EAST ASIA AND PACIFIC UPDATE **NOVEMBER 2009**

TRANSFORMING THE REBOUND INTO RECOVERY

A WORLD BANK ECONOMIC UPDATE FOR THE EAST ASIA AND PACIFIC REGION

THE WORLD BANK

TRANSFORMING THE REBOUND INTO RECOVERY

East Asia and Pacific Update **November 2009**

The East Asia and Pacific Update was prepared by Ivailo Izvorski (iizvorski@worldbank.org) and Antonio Ollero under the guidance of Vikram Nehru (East Asia and Pacific Regional Chief Economist and Director, Department for Poverty Reduction, Economic Management, Private and Financial Sector Development). Inputs were provided by country economists and analysts across World Bank offices in East Asia and the Pacific, and by Andrew Burns, Ratchada Anantavrasilpa, Kirida Bhaopichitr, Eric Le Borgne, Mansoor Dailami, Sung-Soo Eun, Xu Gao, Sepideh Khazai, Ulrich Lachler, Sheryll Namingit, Mick Riordan, Frederico Gil Sander, Philip Schellekens, Manohar Sharma, Ashley Taylor, Hans Timmer, Ekaterina Vostroknutova, and Xiao Ye. The update has benefitted from the assistance and guidance on design and external communications by Mohamad Al-Arief and the External Affairs Team, and from assistance by Lynn Gross.

Emerging East Asia as used in this report includes Developing East Asia (China, Indonesia, Malaysia, Philippines, Thailand, Cambodia, Lao PDR, Mongolia, Papua New Guinea, Timor-Leste, Vietnam and the island economies in the Pacific) and the Newly Industrialized Economies (NIEs). The NIEs include Hong Kong (SAR, China), Korea, Singapore and Taiwan, China. Middle-income countries, as used in this report, refer to China, Indonesia, Malaysia and Thailand. Low-income countries as used in this report include Cambodia, Lao PDR and Vietnam. The ASEAN member countries are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. ASEAN+3 refers to all members of ASEAN plus China, Korea and Japan, and ASEAN+6 also includes Australia, India and New Zealand.

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TABLE OF ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations (Brunei Darusalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam)
BEA	U.S. Bureau of Economic Analysis
BPO	Business Process Outsourcing
CIC	China Investment Coproration
CMI	Chiang Mai Initiative
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
G20	Group of Twenty
G-3	The United States, the Eurozone and Japan
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPO	Initial Public Offerring
LCD	Liquid Crystal Display
NA	National Accounts
NIEs	Newly Industrialized Economies (Hong Kong (SAR, China), Korea, Singapore and Taiwan (China)
NPLs	Nonperforming Loans
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PMI	Purchasing Managers Index
PNG	Papua New Guinea
RMB	Chinese renminbi
SAR	Special Administrative Region
SITC	Standard Industrial Trade Classification
SMEs	Small- and Medium-Enterprises
U.S.	United States

Countries

CHN	China
HKG	Hong Kong (SAR, China)
IDN	Indonesia
KHM	Cambodia
KOR	Korea
LAO	Lao PDR
MNG	Mongolia
MYS	Malaysia
PHL	Philippines
SGP	Singapore
THA	Thailand
TWN	Taiwan (China)
VNM	Vietnam

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SUMMARY

East Asia's rebound from the economic downturn has been surprisingly swift and very welcome. A year ago, exports and industrial production fell sharply across the region, layoffs were on the rise, and capital flowed out weakening asset prices and currencies. A vigorous and timely fiscal and monetary stimulus in most countries in East Asia, led by China and Korea, along with decisive measures in developed economies to prevent a financial meltdown after the collapse of Lehman Brothers, have stopped the decline in activity and set in motion the regional rebound. The shift to inventory restocking since mid-2009 has also helped boost growth. These factors have led us to revise our projection for real GDP growth in developing East Asia up by 1.3 percentage points since the previous forecast in April. All in all, real GDP growth is set to slow to 6.7 percent in 2009 from 8 percent in 2008, or much more moderately than after the 1997-98 Asian financial crisis.

Developments in East Asia remain strongly influenced by China. Take China out of the equation, and the rest of the region is recovering with less vigor. For 2009 as a whole, output is projected to contract in Cambodia, Malaysia and Thailand and barely grow in Mongolia and some of the Pacific islands. Even with solid growth in Indonesia and Vietnam, developing East Asia excluding China is projected to grow more slowly in 2009 than South Asia, the Middle East and North Africa, and only modestly faster than Sub-Saharan Africa.

The aggregate numbers mask not only large differences in growth performance: they tell an incomplete story about the social and poverty impact of the crisis. Lack of high frequency data on household incomes and expenditures makes it difficult to track how the poor are faring. Based on past patterns of poverty and growth – which may not hold during the current downturn and rebound – an additional 14 million people will remain in poverty in the region in 2010 as a result of this crisis. Reduced demand for labor during the downturn typically meant reduced work hours or lower wages, rather than outright layoffs. In some countries, where layoffs occurred, workers moved to the informal sector. In the end, labor incomes fell substantially in 2009, with adverse consequences for living standards. Poverty estimates do not capture these adverse consequences.

The rebound has yet to become a recovery. That is why the authorities in the region are mindful of the risks of a premature withdrawal of stimulus, given the large output gaps and concerns that developed countries are converging to a slower-growth equilibrium. Some governments in the region will have the fiscal space to sustain fiscal stimulus until recovery is on a firmer footing and private investment has been restarted. Others will be more restrained because of limited fiscal space. Overall, governments are aware that fiscal and monetary stimulus alone cannot sustain domestic demand for an extended period of time, especially if investors are not reassured that the authorities will have viable exit strategies in place and will bring government debt to levels that will not jeopardize long-term debt sustainability. There are limits, moreover, to what fiscal and monetary policies can accomplish if recovery in the developed countries, notably the U.S., remains weak for a longer period than currently deemed likely.

The crisis has prompted countries in the region to rethink their development strategies. For most, the choice between growth driven by exports, on the one hand, and growth driven by domestic demand, on the other, is a false one. Countries need to resist protectionism, remain open and become more, not less, integrated into the global economy to continue to reap the benefits of global knowledge, technologies and innovation. At the same time, governments are realizing that more growth can be extracted from domestic demand if they ease or eliminate incentives that favor the quick buildup of export-led, investment-heavy manufacturing supported by undervalued exchange rates and suppressed domestic consumption and services. Some governments are rethinking how to manage risks stemming from large and volatile capital inflows, especially given concerns about new asset price bubbles.

The regional outlook for consolidation of the rebound into recovery and a return to rapid growth confronts downside and upside risks. Downside risks include a double dip in economic activity in the advanced countries as stimulus measures and inventory restocking wear off. This will challenge many East Asian countries that have little fiscal space to continue to finance fiscal stimulus programs without external assistance. But they will be assisted by China that has the resources to maintain its current fiscal stance for several years if necessary. There will be limits to China's capacity for further monetary stimulus, however, following the surge in credit by 30 percent of GDP in 2009. On the upside, a more robust recovery in the advanced countries could remove some of the imperative for rebalancing in developing East Asia and encourage sustaining the pre-crisis export-oriented growth model. The upside also carries with it the risk of larger capital inflows causing new asset price bubbles and complicating macroeconomic policies. Managing both risks will be a challenge that will require measures to rebalance growth while advancing integration with global markets and retooling institutions to encourage innovation.

Over the medium term, can developing East Asia sustain rapid growth, even if the rest of the world grows slowly? This will depend on whether East Asia can integrate further regionally – through better facilitation of trade in goods and by extending its liberal trade policies to services. Moving up the value-added chain in global production networks will present an additional impetus to growth, as the benefits of new technology and innovation spread more broadly through the countries in the region. The service sector holds enormous potential for East Asia. Measures to spur competition in the service sector, combined with policies to ease restrictions to internal migration and trade, bolster education and improve the environment for private investment and innovation, will allow countries to take a fuller advantage of the benefits of agglomeration, and create more favorable conditions for the emergence of innovative global companies.

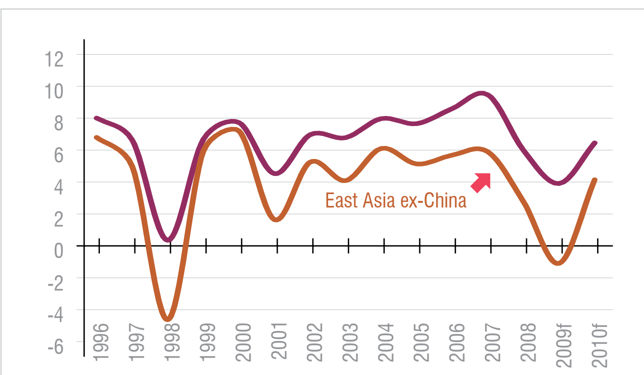
I. THE REBOUND

EAST ASIA IS LEADING THE GLOBAL REBOUND

A vigorous economic rebound is under way in East Asia since the second quarter of 2009, following the sharp impact from the financial crisis and the global recession that began in late 2008. As much as the reduction in exports and industrial production across the region in the fourth quarter of 2008 and the first quarter of 2009 was unexpectedly swift and deep, so is the strength of the rebound, with doubts about green shoots dispelled in a matter of months and replaced by near-consensus views of a synchronized global rebound led by emerging East Asia. The robust rebound is due to a combination of timely and large fiscal and monetary stimulus in most countries in East Asia, notably in China, and a powerful process of inventory restocking that began after mid-2009. Globally, the advanced economies joined the rebound trend in the third quarter of 2009, and their contributions to global industrial production – notably driven by inventory accumulation – have begun to outpace the contribution from the East Asia region. These developments are set against a background of solid macroeconomic fundamentals, including high foreign exchange reserves, large private and corporate savings, and low corporate and government debt. The region's well-capitalized banks and much improved banking supervision since the 1997-98 Asian financial crisis have also helped limit financial contagion and the transmission of the forces of global recession.

Figure 1. Real GDP growth in East Asia slowed by less than during the 1997-98 crisis

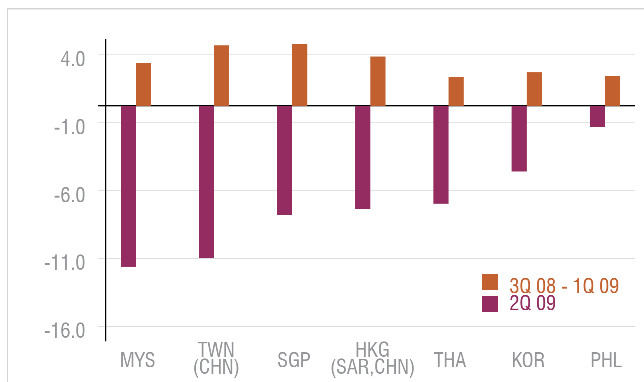
(Percent change year-on-year)



Source: Datastream and World Bank staff calculations.

Figure 2. Those that fell are not fully up:

(Percent change in real GDP, seasonally adjusted not annualized)



Source: Datastream and World Bank staff calculations.

The global economic recession has been the worst since World War II, and the financial crisis the most severe since the Great Depression, but East Asia's real GDP growth did better than during the 1997-98 Asian financial crisis. In fact, growth in 2009 is set to slow to a pace only slightly lower than during the 2001 "dot com" U.S. recession which represented a pure external demand shock to East Asia and during which China, similarly to the current crisis, implemented a large fiscal stimulus package (Figure 1).[1] Four East Asian economies fell into recession during the current global crisis, and all four emerged from it in the second quarter of 2009 (Thailand, Malaysia, Singapore and Taiwan (China)).

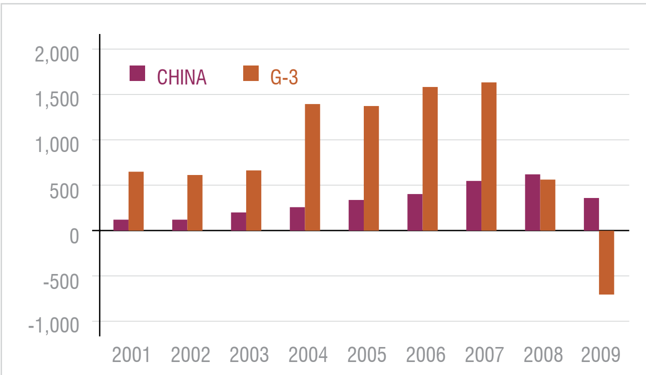
The rebound so far has been strong but it has yet to offset fully the earlier decline (Figure 2). China - and Indonesia and Vietnam - are the exceptions, without a single quarter of negative growth. The rapid increase in China's real GDP and its components has helped the regional and global rebound, but there are limits to the extent China can replace weak final demand in the U.S., the EU and Japan (the G-3) given that the size of its economy is equivalent to a tenth of theirs combined. Yet China's contribution

1 For details of the Chinese stimulus package implemented during 1998-2002, see the April 2009 EAP Update, "Battling the Forces of the Global Recession."

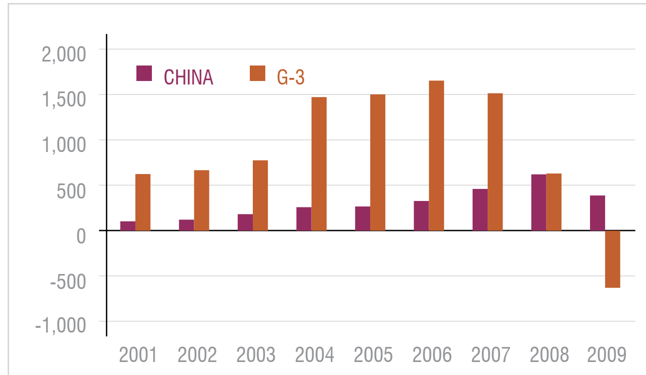
Figure 3. China's global economic position has expanded considerably

(Change year-on-year in billions of U.S. dollars, 2008)

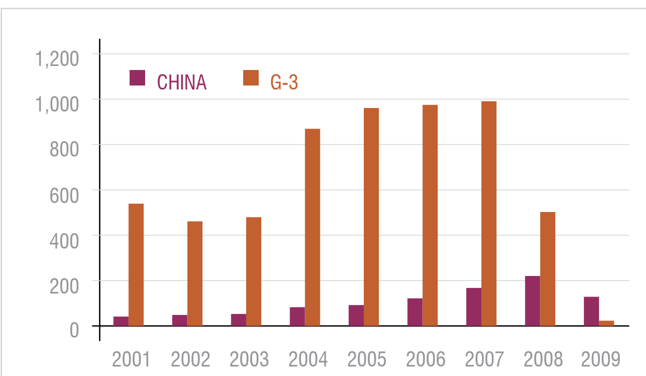
The increase in China's **GDP** was larger than that of the G-3 during the crisis, up from a third before 2008



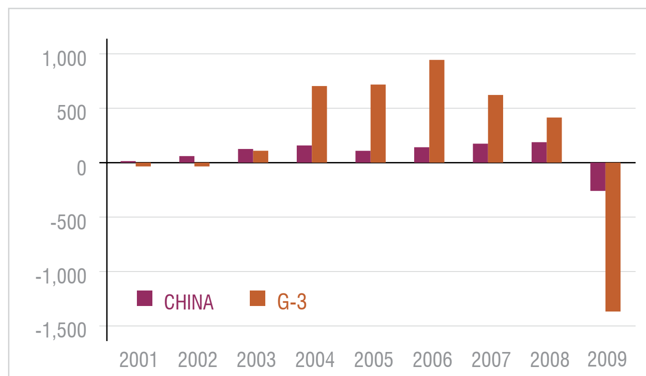
The increment in **domestic demand** has also been larger than the G-3 during the crisis, thanks to government-influenced investment



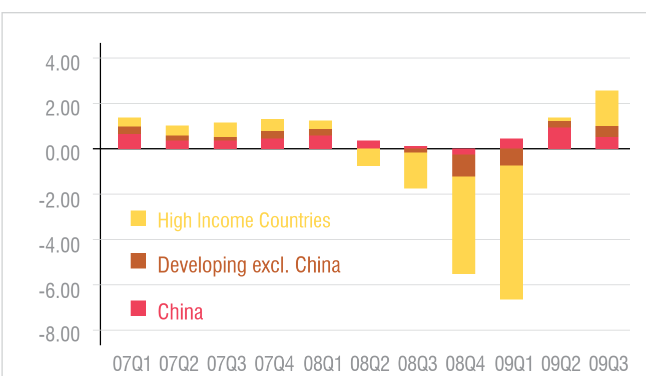
Private consumption was much more subdued, except in 2009



And China's incremental **imports** fell by less than the G-3 in 2009 as a whole



China was instrumental in the revival of global industrial production, but the contribution from high income countries rose much more in the third quarter (contribution to global growth, percentage points, quarter-on-quarter)



Source: Haver, Eurostat and World Bank staff calculations.

