East Asia and Pacific Data Monitor

October 2012

In a fragile external environment, the economy in the East Asia and Pacific (EAP) region continues to slow down. GDP growth for EAP in 2012 is now projected to be 7.2 percent (compared with a 7.6 percent projection in May) whereas China's growth is expected to come in at 7.7 percent (8.2 percent). Tensions on international financial markets have eased in recent months, following developments in the Euro area and central bank action in Europe, the US and Japan. Real economic activity in advanced economies continues to disappoint, though, with lackluster recovery in the United States and recession in Europe resulting in weak demand for EAP's exports. Indeed, net trade is no longer contributing to EAP's growth at all. In contrast, domestic demand is robust in most parts of the region, although it is further slowing in China following the measures taken last year to cool off the real estate market. Domestic demand and growth in other developing countries would drive a mild rebound in growth in 2013, as high income countries are projected to grow at about the same pace as this year. For next year, growth in EAP is projected to reach 7.6 percent, whereas China's growth is expected to top 8 percent. Against this background, poverty will continue to decline, and the share of people living on $2/day will reach 24.5 percent by the end of 2013, down from 28.8 percent in 2010. Although retreating, the Euro area crisis still constitutes a major risk to this outlook, followed by the "fiscal cliff" risk in the United States. Within the EAP region, the risk remains of a more pronounced slowdown in China than currently expected, while commodity exporters are at particular risk of a global slowdown. The recent global food price increases seem less of a risk to EAP, as rice markets are not much affected for now.

Recent Developments

Global financial market tensions are subsiding... Global financial market tensions have eased since late July. The announcement of possible European Central Bank (ECB) measures to defend the Euro in late July was the first step that calmed markets. This was followed by the launch of the ECB's bond-buying program and the German Constitutional Court's favorable ruling on the European Stability Mechanism (ESM) in early September. These actions, as well as the US Federal Reserve Board's announcement of a 3rd round of quantitative easing and the Bank of Japan's extension of its version of the program were cheered by the markets. Global equity markets have rebounded since June, with stocks in high-income countries up 11.8 percent so far in 2012 and in developing countries by 7.3 percent. Emerging market bond spreads have declined as well, and are now around their long-term average levels. Gross capital flows to developing countries, which fell by between 30 and 40 percent year on year (yoy) in May-June, have bounced back with July and September recording record levels of bond issuance. Reflecting the unwinding of Euro area deleveraging, syndicated bank lending to developing countries rebounded in August and September, although it remains more than 25 percent lower than 2011 levels.

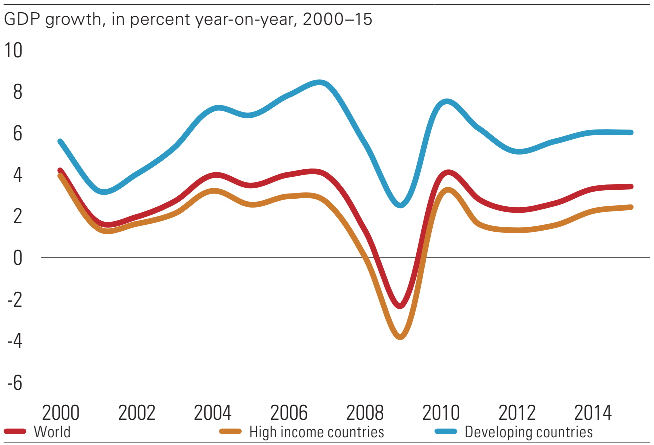
...while global real activity remains subdued. Consumers and firms, having learned from the 2011 scare, appear to have cut back more quickly on investments and big-ticket expenditures. By the same token, they appear to be more cautious this time around in returning to the market. As a result, real-side activity indicators remain depressed: Manufacturing purchasing managers' indices (PMI) worldwide—including for China—remain at low levels, whereas global industrial production declined at a 2 percent annualized pace in the three months up to June, the steepest decline since mid-2009. Preliminary data suggest that the pace of slowdown has moderated somewhat to -0.8 percent in July, largely driven by the Euro area, where the 3 month industrial

The East Asia and Pacific Data Monitor, a product of the World Bank's East Asia region, reviews recent economic developments and outlook for the region. It supplements the twice-yearly EAP Update.

production decline slowed from -8.6 percent annualized in June to -1.3 percent in July. Encouraging, albeit still weak, industrial production growth in developing countries has also turned around from 0.8 percent in June, to 2.8 percent in July, although this is still far below the 11.8 percent pace recorded in March. Global export volumes fell even faster in July (-7 percent) than in June (-4.1 percent). High-income export volumes declined at a 12.3 percent (6.3 percent for Europe) annualized pace during the 3 months ending July 2012. Likely reflecting reduced high-income demand, developing country export growth fell from 11.9 percent in June to 6.0 percent in July.

