

EAST ASIA AND PACIFIC REGIONAL OVERVIEW

Introduction

2004 has turned out to be a remarkable year for East Asia on several dimensions.¹ Economic growth is expected to top 7 percent for the region overall, while among its developing economies it should reach near 8 percent, the strongest since the regional financial crisis, and more than one percentage point higher than we had expected at this time a year ago. Exports have been buoyant since late 2002, supported by unexpectedly strong recovery in the developed world, cyclical rebound in the global high tech industry and a surge in intra-regional trade, led by booming exports from the rest of East Asia to China. Uncertainties about the future of the multilateral trading system - from which East Asia has profited perhaps more than any other developing region - appeared to diminish as WTO members agreed a negotiating framework for the Doha Round. Importantly, the driving forces of the recovery have also been evolving, as late 2003 and early 2004 saw the first robust and really widespread rebound in East Asian fixed investment spending since the crisis, underpinned by continued gradual improvements in the profitability and balance sheets of corporations and financial institutions.

At some point this year or next, we estimate that the number of people living on less than \$2 a day in East Asia will fall below one third of the population. As recently as 1999 that proportion was 50 percent. That is, around 300 million people will have escaped from poverty in the years of recovery since the financial crisis. Perhaps most strikingly, this is a time not only of economic and social progress in East Asia, but also of remarkable political advances. This year saw a sweep of legislative and presidential elections right across the region, including in Cambodia, Indonesia, Malaysia, Korea, Philippines and Taiwan (China). Most recently some 155 million voters - more than 80 percent of the electorate - participated in Indonesia's first ever direct presidential elections, resulting in the peaceful transition of authority from sitting president Megawati Sukarnoputri to the winner, president-elect Susilo Bambang Yudhoyono.

The Indonesian elections cap what has been in essence a genuine political revolution over the last five years, albeit - thankfully - a largely peaceful one, bringing about a transition from a highly centralized political system with autocratic powers concentrated in the hands of the president, to a representative and substantially decentralized one. Political accountability -

the accountability of politicians to citizens - has been tremendously strengthened through genuinely competitive elections for the presidency, the legislature and regional governments, contested by political parties that seem - by East Asian standards - relatively cohesive and based on differentiated political programs and ideas. A free press and a vigorous civil society have emerged, providing greater scrutiny and transparency over government actions. At the global level Indonesia emerges as the world's third largest democracy and - not less important - its largest Muslim majority democracy.

Yet, amid these triumphs, recent data also suggest that the cyclical recovery in East Asia has peaked and that activity is shifting or has already shifted into lower gear, while a number of cross-currents and risks noted in earlier editions of the World Bank's *East Asia Update* have intensified, some without and some within the region. In a word, the environment facing East Asia is more *uncertain*.

Some of these risks are discussed in more detail later in the report. Perhaps the one of most concern is the *steep spike in world oil prices*, which will reduce incomes among the majority of economies in the region that are net energy importers, as well as among the developed nations which comprise Emerging East Asia's major extra-regional export markets - the United States, Japan and Europe. Affected by oil prices, as well as by a variety of domestic factors, *growth in the developed world* shifted to a lower pace in the second quarter of 2004, most notably in Japan, and to a lesser extent in the U.S., while monthly indicators suggested softening activity in Europe in the third quarter. Overlaid on the growth pause in the developed world is the likelihood of another *cyclical downturn in the global high tech industry*, a concern for East Asia which is now the leading location for manufacturing and assembly in this industry. East Asian decision makers are also giving much attention to the *outlook for China*. While efforts to slow China's investment boom have had some success, a re-acceleration could increase the likelihood of a later, more severe 'hard-landing' that could knock away a key source of new export demand in the region over the next few years. Even with a 'soft landing,' the growth of East Asian exports to China will decline from their recent soaring pace, a change that seems to have already begun.

The consensus view remains that the recent slackening of activity in the developed world will prove a temporary pause in a more sustained expansion, while China will continue to expand at rates that - while lower than recently - will remain high by world standards. Nevertheless, the apparently remorseless rise in oil prices has heightened worries about a more serious downturn. These concerns are exacerbated by worries about *large global macroeconomic imbalances*, in particular record sized and growing U.S. current account deficits and the

¹ 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).

foreign financing they require, notably from the current account surplus economies of Japan and Emerging East Asia. Unpredictable changes in investor sentiment and risk appetite could result at some point in interest rate hikes, exchange rate swings and a sharp adjustment in U.S. aggregate demand and imports – a recession. That would be a costly outcome for all.