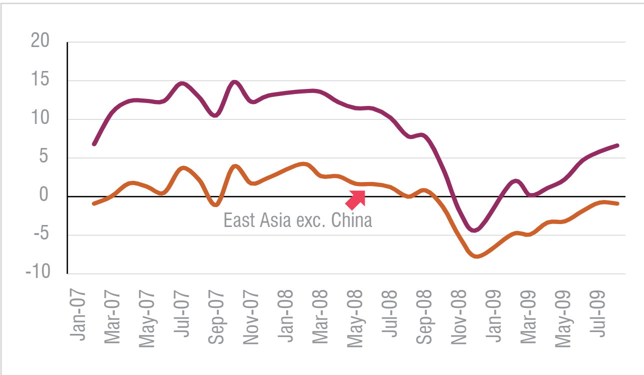
has been rising over the years and its incremental private consumption, domestic demand and imports of goods and services exceeded that of the U.S. and Japan individually in 2008, and almost certainly in 2009 given the recession in those two countries (Figure 3). Rebalancing growth in China should help extract more growth from domestic demand and should help boost further its influence on the region and the world (see below).

INDUSTRIAL PRODUCTION LED THE DECLINE AND NOW THE REBOUND

Inventory restocking, fiscal stimulus and signs of increasing final demand in China are helping drive a strong recovery in industrial production across the region following the sharp contraction in late 2008 and early 2009 (Figure 4). Both

Figure 4. Industrial production in East Asia is recovering swiftly

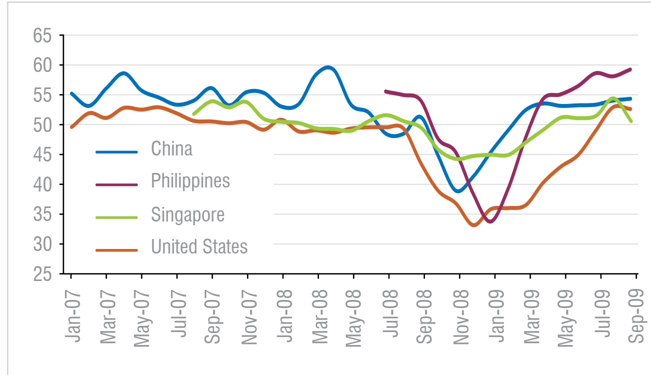
(In percent, year-on-year)



Source: Datastream and World Bank staff calculations.

Figure 5. Purchasing managers indices have also rebounded

(Index, 2007-2009)



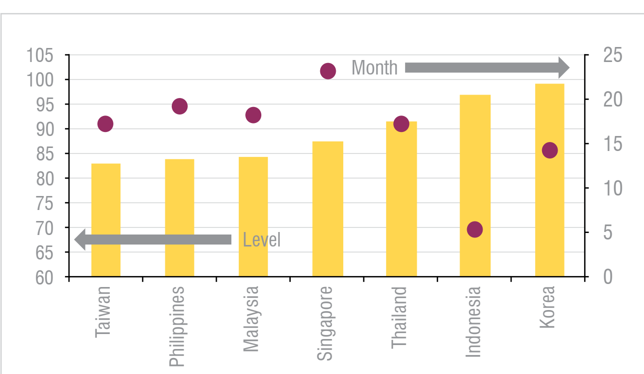
Source: Datastream and World Bank staff calculations.

growth rates and output levels are recovering in a V-shaped fashion, ahead of the rebound in the advanced economies. The Purchasing Managers' Index (PMI) – a measure of business confidence in the expansion of production, sales and employment – has also rebounded sharply, with almost all components, including domestic and export orders, and employment, suggesting expansion (Figure 5). The recovery, much like the preceding decline, has been most pronounced in more open countries or in countries with a larger share of high-technology manufacturing in exports. Of course, high-technology does not mean high value-added, which is why sharp declines in production and activity translated into smaller impacts on GDP.

The recovery in industrial production has been swift, but there is substantial heterogeneity across the region and, on average, production levels are still 10 percent down from the pre-crisis peak. For China, Korea and Indonesia, the recovery in production has been faster than the 21 months it took for regional output to reach the pre-crisis peak after the 1997-98 Asian financial crisis. The large fiscal and monetary stimulus packages in China and Korea have been the key factors underpinning the rebound, in China's case also supporting a larger increase in domestic demand that has drawn imports of electronics, electrical appliances, and capital goods, including from Korea (Figure 6). Tax breaks on automobile sales in China and Korea, together with subsidies for trading in older vehicles, have also contributed to the surge in sales and production. In December 2008, for the first time ever, vehicle sales in China surpassed those in the U.S., making China the largest automotive market in the world (Figure 7). Thailand's production is also close to its pre-crisis peak, even though capacity utilization is below the levels that prevailed through the

Figure 6. Levels of industrial production are still below the pre-crisis peak in most countries */

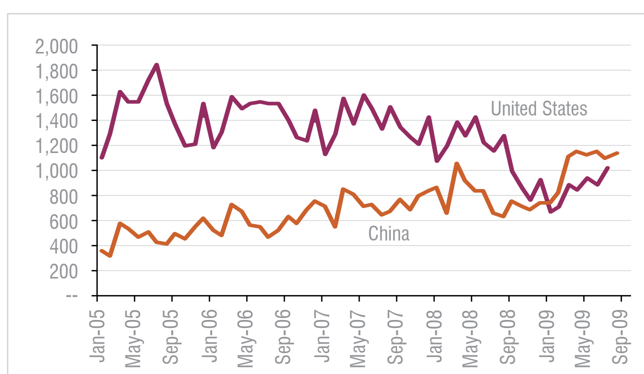
(Index, recent peak =100 and months since recent peak)



Source: Datastream and World Bank staff calculations.
*/Bars (left hand side): level of industrial production relative to the recent peak; dots (right hand side): number of months since the recent peak.

Figure 7. Vehicle sales in China have surpassed those in the U.S.

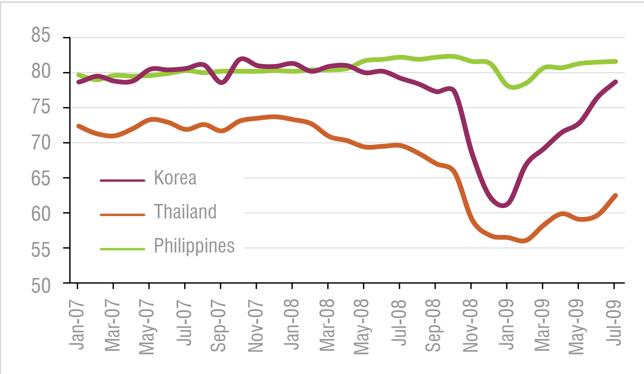
(In thousands, Jan'2005-Aug'2009)



Source: Datastream and World Bank staff calculations.

Figure 8. Capacity utilization is recovering

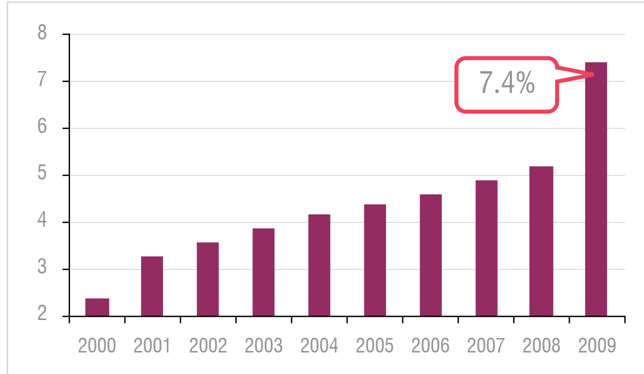
(In percent, Jan'2007-Jul'2009)



Source: CEIC and World Bank staff calculations.

Figure 9. Korea's Hyundai has increased its share in the U.S. during the crisis

(In percent of total automotive market)



Source: Autodata through Fortune magazine.

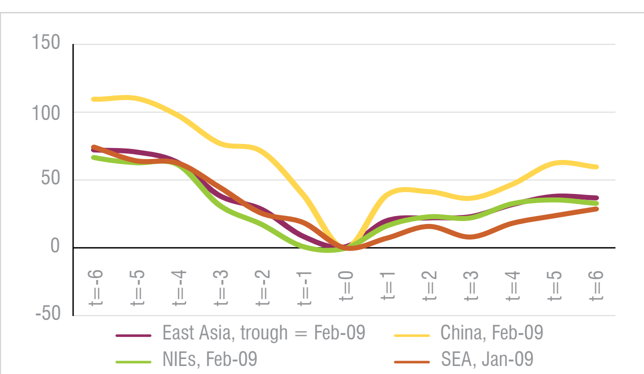
middle of last year (Figure 8). But output levels in other countries in the region, including Singapore and Taiwan (China), are still 15 percent below peaks reached 18 months earlier, trailing the pace at which recovery progressed after the 1997-98 Asian financial crisis.

EXPORTS HAVE ALSO REBOUNDED STRONGLY

Exports have bounced back from the lows reached in early 2009 as companies abroad began restocking depleted inventories and final demand within the region started picking up. But overall export levels are still a fifth lower than in 2008 because of depressed demand in developed countries. In seasonally adjusted terms, exports are up 40 percent from the trough reached in January-February 2009, following a 45 percent contraction from the pre-crisis peak in July 2008 (Figure 10 and Figure 11). Korea has led the recovery with a 65 percent surge in exports, benefitting from increased demand in China for consumer electronics and automobiles, and the ability of several Korean firms, notably car manufacturer Hyundai/Kia, to gain market share in the U.S. despite the recession there (Figure 9). China's shipments abroad have also stabilized and begun to rise, but the 35 percent increase from the February 2009 trough has yet to offset the 55 percent contraction from the peak in mid-2008 given China's dependence on final demand in developed economies.

Figure 10. Exports have rebounded, but levels are still substantially down

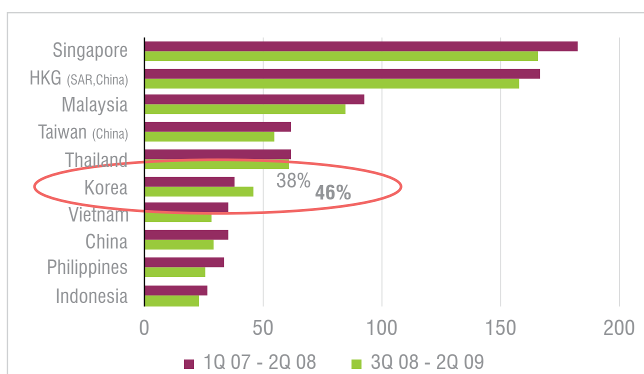
(Percent change from trough; "t" denotes the dates in the column)



Source: Datastream, CEIC and World Bank staff calculations.

Figure 11. The ratio of exports to GDP has risen only in Korea

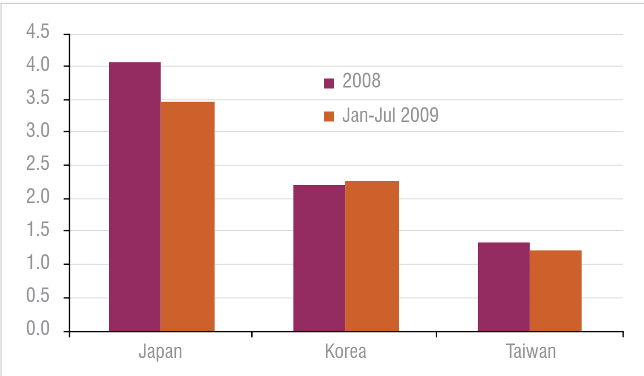
(Exports in percent of GDP)



Source: Datastream, CEIC and World Bank staff calculations.

Figure 12. Korea's companies gained global market share as others in Asia stumbled

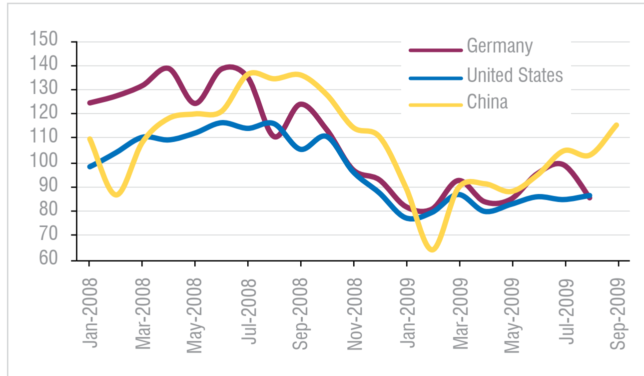
(In percent of world exports)



Source: Datastream, CEIC and World Bank staff calculations.

Figure 13. China has overtaken Germany as the world's largest exporter

(In billions of U.S. dollars)



Source: Datastream, CEIC and World Bank staff calculations.

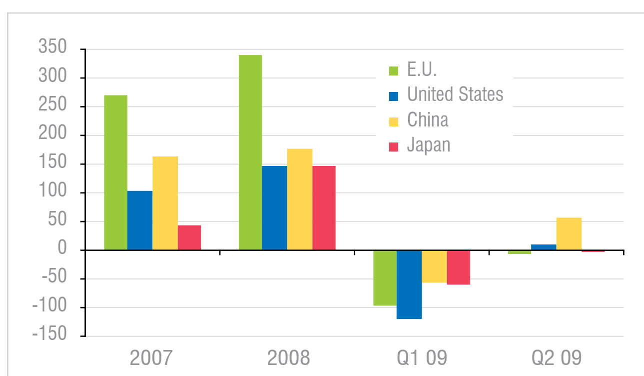
The initial contraction in exports represented a more powerful drag on real GDP growth in countries with larger export sectors, higher domestic value-added for shipments abroad, and higher share of advanced manufacturing in exports. Real GDP fell most in Thailand and Malaysia among the region's middle-income countries, in large part because of these factors, notably the higher value-added component of their electronics and automobile industries (notably in the case of Thailand).

As a result of the crisis, exports now account for a lower share of GDP in all countries in East Asia except Korea. Exports of goods and services in Korea rose from 38 percent of GDP in the year ending with the second quarter of 2008 to 46 percent in the year starting with the third quarter of 2008 (Figure 11). This outcome reflects in large part the ability of Korean firms to gain market share against key competitors from Japan and Taiwan (China) during the recession, including in export sectors with high-value added and high likelihood of strong recovery such as memory chips, mobile phones, and LCD panels.[2] China, meanwhile, overtook Germany as the world's top exporting country starting in April (Figure 13).

China has been a key factor in East Asia's and the world's foreign trade rebound this year. Although China's imports are set to fall for 2009 as a whole, they are projected to decline by much less than the G-3 combined (last panel, Figure 3). Moreover, China's imports fell by less than the imports of any of the G-3 in the first quarter and rebounded more sharply in the second quarter, as measured both in percentage terms and in U.S. dollars (Figure 14). There are two channels by which China has helped lift East Asian export performance. First, as companies began replenishing depleted inventories, those based in China as part of global supply chains restocked parts and components used for the assembly of electronics products bound primarily for the G-3. Secondly, final demand in China has risen robustly this year, supported by expansive fiscal and monetary policy, benefitting both imports of consumer

Figure 14. China's imports have rebounded more strongly than those of the G-3

(In billions of U.S. dollars)

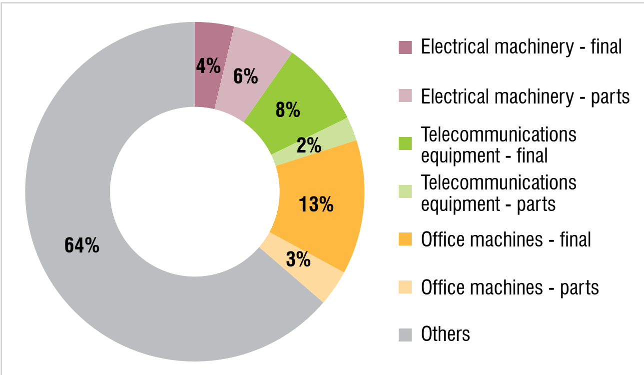


Source: Datastream, CEIC and World Bank staff calculations.

2 Korean semiconductor manufacturers Samsung Electronics and Hynix Semiconductor expanded their share of the global (DRAM) market from 53.1 percent in the second quarter of 2008 to 61 percent in the second quarter of 2009. Korean LCD manufacturers, led by Samsung and LG Display, solidified their control of the global flat-screen display market with shares rising from 45.5 percent to 49.4 percent. Mobile phone makers Samsung Electronics and LG Electronics strengthened their position in the global mobile phone market with shares up from 24.7 percent to 30.6 percent share as the relative positions of key rivals Nokia, Motorola and Sony Ericsson weakened.

Figure 15. Final goods dominate China's exports to the G-3

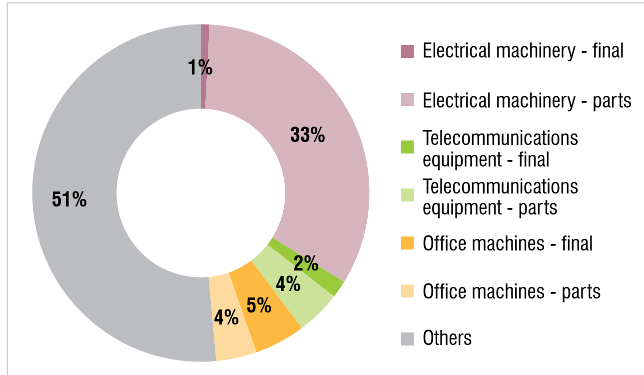
(In percent of total exports)



Source: Datastream, CEIC and World Bank staff calculations.

