies, while smaller economies like Cambodia and Lao PDR are also generally allowing a full pass-through to users. This may curb growth to some extent in the near term, as well as create a temporary bulge in headline inflation. Estimates suggest that higher oil prices may reduce growth by somewhere around 0.8 percent in 2005-06. However the reforms of energy pricing should bolster growth over the medium term by improving efficiency of resource use and putting fiscal policies on a more sustainable footing.

- **Balance of payments.** East Asian foreign exchange reserves continued to accumulate in 2005, rising to \$1.65 trillion in September 2005 from \$1.46 trillion at the end of 2004, an increase of \$196 billion, up from a \$175 billion increase in the first nine months of 2004. The regional picture was dominated by China, where reserves increased by \$161 billion in the first 9 months, sharply up from \$111 billion in the previous year. Unlike last year, when it was primarily driven by capital inflows, this year's reserve increase in China mainly reflects a surge in its trade surplus, which will likely increase to around \$100 billion from \$33 billion in 2004. Reserves were also rising in most other economies, though often less quickly than last year. The rapid reserve buildup in East Asia over the last four years reflects both large increases in current and capital account inflows to the region, as well as the policy decision of most economies to intervene in currency markets so as to limit exchange rate appreciation. Thus even the economies with some form of floating exchange rate have experienced only an average 6-7 percent appreciation against the US dollar since the end of 2001. The large reserve buildup has complicated management of domestic monetary policies, by creating pressure for expansion of domestic money supply, which central banks have to offset through sterilization operations. It was to improve their ability to conduct their own monetary policy that economies such as China and Malaysia undertook changes in their exchange rate regimes announced in July. The de facto US dollar peg was in China replaced by "a managed floating exchange rate regime with reference to a basket of currencies," and entailed an initial 2 percent appreciation against the dollar. While important as a

³ This reference price is an average of Brent, Dubai and West Texas Intermediate (WTI) crudes.

first step, the modest initial appreciation may not reduce exchange rate pressures or the need for intervention and sterilization sufficiently. Given the continued large balance of payments inflows, further well-prepared steps towards greater exchange rate flexibility are likely to prove advisable.

- ***Inflation and Interest Rates.*** East Asian central banks began tightening monetary policy over the course of the past year. The change of course in monetary policy responds to a recent pick up in headline inflation in several economies around the region, and to concerns that, if left unaddressed, price pressures could become embedded in underlying core inflation and in higher inflationary expectations. Headline inflation has been pushed higher by rising oil prices and policy decisions to allow greater pass through of fuel costs to consumers. In addition, monetary policy tightening in the United States has reduced the spread between East Asian and U.S. interest rates, which has contributed to some depreciation of exchange rates against the dollar during 2005, creating pressure for higher import prices. While core inflation rates are in general running significantly below headline rates, there are some indications that core rates are also picking up. Thus the turn to monetary tightening is timely. While higher rates may temporarily moderate the buoyancy of recovery in domestic demand in the region in the near term, by helping to ensure moderate inflation and macroeconomic stability, it will help promote more sustainable growth in the medium term.

Domestic trends and policy issues

- ***Corporate sector trends and issues.*** The profitability and balance sheet position of East Asian firms saw a significant improvement during 2003 and 2004, providing a more secure foundation for an emerging upswing in investment spending in several economies in 2004. Profitability has rebounded from the low points seen after the financial crisis in 1998, supported by stronger economic growth and by continued progress in debt restructuring, which, combined with the low interest rates that have prevailed in recent years, has also resulted in sharply lower interest expenses. Progress on debt restructuring, and equity infusions have also led to lower leverage ratios, which are now broadly in line with

international norms. Macroeconomic developments this year may provide a somewhat more challenging environment in many economies, with profits tending to be affected by the easing in the pace of domestic demand and export market growth in the first six months (especially for high technology firms), higher fuel costs and the turn towards monetary policy tightening and higher interest rates this year. The pace of fixed investment spending growth eased in the first half of the year, most notably in Singapore and Philippines. The improvement in firms' balance sheets in recent years should however generally put them in a good position to ride through these conditions without too great difficulty. Over the medium term the maintenance of macroeconomic stability, growing regional and global integration and continued policy reforms to improve the investment climate, strengthen corporate governance and foster the development of deep and well regulated financial markets should all contribute to reviving investment and continued gains in corporate sector productivity and growth.

- ***Financial sector trends and issues.*** In recent years banks in previously crisis affected East Asian economies have experienced substantial improvements in key indicators of asset quality, capital adequacy and profitability. These trends have generally continued in 2005. Non performing loans, in particular, have continued to edge lower (although the stated NPL ratio in Indonesia rose during the June quarter, due to more stringent loan classification rules, which boosted the estimate of NPLs at state owned banks in particular). Countries continue to address tasks of financial sector restructuring and consolidation left over from the financial crisis, as well as longer term financial sector strengthening and development, including issues such as proper enforcement of prudential regulations, supervisory independence, alignment of capital adequacy requirements with the international standard, consolidated supervision, prompt corrective action provisions, effective bankruptcy arrangements and transparency.