Global Economic Prospects

Fiscal Headwinds and Recovery

Regional appendix: East Asia and the Pacific

Summer 2010

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East Asia and the Pacific

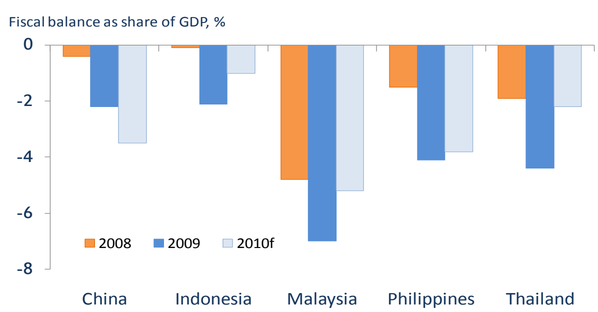
Recent developments

GDP in the East Asia and Pacific region grew 7.1 percent in 2009, a moderate falloff from the strong 8.5 performance of 2008. But, excluding China from the East Asia aggregate, growth slowed sharply from 4.7 percent in 2008 to 1.5 percent in 2009 (Table B1.1). Across countries results were mixed, ranging from an impressively resilient 8.7 percent gain for China to decline of 2.5 percent for Fiji. GDP also fell in Malaysia and Thailand, among middle income countries, and Cambodia among low-income countries. The dispersion of growth was a reflection of initial conditions across countries going into the financial crisis and the recession that followed. Given the importance of trade in East Asia's global presence, these included trade partner orientation and the product composition of a country's exports—and more fundamentally—the magnitude of fiscal and monetary stimulus applied. Lessons learned from the East Asia crisis of the late 1990s were also not forgotten in the region, and stability was supported by widespread reforms of the financial sector and private businesss environment; earlier fiscal adjustment to bring down excessive deficits, and a newfound (and healthy) caution regarding the capital account.

China's massive stimulus package was a major factor in the country's and region's economic resilience. The program was centered in government infrastructure spending, combined with increases in transfers, consumer subsidies and tax cuts. The surge in government-led investment boosted overall GDP by 5.9 points in 2009, though most of the spending was financed through quasi-fiscal measures such as lending by state-owned banks. Indeed, bank lending reached 30 percent of GDP in the year and financed almost two-thirds of the stimulus.

Fiscal packages elsewhere in the region helped cushion effects of the crisis. Many countries went into recession with sufficient fiscal space to respond pro-actively using both fiscal and monetary measures. Fiscal stimulus measures amounted to 2 percent of GDP for the region in 2009. But fiscal deficits (2.9 percent of GDP for 2009) and government debt grew by much less than in other developing regions, reflecting a smaller deterioration in overall growth in East Asia and the relative absence of automatic stabilizers in the region. For Indonesia, where GDP advanced 4.5 percent in 2009, government spending contributed about 1 percentage point of growth. Malaysia's fiscal deficit climbed to near 7 percent in 2009 in part due to weaker revenues, but also to large stimulus measures; while the Philippines and Thailand both undertook fiscal easing (Figure B1.1). Even low-income countries Cambodia, Lao PDR and Vietnam injected discretionary fiscal stimulus of about 3-4 percent of GDP or more each in 2009, helping to cushion the impact of the crisis on domestic activity.

Figure B1.1 Fiscal adjustment will be a challenge



Source: World Bank

Recently, a number of central banks (notably Malaysia) have started to tighten interest rates in the face of strengthening economic activity and rising inflation expectations. But as for all developing-and high-income countries, adjustment of fiscal balances in the post-crisis era will present a challenge for policymakers and play a large role in shaping the outlook to 2012.

The rebound in trade is slowing…East Asian exports and production of capital-, high-tech and durable consumer goods, in which the region is well specialized, dropped off sharply with the global collapse of investment spending and retrenchment by households. At its lowest point industrial production in the region (excluding China) was 9 percent below pre-crisis levels, while trade volumes declined by 21 percent. As the global recovery gathered momentum, regional industrial production and trade levels have recovered much of the loss. The stimulus-charged surge in China's investment led to a sharp increase in imports for domestic use, notably from East Asian trade partners (developing as well as high-income, e.g. Australia, Japan and the Republic of Korea). Chinese demand underpinned exports, production and incomes for partner countries throughout the region in 2009. Though the pace of import growth in China has slowed in the first months of 2010, China's demand continues to grow and support double-digit export growth among partners.