Figure 16. Parts and components dominate China's imports from East Asia

(In percent of total exports)

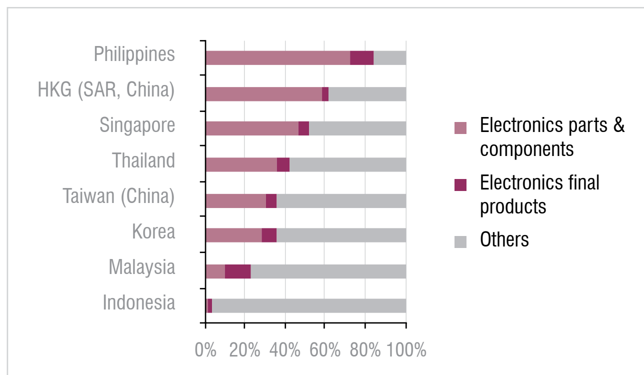


Source: Datastream, CEIC and World Bank staff calculations.

durables, notably from Korea and Taiwan (China), and raw materials used in construction activities. Part of the surge in imports of raw materials reflects strategic stock-piling by state-owned companies taking advantage of what they perceive to be low prices.

Figure 17. Parts and components dominate exports to China for all countries but Malaysia

(In percent of total exports, 2008)



Source: Datastream, CEIC and World Bank staff calculations.

Trade in electronics exemplifies China's role as an increasingly important conduit of growth between the G-3 and the rest of East Asia. Electronics products comprise a significant share of China's exports to the G-3 (36 percent) and China's imports from East Asia (49 percent).[3] China's electronics exports to the G-3, however, consist predominantly of equipment and devices (with final goods amounting to 68 percent of the total and parts for the rest), while electronics imports from East Asia are primarily parts and components with 85 percent of the total (Figure 15 through Figure 17). Until final demand for electronics in the G-3 recovers, production and exports from East Asia of electronic parts and components to China will remain subdued even if the surge in domestic demand in China is sustained.

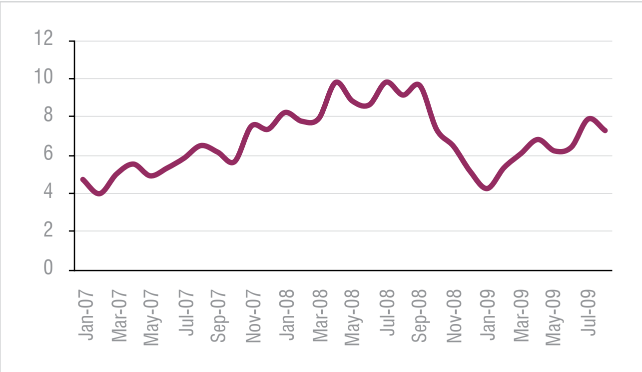
China's infrastructure-focused fiscal stimulus, combined with the surge in the country's automobile production and strategic stocking of raw materials, has boosted commodity imports and contributed to the recovery of regional exports.[4] China's imports of copper were three times the average for 2007 and 2008 in June, and purchases of primary aluminum were also much higher (Figure 18). Normally a net exporter of steel, China became a net importer this year even as its mills boosted production to 90 percent of capacity. Although East Asia's mines and mills are not the largest suppliers of metals to China, they have substantial positions that have been strengthened during the crisis. For some countries in the region, metals comprise a sizable share of total exports. For example, almost all of Mongolia's exports of copper and iron are to China. These exports, in turn, account for two-thirds of Mongolia's overall shipments abroad and strongly affect the country's economic activity (Figure 19).

3 In the discussion, electronic products are defined to consist of: (1) electrical machinery, apparatus and appliances (SITC 77); (2) telecommunications and sound recording apparatus (SITC 76) and, (3) office machines and automatic data processing equipment (SITC 75).

4 China is the world's largest consumer of crude steel (34 percent of global consumption), copper (28 percent), and aluminum (33 percent). But China is also the world's largest producer and exporter of these metals.

Figure 18. China's imports of metal ore have surged

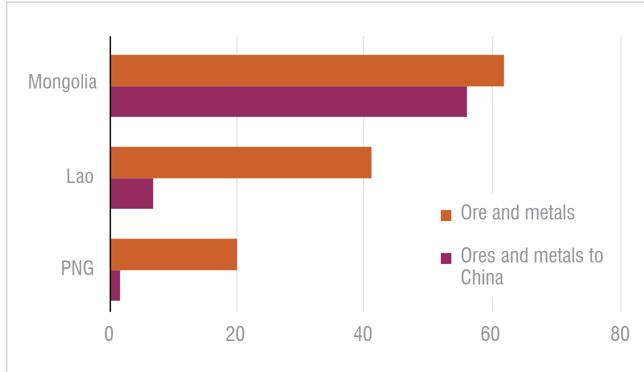
(In billions of U.S. dollars)



Source: Datastream, CEIC and World Bank staff calculations.

Figure 19. Metals account for a large share of exports for some countries in the region

(In percent of total exports, excludes gold)

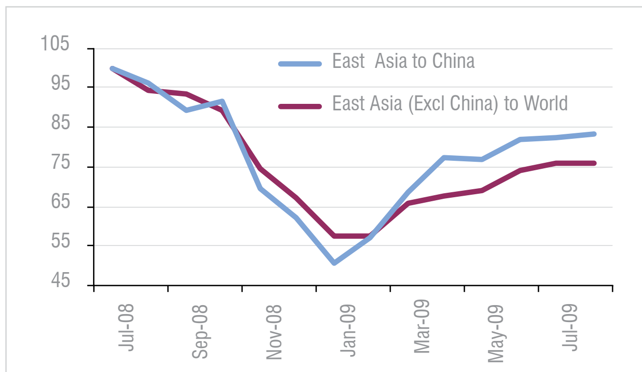


Source: Datastream, CEIC and World Bank staff calculations.

China has provided a larger boost to the rebound in regional exports than the rest of the world thus far. This is the conclusion both at the aggregate level and at the disaggregated level, including the broad range of commodities and manufactures other than electronics – fifteen products, defined at the two-digit SITC level that account for 70 percent of non-electronics trade (Figure 20). Such an outcome cannot be sustained for an extended period of time, given that the rest of the world ultimately accounts for two-thirds of regional exports that are increasingly intermediated through Chinese companies.

Figure 20. China has been a stronger driver of the regional export rebound this year than the rest of the world

(Index, U.S. dollar values of exports, June-2008=100)



Source: Datastream, CEIC and World Bank staff calculations.

Demand by China has raced ahead of global demand and demand by the G3 has lagged. Imports by the EU, the U.S. and Japan each fell more steeply than world imports during this global recession and they have recovered less sharply so far. Weak demand by the G-3, the market for 47 percent of China's exports and nearly two-thirds of the shipments abroad by East Asia, is reflected in China's trade numbers: after electronics, China's largest exports to the G-3 are consumer products (including textiles and footwear) and durables (including furniture) that have shrunk in line with weak consumer spending in the advanced economies. The other countries in the region have similarly suffered from weak G3 demand.

CAPITAL INFLOWS ARE RECOVERING

Renewed nonresident purchases of government debt, combined with repatriation of assets by local investors, shifted large capital outflows in the second half of 2008 into robust inflows during the first half of 2009, notably since March (Table 1). Resident capital reflows in the first half were the largest this decade, reflecting expectations that returns on East Asian assets will outperform those on foreign securities, especially factoring in potential currency appreciation. Such reflows are raising concerns about asset price bubbles, however, and prompting the authorities to rethink policies to address large and volatile investment flows.

Nonresidents have boosted purchases of government debt as well, facilitated by a surge in new issuance (Figure 21). Gross foreign and domestic bond issuance in East Asia amounted to $19 billion thus far this year, two and a half times the average of the last two

Table 1. Capital inflows are recovering

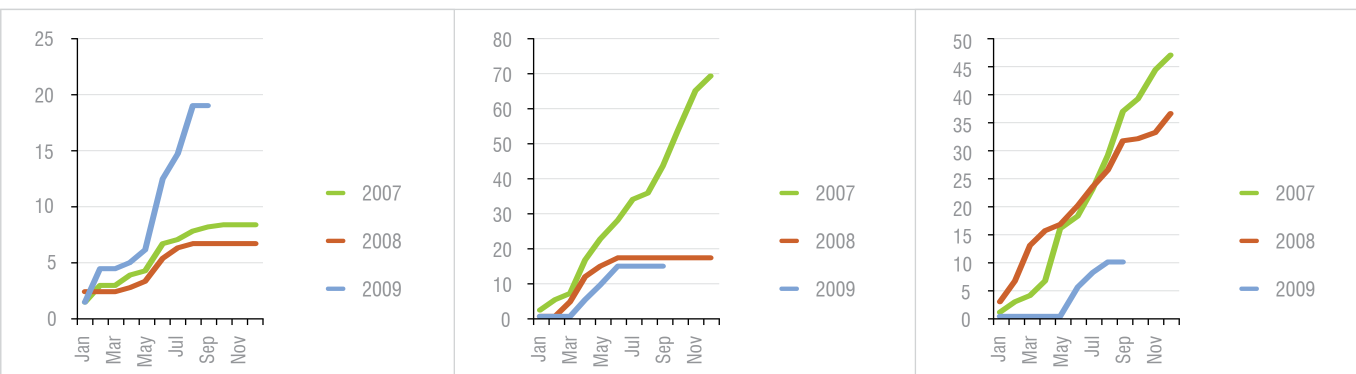
(In billions of U.S. dollars)

	2007			2008			2009
	H1	H2	Total	H1	H2	Total	H1
Net capital flows	**80**	**59**	**140**	**98**	**-99**	**-1**	**44**
Current account balance	236	254	489	253	484	737	238
Merchandise balance	206	225	431	184	402	587	206
Invisibles balance	30	29	59	69	82	151	32
Capital and financial account	64	37	101	86	-75	11	54
of which:							
FDI net	57	37	93	39	102	141	18
Portfolio	-30	-22	-52	-31	-37	-68	-1
Equity	-29	-86	-116	-46	-13	-58	-7
Debt	-1	65	64	14	-25	-11	5
Other investment	116	208	324	153	-51	102	-71
Resident lending abroad	-103	-175	-277	-74	-94	-167	104
Errors and omissions	17	22	39	12	-25	-13	-11
Reserves (-=increase)	-316	-313	-629	-351	-385	-736	-282

Source: National authorities and Bank staff projections.

Figure 21. Bond issuance has surged this year, but new IPOs and syndicated bank loans remain weak

(In billions of U.S. dollars)



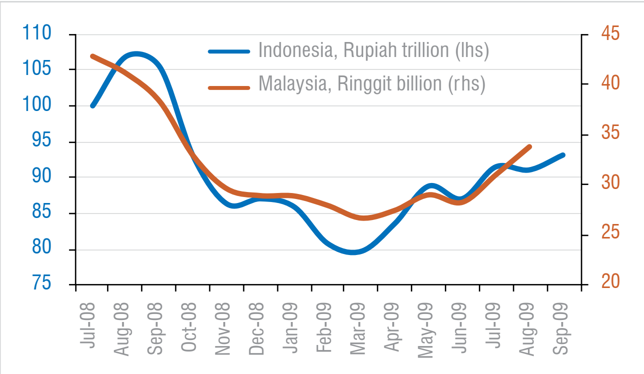
Source: Dealogic and World Bank staff calculations.

years. Indonesia and the Philippines led with issuance of dollar-denominated government bonds of more than $2 billion each, half of which has been purchased by foreign investors. Nonresident purchases of local currency denominated debt have also rebounded throughout the region, mainly in Indonesia, Malaysia and Korea, because of improved investor confidence and expectations of currency appreciation (Figure 22). In Indonesia, nonresidents have purchased the equivalent of about $7 billion since March, offsetting net sales of similar size over the previous twelve months. Yields on ten-year rupiah denominated government bonds have fallen from about 14 percent in March to less than 10 percent at present, while the currency has strengthened 14 percent against the dollar, giving investors a return of more than 20 percent.

Equity investors have returned in force to some markets while reducing holdings in others. Equity inflows have risen strongly in Korea, where investors bought $19 billion worth of equities in the first half of the year and more thereafter, and in Indonesia

Figure 22. Foreigners have resumed local bond purchases

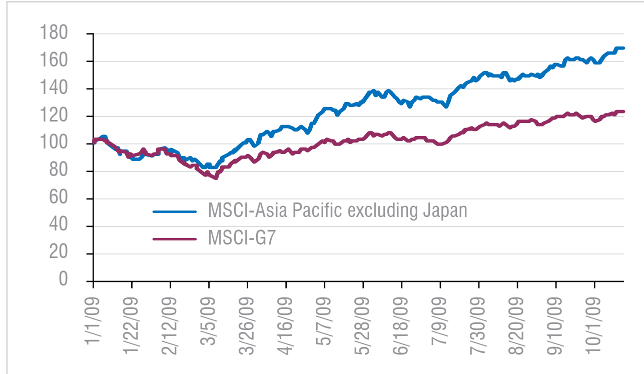
(Nonresident holdings of local-currency government bonds, in trillions of Rupiah and billions of Ringgit)



Source: Haver Analytics.

Figure 23. Equity prices in East Asia have risen faster than in developed countries this year

(Index, January 1, 2009=100)



Source: Datastream and Bloomberg.

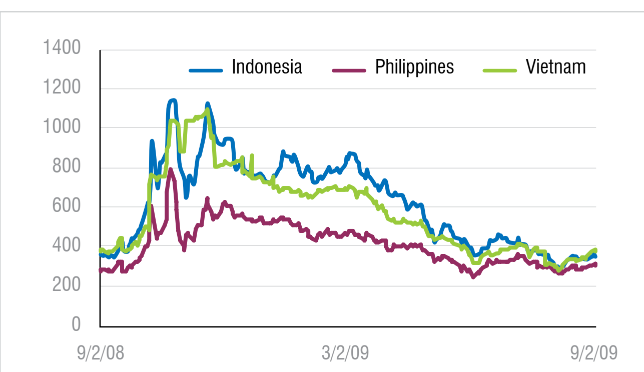
with $4 billion. These inflows compare with very large outflows from Hong Kong (SAR China), Singapore and Malaysia. It is likely that a substantial part of the $80 billion outflows from Hong Kong (China) in the first half of 2009 and the whole of 2008 combined have been repatriated to China or invested in other countries in the region.

Investor optimism that the region's growth differential with the rest of the world will remain high, combined with renewed nonresident inflows have boosted equity prices strongly this year. Share prices gained 60 percent in East Asia on average from the start of 2009 through September, dwarfing the 20 percent rise on average in developed countries and broadly offsetting the decline during 2008 (Figure 23). The market for initial public offerings began to thaw by mid-2009 and was immediately overwhelmed by new or planned large IPOs, especially from China. In July, China State Construction Engineering Corporation, the country's largest homebuilder, raised the equivalent of $7.3 billion in the world's largest IPO in 16 months. The company received bids of $242 billion according to press reports, an amount equivalent to Malaysia's GDP. Although a stronger rebound in equity prices in East Asia is to be expected given perceptions about growth and the region's much increased role in the global economy, the speed of the increase has led to renewed concerns about speculative bubbles.

International financial conditions have improved but ongoing deleveraging among foreign banks is keeping cross-border flows depressed. Gross claims on developing East Asia fell by one-fourth, or about $140 billion, from the peak reached in mid-2008 to

Figure 24. Spreads on foreign bonds are back to pre-crisis levels

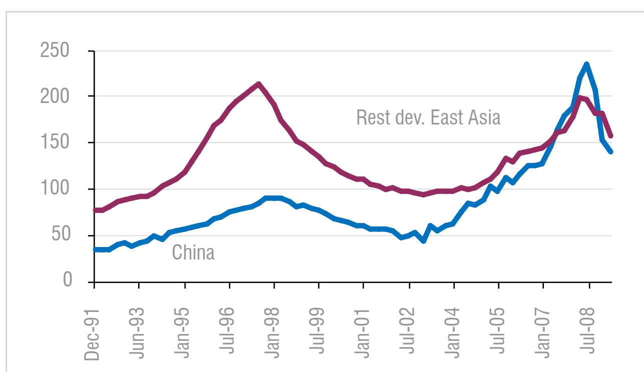
(In basis points over U.S. Treasuries, EMBIG)



Source: JPMorgan.

Figure 25. Loans and other claims by foreign banks on East Asia have declined

(In billions of U.S. dollars, 1991-March 2009)



Source: BIS.