What should the focus of policy makers be in this sort of uncertain and potentially volatile environment? Rather than fretting too much about a cyclical slowdown that is inevitable to some extent, the focus is better placed on nurturing the emerging recovery in private investment. This would enhance the supply capacity of the economy and also has advantages from a near-term demand perspective. So far the regional recovery has been driven by exports and consumer demand. Going forward, however, export growth may be crimped by the cyclical factors and imbalances noted above. Consumption has been boosted in part by rapid growth in credit to households, but, as recent experience in Korea and Hong Kong (China) shows, this has its dangers too. A key issue for policy makers, then, is to nurture the recent investment recovery in the region by *strengthening the investment climate*, so that the recovery is sustained through the present period of global uncertainties and cyclical slowdown.

A recent series of *Investment Climate Surveys* undertaken by the World Bank helps document the key constraints and problems faced by firms and other businesses in East Asia. One key finding is that in many economies uncertainty about domestic macroeconomic conditions or government policies is an important problem for firms, and more global uncertainty further raises the premium on credible, transparent and predictable domestic policies. For those East Asian countries with high public debt levels, like the Philippines, an example would be a pre-announced program to reduce debt, thereby bringing down the sovereign risk premium and borrowing rates for all private investors. Many specific actions can be taken immediately to both cut the costs of doing business and to reduce corruption and arbitrariness by simplifying business regulation, cutting red tape and improving the transparency of procedures. There are likely to be high dividends from reforms to improve cost effective delivery of infrastructure and logistics services, as well as to improve labor market outcomes through greater flexibility and better institutions for upgrading worker skills. Continued efforts to address remaining private sector balance sheet vulnerabilities through financial and corporate restructuring remain worthwhile. Efforts are also needed to strengthen prudential regulation of the financial sector, and further develop capital markets, which will help diversify risk more broadly within the economy, for example through leasing and factoring, more institutional investment, pension funds, insurance companies and mutual funds. More broadly, judicial

reform and faster third-party arbitration can help establish sounder rules-of-the-game.

The priorities vary by country, but the potential for policy reform to assist in the investment recovery seems very real in most countries. An overview of the Bank's recent surveys and analysis in this area is presented in the Special Focus section at the end of this report, entitled "*Strengthening the Investment Climate in East Asia*". Developments at the country level are also discussed in the "Country Sections" towards the back of the report, while fuller Country Briefs are available at the website associated with this report.²

East Asia - at the peak of the cycle?

- **Economic growth** in East Asia is expected to reach 7.1 percent in 2004, over one percentage point higher than in 2003. (Table 1). The strength in activity has been widespread, encompassing most of the diverse economies in the region. Fixed investment spending has also picked up in recent quarters, not only in fast growing economies like China and Vietnam, where it has been strong for some time, but also in the middle and high income economies, where it has been erratic and weak in the wake of the 1997-98 financial crisis and the 2001 high tech crash. Annualized quarter-on-quarter growth in the second quarter of 2004 dipped to an average of only 3-4 percent among the 8 South East Asian and Newly Industrialized Economies. Regional growth is expected to decelerate in 2005, although reaching a relatively robust pace near 6 percent.

Table 1. East Asia Economic Growth

	2002	2003	2004	2005
East Asia	6.0	5.9	7.1	5.9
Develop. E. Asia	6.9	7.8	7.9	7.0
S.E. Asia	4.6	5.3	5.8	5.5
Indonesia	4.3	4.5	4.9	5.4
Malaysia	4.1	5.3	7.0	6.0
Philippines	4.4	4.5	5.4	4.5
Thailand	5.4	6.8	6.4	5.8
Transition Econ.				
China	8.3	9.3	9.2	7.8
Vietnam	7.0	7.2	7.2	7.5
Small Economies	2.6	4.2	4.1	3.4
Newly Ind. Econ.	4.7	3.0	5.9	4.4
Korea	7.0	3.1	4.9	4.4
3 other NIEs	2.8	2.9	6.9	4.4
Japan	-0.3	2.5	4.3	1.8

World Bank East Asia Region; Oct. 2004. Consensus Forecasts for NIEs

- **Poverty.** The number of East Asians living below \$2 a day is estimated to have fallen to around 34 percent in 2004, amounting to some 636 million people. As recently as 1999 that proportion was 50 percent,

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

representing some 890 million people. With per-capita real GDP growth in Developing East Asia having averaged around 6 percent a year in the years since 1999, there could hardly be more striking evidence as to the power of sustained economic growth to reduce poverty. Developments in *China*, which contains two thirds of the poor in East Asia – some 418 million – naturally dominate the regional picture. Poverty at the \$2 a day in China is estimated to have fallen to about 32 percent in 2004, driven by significant recent gains in rural income. Rural income gains in 2004 were mainly due to increased agricultural output, a more than 30 percent increase in grain prices, the introduction of direct subsidies to farmers, and a reduction in agricultural taxes. Outside of China, the bulk of recent poverty reduction in terms of absolute numbers of poor has occurred in three other economies, Indonesia, Thailand and Vietnam.