Among regional sources for energy and raw materials, imports into China from Indonesia moved higher by a full 105 percent by March 2010 (y/y) amounting to $14 billion during 2009; and imports from Malaysia, a country with a mix of energy, materials and high-tech goods also gained over 100 percent by early 2010. Regional exports to China helped to shift the contribution of trade to GDP to positive during the second half of 2009 for a large number of countries. East Asian imports also increased rapidly, with the result that the external sector provided a net 3.2 percent drag on regional growth during 2009.

Export volumes bottomed-out toward the end of 2008 and early 2009, but have recovered rapidly since that time, expanding at more than 30 percent annualized rates for much of 2009 (Figure B1.2). Growth rates are beginning to slow, as spare capacity is absorbed and demand subsides. By the end of the first quarter of 2010, exports had regained pre-crisis levels in most countries, though "only just" in the cases of Thailand and the Philippines. These developments, plus a deterioration of the

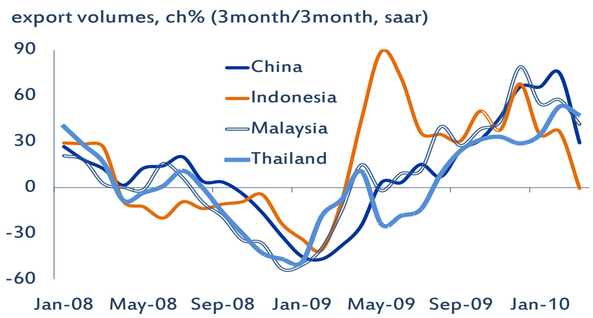
Table B1.1 East Asia and Pacific forecast summary
(annual percent change unless indicated otherwise)

				Est.	Forecast		
	95-05 [1]	2007	2008	2009	2010	2011	2012
GDP at market prices (2005 USD) [2]	7.4	11.4	8.5	7.1	8.7	7.8	7.7
GDP per capita (units in USD)	6.3	10.5	7.6	6.2	7.9	7.0	6.8
PPP GDP [3]	7.3	11.3	8.4	7.0	8.7	7.8	7.7
Private consumption	5.7	7.8	6.6	5.9	7.7	7.4	7.2
Public consumption	8.1	9.0	10.1	11.1	9.4	8.2	7.0
Fixed investment	8.1	9.8	10.1	18.8	10.5	7.7	7.9
Exports, GNFS [4]	12.5	15.7	7.6	-10.8	10.7	9.8	9.0
Imports, GNFS [4]	9.7	11.4	5.8	-5.4	12.1	9.0	8.3
Net exports, contribution to growth	0.7	2.9	1.5	-3.2	0.2	0.9	0.9
Current account bal/GDP (%)	2.2	9.6	8.7	6.0	4.3	4.2	4.2
GDP deflator (median, LCU)	5.9	4.8	7.3	4.9	3.5	3.0	2.8
Fiscal balance/GDP (%)	-2.1	0.4	-0.7	-2.9	-2.6	-2.0	-1.7
Memo items: GDP							
East Asia excluding China	3.5	6.2	4.7	1.5	5.8	5.3	5.6
China	9.1	13.0	9.6	8.7	9.5	8.5	8.2
Indonesia	2.7	6.3	6.0	4.5	5.9	6.2	6.3
Thailand	2.7	4.9	2.5	-2.3	6.2	4.0	5.0

Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2005 U.S. dollars. 3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.
Source: World Bank

region's terms of trade led to narrowing of the regional current account surplus from $470 billion in 2008 (8.7 percent of GDP) to $355 billion (6 percent of GDP) in 2009, with most of the decline stemming from China (Table B1.1).