Box 1: China's Foreign Acquistions

	Outward FDI	o/w: acquisitions
	(In billions of U.S. dollars)	
2007	27	25
2008	56	20
2009	…	22
2000-2009	…	115

2009 Acquisitions

	Company	Sector	Country	Amount (In billions of US$)	Target
I. Successful aquistions				**21.9**	
Apr-09	CNPC, PetroChina	Oil/Gas	Kazakhstan	3.3	Kazmunajgaz
May-09	PetroChina	Oil	Singapore	1.0	Singapore Petroleum, 45.5 percent
May-09	Minmetals	Metals	Australia	0.9	OZ Minerals
Jun-09	Sinopec	Oil	Switzerland	7.2	Addax Petroleum
Jul-09	CNPC & Sinopec	Oil	Angola	1.3	Marathon Oils' field
Aug-09	Yanzhou Coal	Coal	Australia	2.9	Felix Resources
Sep-09	CIC	Oil/Gas	Kazakhstan	0.9	Kazmunajgaz
Oct-09	Jein Jein Nickel	Metals	Canada	2.0	Canadian Royalties
Oct-09	CIC	Oil	Russia	0.3	45 percent stake in Nobel Oil
Oct-09	PetroChina	Oil	Canada	2.0	Athabasca oil sands
II. Acquisitions in process					
Sep-09	Chinalco	Aluminum	Russia		A stake in UC Rusal, world's largest producer
Oct-09	CNOOC	Oil	Nigeria		Offshore oil fields
Oct-09	CNOOC	Oil	US		Norway Statoil's 20 of 451 drilling leases
III. Unsuccessful acquisitions					
Oct-09	China Nonferous Metals	Rare minerals	Australia		Australia requested stake in Lynas be cut below 50 percent
Sep-09	CNOOC	Oil	Nigeria	4.0	Kosmos stake in oil field
Jun-09	Chinalco	metals	Australia	19.5	Rio Tinto

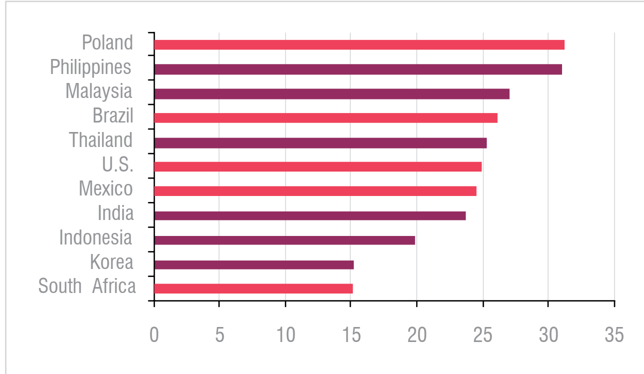
Source: News agency reports. Prepared by Sepideh Khazai.

the end of the first quarter of 2009. In dollar terms, the decline has been the sharpest in China, reflecting a much steeper earlier surge that underscored concerns about bubbles fueled by foreign flows (Figure 25). Claims on Korea also fell sharply, reflecting concerns that lasted until early 2009 about large short-term foreign currency-denominated debt. Cross-border lending has begun increasing modestly as markets began to thaw around midyear, lifting this year's new loans to about $10 billion, or one-third of last year's level. Almost all syndicated loans to East Asia this year have been for short-term maturities, however, the renewed confidence in the region notwithstanding. This contrasts with 2007 when two-thirds of lending to Malaysia was long-term.

In contrast to the other categories of capital, net inflows of foreign direct investment (FDI) have fallen after the completion of earlier agreed deals boosted net inflows to a record high in the second half of 2008. Countries that are normally net FDI recipients (China, Indonesia, Malaysia, the Philippines and Thailand) reported lower inflows, and countries that are usually net FDI investors (Korea and Taiwan, China), reported reduced outflows. The Chinese authorities and public companies have used the crisis to increase investments abroad to earn higher returns on their large foreign exchange reserves (including the $200 billion of the country's foreign exchange reserves entrusted to the China Investment Corporation, CIC, the sovereign wealth fund)

Figure 26. Corporate debt levels vary substantially across the region

(Debt in percent of assets)



Source: CEIC, Federal Reserve, IMF report 09/262.

and, led by the large state-owned companies, secure access to much needed raw materials such as oil, coal and metals (Box 1: Acquisitions by Chinese entities abroad).

THE RISING TIDE IS NOT LIFTING ALL ENTERPRISES

The corporate sector is benefitting from the broad recovery, but with exports and production below pre-crisis levels, and financing conditions tighter for all but the large companies, many small enterprises remain under substantial stress. Measures to alleviate pressures on the small and medium enterprises (SMEs) have been adopted by several countries as part of fiscal stimulus packages, with the most comprehensive package in Korea where even before the crisis nearly half of all SMEs had interest burdens in excess of operating incomes. Efforts to support the small and micro enterprises, by contrast, have been limited.

The corporate sector entered the crisis in robust health in most countries after a decade of strong growth and efforts by governments and companies to reduce reliance on external borrowing and boost cash cushions. Leverage ratios were reduced substantially over the last decade, notably in the NIEs and the countries that suffered most in that crisis. Debt levels appeared reasonable even if somewhat higher for some countries given the policy bias in favor of capital-intensive development (Figure 26). Profitability was on a modest upward trend for years before the crisis, averaging about 8 percent for East Asia by 2008 as measured by return on assets.

The impact of the crisis on companies has varied across countries, sectors and corporate characteristics.

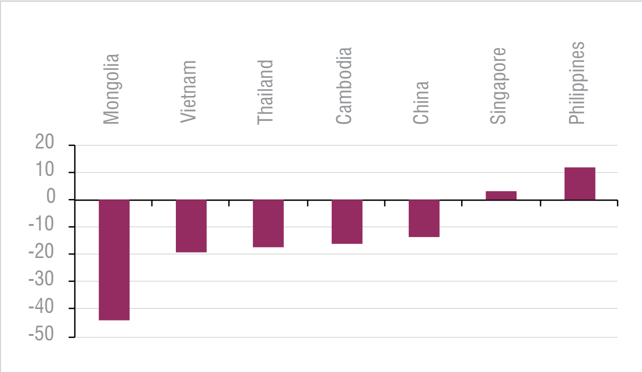
- Corporate profits fell substantially in most countries in the region in 2009 (Figure 27).[5] Indonesia, the Philippines and Lao PDR seem to be the main exceptions with rising profits. In Indonesia, the overall resilience of diverse enterprises serving the large domestic economy has partly offset the negative impact of lower prices for commodity exports to limit the slowdown in profits to 8 percent in 2009 from 29 percent the previous year. In the Philippines, profits of the companies listed on the stock exchange are on track to rise 12 percent on average in 2009 after a 27 percent reduction in 2008. Since the listed companies in the Philippines include almost exclusively firms focused on the domestic market (such as real estate developers, retailers and banks) while companies in the electronics industry and most large exporters are not listed, the results reflect primarily the robust health of the domestic economy supported by much stronger than expected remittance inflows. Anecdotal evidence also suggests that companies in Lao PDR, all of them state-owned, have done well as they have continued to benefit from ongoing work on large energy projects financed from foreign investors, and construction of infrastructure facilities in preparation for the 25th Southeast Asian Games in December 2009.

- Corporate profit growth in China has rebounded strongly among most manufacturing, construction and utility companies. This was due to the infrastructure-focused stimulus package that included a surge in new bank lending, much of it directed to state enterprises. (Figure 28).

5 For China and the Philippines, corporate income tax receipts give similar information to data on corporate profits. Such data is not available for the other countries. Data are adjusted in countries where companies pay taxes in the current year on the basis of assessments for the previous year. For Cambodia, receipts from corporate income taxes account for less than 2 percent of GDP and may not be representative of the corporate sector, as the garment manufacturers - the companies hit worst by the recession - are still exempt from paying tax.

Figure 27. Corporate profits are mostly down in 2009 */

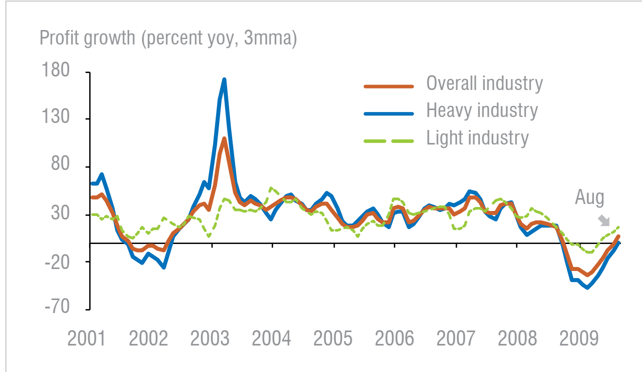
(Percent change year-on-year)



Source: National authorities and World Bank staff calculations.
*/ Philippines: data for companies listed on the stock exchange (which represents a subset of all companies); China: industrial profits; all other countries: receipts of corporate income taxes in January-August, except for Cambodia where June to August is used, as the earlier period reflects payments of taxes on income from 2008.

Figure 28. Profit growth in China has rebounded, levels still down for 2009

(In percent, year-on-year from 3-mo moving average)



Source: Eric Le Borgne, S. Namingit and F. Loyola, 2009, Impact of the Global Crisis on the Philippines' Non-Financial Corporate Sector, the World Bank.

- The downturn hit export-oriented companies and small- and micro-enterprises the hardest. Companies that were part of global production networks faced a precipitous drop in orders and output in late 2008 and early 2009, prompting them to freeze investment and reduce labor costs. With balance sheets strong, most electronics companies preferred to retain staff, in part because of concerns that once a recovery starts they will have difficulty finding skilled workers (Box 2: Impact of the crisis on the electronics and electrical sector in Malaysia). In Cambodia, nearly a fifth of garment factories closed (many without paying final wages) and many more trimmed production substantially after the sharp decline in garment exports to the U.S., Cambodia's main market. Industries with a larger share of contract workers suffered a deeper cut in employment. Output and exports in the Thai automotive industry fell about 40 percent year-on-year in the first quarter of 2009, reducing capacity utilization in half and prompting companies to lay off or furlough about a third of the labor force, or 100,000 workers (equivalent to a third of the total job losses in the formal sector in Thailand).

- Most large retailers have weathered the crisis well, while informal retail outlets are experiencing sharply reduced sales in most countries. In the Philippines, a recently completed survey reveals that sales of informal garments, bags, shoes and electronics are down 35-40 percent in January-August from a year earlier, and a quarter of all owners of such outlets feel the crisis has not bottomed out yet.[6] Individuals in the minimum wage segment who have experienced the brunt of the crisis are now cautious to spend.

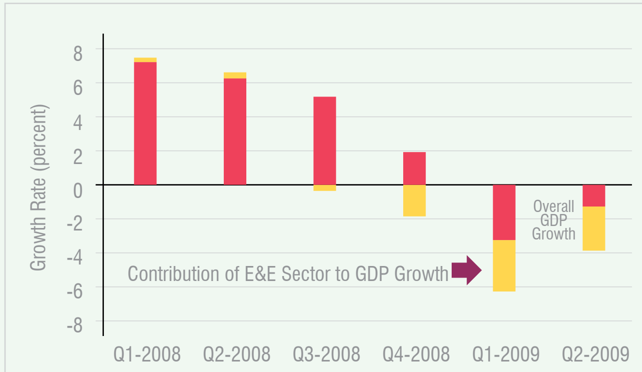
- The Business Process Outsourcing (BPO) industry in the Philippines remains a bright spot. Revenues are on track to increase 20 percent in 2009, despite a modest slowdown in the first half when the volume of voice services slowed because of difficulties among the main retail clients in the U.S. As the global recession intensified, so did the need for companies in developed economies to review their cost structures, operating processes, and value added chains. This is leading to a renewed wave of outsourcing with sectors that experienced large disruptions (e.g., banking) being the quickest to react: many large banking groups, as a result, are significantly expanding their presence in the Philippines. The global BPO sector is strategically looking for a back-up to India ("India plus one" strategy) and the Philippines seems to have established itself as the preferred choice given comparable costs, knowledge of English, and technical skills.

6 The survey was carried out by a team led by Eric le Borgne from the World Bank office in the Philippines during August 15 to September 15, 2009.

Box 2. Malaysia: Crisis, Recovery and Supply Chain Management, Insights from Japanese Multinationals in the Electrical and Electronics Sector[1]

The electrical and electronics (E&E) sector makes a large contribution to the economy of Malaysia, accounting for 38 percent of exports and 9 percent of GDP. The slump in foreign demand led to sharp production cuts among E&E companies and was a key contributor to the contraction in real GDP in the fourth quarter of 2008 and the first quarter of 2009 (Figure 1). With signs of recovery emerging, the industry is playing a similarly important part in the pickup of overall activity. Because of the significance of the E&E sector, it is essential to understand the impact of the crisis and the rebound at the firm level. What has allowed firms to cut production so quickly? How are firms seeing the prospects for the recovery?

Figure 1. The E&E Sector accounted for 55 percent of the GDP contraction in H1-2009



Focusing on the Japanese multinationals in the E&E sector, a subset of all manufacturers in Malaysia, we argue that a crucial role is played by the supply chain management practices of these firms.[2] Following decades of foreign direct investment, Japanese multinationals have contributed to the massive expansion of trade both between Malaysia and the rest of the region, and within Malaysia, as supporting industries have followed their larger clients. As a result of these developments, and thanks to the move towards less vertical integration of production within firms, there are now more than 1,300 Japanese and Japanese-related companies in Malaysia, and their supply chains embody complex linkages—both regionally and locally. As argued below, the efforts by firms to manage total supply chain costs provide important clues to the impact of the crisis and prospects for a recovery.

One of the most distinctive features of the recent crisis was the very rapid adjustment of production in response to cuts in forecasts for final demand. Purchase contracts for firms' output are usually specified on a monthly basis (depending on the level of customization of products). Therefore, when forecasts of final demand were reduced around September and October, buyers were able to cut their orders immediately, affecting deliveries starting in November and December. As orders for their products were cut, firms reduced or shut down production with minimal lag. This was thanks to the use of short-term supply contracts that matched contracts for their outputs, flexibility in adjusting labor costs, and improved management of inventories of both inputs and outputs (including the increased use of suppliers located in Malaysia). As a result, some of the companies interviewed cut production by 60-75 percent in December 2008.

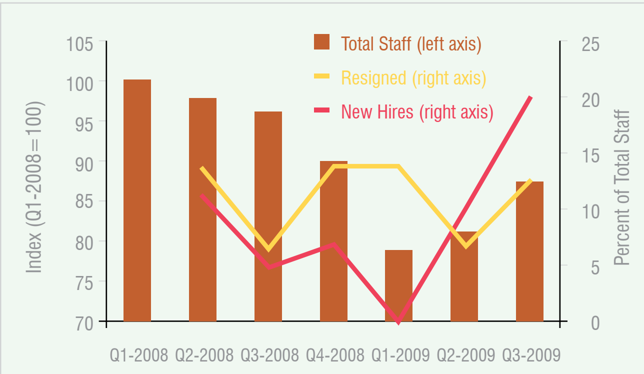
Firms began cutting labor inputs by reducing hours, including second and third shifts, laying off contract laborers, and freezing hiring. Wage cuts were not reported, but companies shut down plants (especially around holidays) with proportional cuts in salary payments. Few regular staff were laid off, reflecting company concerns that they will not be able to hire workers with the same sets of skills given widely perceived shortages of skilled and semi-skilled labor. However, the contracts of many contract workers were not renewed. This was especially true of foreign workers who comprise as much as 40 percent of the labor force in the companies interviewed. Termination of contract workers appears to have been the main mechanism through which companies reduced headcount, with one firm reporting that its staff was reduced by 25 percent, mostly from cutting foreign contract workers. Other firms implemented hiring freezes, which reduced headcounts given normal attrition following the payment of year-end bonuses (staff turnover was reported to be very high in general, likely due to chronic labor shortages). Figure 2 illustrates how an actual firm accomplished labor reductions through turnover.

Adjustments to material inputs were linked to tight management of inventories, especially through the use of short-term supply

1 This box draws upon forthcoming study on Japanese supply chains in the E&E industry in Malaysia and Thailand, produced by Ratchada Anantavrasilpa, Kirida Bhaopichitr, Frederico Gil Sander, Rie Hikiji, and Philip Schellekens.

2 Companies interviewed included producers of semi-conductors, consumer electronics, electrical equipment and white goods, as well as suppliers to these companies.

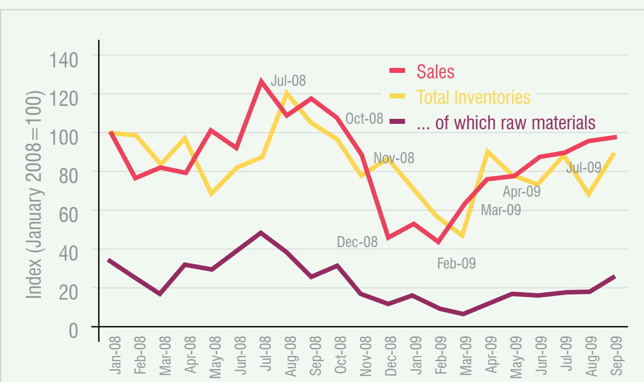
Figure 2. This firm froze hiring in Q1-2009, resulting in a 20-percent cut in headcount from Q1-2008



contracts, information technology, and local suppliers. Supply contracts (including for business services, such as logistics), are usually adjusted quarterly and typically only specify prices and quality, while quantities are adjusted more frequently. Figure 3 shows an example for an actual firm that illustrates this point. In addition, a gradual move to local supporting industries also reduced the need for inventories. For example, a supplier who ten years ago had to buy critical inputs in bulk because of freight costs now can place orders from a local supplier on an almost daily basis. Finally, the use of information technology in supply chain management has allowed firms to have an accurate and timely picture of their input needs, inventory situation and orders, contributing to a quick transmission of final demand drop through the entire supply chain.

Some of the factors that contributed to the speed of the contraction are playing a role in the recovery. Because final demand dropped by less than forecast at the onset of the crisis, orders had to be filled from existing inventories. The advances in inventory management described earlier implied that inventory levels were low, so the drawdowns in inventories in the first quarter quickly led to new orders. The companies' ability to quickly adjust costs downward in the downturn protected their balance sheets, which were relatively healthy at the onset of the crisis anyway. The soundness of corporate balance sheets contributed to a quick restart of production, as few firms faced constraints to finance the working capital required. One additional reason for the financial soundness of a number of smaller Malaysian E&E firms has been lack of investment in recent years, which meant firms had higher levels of retained earnings that could be used as a buffer in case of a shock.