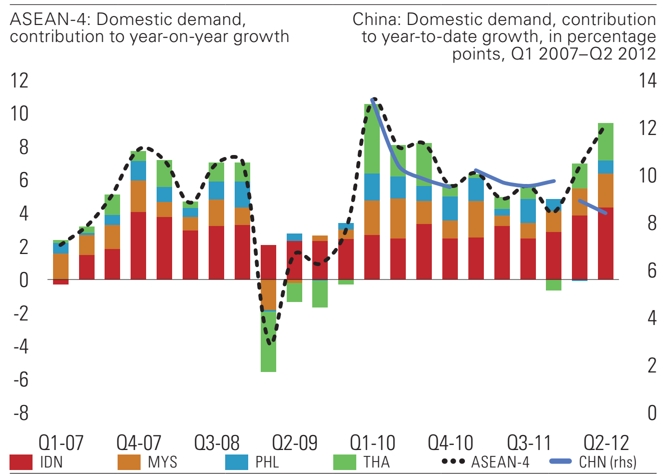
The weak external environment continues to affect East Asia… Exports growth for East Asia as a whole slowed to 4.5 percent (yoy) in the second quarter of 2012, easily outpaced by import growth of 5.2 percent, and trade as a whole now no longer contributed to the region's growth. With the exception of China, for which exports grew by a meager 1 percent (yoy) in July, and Vietnam, all of the other major economies in the region saw a decline in exports, a sharp change from the 15–20 percent export growth rates recorded in 2011. Imports, meanwhile, slowed down for most countries as well, but less rapidly so, and trade balances and current account balances deteriorated across the region in the first half of the year compared to last year.

Figure 1. The external environment continues to be weak, and will be so for the foreseeable future



Source: WB DEC, Unified Survey Assumptions.

Figure 2. Domestic demand is holding up well (in the ASEAN-4), but is slowing in some countries (China)



Source: Haver Analytics and China National Bureau of Statistics.

…but domestic demand is thriving. In contrast to external demand, domestic demand continues to thrive in most of EAP. In particular, among the large ASEAN countries, domestic demand is driving growth, with a growth rate of 9.4 percent in the second quarter. Some special circumstances explain part of this growth, notably election-related spending in Malaysia and spending on reconstruction after last year's flood in Thailand. But more seems to be going on: in particular investment spending in Thailand, Malaysia and Indonesia is booming, and the latter has now reached investment to GDP levels equaling those from before the Asian Financial Crisis for the first time. In Vietnam, which has focused on fighting inflation in the past year and a half, investment growth has seen a considerable slowdown in the past year, which may partially reversed in the remainder of the year now that the policy stance has become more accommodative.

China shows a more mixed picture on domestic demand.[1] Overall domestic demand growth came down in the first half of 2012, contributing 8.4 percent to growth through the second quarter, compared to 9.7 percent

1 China does not publish quarterly data on the expenditure side of the national accounts. Retail sales and Fixed Asset Investment numbers are only imperfect proxies for consumption and investment.

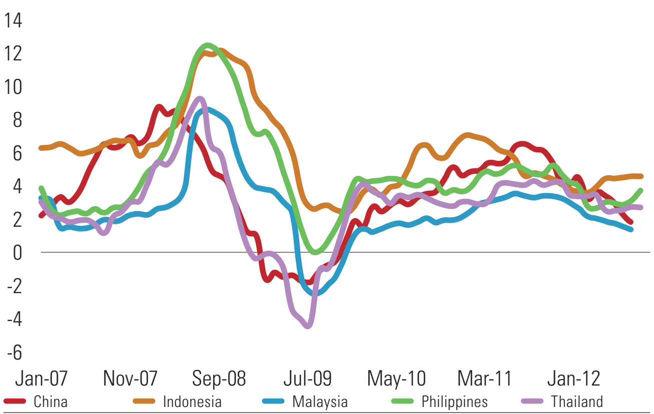
the year before. The slowdown was led by investment demand, following last year's measures to reign in real estate investment. Non-state investment growth declined most, while SOE investment started to accelerate again since the end of 2011. In contrast, consumption is still growing robustly on the back of real wage increases, notably for migrant workers, which showed real increases in the order of 13 percent (yoy). The slowdown in demand was reflected in industrial production growth, which dipped below 9 percent (yoy) in August, down from 13.5 percent in the same month in 2011. The official PMI index as published by the National Bureau of Statistics has been below 50 since July, indication continued contraction, although the new order sub-index showed some recovery in September. The PMI index published by HSBC, a commercial bank, has been below 50 for the last 9 months.

