

EAST ASIA AND PACIFIC REGIONAL OVERVIEW

An improving cyclical outlook

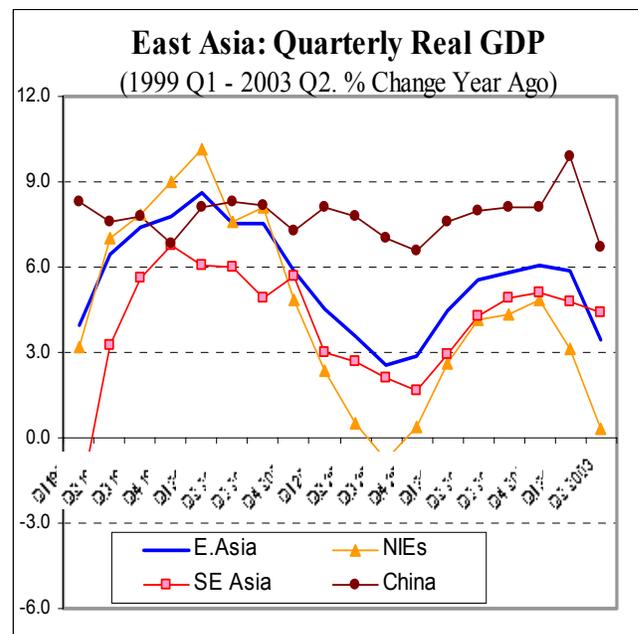
Economic activity in East Asia² is expected to strengthen in coming months. Growth dipped in the second quarter of 2003, principally because of the shock to consumer and business confidence from the unexpected SARS crisis. However, although growth outcomes in the second quarter were quite diverse, on balance the impact of SARS seems to have been more modest than previously feared. Readings on how the regional economy did in the third quarter are not yet clear cut because of conflicting signals from different indicators and differences across countries. On the one hand, the quick passing of SARS – at least for the time being – has been accompanied by sharp rebounds in tourist arrivals and retail sales. Far from concerns about too little growth, China is in the midst of such a strong boom in investment that policy makers are focusing on preventing overheating in some sectors, thereby avoiding a ‘hard landing’ for the economy in 2004 or beyond. On the other hand, export growth in the majority of countries slowed during the summer and in some has yet to recover.

Developing a firm view on the near term outlook is difficult in the face of these conflicting signals. However, on balance we think the prospects for a stronger cyclical recovery in East Asia are now good, on the basis of a number of supportive global and domestic conditions that are discussed in more detail in the rest of this report. The recovery in the developed world is picking up, led by stronger growth in the US and Japan, and the pace of world trade growth will likely follow, helped also by the roaring pace of domestic demand and import growth in China. With investment spending in the developed world starting to revive, even the long depressed world high tech industry seems to be advancing, if in fits and starts. East Asia seems set to emerge as an even more important global production base for high tech MNCs, centered in China but drawing on many countries in the region. Looking forward to better times, world stock markets have mounted a strong advance, while global investors’ appetite for riskier higher return assets has grown keener, leading to reviving portfolio flows to developing countries and especially strong rallies in emerging market stock and debt markets, including in East Asia. Domestic interest rates are low and, partly as a result of restructuring efforts, the profitability and asset quality of East Asian banks has improved in most of the post-financial crisis countries, supporting a marked revival in new bank credit flows. Corporate profitability and balance sheets have

also improved in several of the post-crisis countries, which should further help foster a recovery in business investment.

Not that the outlook is entirely sunny, of course, and the report also discusses a number of concerns or risks that will need to be addressed if the prospective cyclical recovery is to mature into a long period of sustained expansion. There are well known macroeconomic imbalances and structural weaknesses among developed countries that could yet frustrate the global recovery. The breakdown of the global trade talks at Cancun needs to be overcome. China’s economy faces new problems for economic management, in part as speculative capital inflows put upward pressure on the country’s exchange rate peg and add to rapid growth in foreign reserves, domestic money supply and bank credit. Large foreign exchange reserve accumulations in several other countries, while reducing vulnerability to external shocks, can also complicate macroeconomic management, a topic discussed in more detail later in this report. More broadly, long run growth may be constrained by institutional weaknesses in the investment climate and governance. An assessment of governance outcomes suggests the region has made little progress in this area over the last 6-7 years, a time when emerging economies in Central and Eastern Europe have made dramatic progress on governance. A higher and more sustained pace of FDI inflows to emerging Europe suggests that governance issues may be having direct implications for the region’s competitiveness.