Figure 3. Inventories of this firm were cut (or increased) with about a one-month lag to change in sales

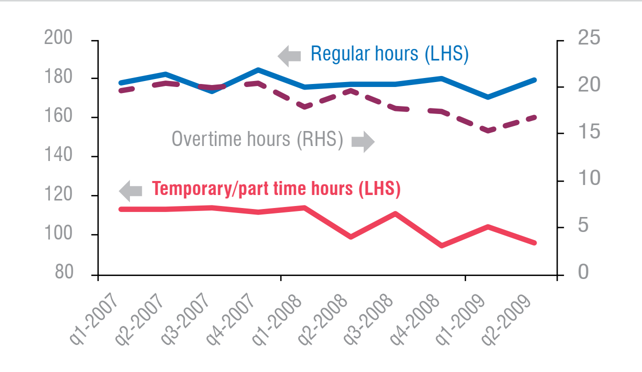


In other cases, responses to the crisis created frictions that slowed recovery, especially with respect to labor inputs, and shortage of semi-skilled and unskilled workers was widely reported in firm interviews. By April and May firms were already trying to re-hire workers, but they faced shortages. Firms attributed shortages partly to government efforts to reduce the economy's dependence on foreign workers, which contributed to delays in renewed labor inflows. Some companies claimed that production was still below order levels due to worker shortages and as a consequence were offering higher wages. Frictions created by suppliers' ability to restart production were also reported, but appeared less salient than labor issues.

Firms were unsure about the outlook for the recovery, but the impact of expectations within the supply chain is limited since in the near term firms are "expectations takers" from the parent companies. Improvements in inventory management have decreased the horizon of forecasting at the level of the firms within the supply chain, which are able to quickly ramp up production in response to increased orders – at least while capacity utilization is still well below potential. However, the uncertain outlook may have important implications in the medium-term, as some firms may delay capital expenditures needed to increase capacity. Because of limited vertical integration, bottlenecks may emerge that could initially limit the speed of the recovery.

Figure 29. Korea: overtime, temporary and part-time hours cut

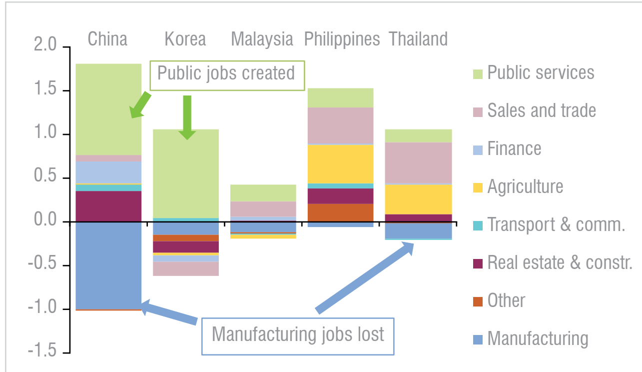
(Average hours worked per month)



Source: CEIC database and country statistical offices.
*/ For Thailand and Malaysia pre- crisis period is October 2007- April 2008 and post -crisis period is October 2008- April 2009. For the Philippines: October 2007- July 2008 vs. October 2008- July 2009. For Malaysia: October 2007- April 2008 vs. October 2008- April 2009. For Indonesia and Singapore: February-June 2008 and February-June 2009.

Figure 30. Out of manufacturing and into public services or retail trade

(In millions, second quarter of 2009 or latest available compared with a year earlier)



Source: CEIC for China, Korea, and the Philippines; Labor Market Reports of the Department of Statistics for Malaysia; and the Thailand National Statistical Office.

Government policies to support micro, small and medium-sized enterprises (MSMEs) have helped in some countries, but significant vulnerabilities remain especially for small and micro enterprises. In Thailand, MSMEs account for 99.7 percent of all registered firms, 38 percent of overall GDP and 76 percent of jobs created in a typical year before the crisis. While they continued to generate jobs during the downturn, absorbing the laid off formal sector workers in many cases, their incomes are reported to have declined by 20-40 percent on average. Tighter bank credit conditions, including the reduced availability of trade financing and the slowdown in remittances (that tend to finance investment for the small- and micro-enterprises), also disproportionally affected such firms.

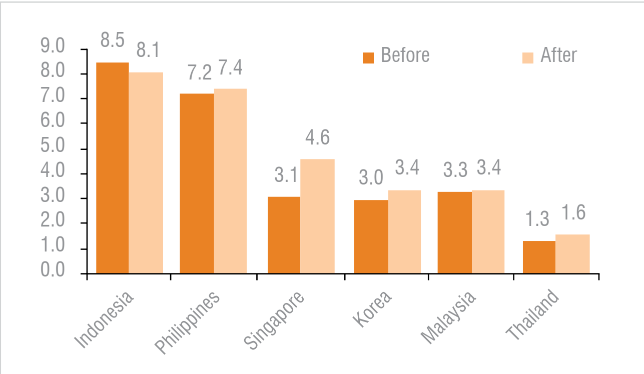
THE CRISIS HAS AFFECTED WORKERS ACROSS SECTORS AND REGIONS

Enterprises – both formal and informal – adjusted to weaker demand through reducing hours worked and often through cutting wages and incomes and less often through letting workers go. Where workers were laid off in the formal sector, employers began by cutting temporary and part-time workers and only as a last resort did they reduce permanent employees. In Vietnam, as in many other countries in the region, factories have preferred to reduce the working hours of trained and skilled workers so as to contain eventual re-recruitment and training costs. In Korea, companies cut overtime, extra shifts and part-time workers, while preserving full-time workers that are backed by strict labor laws (Figure 29). In Thailand, the automotive sector cut a third of its labor force at the start of 2009, or 100,000 workers, and almost all of them were part-time or contract employees. In Cambodia, the number of working days of construction workers fell to 10-20 days a month for several months, while some garment workers work as few as 10 days.

Job losses were substantial in key export manufacturing sectors in many countries, but companies have begun hiring again since mid-2009. In China, Philippines and Thailand, employment in the manufacturing sector fell 2 percent year-on-year by April 2009, when job losses in manufacturing appear to have troughed. Factories in China's coastal regions now report shortages. In Thailand, automotive factories added a second shift to their production in August after eliminating it in January, and have begun hiring temporary and contract workers anew. In Malaysia, companies in a segment of the electronics sector (as described in Box 2) froze hiring in the first quarter of 2009 and refused to renew contracts of contract workers, resulting in a 20 percent reduction in headcount in the first quarter of 2009 from a year earlier. A few months later, however, companies have begun looking for new workers but are reporting shortages. In Cambodia, by contrast, there is scant evidence that companies are moving to boost

Figure 31. Increases in unemployment rates have been limited */

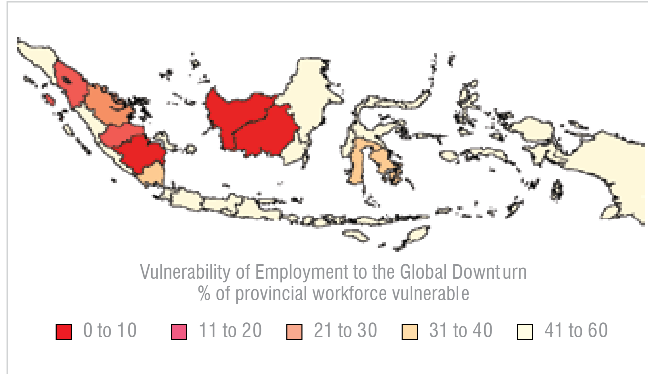
(In percent, average for the year before September 2008 and the year after)



Source: CEIC database and country statistical offices.
*/ For Thailand and Malaysia pre- crisis period is October 2007- April 2008 and post -crisis period is October 2008- April 2009. For the Philippines: October 2007- July 2008 vs. October 2008- July 2009. For Malaysia: October 2007- April 2008 vs. October 2008- April 2009. For Indonesia and Singapore: February-June 2008 and February-June 2009.

Figure 32. Indonesia: employment dislocations are spatially concentrated

(Percent of provincial workforce vulnerable)



Source: World Bank, (2009) Indonesia Quarterly, Weathering the Storm, June 2009.
Note: "Vulnerable employment" is defined as employment in crisis-affected sectors.

employment after laying off 65,000 workers earlier this year.

Workers let go have typically found jobs either in other sectors or more often in the informal sector at lower pay. In China, Korea, and the Philippines, job losses in the manufacturing sector were accompanied by job creation in agriculture, trading, and construction, with large share of the jobs in some countries in the informal sector. Moreover in China, Korea and the Philippines, new publicly financed jobs were created as a result of the fiscal stimulus packages (Figure 30). As a result, unemployment rose by less than half a percentage point on average in the year after the crisis compared with the year before the crisis, except in Indonesia (where it fell) and in Singapore (Figure 31). Nonetheless, the significant proportion of job creation in agriculture and the wholesale and retail sectors during the crisis suggests that many workers have moved into marginal urban jobs as a coping strategy. Though specific data are scarce, qualitative assessments of the crisis suggest that this shift has increased competition among informal enterprises and put downward pressure on incomes.

The impact of the employment dislocations have typically been spatially concentrated., given the rising role of agglomeration economies in the region. In Indonesia, vulnerable jobs are spatially concentrated in the few regions that produce estate crops for which world prices have dropped significantly and where local economies are relatively undiversified, such as parts of Kalimantan and Sumatra (Figure 32).

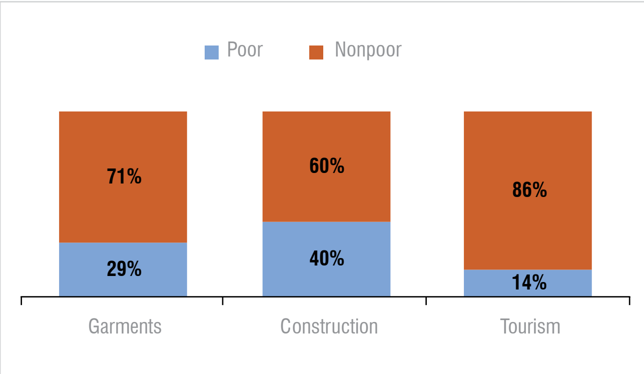
The crisis has affected workers across genders and across the income distribution. In Cambodia, the three most affected sectors have been export manufacturing (garments), construction, and tourism. Layoffs in the garment sector have affected workers at all levels of income given the fairly even income distribution for such employees. In the construction sector, meanwhile, the bulk of the workers are poor, while a small share of employees are poor in the tourism industry. Although much attention has focused on the impacts of the crisis on female workers who are concentrated in the garment sector, the data suggest that male workers, concentrated in the construction sector, have also been quite vulnerable during the crisis.

THE PACE OF POVERTY REDUCTION HAS SLOWED

The crisis has slowed the pace of poverty reduction in the region. It is estimated that there will be about 9 million more extreme and moderate poor in the region – people earning less than $2 day – in 2009 and 14 million more extreme and moderate poor in

Figure 33. Cambodia: the impact of the crisis is felt by both the poor and the non-poor ...

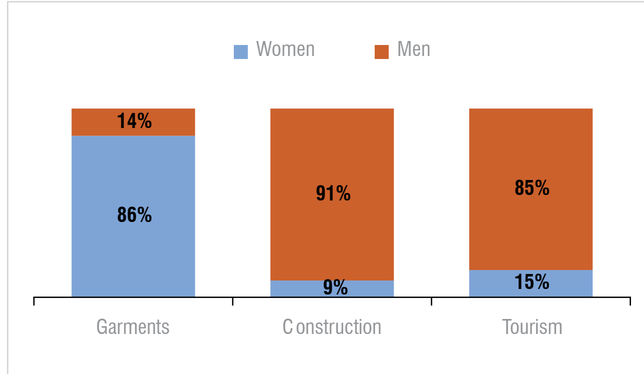
(Percent of total employed in sector)



Source: Cambodia Statistics Office.

Figure 34. ... and across the gender divide

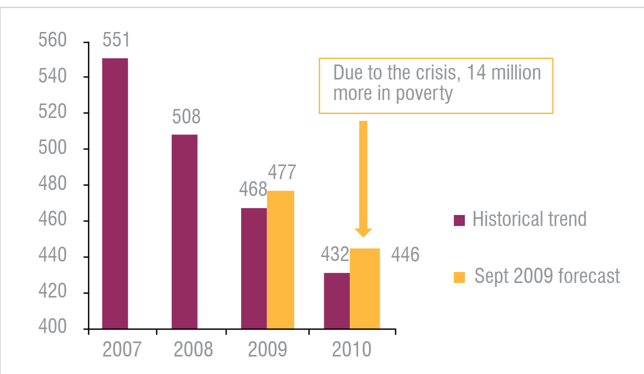
(Percent of total employed in sector)



Source: Cambodia Statistics Office.

Figure 35. Due to the crisis, 14 million more people will be in poverty in 2010 */

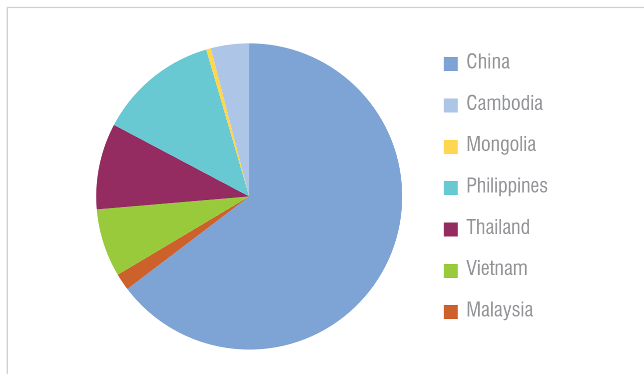
(In millions)



Source: World Bank staff estimates.
Note: Estimates using a poverty line of $2-a-day (purchasing power parity), calculated as the difference between: (a) the poverty headcount in 2010 that would have resulted had historical (2001-2005) growth rates persisted and (b) poverty headcount in 2010 using current growth projections in the form of the crisis.

Figure 36. Most of the additional poor will be in middle-income countries

(In millions)



Source: World Bank staff estimates.
2010 using current growth projections in the form of the crisis.

the region in 2010 as a result of the crisis (Figure 35).[7] These numbers are about eight million lower than our projections from April 2009, primarily because of upward revisions of our growth projections. As in our earlier assessments, most of the additional poor will come from the large middle- income countries because of the sheer size of the population there. China is projected to account for nearly 9 million of the additional estimated poor (Figure 36). The additional estimated poor coming from the smaller, low income countries in the region is expected to be around 5 million. All of these projections are subject to substantial uncertainty, both because of risks to the global and regional economic outlook, but also given the lack of higher frequency data on disaggregated household incomes and consumption. Even when such data are available, interpretation may be challenging, with additional complications for the appropriate policy response (see Box 3, Philippines: The Growth-Poverty Nexus).

7 With rapid income growth and the emergence of several middle-income countries in the region since the 1990s, consideration of a poverty benchmark higher than the absolute poverty line of $1.25 a day is being increasingly dominant in policy discussions. The $2 a day poverty line has more relevance for poverty is used in this update to maintain greater policy relevance.

Box 3. Philippines: The Growth-Poverty Nexus

Weak economic growth has been a long-standing problem in the Philippines, and largely accounted for the slow progress made in poverty reduction during the 1980s and 1990s. When economic growth finally accelerated after 2001, expectations were raised that poverty would henceforth fall at a faster pace. These hopes were dashed by the 2006 household survey, which indicated that the improved economic performance had not translated into poverty reduction. Rather than declining, the poverty headcount ratio was unchanged in 2006 compared with 2000, and actually increased relative to 2003.

Poverty Estimates based on Constant (2006) National Poverty Lines

	Poverty Headcount Ratios		
	2000	2003	2006
Urban	16.8	17.3	19.5
Rural	44.7	44.4	45.9
Total	**31.0**	**31.1**	**32.9**
Official estimates based on variable poverty lines			
	33.0	**30.0**	**32.9**

Source: World Bank, based on FIES 2000-2003-2006

Why has poverty not declined since 2000? The stronger real GDP growth during 2000-2006 according to national account statistics (NA) is in contrast to data from the Philippines household surveys that indicate average real household income and consumption were steadily declining during this period. According to the Family Income and Expenditure Surveys (FIES), from which the poverty indicators are drawn, average per capita consumption declined by 1.5 percent a year. This removes all mystery from the observed increase in poverty after 2003, since it only confirms the commonly observed negative relationship between poverty and growth in consumption. Instead, what remains puzzling is that the NA data indicate annual per capita growth of more than 2 percent a year in 2000-06, while the FIES surveys show negative growth.

Per Capita Income and Expenditures in the Philippines

(In percent, average annual growth rates in constant prices)

	1985-1997	2000-03	2003-06	2000-06
	Based on data from household surveys			
Expenditures per capita	2.7	-0.9	-0.5	-0.7
Income per capita	na	-1.7	-1.2	-1.4
	Based on national accounts data			
Consumption per capita	1.7	2.3	3.5	2.9
GDP per capita	1.4	1.7	3.6	2.7

Source: The household survey-based figures refer to the Family Income and Expenditure Survey; the figures up to 1997 are from the World Bank (2001), Philippines Poverty Assessment, and the figures as of 2000 are from the Philippines National Statistics Office. The National Accounts-based growth rates are from the World Bank Development Database.