In 2011 China's consumption contributed more to GDP growth than investments for the first time since records of GDP began in 1952. Some observers see this as the start of a trend in domestic rebalancing, and associate this with a more permanent growth slowdown in China. The *China 2030* report the World Bank and the DRC released earlier this year, projects that rebalancing and a gradual slowdown in China's growth will happen over the next two decades, and is indeed desirable for more balanced, inclusive growth. However, it seems too early to tell whether the tide has already turned. Moreover, relaxation in monetary policy earlier this year and a local government stimulus could again reverse this trend in months to come.

Policy developments suggest a more accommodative stance in most EAP countries. As inflationary pressures are receding across the region, and the balance is yet again shifting to concerns on growth, monetary policies have started to adjust. Most major central banks in the region lowered their policy rates in 2012, and some, like China's People's Bank that reduced the reserves that banks need to hold against deposits, introduced other measures to increase liquidity as well. Vietnam rapidly reduced interest rates from 15 percent at end-2011 to 11 percent by mid-year, in line with rapidly receding inflation. Ample liquidity has been feeding buoyant credit growth in the Philippines and Indonesia—both countries with low credit over GDP and loan over deposit ratios—and has reignited credit growth in China in recent months. In China, other sources of credit, notably bonds issuance, are rapidly gaining in importance, and growth in domestic credit and "social financing"—the latter including other sources of credit—are increasingly diverging.

Figure 3. Headline inflation has decelerated across the region

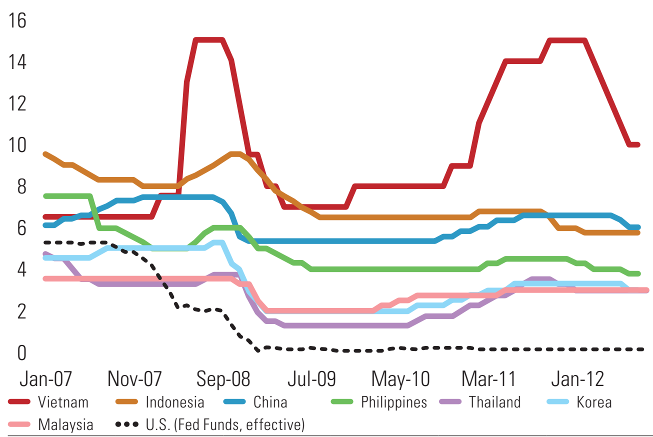
CPI inflation, in percent year-on-year, January 2007–August 2012



Source: Haver Analytics.

Figure 4. In some countries, central banks have started cutting interest rates

Policy rates, in percent per annum, January 2007–September 2012



Source: Haver Analytics and Thomson Datastream.

On the fiscal side, policy actions have remained more limited in the region. In the Philippines, the acceleration of government infrastructure spending has contributed to the strong growth performance in the first half, while revenue growth is supported by tax administration reforms as well as strong GDP growth. In China, notwithstanding concerns on local government debt, several local governments have started their own fiscal stimulus program focused on infrastructure. This was reflected in the sharp rebound in infrastructure investment, which had started to fall at a rate of 20 percent (yoy) in end-2011, but grew again at a 15 percent pace by mid-2012. In Indonesia, the budget deficit is likely to come in at just above 2.2 percent of GDP, 0.7 percentage point higher than originally planned, but in line with the revised budget. Spending on fuel subsidies is projected to exceed the revised budget level by 60 percent. There has also been some softening in revenue growth, particularly commodity related revenues. However, disbursement challenges for core spending, particularly on infrastructure, will partly offset these factors. In Malaysia, the budget deficit widened to 3 percent of GDP in H1 2012 vs. 1 percent in H1 2011, and is expected to reach 4.5 percent of GDP as budgeted. Both expenditures and revenues were considerably higher than planned, with spending on civil service compensation and cash transfers to households leading expenditure increases. Infrastructure spending on-budget grew by a modest 4 percent, as some of infrastructure spending has been shifted to state enterprises or the private sector, with support of government guarantees. The recently announced budget for 2013 promises a consolidation of the deficit to 4 percent of GDP.

Outlook

While real activity in high income countries could recover in the coming months in the wake of renewed stimulus measures taken by the central banks in the G-3, this is unlikely to outweigh the continuing drag on growth from fiscal consolidation and deleveraging in the banking systems. GDP growth in advanced countries is now expected to remain at 1.3 percent this year, with a shallow recession in the Euro area. For next year, growth will hardly be higher at 1.5 percent, while global growth is now expected at around 2.3 percent in 2012, and 2.6 percent in 2013.