Figure B1.2 Export growth is easing



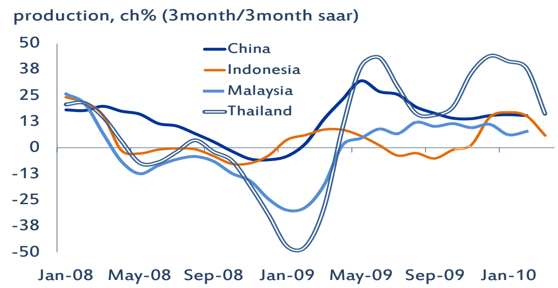
Source: World Bank

The recent decline in the pace of export growth across the region from a peak of 68 percent in February, to 24 percent by April 2010 (saar) reflects, in part, an end to the "rebound factors" from recession (including the pronounced inventory cycle, and onset of fiscal support) that have been driving growth in the final months of 2009. Looking forward, export growth is expected to ease to more sustainable rates, as China's import demand eases and growth in the OECD (notably Europe) continues to disappoint.

… and growth in industrial production is also easing to a more sustainable pace

The collapse in global demand and exports of investment and durable goods was reflected in an 11 percent decline in regional industrial production between August 2008 and January 2009. If China is excluded, production echoed the pattern of export volumes, contracting at a 22 percent annualized rate in January 2009 (saar), then rebounding to a positive 22 percent pace a year later. The trajectory of output growth also displays a tailing off during the first months of 2010 to 17.5 percent by April (saar), in part as spare capacity has been re-absorbed and- with the exception of Malaysia-, all countries in the region have reached or exceeded their pre-crisis peak levels (Figure B1.3).

Figure B1.3 Industrial production growth is slowing



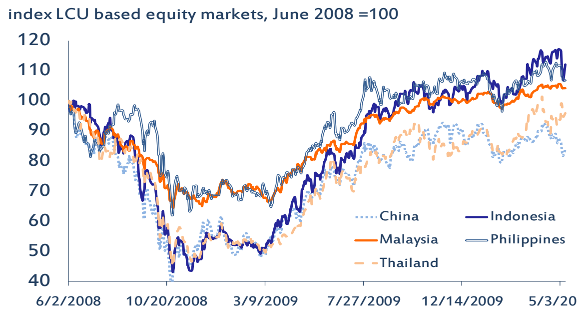
Source: World Bank

Financial markets in East Asia avoided the worst effects of the crisis

To a large degree, financial markets in developing East Asia were insulated from the direct effects of the global (read 'high-income') financial crisis. Commercial banks and other institutions in the region were only small holders of toxic CDOs and related derivatives, and carried little direct exposure to the worst-hit institutions in the high-income world. Nevertheless, markets in East Asia were roiled by the (almost immediate) second-round effects of the crisis. Both equity markets and currencies were hard hit as international capital fled to perceived safety, and/or given mammoth losses by financial institutions, assets were reclaimed to shore-up balance sheets. Stock valuation in local currency dropped 52 percent in Thailand and 56 percent in Indonesia (Figure B1.4). Exchange rates also depreciated sharply vis-à-vis the dollar with the outflow of foreign funds, pressuring currencies to 15-to 20 percent declines by early 2009, before capital began to reflow to the region and currencies stabilized—then appreciated once more. Since that time, as elsewhere, markets recovered as investor's confidence returned.

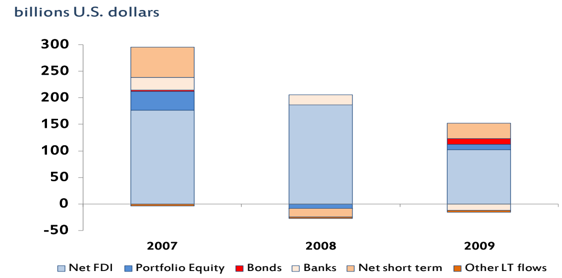
Capital flows to the region fell off sharply in 2009. Overall international capital flows to East Asia fell from a peak of $295 billion in 2007 (6.5 percent of regional GDP) to an estimated $138 billion in 2009 (Table B1.2 and Figure B1.5). Key to the decline was a large 45 percent fall in FDI flows to the region, from $187 billion

Figure B1.4 Most regional equity markets have recouped pre-crisis levels



Source: World Bank

Figure B1.5 Capital flows to East Asia have declined



Source: World Bank

in 2008 to $102 billion during 2009, and a $31 billion turnaround in net bank lending, as high-income banks sought to redress their balance sheets). Capital flows continued to strengthen during the first four months of 2010, with bond flows at $11 billion almost twice as strong as in the same period of 2009, while syndicated bank loans came in at $9.8 billion—80 percent higher than a year earlier. First-time IPOs and new equity issues, on the other hand, were off by about 20 percent from the pace set in early 2009.