The international and regional environment

- ***A 'growth pause' in the developed world.*** Growth in the OECD economies is expected to reach 3.5 percent in 2004, about one percentage point stronger than had been expected a year ago. Growth in the United States and Japan, is expected to reach over 4 percent in 2004, before slowing in 2005 to a little over 3 percent and a little under 2 percent respectively. In the U.S. consumer spending had already shifted to a lower pace in mid 2004, likely reflecting the impact of higher oil prices, lower tax rebates and a reduced pace of mortgage refinancing. In Japan business investment, hitherto one the strongest elements in the recovery, took a breather in the second quarter, perhaps reflecting concerns about higher oil prices, indications of a slowdown in global high tech and slowing growth in exports to China and the rest of Asia. During the third quarter downside surprises were the largest in Europe, where industrial production actually contracted. OECD growth is forecast to ease significantly to 2.6 percent in 2005, although that would still be well above the OECD growth pace in 2001-03, the period of the last major global slowdown and subsequent upturn.
 - ***China – what kind of landing?*** In China the authorities have used a growing array of instruments to try and slow potentially excessive growth in investment spending, including credit restrictions, administrative controls on investment, and finally, in late October, higher interest rates, with some success. Fixed asset investment growth (in current prices) did indeed fall to 23 percent in the second quarter, although it recovered somewhat in the third, after the completion of administrative inspections, and several other demand indicators remained strong. However, the quality of adjustment in China might improve now that interest rate caps have been removed. That will give much needed support to SME lending and to the development of the secondary market in mortgages. GDP growth slowed from 9.6 percent in the second quarter to 9.1 in the third.
- Some impact is being felt on China's imports from East Asia, which grew less quickly in July-August than in the first half of 2004 or 2003, although in most cases still running at 25 percent or more. Beyond these cyclical developments, however, trade between China and the rest of East Asia is likely to be sustained by the growing industrial integration of the region, and the continued expansion of cross-border production networks and ties among multinational companies, their suppliers and customers. In the economic boom of the last two years (2002 and 2003) China's worldwide imports grew by 69 percent, led by an 80 percent increase in imports of machinery and transport equipment. Imports of machinery and transport equipment from other East Asian economies (excluding Japan) however jumped 117 percent, implying a gain in market share of over 6 percentage points in just these two years.
- ***High tech cycle turning over?*** Concerns about slowing OECD and China growth are amplified by evidence of slowing demand growth in the highly cyclical global high tech industry. East Asian tech production growth slowed in the third quarter as customers ran down unwanted inventories. New orders for tech output in the G-3 countries slowed, as did momentum in global semiconductor sales.
 - ***Commodity markets and the new oil shock.*** Perhaps the most alarming recent global development is the rise in average crude oil prices over the past year from around \$27 a barrel in September 2003 to \$46.7 in the first three weeks of October 2004 (and to \$50-55 for specific crudes like WTI), although in real terms prices still remain about half their peak level in the 1979-80 second oil shock. Prices have surged because of unexpectedly strong and coordinated global demand growth, led at the margin by rapid growth in China, low spare production capacity due to a lack of investment in the 1990s and a series of natural and political disruptions. Oil prices are currently expected to average \$39 in 2004 and \$36 in 2005, thanks to the growing production and fall in price of crudes from the Persian Gulf. Strong world growth has also contributed to a surge in metals and other non-oil commodity prices. Studies of the impact of the oil shock suggest it could knock 0.5 percent off world GDP growth, with a 0.8 percent impact in Asia. Impacts within the region will be highly differentiated, with substantial net oil importers like Korea, Philippines and Thailand suffering the largest income losses. At the other extreme small net exporters of both oil and non-oil commodities like Papua New Guinea are expected to enjoy very large windfall gains. Proper macroeconomic management and use of such gains will be a major challenge in such economies.
 - ***Trade policy developments.*** The July 31 WTO General Council agreement on a negotiating framework for the Doha Round of multilateral trade talks is good news for East Asia, which is expected to be one of the

main beneficiaries of the Round. The agreement laid out a road map for progress in four areas: agricultural trade liberalization, non-agricultural market access, services and trade facilitation. Most of the hard work of arriving at specific detailed agreements still lies ahead, however. East Asian economies, having much to gain, need to be active in the negotiations, pushing for a speedy conclusion.