Exhibit 1



² East Asia comprises Developing East Asia (China, Indonesia, Malaysia, Philippines, Thailand and some smaller economies) and four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan, China).

Diverse growth outcomes in the wake of SARS

Aggregate East Asian GDP growth in the second quarter of 2003 fell to a year on year (y-o-y) rate of a little over 3 percent, down from almost 6 percent in the first quarter of the year.³ (Exhibit 1). One adverse factor affecting several economies was the renewed and rather unexpected slowdown in the developed world in late 2002 and early 2003, which contributed to a slower pace of export growth in several economies. More important, however, was the impact of public concern about the SARS virus, which took off in the second half of March and reached its peak in May, before tailing off as strong public health measures around the region took hold and the number of new cases fell to zero by mid-June.

But, while second quarter growth slowed almost everywhere, there was still a great diversity of outcomes. In China, growth, while decelerating from an exceptionally high pace in the first quarter, remained robust by ordinary standards, and appears to have resurged in the third quarter. Strong growth in Vietnam also seems to have been little affected. At the other extreme, there was a sharp slowdown in the Newly Industrializing Economies, while, in between, the SARS impact on the middle income economies of South East Asia seems to have been less than initially feared.

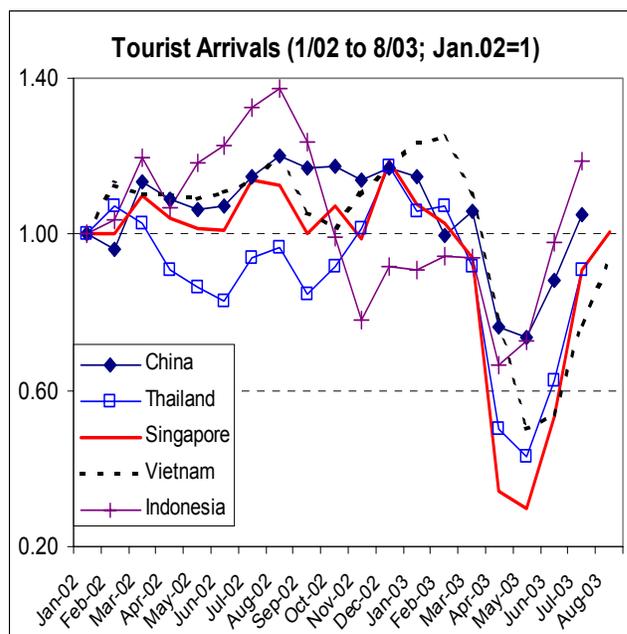
China, which is otherwise in the midst of an exceptionally powerful expansion, saw growth dip from 9.9 percent on a year ago in the first quarter to a (still strong) 6.7 percent pace in the second as a result of SARS. Although China was the center of the epidemic, with over 5000 cases, its impact on the economy was cushioned by the size and diversity of the country and the underlying momentum of growth. Tourist arrivals fell by around 30 percent from a year earlier in May, the peak of the crisis, but began rebounding in June. (Exhibit 2). The economic impact of the tourism decline was also limited by the fact that tourism comprises a much smaller part of the economy than in many other countries of the region. Retail sales slid to a still positive year on year pace of 4-5 percent in May but have since bounced back to near 10 percent by August. Fears that SARS would disrupt cross-border business contacts and exports appear to have been overstated, since exports have continued to grow by around a 30 percent pace through August in nominal dollar terms. Indeed the attention of policy makers is now focused on moderating the pace of expansion in sectors such as real estate and other areas of infrastructure at the level of sub-national governments, which is fueled by credit expansion, and which is raising concerns about potential adverse effects on the quality of investment, the fiscal position and the health of the banking system. The authorities have taken steps to better control

³ Quarterly growth figures for East Asia refer to a GDP weighted average of 9 economies: China, four South East Asian economies (Indonesia, Malaysia, Philippines and Thailand) and four Newly Industrialized Economies or NIEs (Hong Kong, Korea, Singapore and Taiwan (China)).

new lending as well as to slow speculative short term capital inflows. Thus, while growth in the rest of the region is expected to be accelerating into 2004, it is expected to be slowing in China, easing from near 8 percent in 2003 to around 7.4 percent next year.

The other fast growing transition economy of the region, Vietnam, experienced just over 60 SARS cases, a significant number. Tourist arrivals in May were down around 50 percent on a year earlier but have rebounded since, with little apparent effect on overall economic growth, which is expected to reach around 7 percent this year, support by healthy broad-based expansion in exports, consumption and investment.