Inflation pressures building

As spare capacity has been absorbed and with growth at double-digit rates, there are increasing signs of supply-bottlenecks and incipient evidence of localized asset-bubbles emerging. For the region as a whole, the median inflation rate increased from 3.2 percent to 5.7 percent between January 2009 and March 2010. Asset price bubbles appear to be forming in the housing sector in China, partly reflecting easy financing but also tied to the massive expansion

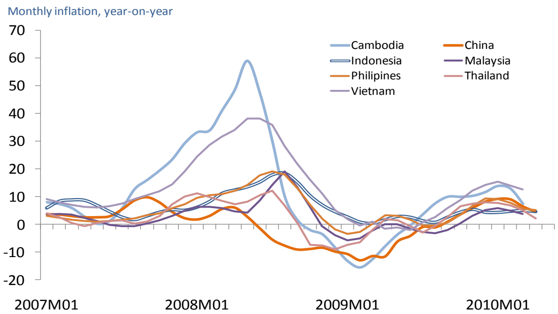
Table B1.2 Net capital flows to East Asia and the Pacific
$ billions

	2003	2004	2005	2006	2007	2008	2009e	2010f	2011f	2012f
Financial flows:										
Net private and official inflows	**76.0**	**127.1**	**184.1**	**193.9**	**291.8**	**178.7**	**136.6**			
Net private inflows (equity+debt)	**83.2**	**132.3**	**187.0**	**203.5**	**294.9**	**179.2**	**137.6**	**147.6**	**176.4**	**224.1**
..Net private inflows (% GDP)	3.6	5.0	6.1	5.6	6.5	3.1	2.2	2.1	2.2	2.5
Net equity inflows	69.3	89.7	130.0	161.8	212.1	179.0	112.3			
..Net FDI inflows	56.8	70.4	104.4	105.7	177.0	187.1	101.9			
..Net portfolio equity inflows	12.5	19.3	25.7	56.2	35.1	-8.1	10.4			
Net debt flows	6.7	37.4	54.1	32.1	79.7	-0.3	24.3			
..Official creditors	-7.2	-5.2	-2.9	-9.6	-3.1	-0.5	-1.0			
....World Bank	-1.5	-1.9	-0.6	-0.4	-0.3	1.2	2.2			
....IMF	-0.5	-1.6	-1.6	-8.5	0.0	0.0	0.1			
....Other official	-5.2	-1.7	-0.7	-0.7	-2.8	-1.7	-3.3			
..Private creditors	13.9	42.6	57.0	41.7	82.8	0.2	25.3			
....Net M-L term debt flows	-9.9	9.1	13.9	14.2	26.0	15.8	-3.4			
......Bonds	1.8	9.6	12.1	6.0	2.3	-0.5	10.8			
......Banks	-8.6	1.6	3.8	9.8	24.1	18.6	-12.3			
......Other private	-3.1	-2.1	-2.0	-1.6	-0.4	-2.3	-1.9			
....Net short-term debt flows	23.8	33.5	43.1	27.5	56.8	-15.6	28.7			
Balancing item	**-6.4**	**21.8**	**-141.2**	**-196.5**	**-180.5**	**-209.8**	**11.7**			
Change in reserves (- = increase)	**-139.7**	**-237.1**	**-217.7**	**-295.3**	**-537.3**	**-427.9**	**-491.0**			
Memorandum items										
Workers' remittances	32.7	40.3	50.5	58.0	71.0	86.0	86.0	**94.0**	**103.0**	

Source: World Bank. *Note*: e = estimate; f = forecast.

in infrastructure associated with the stimulus plan (Figure B1.6).