It turns out that the divergence between survey- and NA-based growth data is not unique to the Philippines. As noted by Angus Deaton (2006) in a comprehensive cross-country review,[1] NA estimates are typically, though not always, larger than survey-based estimates, and there is a tendency for the National Accounts-based estimates to grow more rapidly than the survey-based estimates. He also notes that household survey data generally underestimate real consumption and income growth (mainly because the more affluent households are generally under-represented in the survey samples), while NA data tend to over-estimate growth (primarily on account of measurement conventions in the compilation of GDP).[2] Even though the National Accounts tend to over-estimate growth, however, an abundance of anecdotal evidence (e.g., export growth, corporate profits) indicates that, on balance, aggregate economic growth has been positive during 2000-06. Similarly, reports from the Philippines' Social Weather Station corroborate the finding that poverty has not declined. This suggests that the growth that did take place during that period in the Philippines must also have been associated with a deteriorating distribution of income. This is a matter of concern, as the country already exhibits among the highest degrees of income inequality in the region.

1 Deaton, Angus (2005), "Measuring Poverty in a Growing World (or Measuring Growth in a Poor World)" Review of Economics and Statistics, Vol. LXXXVIII, No. 1, February, page 6.

2 There may also be shortcomings in the quality of the Philippines National Accounts that have exacerbated the overestimation of GDP growth. See, Medalla, F. and K. Jandoc (2008), "Philippine GDP Growth after the Asian Financial Crisis: Resilient Economy or Weak Statistical System?", University of the Philippines, School of Economics Discussion Paper No. 0802, May.

II. ECONOMIC POLICIES SUPPORTING RECOVERY IN EAST ASIA

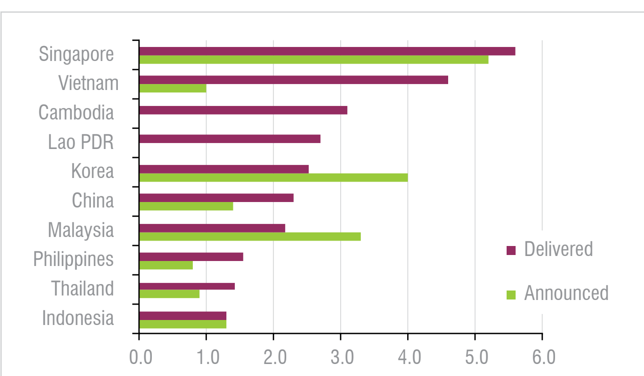
FISCAL POLICIES HAVE BEEN EASED SUBSTANTIALLY

Fiscal easing, including through implementation of fiscal stimulus measures, has helped support domestic demand in most countries in the region. As the crisis hit, the headlines were focused on the fiscal stimulus measures enacted by all of the region's middle-income countries and the NIEs. In our update issued in April ("Battling the Forces of Global Recession"), we estimated that the announced fiscal stimulus packages among these countries and Vietnam amounted to about 3.6 percent of regional GDP, with measures worth 1.7 percent of GDP to be implemented in 2009.[8] We now estimate that the fiscal stimulus in the region's middle-income countries would amount to 2.1 percent of GDP in 2009, as most countries increased spending by more than planned earlier either by announcing additional stimulus packages or accelerating expenditure plans already in the pipeline (Figure 37 and Table 2). Even if stimulus spending in some countries falls short of projections because of delays in disbursements on infrastructure projects, the outcome for the year as a whole will be almost as large as the stimulus estimated for the G-20 of about 2 percent, and will compare favorably with the outcome in the U.S. (2.4 percent), the eurozone (1.5 percent) and Japan (3.5 percent) (Figure 38). Automatic stabilizers, however, are also supporting domestic incomes and demand, although they are smaller in the region than in the advanced economies.

During the year, several of the low-income and resource-rich countries in the region implemented substantial spending increases that were considered less likely at the start of the year. The discretionary stimulus injected by the governments of Cambodia and Lao PDR, amounted to about 3 percent of GDP, larger than many of the region's middle-income countries. Contrary to earlier expectations that low-income countries would limit spending increases to additional foreign aid, the countries primarily financed additional spending by drawing down domestic deposits, borrowing from domestic banks and direct lending by the central bank (in Lao PDR). Among the resource-rich countries that were able to save substantial portion of earlier windfall gains from high commodity prices, PNG boosted spending by about 5 percent of non-oil GDP.

Figure 37. Most countries delivered more fiscal stimulus than announced

(in percent of GDP)



Source: National authorities and staff estimates and projections.

Table 2. Fiscal deficits have risen due to fiscal stimulus packages and weaker economic activity

(in percent of GDP)

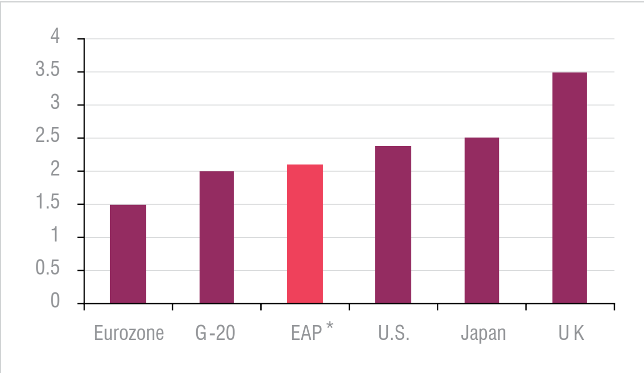
	2007	2008	2009
Cambodia	-2.9	-2.2	-6.7
China	0.6	-0.4	-3.3
Indonesia	-1.3	-0.1	-2.4
South Korea	3.8	1.2	-2.5
Lao PDR	-2.8	-2.0	-6.7
Malaysia	-3.2	-4.8	-7.8
Mongolia	2.8	-5.0	-6.5
Philippines	-1.7	-1.5	-3.8
Singapore	7.3	12.4	4.2
Thailand	-1.7	-1.1	-4.2
Vietnam	-5.3	-4.2	-9.4

Source: National authorities and Bank staff projections.

8 This calculation refers only to the fiscal stimulus to be implemented only by central governments, which in China is only a third of the RMB 4 trillion infrastructure-stimulus package; in Malaysia is about half of the MYR 67 billion total of the first and second stimulus packages, and in the Philippines is about two-thirds of the PHP 330 billion resiliency package. There are other elements in fiscal stimulus packages in the packages of the other countries in the region that do not immediately affect the central government budget. The headline number of all announced stimulus packages in the region's middle-income countries and the NIEs was equivalent to 9.4 percent of their GDP, with measures equivalent to 5 percent of GDP to be implemented in 2009.

Figure 38. Fiscal stimulus implemented in East Asia compares favorably with that in advanced countries

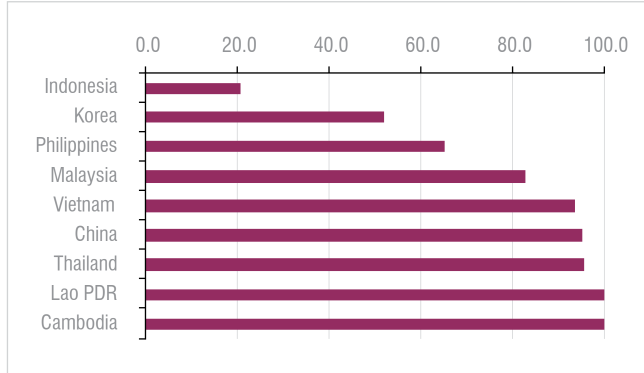
(in percent of GDP)



Source: National authorities and staff estimates and projections. */EAP denotes East Asia and the Pacific

Figure 39. Fiscal stimulus has been biased toward expenditures

(in percent of total stimulus)



Source: National authorities and Bank staff estimates.

Tax cuts, a category of stimulus that is the fastest to implement but is understood to have a lower short-term impact on economic activity, accounted for about one-sixth of the overall stimulus packages in the region in 2009. Only Indonesia and Korea relied on tax cuts for the bulk of their packages, emphasizing reductions in personal income taxes in the former and corporate income taxes in the latter (Figure 39).

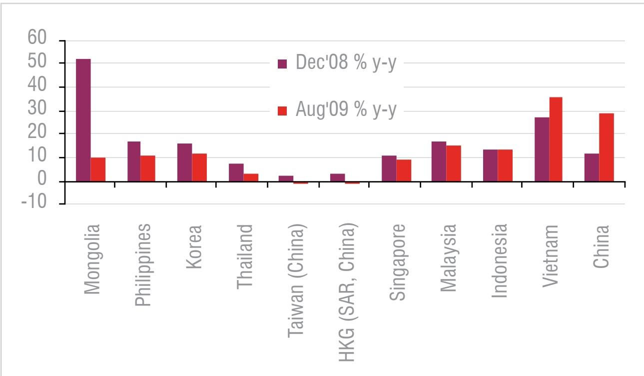
Countries in the region increased support for the poor and vulnerable. Measures included targeted and untargeted social transfers (China, Indonesia, Korea, the Philippines and Thailand), vouchers to low-income or rural households (in some cities in China, Indonesia, and Taiwan (China)), school feeding and other such schemes, and support for housing (in addition to the construction of low-income housing in China, Indonesia and Thailand). Although such support has been crucial for limiting hardship, the support in most cases was not well targeted given the lack of properly developed social protection systems in the region.

The impact of fiscal stimulus packages has varied from strongly positive in China, Singapore and Korea, to limited in Indonesia, Malaysia and Thailand. In general, the limits to countercyclical fiscal policy in countries with open economies, notably Malaysia and Thailand, are well known. Stimulus that was dominated by infrastructure and targeted social spending appears to have had the largest impact, while those focused on tax cuts and untargeted social transfers and wage increases have been least effective. In China, the government forcefully front-loaded the overall RMB4 trillion infrastructure stimulus package and combined it with a surge in bank lending to help activity bottom out in the first quarter of 2009. In Singapore and Korea, the fiscal stimulus also caused activity to rebound strongly, as it was focused on schemes to generate new jobs, support bank lending and SMEs, and accelerate already planned infrastructure spending. The inclusion of untargeted social transfers in fiscal stimulus packages, such as in Malaysia and Thailand, also led to a somewhat more limited impact on activity. Long implementation lags in Malaysia, moreover, mean that the impact on domestic demand will be felt more in late 2009 and in 2010. The fiscal package in Indonesia dominated by tax cuts did little to support economic activity; rather, it was pre-election spending that provided a more important and timely boost.

Some countries, notably China, are using their fiscal stimulus packages to advance medium-term goals. An important aspect of China's stimulus package is the extent of its investment in energy efficiency and low-carbon alternatives to road and air transport. The government is spending the equivalent of $90 billion on new rail projects in 2009, with a similar amount planned for next year. China will also spend an average $31 billion per year on energy conservation, pollution reduction and ecological improvement in 2009-11 and another $54 billion on technological upgrades in industrial restructuring in energy intensive sectors.

Figure 40. Credit growth has accelerated this year in China and Vietnam ...

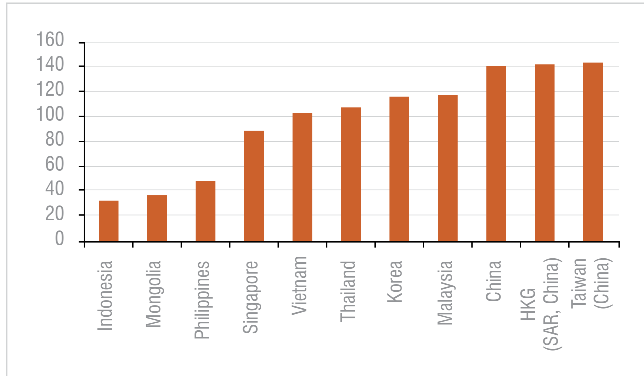
(percent change year-on-year)



Source: CEIC.

Figure 41. ... boosting substantially the level of credit to GDP

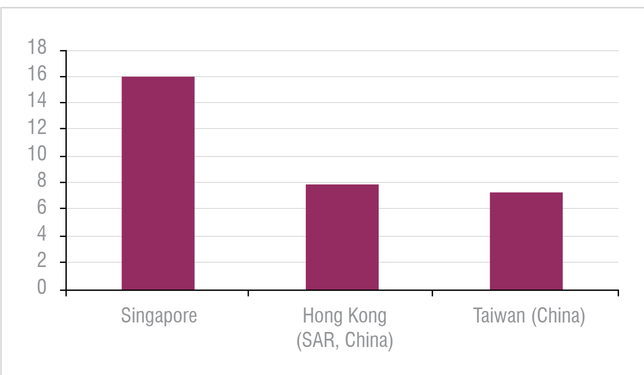
(in percent of GDP)



Source: CEIC.

Figure 42. Housing prices have rebounded sharply ...

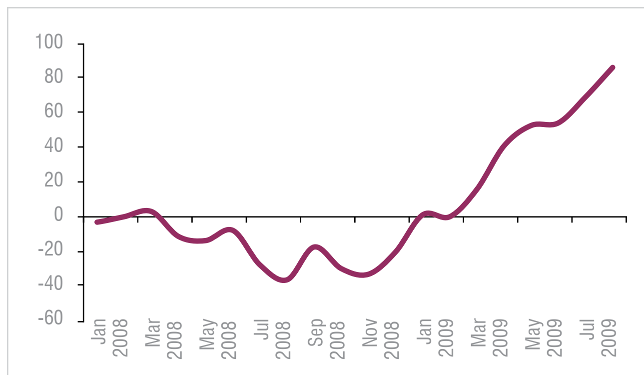
(in percent since January 2009) */



Source: CEIC. */In Singapore, during the third quarter of 2009.

Figure 43. ... as have property sales in China

(residential floor space, % change year-on-year)



Source: CEIC.

MONETARY EASING HAS SUPPORTED THE RECOVERY

With price pressures subdued, the monetary authorities in the region have maintained monetary accommodation, including low policy rates, reduced reserve requirements and other exceptional measures to support economic activity and facilitate financial institutions' access to ample liquidity. Loose monetary policy in China resulted in a surge in bank lending that provided local governments and state-owned companies with the complementary resources needed to carry out the infrastructure-focused stimulus program. As a result, new bank credit extended in China in 2009 amounted to the equivalent of one-third of GDP, raising the ratio of credit to GDP to 141 percent, the highest in the region together with Hong Kong (SAR, China) and Taiwan (China). Credit growth has also accelerated in Vietnam since the start of the year, leading to concerns that credit may be fueling asset price bubbles in both countries (Figure 40 and Figure 41).

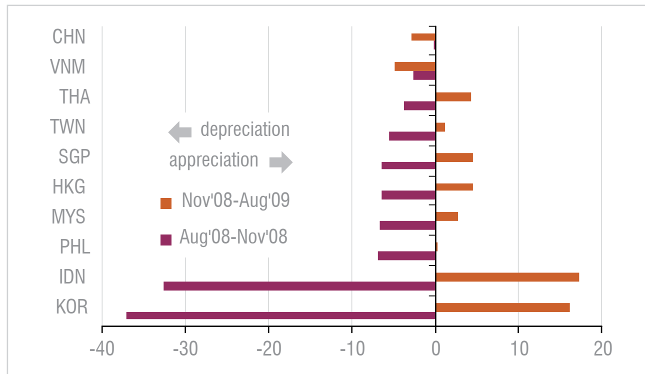
Concerns about asset price bubbles are reinforced by the rapid increase in equity and housing prices across the region. Sales of real estate have also risen strongly, notably in China, Hong Kong (SAR, China) and Singapore (Figure 42 and Figure 43). In Singapore, the 16 percent surge in property prices during the third quarter led the authorities to ease capacity constraints by releasing more land for development and to take steps not to allow borrowers to defer payments. Some central banks could set targets for the overall rate of growth of bank credit, establish caps on the share of bank lending for real estate and portfolio investments, and ban loans for short-selling – similar to what Vietnamese did in early 2008. Other measures that supervisors could use include higher collateral requirements, higher capital requirements for riskier lenders and mandatory lower loan-to-value and loan-to-repayment ratios for mortgage lending – as the monetary authority in Hong Kong (SAR, China) did recently for larger mortgages.

EXCHANGE MARKET INTERVENTION LIMITED CURRENCY APPRECIATION

China's de-facto peg to a weakening US dollar has forced the authorities in most East Asian countries to intervene heavily in foreign exchange markets to limit appreciation of their own currencies (Figure 44). The view that stronger exchange rates will be important in extracting more growth from domestic demand is yet to take firmer hold. Moreover, central banks in the region continue to show little tolerance for exchange rate volatility, even if countries such as Indonesia, Korea and Vietnam adjusted well to the adverse demand shock by allowing their currencies to weaken last year, thus limiting the drawdown on reserves. Going forward, exchange rate flexibility will be critical in managing foreign exchange inflows while keeping inflation and asset price increases in check.

Figure 44. Limited appreciation after the crisis

(percent change in nominal effective exchange rates)



Source: IMF INS.

SOCIAL POLICY HAS HELPED AMELIORATE THE IMPACT OF THE CRISIS ON THE POOR[9]

East Asian country governments, especially in the large middle income countries, have implemented several measures to cushion the impact of the slowdown on the most vulnerable. Policy responses have been helped by the smaller than expected negative impact of the crisis on unemployment and labor incomes. At the same time, the effectiveness of the responses has been limited by the lack of adequately structured and financed social safety nets in most countries.