Exhibit 2

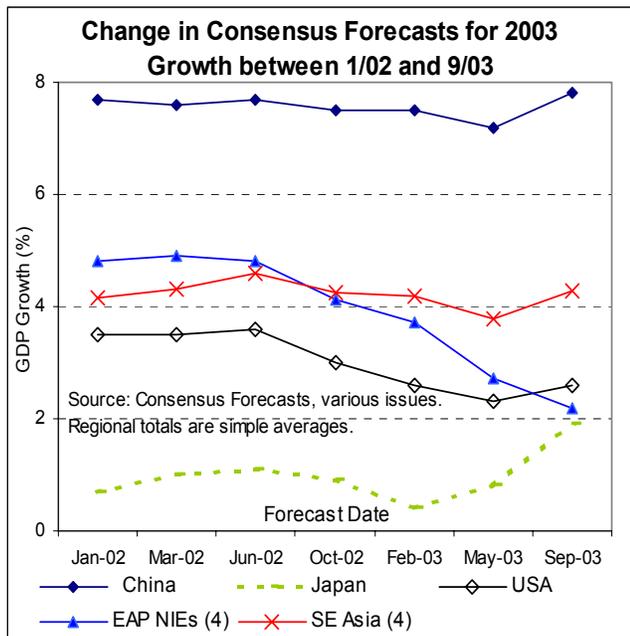


The middle income economies in South East Asia had fewer SARS cases – the highest was 14 cases in the Philippines – and experienced only relatively mild effects on growth in the second quarter. Thailand, where tourism plays a larger than average role in other East Asian economies, also experienced a significant 50 percent fall in arrivals by May, but this was offset by continued growth in goods exports, consumption and investment. The year on year pace of GDP in the second quarter only dipped to a still high 5.8 percent from 6.7 percent in the first. SARS also seemed to have limited impact on underlying trends in the other South East Asian economies. Second quarter growth continued at a 4-5 percent year on year rate in Malaysia, and at 3-4 percent in Indonesia, slowing most in the Philippines, although this seems to have had less to do with SARS than with weak goods export growth and cuts in public spending aimed at reversing a large fiscal deficit.

Monthly indicators for the third quarter suggest the softer tone for growth could continue a little longer. In particular, as discussed in the next section, year on year export growth in South East Asia continued to slow through

August. However, in contrast to the Newly Industrializing Economies, private consumption growth in particular has remained strong in South East Asia, while more recently investment growth has also strengthened to a robust 7-9 percent year on year rate in Thailand, with more modest signs of revival in some other countries. With prospects for world recovery improving, consensus forecasts for most of these countries have also turned up recently, after having been pared lower over much of the past year. (Exhibit 3)

Exhibit 3



Among the *Newly Industrialized Economies* (NIEs), second quarter growth fell to a negative year on year pace in Hong Kong (China), Singapore and Taiwan (China), which were among the economies with significant numbers of SARS cases. By May tourist arrivals were down by around 70 percent from year earlier levels in Singapore and Hong Kong. Retail sales fell as cautious consumers stayed away from markets, shops, restaurants and other places where SARS could be transmitted, adding to the effects of already low consumer confidence pre-SARS. The prevailing uncertainty also contributed to further declines in already weak fixed investment. The outlook for these economies improved with the steep fall in SARS cases in late May and early June. Tourist arrivals are rebounding, returning to near year earlier levels by August, and retail sales are also recovering. In contrast to South East Asia, there are indications of a pick up in export growth, led by a strong rebound in electronics and other high tech exports. In Singapore, GDP, which had fallen by 11 percent in the second quarter (at a seasonally adjusted annual rate from the first quarter), rebounded by 15 percent in the third.