Figure B1.6 Inflation has picked up with the recovery



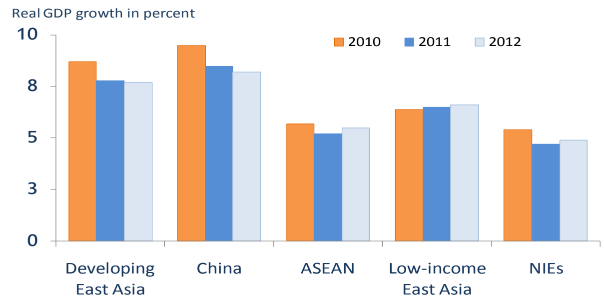
Source: World Bank and Datastream

Near-term outlook

GDP is projected to expand by 8.7 percent in 2010, led by 9.5 percent growth in China. Excluding China, GDP in the remaining developing countries of East Asia is anticipated to increase by 5.8 percent (Figure B1.7). Both for China and other countries, growth will continue to reflect strong expansion of domestic demand, which in China was responsible for 95 percent of the increase in GDP (85 percent in the rest of developing East Asia and the Pacific). Looking forward, strengthening demand in high-income countries should boost export growth. This, in addition to a gradual strengthening in capital inflows (and associated investment) will help offset some slowing in domestic demand into 2011-12, as fiscal and monetary stimulus measures are gradually withdrawn. Growth is projected to ease to a still-robust average of 7.8 percent over the final years of the forecast (8.4 percent for China and 5.5 percent for the remaining countries) (Table B1.3).

The region-wide slowing of growth and tightening of policy measures is expected to rein -in inflation pressures by 2011 and 2012. Despite strengthening export growth, and moderately weaker imports in line with slower domestic demand, the region's current account surplus is expected to remain relatively steady near 4 percent of GDP, in part because import prices are likely to increase more rapidly than export prices – reflecting productivity differentials and policy efforts to reorient production in China toward satisfying domestic demand.

Figure B1.7 Recovery expected to slow 2011



Source: World Bank

Risks

The main risk facing the global economy in the near term stems from debt sustainability issues in high-income Europe. Should these problems not be resolved in a smooth manner, global GDP could be much weaker, with the level of GDP lower by between 2-and 5 percent (see main text). For the countries of East Asia, the effects of such a cycle are potentially serious, in part because both exports and investment are large shares of regional economies, and these are precisely the two channels through which a deeper European crisis might be transmitted to developing countries.

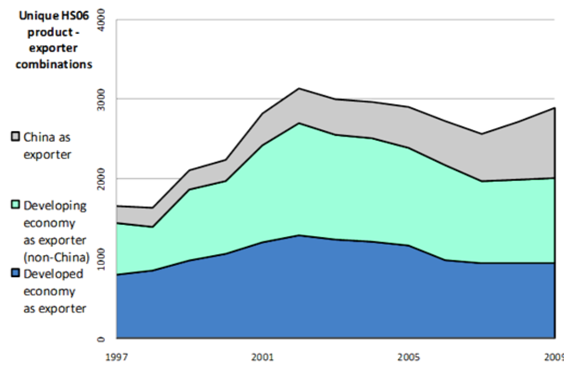
As was the case with the first phase of the financial crisis, countries in the region should be well placed to introduce macroeconomic policies to limit the impact of such a "second" crisis. Indeed, events in Europe grounded in the sovereign debt difficulties of Greece, Spain and Portugal, and the consequent EU/IMF Stabilization Package for the Euro Area have dampened several of the emerging trends of importance for the East Asia region. The economic outlook for Europe has dimmed, as austerity measures are in place among the highly -indebted countries of the Southern Euro Zone, as well as in France, Italy, the United Kingdom and others. These adjustments will work to slow near-term economic activity—and import demand—in a large market, that was worth some

$375 billion, or 18 percent of total exports for developing East Asia during 2008.