As the economic crisis came on the heels of the food and fuel crisis that hit the region in 2008, all of the middle-income countries and Vietnam had already introduced social protection measures before the economic downturn accelerated at the turn of 2009. In the Philippines, the government scaled up the existing conditional cash transfer program (Pantawid Pamilyang Pilipino Program or 4P) by increasing its budget tenfold and Indonesia reinstated targeted unconditional transfer (Bantuan Langsung Tunai –BLT) it had first used in 2005 in response to high fuel prices. In China, rural health insurance was expanded and deepened and allocation to earthquake reconstruction in Sichuan Province was increased considerably. Even in the low-income countries including Cambodia and Laos, actions to address the food and fuel crisis provided a stepping stone to build a more systematic response to the economic downturn, and partnerships continued with donors and NGOs on cash- and food-for-work programs that were particularly well suited to countries with lower capacity.

9 This section draws heavily from: ASEAN and World Bank (2009) "ASEAN Assessment on the Social Impacts of the Global Financial Crisis: A Snap-shot Report for notation at the 15th ASEAN Summit, Thailand, 23 October 2009"

Additional social protection measures implemented during the crisis have depended on available fiscal space and institutional capacity. Cash transfers, both targeted and untargeted, were combined with in-kind transfers in Vietnam and all middle-income countries except Indonesia, extended benefits under existing social safety nets (Cambodia, China and the Philippines), and subsidies to households for health and education (the Philippines and Thailand).

The investments in infrastructure supported under the fiscal stimulus packages have also had a substantial positive labor impact. China's infrastructure-focused stimulus package has captured the headlines. But the stimulus packages in Indonesia, Philippines, Vietnam, and Thailand also included community-based small-scale infrastructure projects that were designed to create temporary employment opportunities.[10]

Subsidies for worker training were also a common element in the region's stimulus packages. Malaysia has provided employers with monetary incentives to retain or hire employees and provide training, and Thailand devoted significant stimulus funds to subsidized capacity building programs. Special skills training program have also been implemented in China, Cambodia and Laos.

The crisis has underscored the urgency of developing a more coherent approach to social protection in the region, including through selective social insurance schemes. In the Philippines, additional benefits have been provided to members of various social security institutions, while in China significant efforts were made to increase pension benefits, expand rural pension schemes, and broaden rural health insurance. The latter measures have been implemented in addition to increasing the threshold for minimum living allowance under China' Dibao program and providing a one- time income support for 74 million poor.

10 Thailand's Sufficiency Economy Community Project, Indonesia's Community Empowerment Program, Vietnam's program for the 61 poorest districts, and the Comprehensive Livelihood and Emergency Employment Program in the Philippines are all examples of community-based approaches to mitigating the social impacts of the crisis.

III. TRANSFORMING THE REBOUND INTO RECOVERY

The economies of East Asia and the Pacific have rebounded sharply from the steep drop in activity in early 2009, thanks to fiscal and monetary stimulus, substantially improved global financial conditions, and an upturn in the inventory cycles. We are revising our projection for regional growth for 2009 up by 1.3 percentage points compared to our April forecast ("Battling the Forces of Global Recession" issued on April 6, 2009) even as our forecast for developed economies in 2009 are further downgraded. Real GDP in the G-3 is now projected to fall 3.5 percent in 2009 compared with a projected decline of only 0.4 percent a year ago and 3.1 percent in April, while projections of global trade volumes are now revised to show a contraction of 11.4 percent versus a drop of 2.1 percent forecast a year ago (Table 3).

Growth in the developed economies is projected to recover at a modest pace in 2010, as banks continue to deleverage, and high and rising unemployment subdues the recovery in private consumption. Global capital flows are likely to recover moderately from the lows of 2009 but will remain smaller than the record highs reached in 2007 as cross-border lending continues to suffer from international banks recognizing credit losses (now about half of the total projected) while inflows of foreign direct investment remain limited by large excess capacity.

East Asia may receive a larger share of these inflows because of a combination of investor expectations of stronger growth in the region than the rest of the world, the potential for currency appreciation and the growing liquidity and sophistication of the region's financial markets. Although limited availability of capital is a key risk, a surge in capital flows will create a separate set of challenges.

Premature withdrawal of fiscal and monetary stimulus is among the key concerns of policymakers in the region, just as it was on top of the agenda during the recent meeting of the G20 heads of state in Pittsburgh. Nonetheless, as growth recovers broadly and inflation pressures begin to materialize, monetary policy may need to be tightened sooner rather than later in East Asia, following the recent policy rate hikes by the central banks in Israel, Australia, and Norway. It is more likely that the monetary authorities in East Asia will move first by removing some of the support for liquidity in domestic and foreign currencies (similar to the reabsorption of foreign currency liquidity by the Korean authorities which they had extended to the market earlier), returning reserve requirements to pre-crisis levels (following up on the steps of Indonesia's central bank) and scaling back the scope for collateral eligible for accessing central bank facilities before hiking policy rates.

Table 3. Growth projections are revised up
(Percent change y-y unless indicated otherwise)

				Prev Forecasts	
				Dec'08	Apr'09
	2008	2009f	2010f	2009	2009
Developing East Asia	8.0	6.7	7.8	6.7	5.3
China	9.0	8.4	8.7	7.5	6.5
Indonesia	6.1	4.3	5.4	4.4	3.4
Malaysia	4.6	-2.3	4.1	3.7	-1.0
Philippines	3.8	1.4	3.1	3.0	1.9
Thailand	2.6	-2.7	3.5	3.6	-2.7
Vietnam	6.2	5.5	6.5	6.5	5.5
Cambodia	6.7	-2.2	4.2	4.9	-1.0
Lao PDR	7.3	6.4	7.5	6.0	5.0
Timor-Leste	12.8	7.4	8.0	1.4	1.0
Mongolia	8.9	0.5	3.0	7.5	2.7
Fiji	0.2	-0.3	1.8	1.1	2.4
Papua New Guinea	6.6	3.9	3.7	5.0	4.7
Memoranda:					
Developing East Asia					
Middle-income countries	8.1	6.9	7.9	6.8	5.4
Low-income countries	6.3	4.5	6.0	6.1	4.7
Excluding China					
Developing East Asia	4.7	1.1	4.5	4.1	1.1
Middle-income countries	4.5	0.7	4.3	3.8	0.7
G-3	0.3	-3.5	2.0	-0.4	-3.1
Global trade volumes	3.2	-11.4	4.0	-2.1	-6.0

Source: Datastream; DECPG; and World Bank staff estimates and projections. f=forecast

Governments in the region plan to continue implementing already announced fiscal stimulus packages until the recovery is on firmer footing. Moreover, some governments have announced additional stimulus measures, including in Thailand and Singapore. The Thai government is boosting spending with a second stimulus package equivalent to 16 percent of GDP to be spent over 2010-2012 to largely alleviate critical transportation bottlenecks. About a third of the package will be within the central government budget, and the rest off-budget. In Singapore, the government decided to extend for six months the Jobs Credit Scheme, a key and successful part of its stimulus program that was set to expire this year. Balancing between projections for ongoing recovery and concerns that activity may weaken again, the government is reducing the amount of subsidy under the program that encourages new hiring, but is keeping it operational to allow for more rapid response in case of economic weakness. Other governments have drafted budgets that allow for discretionary increases should economic activity weaken. This is the case in Indonesia, where the government targets the 2010 deficit to narrow to 1.6 percent of GDP from 2.2 percent in 2008, but the budget authorizes the government to enact new spending and boost the deficit to 2 percent of GDP should the recovery of growth sputter.

The low-income countries will remain under pressure to support domestic demand. Some, including Lao PDR, are planning to sustain large fiscal deficits to be financed from government deposits and the domestic banks. Other countries, such as Mongolia, are set to carry out somewhat tighter fiscal policy under the IMF-supported program. The continued need to mobilize resources from the multilateral institutions to help the most vulnerable remains a priority, as emphasized by the recent Leaders' G-20 summit held in Pittsburgh.

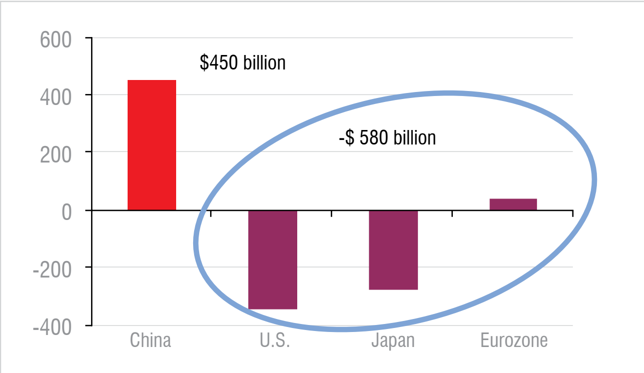
The authorities in the region are aware that the limits of what fiscal policy could accomplish in stimulating domestic demand will be reached faster unless investors are reassured that exit strategies will be put in place to unwind the stimulus when recovery sets in more firmly. Such strategies will be more credible if supported by robust medium-term fiscal and debt frameworks. Coordinated withdrawal of stimulus, much like the coordinated introduction of the extraordinary fiscal support will be important, as emphasized at the recent leaders' summit of the G20.

Helped by large and timely fiscal and monetary support and on the basis of strong fundamentals before the crisis, growth in developing East Asia is projected to reach 6.7 percent in 2009, the same pace of expansion we forecast a year ago. But the composition of growth is expected to be fundamentally different from what we projected a year ago, however. On the expenditure side, the contribution of net exports turned substantially more negative in China after several years of increasingly stronger boost to output, and the contribution of private investment is also negative in almost all countries. Government spending, by contrast, whether on consumption or investment, has contributed more than expected earlier as stimulus spending was either accelerated or augmented. There are substantial differences across countries as well. Growth in China is now stronger than we projected both a year ago and in April 2009, but we have revised down by about 6 percentage points compared with a year ago the growth projections for two middle-income countries (Thailand and Malaysia) and by about 7 percentage points growth for two low-income countries (Cambodia and Mongolia).

Thanks to China, East Asia remains the fastest growing developing region in the world. Although China's economy accounts for less than a tenth of the global economy, the increase in China's GDP in 2009 will offset three-fourths of the decline in G3's GDP. This number underlies China's markedly increased global role, but also reveals the limits to what China alone can do, because this year's outcome was achieved through a huge monetary and fiscal stimulus that the authorities will find neither prudent nor necessary to sustain for an extended period of time. Take China out of the equation, however, and the remainder of the region is set to expand at a slower pace than the Middle East and North Africa, South Asia, and only modestly faster than Sub-Saharan Africa (Table 4). This reflects the openness of East Asia and the fast transmission of shocks through production networks serving the U.S., Japan and other global markets.

Figure 45. The increase in China's GDP offset three-fourths of the decline in G3's GDP

(in billions of dollars, 2009)



Source: World Bank.

Table 4. Thanks to China, developing East Asia will remain the fastest growing world region

(Percent change y-y)

	2007	2008	2009f	2010f
Developing East Asia	11.4	8.0	6.7	7.8
Dev. East Asia excl. China	6.2	4.8	1.1	4.5
Europe and Central Asia	7.1	4.3	-6.1	1.9
Latin America and Caribbean	5.5	3.9	-2.5	3.0
Middle East and North Africa	5.3	5.8	3.0	3.4
South Asia	8.5	5.7	5.3	6.4
Sub-Saharan Africa	6.5	4.9	0.7	3.8
OECD countries	2.5	0.4	-3.2	1.7

Source: DECPG and World Bank staff estimates and projections.

China's economy will continue to influence substantially developments in the region in 2010. Real GDP growth is projected to strengthen modestly to 8.7 percent in 2010 from 8.4 percent in 2009, but the composition of growth is set to change significantly. Exports are projected to grow significantly after falling sharply in 2009, and real estate investment is bound to expand briskly. In 2010, the government stimulus is set to decline sharply. The authorities are committed not to withdraw any fiscal stimulus, but at the same time are mindful that substantial additional stimulus is also not warranted, given the strong growth prospects. Moreover, the extraordinary expansion in credit by the equivalent of 30 percent of GDP in 2009 could add to nonperforming loans (NPLs) in a repeat of the NPL accumulation during the 1990s. The government, as a result, may supplement the recently adopted measures to limit expansion in certain industries, including cement, steel and aluminum, with steps to slow rapid credit growth. This should also help address the authorities' growing concern about potential asset price bubbles.

Thailand and Malaysia are the region's middle-income countries worst hit by the crisis. In Thailand, a sharp decline in exports was the main cause for the economy to contract by 2.7 percent in 2009 amidst renewed political tensions. Prospects are for growth to recover in 2010 benefitting from inventory restocking and the pickup in demand for electronics and automobiles abroad. In Malaysia, the sharp drop in exports of oil, palm oil and electronics caused output to contract 2.3 percent this year.[11] The factors that battered the country on the downside are likely to support it as strongly on the upside, with increasing global demand, together with the positive effect from the second government stimulus package output projected to output to grow 4.1 percent in 2009.

Mongolia and Cambodia are the low-income countries hardest hit by the crisis. The collapse in copper prices hit Mongolia harder than the other major copper producers because of the country's particular combination of expansive fiscal and monetary policies, a fixed exchange rate and – at that time - an overheating financial sector. The government took strong actions to address the economic downturn from the start of 2009, supported by programs with the IMF, the World Bank, the ADB and Japan. These efforts have led to a stabilization of the external sector, the exchange rate and the budget, although nonperforming loans are still rising. Real GDP growth is projected to slow from nearly 9 percent in 2008 to 0.5 percent in 2009 before recovering modestly in 2010. The slowdown in economic activity in Cambodia is as sharp, with real GDP projected to contract 2 percent in 2009 after expanding nearly 7 percent in 2008. Exports of garments – which account for the bulk of shipments abroad and are almost all directed to the U.S. market - fell 26 percent in the first six months of 2009 from a year earlier. More worrisome than the decline in garment exports, however, is the loss in U.S. market share that indicates competitiveness challenges. The other key sectors of the economy were also negatively affected. Tourism arrivals declined and construction projects approved dropped one-fourth from a year before in the first half of the year. As in Mongolia, developments in the banking sector bear close watch. Very rapid growth

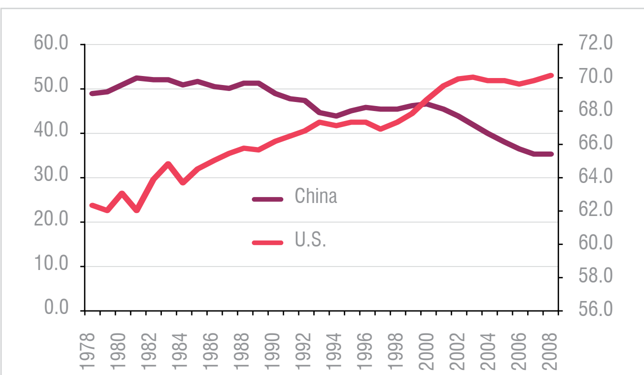
11 Malaysia's value added contribution to electronics exports is the highest in the region.

over 2005-2008 has slowed to a halt, while non-performing loans have increased during the first six months of 2009 and will be under further pressure because of economic weakness and the sharp downward correction in real estate prices.

Looking beyond next year, East Asia has the potential to sustain high growth rates even in a more slowly growing global economy, but such an outcome will require substantial policy efforts. Until recently, some of the economies in the region strived to achieve rapid growth by imitating the earlier policies in Japan, Taiwan (China) and Korea of relying on export-led manufacturing growth, often without full regard for the costs and distortions incurred in the process. At the heart of these policies were undervalued exchange rates, accompanied with government measures to encourage the rapid build-up of manufacturing capacity for export, while boosting domestic saving, depressing household consumption and limiting competition, both domestic and foreign, in the nontradeable sectors. Favorable tax, customs and credit policies benefitting large export-oriented companies have been essential, as have been efforts to create the necessary facilitating infrastructure and conditions for attracting foreign investors in export-oriented sectors.

Figure 46. Domestically unbalanced: private consumption in the U.S. and China

(In percent of GDP)



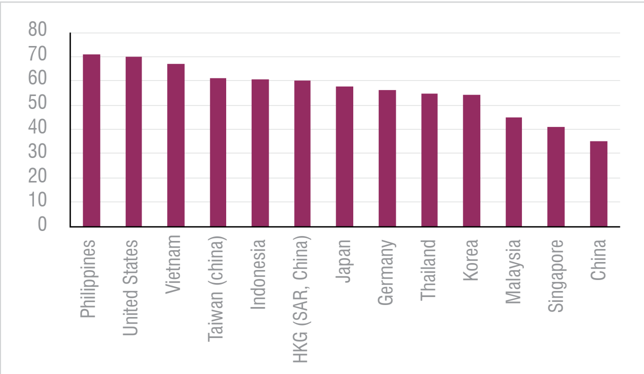
Source: Datastream and BEA.