- **International capital markets and flows.** After last year's return of large scale private capital flows to emerging markets, 2004 has seen something of a pause, with flows continuing at the levels reached in the second half of 2003, but not growing as rapidly as before. The pause is likely the result of the heightened uncertainties affecting the global outlook, as well as the shift towards higher interest rates in the U.S. That emerging capital markets were taking a fairly relaxed view of these developments was suggested by a number of other indicators. Spreads on East Asian Eurobonds, which fell sharply in 2002 and 2003, have been largely stable in 2004. Stock prices surged in 2003, peaked in January-February this year, pulled back by 5-10 percent in the second quarter, before starting to move higher once more in the third quarter.
- **East Asia and Global Rebalancing.** If Emerging East Asia is a recipient of private capital inflows, it, together with Japan, is also one of the major suppliers of finance for the main macroeconomic imbalance in the world at present, the U.S. current account deficit, which amounted to \$568 billion in the year to the second quarter of 2004. The Emerging East Asian economies alone had current account surpluses of about \$138 billion over this period, which, combined with net capital inflows, allowed them to accumulate over \$250 billion of official foreign exchange reserves, a significant proportion being invested in U.S. financing instruments. There is now a consensus that these imbalances cannot continue in this fashion for too much longer, and that policy makers need to find a means of achieving a 'global rebalancing' that is not disruptive of global growth. A part of this obviously depends on U.S. policy efforts to boost national savings by reducing the U.S. budget deficit. But global imbalances have also increased because of the sharp fall in domestic investment in many emerging East Asian economies after the regional financial crisis – averaging about 11 percentage points of GDP between 1997 and 2003. Within the region, the major surplus economies are Japan and the NIEs, but even developing Asian economies will need to play a part. The best outcome is for East Asia's contribution to global rebalancing to center on fostering much stronger domestic private investment, which would also position these economies for sustained long run growth. Continued adjustment in exchange rates can also play a role, as can sustained trade liberalization efforts, in particular in services sectors, where East Asia has tended to lag other developing regions.

Domestic trends and policy challenges

- **Strengthening fiscal positions.** Governments in the region continue to grapple with the burden of substantial public sector debt built up after the 1997-98 financial crisis as a result of governments shouldering the cost of recapitalizing and restructuring insolvent financial institutions, the calling of other contingent claims on government, wider public sector deficits and real depreciation of currencies. In light of the weakness of the fiscal position, the most pressing challenge is in the Philippines, where gross public debt has reached over 100 percent of GDP. President Macapagal-Arroyo submitted a package of fiscal measures for approval to Congress that, if fully implemented, would help stave off a fiscal crisis. In Indonesia several years of prudent fiscal management have helped nudge debt-GDP ratios steadily lower in recent years, although significant challenges remain, including reducing costly fuel subsidies so as to free up resources for more economically efficient and equitable uses (such as infrastructure, development spending and debt reduction). Malaysia also is focusing on significant fiscal consolidation in its latest budget. In Thailand, where budgets moved into surplus a couple of years ago, the government has boosted public investment and is pondering a five year program of large scale infrastructure projects.
- **Recent corporate sector trends and issues.** The profitability and balance sheet position of East Asian firms have continued to strengthen, providing a more secure foundation for the recent upswing in investment spending observed around the region. Ordinary income to sales ratios for listed non-financial firms have risen substantially from their low points in 1998, while debt-equity ratios have fallen, and are now broadly in line with international norms. Countries continue to make efforts to resolve the situation of weak firms and deal with the remaining stock of distressed assets. Since the special debt workout frameworks that were established in the aftermath of the crisis have mostly been wound down, progress on corporate restructuring increasingly depends on the effective functioning of the legal and judicial system, and, in particular of effectively functioning bankruptcy systems and market-based asset disposition. More generally, policy makers are increasingly focusing on measures to strengthen the broader investment climate, the subject of the 'Special Focus' in this report.
- **Recent financial sector trends and issues.** Banks have also benefited from the acceleration of economic activity over the past one and a half years. The profitability of commercial banks—as measured by the rates of return to assets and equity—has improved sizably in Indonesia and Thailand, and marginally in the Philippines and Korea, and remains comfortable in Malaysia. Average risk-weighted Capital Adequacy

Ratios (CAR) have also been above the 8 percent BIS norm in all five countries for several years now, while Non Performing Loan (NPL) ratios have continued to decline, reflecting, to varying degrees, continued restructuring efforts, improved capacity of borrowers to repay, and new loan growth. Some caveats should be noted. First, despite progress, NPL ratios remain in double digits in Thailand and the Philippines. Second, aggregate numbers on profitability and loan quality can sometimes mask considerable differences across groups of banks; some segments remain vulnerable. One trend and potential vulnerability across countries in the region has been rising household debt and with it, increases in the share of NPLs from household lending. In Korea household debt grew quickly between 2000 and 2002, and subsequent problem with credit card delinquencies have had a serious macroeconomic effect in slowing consumer spending. Household debt has also grown in Malaysia and Thailand, without so far running into serious difficulties. Countries are also continuing to make progress on various aspects of strengthening the financial system in terms of regulation and supervision.