In East Asia, growth among developing economies is expected to decline a full percentage point from 2011 to 7.2 percent this year, before recovering to 7.6 percent in 2013 backed by continued strong domestic demand and aided by an uptick in global trade growth. Growth will slow this year in China to 7.7 percent from 9.3 percent last year, driven by weak exports and lower investment growth. This is 0.5 percentage point lower than our 2012 forecast issued last May. For 2013, growth is expected to pick up in most of the region's other developing economies, where domestic demand remains robust. Support from monetary measures already taken, some local government stimulus and accelerated approval of central investment projects amid a prospective upswing in the political business cycle is expected to help China's growth recover next year to a projected 8.1 percent. Meanwhile, domestic demand is expected to thrive further

Table 1. East Asia and the Pacific: GDP Growth Projections

percent change from a year earlier

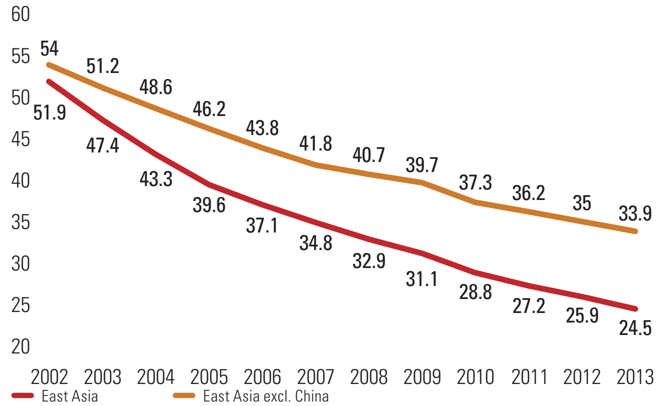
	2010	2011	Forecast 2012	Forecast 2013
East Asia	**9.3**	**7.1**	**6.0**	**6.6**
Developing East Asia	**9.7**	**8.3**	**7.2**	**7.6**
China	10.4	9.3	7.7	8.1
Indonesia	6.2	6.5	6.1	6.3
Malaysia	7.2	5.1	4.8	4.6
Philippines	7.6	3.7	5.0	5.0
Thailand	7.8	0.1	4.5	5.0
Vietnam	6.8	5.9	5.2	5.7
Cambodia	6.0	6.9	6.6	6.7
Fiji	-0.2	2.0	2.2	2.2
Lao PDR	8.5	8.0	8.2	7.5
Mongolia	6.4	17.3	11.8	16.2
Myanmar	5.1	5.3	5.5	6.2
Papua New Guinea	7.6	9.0	7.5	4.0
Solomon Islands	7.0	9.0	6.0	4.0
Timor-Leste	9.5	10.6	10.0	10.0
Developing East Asia exc. China	**7.0**	**4.3**	**5.3**	**5.5**
Assumptions about the external environment:				
Growth:				
World	3.9	2.8	2.3	2.6
High-income countries	3.0	1.6	1.3	1.5
OECD	2.7	1.5	1.2	1.4
Developing countries	7.4	6.2	5.1	5.6
Trade:				
Growth of trade volume	11.0	6.3	3.7	5.5
Commodity prices:				
Oil, $/bbl	79.0	104.0	105.7	106.5
Non-oil commodity index	27.6	20.7	-9.4	-1.0

in the other developing economies in EAP, aided in part by more accommodative policies, driving growth slightly higher next year, to around 5.5 percent.

Against this background, poverty will continue to decline, and the share of people living on $2/day will reach 24.5 percent by the end of 2013, down from 28.8 percent in 2010.

Figure 5. Poverty will continue to fall

Proportion of the population living below $2 a day in constant 2005 PPP prices, 2002–13



Source: WB staff estimates.

Risks

Considerable risks continue to cloud the outlook. Economic projections for EAP are surrounded by considerable uncertainties, and a variety of risks continue to loom over the global and regional economy. Although recent policy moves have reduced the risk stemming from the Eurozone, financial market disruptions still constitute the main risk to this outlook, followed by the "fiscal cliff" risk in the United States.

The Euro area crisis has already had significant impacts on developing economies. The reduction in Euro area spreads following the launch of ECB's bond-buying program and the German Constitutional Court's favorable ruling on the European Stability Mechanism suggest lower risk of an acute crisis. But uncertainties remain, and should conditions in Europe deteriorate sharply, no developing region would be spared. A crisis in the Euro area will affect the developing economies in the EAP Region mainly through trade and to a lesser extent financial sector links. With a "major" crisis, GDP growth could drop by more than 2 percentage points in 2013. The US fiscal cliff also poses a risk of more headwinds in the global economy. Current legislation, unless modified would impose a 5 percent of GDP fiscal drag in 2013, which would induce a significant recession in the United States. Our baseline forecasts assume a smaller cut of around 1 percent of GDP.