First among the countries in developing East Asia, the authorities in China began to recognize that the investment-heavy, industry-led pattern of export-led manufacturing growth pursued over the last three decades has led to unsustainable domestic and external imbalances (Figure 46). The Chinese authorities remain committed to rebalancing growth as the key objective in its 11th five-year plan by giving greater attention to domestic sources of growth, increasing the role of services and consumption, improving energy efficiency, encouraging environmental sustainability, and reducing urban-rural inequalities. In this context, further reform of energy prices is one of the government's priorities, and carrying it forward will bring more starkly into focus the important question of reforming other relative prices, including interest rates and the exchange rate. The current crisis arguably slowed progress in rebalancing, as the authorities focused on limiting the slowdown in growth by implementing the 4 trillion RMB infrastructure-dominated fiscal stimulus package and effectively re-pegging the currency to the U.S. dollar. Nonetheless, senior Chinese leaders have stressed that the crisis makes rebalancing more urgent and important. Several measures to support private consumption have been undertaken thus far this year, including tax breaks for automobile purchases and subsidies for electronics sales, increases in pensions, the rolling out of a rural pension program, and the start of an important health reform program. These measures are helping sustain growth in private consumption in 2009 at a pace little changed from last year, modestly boosting the share of consumption in GDP. Nonetheless, significantly more efforts will be needed towards rebalancing, particularly in the area of removing the distortions that have kept growth in services, wages and private consumption lower than growth in overall GDP.

Other developing East Asian countries are also likely to explore ways for extracting more growth from domestic demand while recognizing that developing countries will need to increase integration with global goods and service markets to sustain convergence with high-income economies. Observers point out that Vietnam faces challenges not very different from those faced by China, given the similarity of growth models pursued thus far. Malaysia and Thailand are striving to avoid the middle income trap, including by focusing on improving education and skills, tackling infrastructure bottlenecks, and enhancing competition in

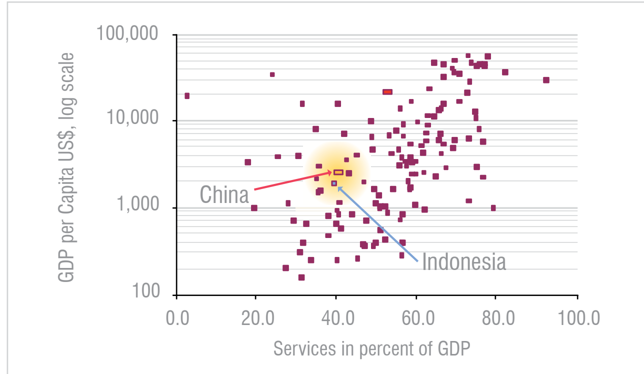
Figure 47. Not all countries have subdued private consumption as in China

(Private consumption, in percent of GDP, 2008)



Source: Datastream and national authorities.

Figure 48. The service sector is much smaller in China and Indonesia than in countries at similar income levels



Source: Datastream, Haver and World Bank staff estimates.

both the manufacturing and the service sectors. Malaysia's recent measures and announcements to liberalize the service sector and promote private investment, research and development and new niche areas are important first steps in this regard but would have greater impact if followed by further reforms in the regulatory framework.

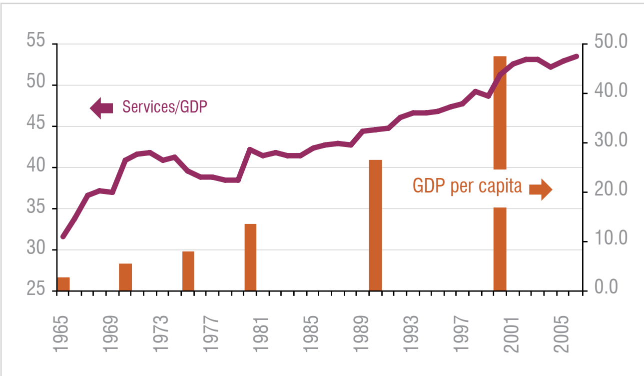
In contrast to these countries, the authorities in the Philippines and some of the low-income countries face a different challenge. In the Philippines, the level of household consumption relative to income is similar to that in the U.S. and is much higher than in other countries in the region, fueled by strong inflows of remittances (Figure 47). Capital-intensive production of goods and services, meanwhile, is predominantly inward-oriented and the value-added of exports is lower than in the other middle-income countries in the region. Transforming the economy by increasing its outward orientation will remain an important challenge for the government (see below).

East Asia's process of regional integration – that followed the global integration of most countries – has been a powerful driver of growth in the region. Although advanced, the process of regional integration could be deepened substantially further by addressing behind-the-border trade facilitation problems, tackling the liberalization of the services sector, including the financial sector (see below), and facilitating intra-regional migration. Harmonizing infrastructure and improving policy transparency are also important avenues for the authorities to explore. Global and regional production networks, along with the rapid rise in intra-regional trade in parts and components, have further room for growth and improvement, although some point out that higher energy prices in the future and concerns about climate change may lead to a rethink of the level of specialization and intra-industry trade which may place limits on economies of scale in manufacturing. Moving up the value-added chain in production networks will give growth a new impetus, as the benefits of new technology and innovation spread more broadly throughout the countries in the region.

The service sector – underdeveloped in many East Asian countries due to the bias in favor of merchandise tradeables – holds enormous potential for the region. Removing barriers to the development of the service sector needs to be pursued with sufficient urgency in countries such as China, Malaysia, Korea and Thailand where the need for finding new sources of growth is becoming crucial given the likelihood that import demand in developed countries is set to remain weak and where the limits of traditional growth strategies as vehicles of reaching high income status are being tested. Efforts need to include the reduction and elimination of tax incentives in favor of export-oriented manufacturing, opening up the service sector to more competition, including from foreign investors, and helping improve the access to finance for small- and medium-size enterprises. Easing restrictions to internal migration in China and advancing reforms to limit preferential treatment of different classes of citizens in other countries should offer substantial scope for increasing urban employment, raising household incomes, and allowing for better use of agglomeration

Figure 49. The share of services in GDP has risen along with incomes per capita in Korea */

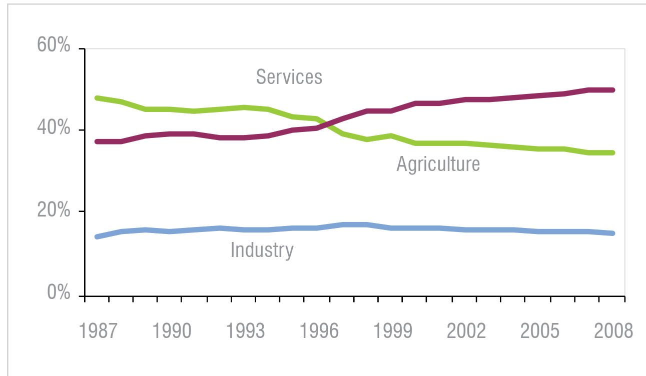
(In percent)



Source: WDI, OECD and Haver Analytics. Note: */GDP per capita is in current U.S. dollars relative to the U.S.

Figure 50. Philippines: service employment denominates

(In percent of total)



Source: Philippines growth brief prepared by Ulrich Lachler, World Bank, based on data from the national authorities.

economies. In Korea, the authorities are rightly concerned that labor productivity in the service sector – dominated by SMEs – has expanded by just about 1 percent a year this decade, six times slower than manufacturing productivity, largely due to the financial difficulties among SMEs in accessing finance, dealing with business regulation and labor market rigidities.

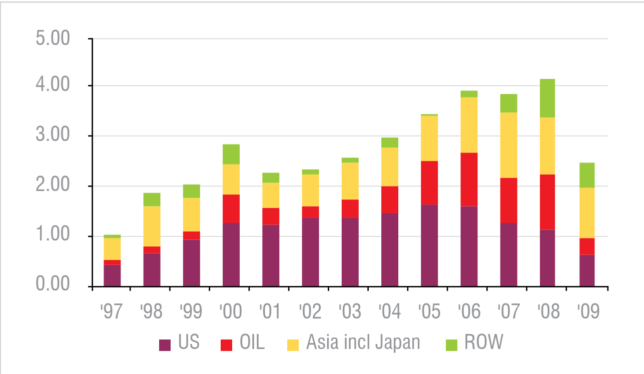
Consider the potential of the service sector for China. Value-added in services accounts for 40 percent of GDP, below the midpoint of the range for countries with broadly similar income per capita (25-75 percent) and the same as in Indonesia (a country with half of China's income per capita). Indeed, the share of value-added in services in China has risen modestly from 32 percent of GDP in 1960, when GDP per capita was substantially lower. In Korea, services accounted for about 40 percent of GDP in the mid-1970s when GDP per capita was the same as China's level today relative to the U.S. The share of services has risen to about 50 percent subsequently, measured in current prices. As emphasized above, development of the service sector in Korea has been restrained by policies geared toward export-led goods manufacturing and this is an important similarity with China. Nonetheless, services accounted for half of the increase in real GDP in Korea over the last 25 years, or a contribution equivalent to that of the rest of the economy. An ambitious agenda for developing the service sector in China, therefore, could help boost output, employment and living standards well beyond current projections.

In contrast to China and Indonesia, the service sector in the Philippines is large but that reflects a failure to boost economic activity more generally, rather than a mark of success in diversifying the structure of growth. The Philippines was the most developed country in developing Asia in the 1950s, but subpar rates of growth, coupled with policies protecting inefficient manufacturing based on excessively capital-intensive technology in the subsequent three decades, caused living standards to stagnate to levels that are now below all other middle-income countries in the region. Industry was unable to absorb the rapidly growing labor force, including migrants from the rural areas, leaving the service sector as the safety valve. Services account for 65 percent of GDP and nearly half of employment, but anecdotal evidence suggests that the bulk of the service sector simply masks severe urban underemployment with very low productivity. A ray of hope has been offered by the success of the Business Process Outsourcing (BPO) service sector, which in less than a decade has risen as a formidable global competitor to companies in India – still the preferred destination for BPO. More will need to be done to help the BPO boost employment from 1 percent of the total in the country, however, and policies to be pursued will also facilitate the emergence of other higher value-added and high productivity services and manufacturing.

There are both downside and upside risks to the outlook presented in this report. On the downside, the main risk is that private investment and consumption in developed countries remain very weak because of sizable excess capacity and high unemployment, keeping overall growth in the advanced economies dependent on sustaining for an extended period of time fiscal and monetary

Figure 51. Global imbalances have been reduced – but not by Asia

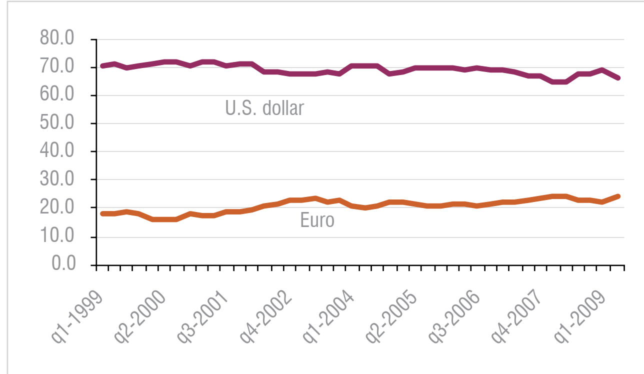
(absolute value of current account balances, in percent of global GDP)



Source: Datastream and national authorities.

Figure 52. The share of foreign exchange reserves denominated in dollars has eased only slowly

(In percent)



Source: IMF.

stimulus. The authorities, as a result, may face the unpalatable choice of whether to keep up the stimulus at greater risks to fiscal sustainability and developed country currencies, or withdraw it and risk a double dip in economic activity. Even if stimulus is sustained, the risk is that the crisis has triggered a more permanent shift to lower potential growth for the developed countries. Such economic developments will give rise to populist and protectionist sentiment in developed and developing countries alike. Finally, continued problems with financial institutions that have yet to realize more than half of likely losses could also trigger another round of financial instability.

The upside risks are substantial as well. A more robust recovery in the developed countries than currently expected could come before global imbalances are tackled more vigorously and financial regulation in advanced economies improved to rein in the excesses that led to the crisis. Such a recovery will likely put East Asia under strong pressure to return to the status quo ante of supporting manufacturing exports at any cost. The upside also carries with it the risk that East Asia's growth potential and much improved financial markets attract larger capital inflows than assumed under the baseline scenario, leading to new and larger asset price bubbles and complicating macroeconomic policies. Managing both the upside and the downside risks will be a challenge to any government. Rebalancing growth, together with advancing integration with global markets and retooling institutions to encourage innovation however, seems to be the key ingredient of any strategy to tackle the problems the next two years will bring to policymakers in the region.

The crisis accelerated the process of reducing global current account imbalances but it is unclear if progress will be sustained. The U.S. current account deficit peaked in 2006 at 6 percent of GDP (1.6 percent of global GDP) and was declining even before the crisis began, as the weak dollar helped slow growth in imports more than exports (Figure 51). Surpluses among the oil producers peaked in 2008 along with oil prices. The current account surplus in East Asia (developing East Asia, the NIEs and Japan), by contrast, has narrowed only modestly in 2009 from the 2008 peak. Continued dollar weakness, reflecting improved confidence in the rest of the world – notably in East Asia – and increased worries about the potential difficulties in reducing the U.S. fiscal deficits that are set to average 10 percent of GDP in the fiscal years 2009 and 2010, holds the potential of reducing imbalances further in the near term. A lot will depend, however, whether the dollar will weaken against a broader basket of currencies, notably the currencies of the countries with the largest surpluses.

But currency appreciation cannot be a goal in itself. Allowing currencies in the region to strengthen, but by no more than differential labor productivity growth in the tradeable sectors, will help rebalance the economy gradually and improve living standards without endangering competitiveness. Most authorities in the region nonetheless worry that appreciation will stymie the potential recovery in exports in the short term, while encouraging capital inflows that would bring instability to financial systems and exert further upward pressure on currencies. The authorities in many East Asian countries, moreover, are concerned about losing competitiveness against China, should they allow their currencies to strengthen at a time when China has effectively re-pegged the renminbi to the weakening dollar since mid-2008. Some observers have suggested that if such concerns persist, countries in the region may consider intervening jointly to appreciate their currencies against the dollar in a move similar to the Louvre Accord signed in 1987 to stem the depreciation of the U.S. dollar.[12] The likelihood of such a development does not appear high at present, however.

Over the longer term, the likely sustained shift in global economic power to East Asia, notably to China, will play an increasingly larger role in shaping the available options of reserve currencies. The firming multi-polarity in the world economic order in the aftermath of the recent global crisis has led some to question the role of the U.S. dollar as the world's predominant reserve currency. The dollar's share of global foreign exchange reserves was trending modestly down before the global financial crisis intensified with the failure of Lehman Brothers, but demand for short-term U.S. government bonds surged at the height of the crisis even as their yields fell essentially to zero. A renewed shift away from the dollar has been evident again from the start of 2009, supported by returning confidence in the rest of the world and concerns that U.S. fiscal deficits of about 10 percent of GDP in 2009 and 2010 and government debt up by about 25 percent of GDP by 2011 will dampen prospects for the U.S. currency (Figure 52).

What options are there for global reserve currencies in the future? Demand for the euro as a reserve currency may increase somewhat further over the medium term, but observers note that the currency's position will be limited as long as the eurozone lacks a single euro-bond market and a single eurozone finance authority. Officials from the BRIC countries have recently proposed a greater role for both the SDR and their own currencies. The general IMF SDR allocation in August injected the equivalent of $250 billion into the global economy and gave rise to much of the discussion about using the synthetic currency as an alternative reserve currency. The allocation amounted to just 3 percent of global foreign exchange reserves, however. There may be a role for the SDR in a global reserve system, but it must be supported by improved governance arrangements, along the lines articulated at the recent G20 Summit in Pittsburgh. The Chinese authorities, meanwhile, have begun work to encourage the use of the renminbi in trade settlements with trading partners, and promoting its financial centers, including Hong Kong (SAR China), with the ultimate goal of making the currency convertible and elevating it to global reserve currency status. Such ambitions are underpinned by the likelihood that even with slower growth than recorded in recent years, China's GDP is likely to exceed that of the U.S. in about 25 years – and Japan's perhaps in as few as five.[13] All in all, these factors make it more likely that a multi-polar reserve currency world will emerge over the longer term and, if supplemented with stronger global economic cooperation as pledged at the G20 Summit in Pittsburgh, could ultimately limit the need for countries to hold ever larger foreign exchange reserves to self insure against unfavorable external shocks.[14]

The November G20 Summit in Pittsburgh acknowledged the need to sustain strong policy responses until a durable recovery is secured, and stressed yet again the need for continued policy coordination and consultation to tackle global imbalances and improve regulatory frameworks that are understood to be among the primary causes of the crisis. The authorities in the region are mindful of the risks of a premature withdrawal of stimulus before recovery of private investment is on a sound footing. Some governments in the region will have the fiscal space to sustain fiscal stimulus until the transition from a rebound to a recovery is ensured, while others will be more fiscally constrained. Nonetheless, even those with ample room for fiscal maneuver are aware

12 The signing of the Louvre Accord by the G-7 (other than Italy) followed the Plaza Accord in 1985 which aimed to weaken the dollar against the DM and the Japanese yen.

13 Assuming real GDP growth in China exceeds that in the U.S. by 5.5 percentage points, for example, 8 percent growth in China and 2.5 percent real GDP growth in the U.S.

14 Also see the discussion in Mansoor Dailami and Paul Masson, 2009, The Multipolar International Monetary System, manuscript.

that fiscal and monetary policy alone cannot ensure a return to the levels of production that prevailed before the crisis if, as it seems likely, developed countries will recover only slowly.