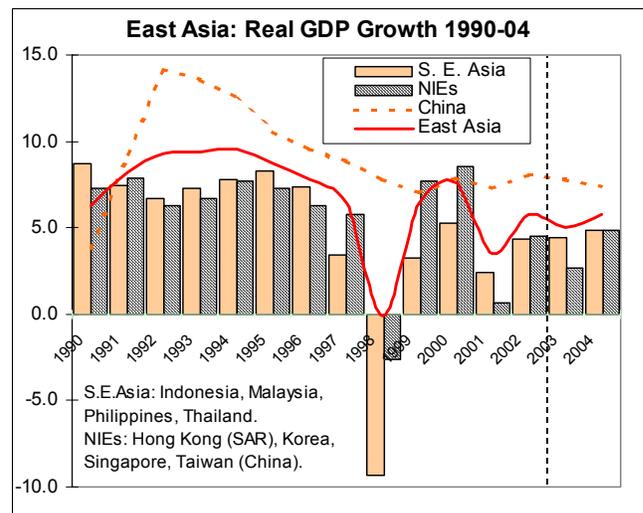
Among NIEs, Korea was much less directly affected by SARS, experiencing only 3 cases as compared to over 1700 in Hong Kong, over 200 in Singapore and over 300 in Taiwan (China). Growth was however depressed by

other more purely domestic factors. High consumer debt levels and new credit restrictions have led to retrenchment in consumer spending and housing construction. Confidence has also been hurt by labor unrest and the North Korean crisis. GDP contracted from the preceding quarter by 1.6 percent in the first quarter and 2.9 percent in the second (seasonally adjusted annual rate). Revival of activity in the third quarter was dampened by a serious typhoon hitting the southern part of the country, but should strengthen with the completion of adjustment in household balance sheets, supportive fiscal policy and further recovery in the world economy.

Prospects have also turned modestly higher in the Pacific Island economies. Growth in Fiji is projected around 5 percent as a result of higher tourism and garment and sugar exports. Papua New Guinea is expected to see its first positive growth since 1999 as a result of higher prices for its commodity exports such as gold, oil and traditional agricultural products. The outlook is even greatly improved in the Solomon Islands, where a regional assistance mission led by Australia has succeeded in reestablishing law and order after a long period of ethnic strife that led to massive declines in economic activity.

All told, this year's cross-cutting or divergent trends add up to an aggregate regional downturn that may be milder than previously expected, with growth dipping to around 5 percent from 5.8 percent in 2002, almost entirely due to the weakness in the Newly Industrializing Economies. (Exhibit 4). But with stronger world growth and supportive domestic conditions discussed in the rest of this report, regional growth is expected to recover to a little under 6 percent in 2004. Leaving out the NIEs, growth in Developing East Asia is expected to reach 6.5 percent this year - the highest among all developing regions, and little changed from 2002 - and to continue at about the same rate in 2004.

Exhibit 4



Concerns remain however that SARS may have become endemic and that - like other influenza like diseases

– it may return with the lower temperatures of winter. This possibility underlines the importance of policy makers drawing appropriate lessons from their responses to this spring's SARS outbreak and further strengthen the preparedness of public health systems to deal with cross-border epidemics. Box 1 on *Policy Responses to SARS* discusses the recent experience and its lessons further.

Box 1 – Health Policy Responses to SARS

The responses to the SARS epidemic, although varied across countries, highlight the importance as well as vulnerability of public health infrastructure in the region. Several lessons can be drawn from these experiences. Vietnam showed how to decisively contain an epidemic, quickly and at relatively modest cost. The government facilitated prompt and open reporting, requested immediate assistance from the World Health Organization (WHO), initiated rapid case detection, and performed vigorous contact tracing. Political commitment at the highest level was a key factor. In Singapore action was also swift, comprehensive and on a large scale. The government mobilized many sectors of the community, not just the medical profession; cooperated with neighboring countries to restrict travel; and promoted individual social responsibility. In China, the reaction varied over the duration of the outbreak. After an initial delay in recognizing the scope of the issues and problems with data sharing, China became fully committed to fighting the disease, and, additionally, expanded capacity to be better prepared for a renewed outbreak or other similar events. The Government launched a program to address SARS-related diagnosis and clinical management, with assistance from WHO, the World Bank and bilaterals (UK, Canada, Japan). The program also aims to strengthen the capacity of the public health system for infectious disease prevention and control more generally. It has also renewed commitment to improving health care services.