Just as the larger countries of East Asia are recognizing that—in the new "post-crisis world" concerns may include slower growth of high-income economies, tighter global financing conditions, high and rising high-income debt levels and a more difficult environment for trade—the growth of export markets and trade for East Asia may be less robust than in previous decades. In this overall environment the *risk of protectionism* may come more prominently to the fore. In the post-crisis period, developing countries have emerged as the most active users of trade remedies in the crisis, initiating three-quarters of all investigations since 2008, with India and Argentina as the most active users, followed by Turkey, Brazil, and China. Should this trend intensify, it could have serious implications for countries in the region; especially if, as appears to be the case, the implementation of trade measures is prompting the retaliatory actions (Figure B1.8).

Other elements of risk for East Asia are financial, including the challenge of shifting into a prudent "exit" strategy for fiscal accounts that is not premature, and which allows private sector activity to become more self-sustaining. Moreover, avoidance of "hot" capital inflows that could risk economic stability and damage exchange rate regimes is important; and of note is potential competition in international bond markets with the issuance of high-income sovereign debt, funding the stimulus packages of the financial crisis years.

Figure B1.8 Post-crisis use of trade remedies



Source: Global Antidumping Database and World Bank Calculations

Table B1.3 East Asia and Pacific country forecasts

(annual percent change unless indicated otherwise)	95-05 [1]	2007	2008	Est. 2009	Forecast 2010	Forecast 2011	Forecast 2012
Cambodia							
Real GDP at market prices	8.3	10.2	6.7	-2.0	4.8	6.0	6.5
Current account bal/GDP (%)	-4.4	-5.8	-9.9	-7.8	-11.1	-10.3	-9.7
China							
Real GDP at market prices	9.1	13.0	9.6	8.7	9.5	8.5	8.2
Current account bal/GDP (%)	2.6	11.1	10.6	6.4	4.7	4.7	4.8
Fiji							
Real GDP at market prices	2.3	-6.6	-0.1	-2.5	2.0	2.2	2.4
Current account bal/GDP (%)	-3.3	-14.3	-18.3	-8.6	-15.8	-17.7	-17.9
Indonesia							
Real GDP at market prices	2.7	6.3	6.0	4.5	5.9	6.2	6.3
Current account bal/GDP (%)	1.5	2.4	0.0	2.1	0.4	0.1	0.1
Lao PDR							
Real GDP at market prices	6.2	7.9	7.5	6.7	7.7	7.5	8.0
Current account bal/GDP (%)	-9.8	2.5	2.7	1.9	1.0	1.8	1.6
Malaysia							
Real GDP at market prices	4.8	6.3	4.7	-1.8	5.7	5.3	5.5
Current account bal/GDP (%)	6.5	15.7	18.3	15.7	15.2	15.1	14.9
Papua New Guinea							
Real GDP at market prices	0.7	6.2	6.7	4.5	6.5	4.2	4.5
Current account bal/GDP (%)	3.0	16.9	14.0	-3.1	0.3	2.0	-0.1
Philippines							
Real GDP at market prices	4.2	7.1	3.7	1.1	4.4	4.0	4.0
Current account bal/GDP (%)	-1.4	4.9	2.2	5.3	3.8	3.4	2.8
Thailand							
Real GDP at market prices	2.7	4.9	2.5	-2.3	6.2	4.0	5.0
Current account bal/GDP (%)	1.9	6.6	0.6	7.3	2.5	1.5	0.7
Vanuatu							
Real GDP at market prices	1.5	6.8	6.6	4.2	4.5	5.5	5.5
Current account bal/GDP (%)	-9.8	-10.6	-9.6	-8.4	-6.4	-6.9	-6.0
Vietnam							
Real GDP at market prices	7.2	8.5	6.2	5.3	6.5	6.5	6.5
Current account bal/GDP (%)	-2.5	-10.0	-11.9	-12.8	-11.1	-10.2	-10.4

Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. Micronesia, Fed. Sts., Kiribati, Marshall Islands, Myanmar, Mongolia, Palau, Korea, Dem. Rep., Samoa, Solomon Islands, Timor-Leste, Tonga are not forecast owing to data limitations.

Source: World Bank

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.