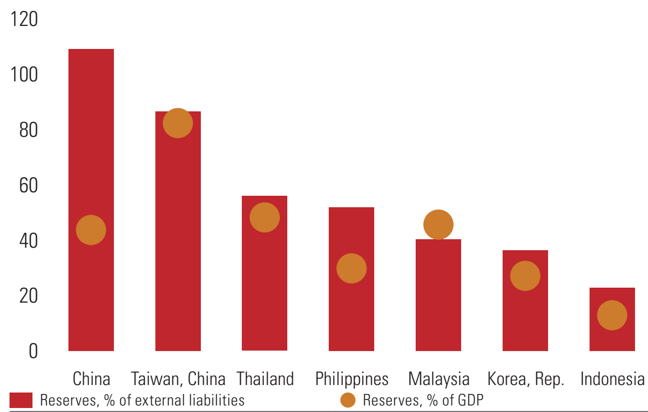
Concerns remain over a further slowdown in China. China's slowdown this year has been significant, and some fear it could still accelerate. The announced local governments' ambitious investment plans could well face funding constraints, not least because governments are feeling the pinch of a cooling real estate market, which lowers land sales revenues. As policy makers try to balance their support for growth with their concerns of a rebound in housing prices and of a reversal of hot money flows from QE3 in the U.S., many see a major fiscal stimulus package as unlikely. Thus, economic momentum is expected to be weak during the coming months with limited policy easing, a property market correction, and faltering external demands. At the same time, measures taken on the monetary front earlier this year are finding their way in credit numbers, and the most recent PMI data and data on power and cement production suggest some rebound in activity. Further, the central government has recently accelerated project approvals of its investment projects, which are more likely to find funding than those of local governments, and therefore could further support the recovery in investment and activity in the quarters to come. We therefore believe that the risk of a "hard landing" remains small.

Commodity export dependent countries could be most at risk in case of a renewed global slowdown. Countries such as Mongolia, Lao, Timor Leste, Fiji and Papua New Guinea, where commodity exports make up some 80 percent and more of total exports, could experience a sharp terms of trade shock in a major slowdown. This could in turn squeeze government spending and private investments in natural resource sectors. Budget revenues from commodities are also relatively high for Timor Leste, Indonesia, and Malaysia. Timor Leste, however, has a large trust fund of accumulated past commodity revenues, whereas Indonesia and Malaysia are in part hedged because their spending (subsidies) also depends on commodity prices.

Most developing East Asian economies are well positioned to weather a European crisis or a renewed global slowdown. Most countries have current account surpluses or only modest deficits and most hold high levels of international reserves compared to international payment obligations. Banking systems are generally well-capitalized and profitable and non-performing loans are relatively low (except in Vietnam and Timor-Leste) and external funding and wholesale funding as a share of total liabilities is low compared to other regions. Encouragingly, financial vulnerabilities to shocks in the Euro banking system are receding, as deleveraging in European banks has been accompanied by expanded presence of Asia-Pacific banks. Central banks in the region have also introduced macro-prudential measures, such as high down payments for mortgages in China and limits on loan to value for vehicle loans in Indonesia, further solidifying the banks.

Figure 6. The region has considerable cushions to fall back on

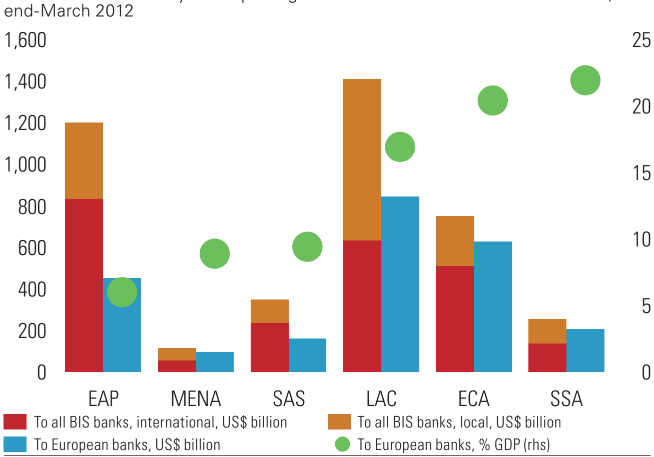
Reserves, in percent of total external liabilities, and GDP, end-2011



Source: WB, World Development Indicators and IMF, International Financial Statistics.