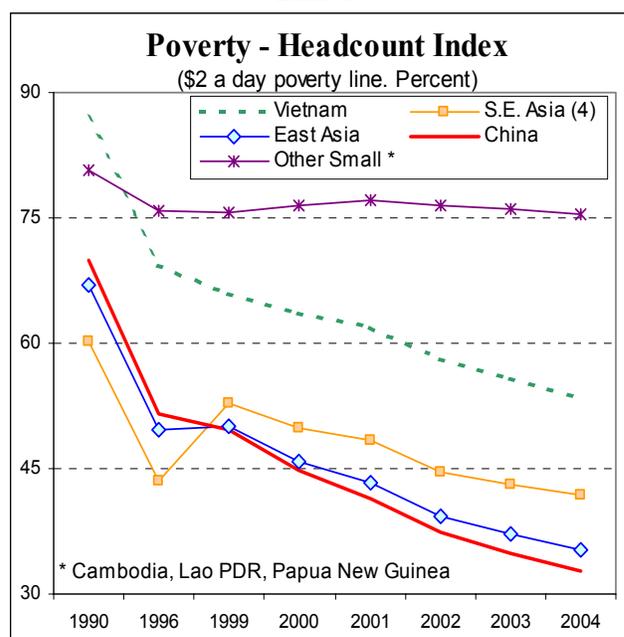
These examples highlight some main lessons learned in combating the SARS epidemic: the need for government commitment at the highest levels, improved surveillance and reporting, transparency of information, involvement of the media to build support and share knowledge, strengthened overall capacity in the health system, and in particular strengthened capacity for infectious disease prevention and control, together with better global preparedness and collaboration and the need to stimulate rapid, high level research for recommending sound control interventions.

Looking forward, the region faces the challenge of ensuring that SARS or other infectious diseases do not evolve into serious epidemics. This will be a fight against complacency. There is a need to strengthen the overall public health infrastructure while also addressing broader issues of health sector reform and development. Cross-sectoral interventions in the infrastructure and environmental sectors to ensure clean water supply also need tackling. Information, monitoring and surveillance systems need improvement. The World Bank stands ready to continue supporting these efforts.

Poverty continues to move lower – but is it getting harder?

This year's mild downturn in regional growth is unlikely to have much of a negative impact on income poverty, since most of the slowdown was concentrated in the Newly Industrializing Economies, which contain virtually no people living at the \$1 or \$2 a day level. The number of poor in East Asia at the \$2 a day level is expected to have fallen by around [30] million to around 680 million in 2003. The poverty rate (or headcount index) at the \$2 a day level would then fall to about 37 percent, its lowest ever level, down from 39 percent in 2002. (Exhibit 5 and Appendix Tables 6 and 7).

Exhibit 5

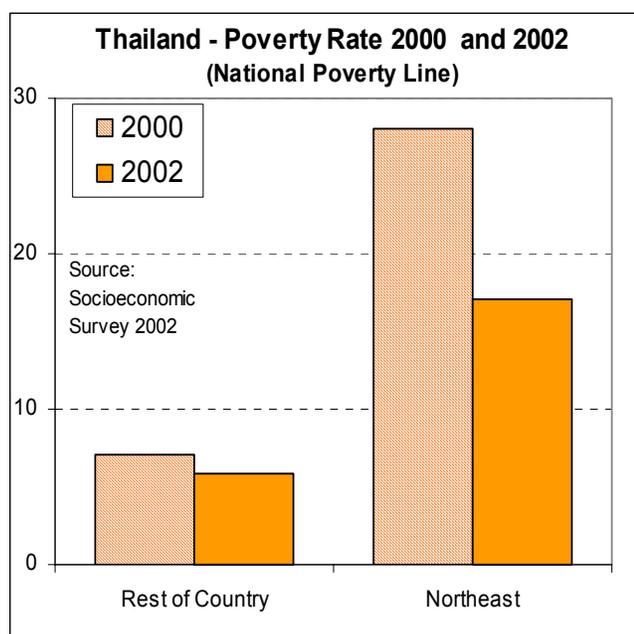


About two thirds of the East Asian poor at the \$2 a day level live in China, and of those about 90 percent live in China's rural areas. Although the pace of rural poverty reduction in China slowed during the 1990s, the poverty rate at the \$2 a day level is estimated to have fallen to 37 percent in 2002 from 42 percent in 2001, a notable advance, supported by rural real income growth of about 5 percent. Poverty reduction is likely to have been slower in the first half of 2003 compared to 2002. In rural areas, the growth rate of agricultural value-added was under 3 percent in the first half of 2003, mainly because of weak sales of animal husbandry products, fruits and vegetables. Cash income of rural residents was also negatively affected as migrants to the cities returned home during the SARS crisis and have only partly reclaimed their urban jobs since. In the first half of this year, per capita cash income of rural residents was RMB 1,158, a real increase of 2.5 percent, only half the 2002 pace. Unemployment is up in urban areas, partly a result of SARS-induced problems in the services sector, and partly a result of continued enterprise restructuring.