Figure 7. Developing East Asia is least exposed to European banks relative to GDP, but claims by European banks top US$450 billion

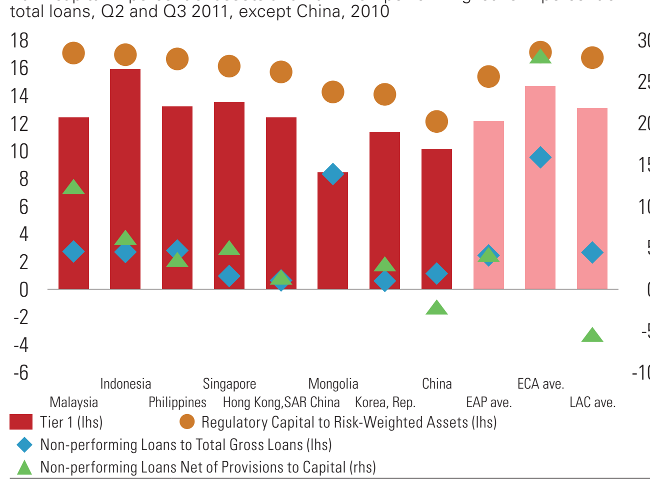
Consolidated claims by BIS-reporting banks on an immediate borrower basis, end-March 2012



Source: BIS, Consolidated Banking Statistics.

Figure 8. Bank capital buffers are large and NPL ratios are low in most countries

Bank capital in percent of assets and Bank non-performing loans in percent of total loans, Q2 and Q3 2011, except China, 2010

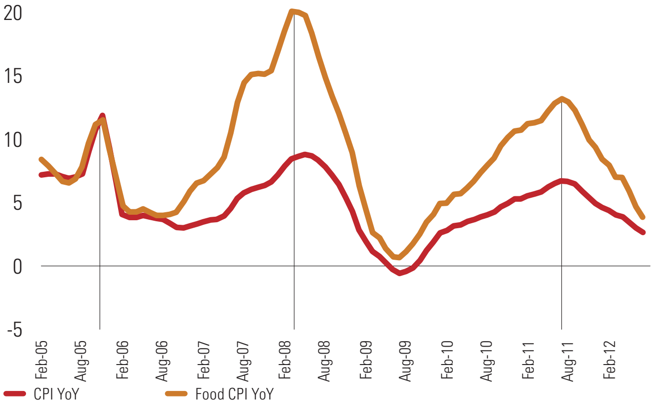


Source: FINSTATS and WB staff estimates.

The recent global food price increases is less of a risk to EAP, as rice markets are not affected for now. Following the 40 percent jump earlier in the summer, maize and wheat prices have been more stable during the past two months. In its September update, the USDA left the 2012/13 global crop outlook largely unchanged, implying that supply conditions for maize and wheat will be tight. End-of-season stocks for these commodities are expected to be 10 percent lower than last season, with maize reaching its lowest level since 1973. In contrast, rice prices have been relatively stable, with most of the price risks on the downside as stocks in Thailand continue to build as a result of the new floor price policy, and good crops in Cambodia, Vietnam and the Philippines. Food price inflation across the region has continued to come down in recent months.

Figure 9. Recent global food price increases have not yet affected EAP prices

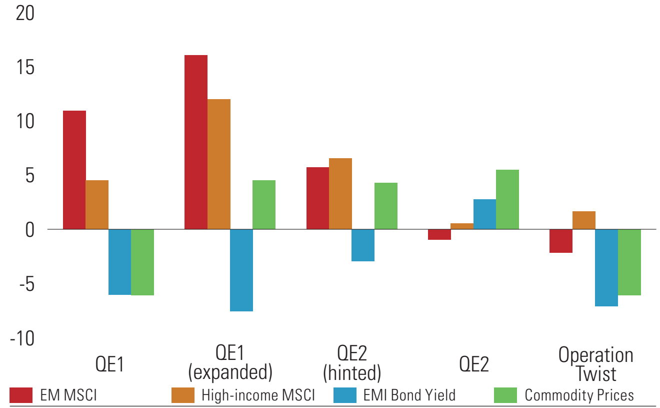
Regional CPI and food inflation, population-weighted, in percent, through July 2012



Source: WB staff estimates.

Figure 10. Past quantitative easing suggests effect on emerging markets may be waning

Selected assets response to earlier U.S. QE measures, in % change 1-month after the announcement



Source: World Bank Development Economics Prospect Group.

Renewed monetary stimulus in the G3 economies could again trigger capital inflows to EAP. In September, the European Central Bank announced an unlimited bond buying program for qualifying countries, the Federal Reserve announced a $40 billion per month asset purchase program, and the Bank of Japan added ¥10 trillion ($129 billion) to its asset purchase program. Based on past experience, these steps could support capital flows to developing countries as well as commodity prices, and the recovery of stock markets around the world and firming of EAP exchange rates suggests that markets expect this to happen. In turn, this could reignite inflationary pressures, and increases in asset prices in particular. However, this time around, the impact may be modest because of ongoing economic uncertainty; lower interest rate spreads; and because the efficacy of quantitative easing measures appears to have been declining over time. Available data show only a weak correlation between recent quantitative easing measures and hot-money flows to developing countries. Also, slower trade growth and diminishing current account surpluses in EAP offer authorities some respite, as liquidity flows from other sources is more modest. Nevertheless, in the coming months this remains a risk that the authorities should closely monitor.

Policy Considerations

Policy makers in EAP will have to manage continued growth and poverty reduction in an external environment that will remain volatile and deliver only lackluster growth over the medium term. Continued crisis preparedness remains a priority, while any resurgence in capital flows needs to be addressed with proper macroeconomic policies as well as macro-prudential policies so as to avoid excessive risks building up domestically. Countries that have experiences high credit growth should be particularly alert, while commodity exporters should continue to take measures and build the institutions that help avoid over-reliance on commodity revenues and increase resilience to shocks in those prices.

The subdued outlook for advanced economies continues to put a premium on domestic demand, and thus rebalancing remains important for most countries in the region. As external demand has further moderated and inflationary pressures recede, there is some space for accommodative policies in most countries, and in case of a major external slowdown, sufficient fiscal space for a stimulus. The latter is likely to be more effective in keeping up demand, as policy rates are already low and liquidity relatively abundant in most EAP countries. The fact remains, though, that most demand will come from private consumption and investment; the past global financial crisis suggests that informed, credible and responsive policies are the best guarantee to maintain people's confidence in the economy, and thus keep up demand.

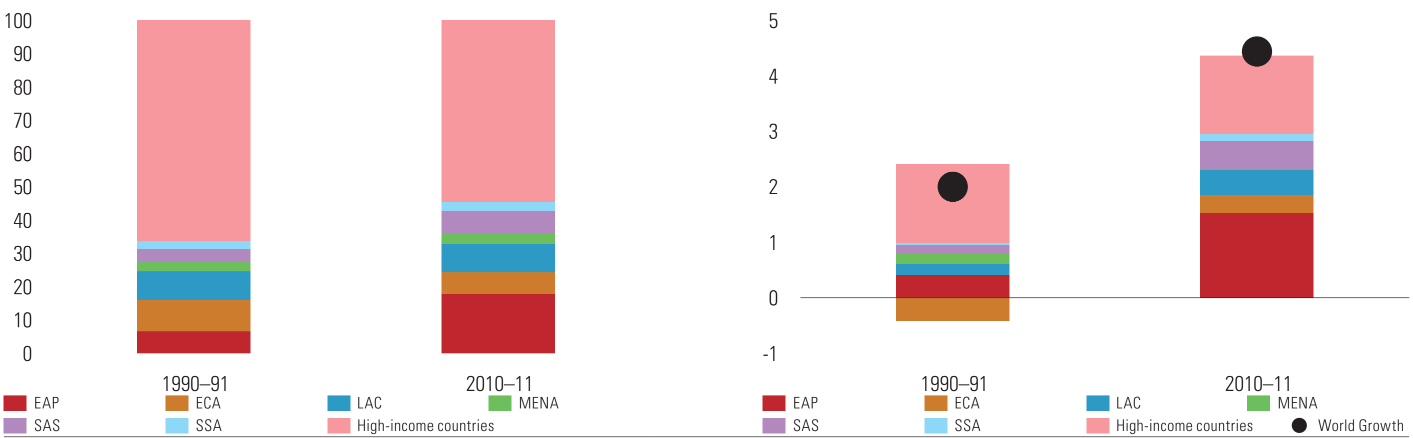
Medium Term Growth Outlook

Growth in EAP is of rising importance to the world. EAP's share in the world economy has tripled in the last two decades, from a little over 6 percent in 1990/91 to almost 18 percent now (as measured in purchasing power parity). EAP's share in world growth was even higher at more than 1/3rd in 2010/11, up from 1/5th in 1990/91. Over the last three years, including the crisis year 2009 in which output fell in high income countries, EAP even accounted for almost half of global growth. Thus, for both EAP as well as the world, continued growth in the region is of importance.

Figure 11. East Asia's share in world output and growth has been rising rapidly

Developing East Asia's share of global GDP (PPP, Constant 2005 International $)

Developing East Asia's contribution to global GDP growth (PPP, Constant 2005 International $)

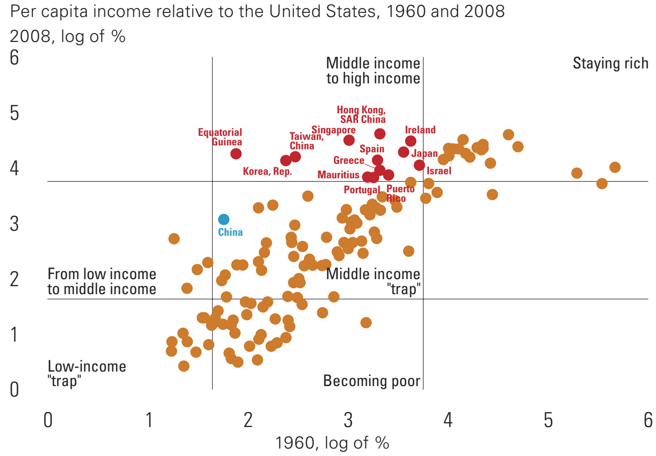


Source: WB, World Development Indicators.

Over the medium term, for an increasingly middle income region such as EAP, productivity increases will drive growth. Without this, countries risk getting stuck in a middle income trap, and there is some evidence to support the existence of such a trap, although EAP economies have been relatively successful in avoiding the trap: of the 101 middle income countries in 1960, only 13 made it to high income by 2010, but 5 out of those 13 are in EAP.[2] Labor productivity gains have been large across the region since the 1997/98 regional financial crisis, but China, where output per worker grew by more than 8 percent per year, has taken a disproportionate share in this. Progress in other EAP countries has been more modest at a little over 3 percent per annum. Demographic factors will play less of a role in the

Figure 12. Few middle income economies became rich, but many of those are in EAP

Per capita income relative to the United States, 1960 and 2008



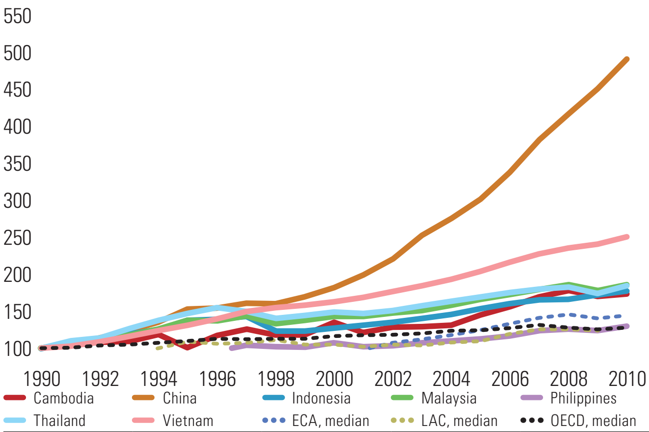
Source: World Bank and Development Research Center 2012, *China 2030*.

2 Source: World Bank and Development Research Center 2012, *China 2030*.

decades ahead, and for China, the demographic dividend will turn negative. And even if investment is to stay high, its contribution to growth will diminish over time. Continued structural reforms in product and goods market, improvements in the business climate and investment in education systems and infrastructure to remove the bottlenecks that are apparent in several countries will therefore become more important for growth. As short term concerns continue to loom large on the policy agenda, policymakers should keep focus on this important structural agenda.

Figure 13. Labor productivity has grown across the region with China experiencing explosive growth

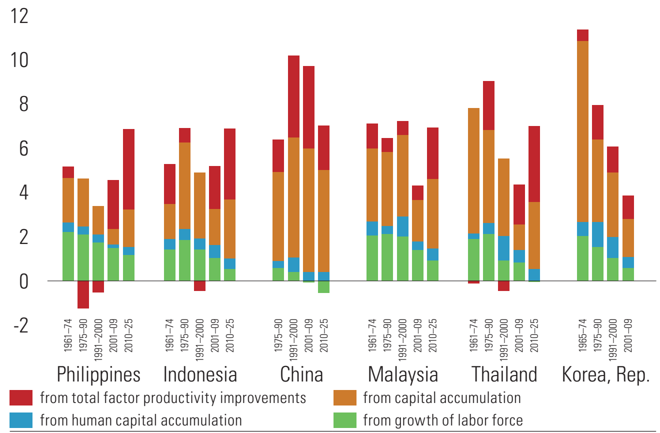
GDP per person employed, index, 1990=100



Source: ILO, Key Indicators of the Labor Market, and WB staff estimates.

Figure 14. Future growth requires more total factor productivity increases

Contributions to per capita growth rate. Simulated at 7 percent beyond 2010



Source: Updated from Bosworth and Collins, World Development Indicators, and National statistics .