However, per capita disposable income of urban residents in the first half of this year reached RMB 4,301, a real increase of 8.4 percent. Poverty alleviation policies continued to focus on targeted support to poor counties and on regional development in the lagging provinces. In addition, new initiatives (tax credits and subsidies) have been launched to promote job creation and to establish some rural health insurance and a public health crisis response system.

The other main concentrations of poor people are among the low and middle income countries in South East Asia, in particular Indonesia (around 115 million people below the \$2 a day line in 2002), Vietnam (48 million), Philippines (36 million) and Thailand (17 million). Here poverty rates have generally been trending lower in the years since the financial crisis, although at varying rates.

Exhibit 6

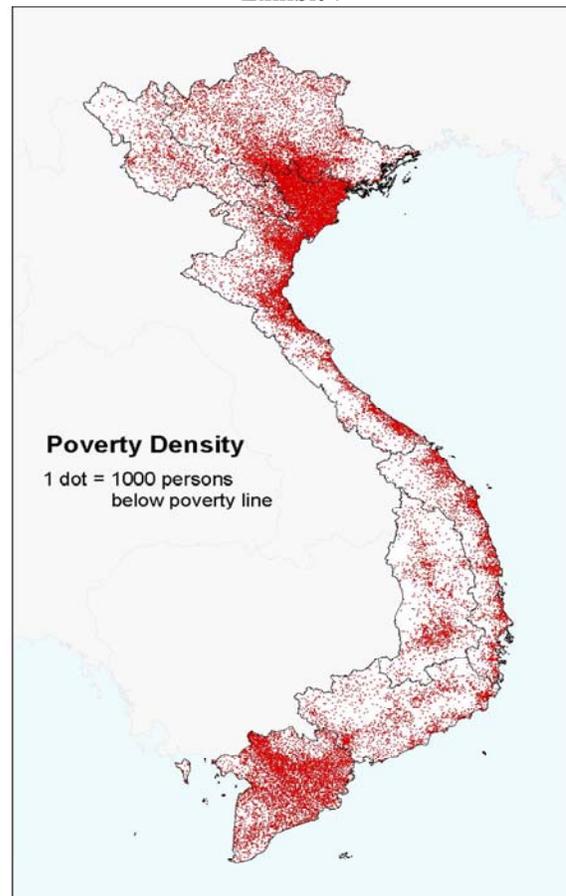


According to *Thailand's* recently released "Socioeconomic Survey 2002", poverty at the national poverty line⁴ rose from 11.4 percent in 1996 to 14.2 percent in 2000, but then fell rapidly to only 9.8 percent in 2002, less than pre-financial crisis levels. Poverty reduction has been especially strong in the backward North-East, where two thirds of Thailand's poor are concentrated. The pace of poverty reduction was twice as fast as in the rest of the country. (Exhibit 6). Farm households benefited from substantial price increases in 2001-02 for important crops like paddy rice, rubber, tapioca, palm, and oilseeds, reflecting both higher world prices and domestic conditions. In addition strong economic growth has fueled labor demand, drawing labor out of agriculture into higher paying jobs in industry and services. The share of workers employed in agriculture declined from 44.2 to 42.5 percent

⁴ The poverty line equals to 30 Baht per person per day, or US\$0.70, or about US\$1.5 in Purchasing Power Parity

in this period. Given this year's acceleration in growth and with commodity prices remaining at higher levels, progress on poverty reduction in Thailand is expected to continue.

Exhibit 7



Vietnam completed an extensive new household living standards survey (VHLSS) in 2002, allowing a more accurate monitoring of poverty trends at national and regional levels. The proportion of the population with per capita expenditures under the national poverty line dropped dramatically during the last decade from 58 percent in 1993 to preliminary estimates of around 29 percent in 2002. As would be expected in a country rapidly expanding manufactured exports into world markets, urban poverty fell sharply from 29 to 6 percent, but – more impressively – rural poverty also fell sharply, from 66 to 34 percent. However, while progress in poverty reduction over the last decade has been impressive, recent data suggests a slowdown in the pace in the last five years. The rapid gains in productivity generated by rural reforms may have run their course in boosting rural incomes, and reducing poverty further in Vietnam may become increasingly difficult as poverty becomes concentrated in remote areas and among ethnic minorities. Regional disparities in poverty and the rate of reduction are large and reflect both geographic/ethnic factors and the extent of integration with national and international markets. The information in VHLSS is being combined with data available from the population census to make

detailed studies of the geographical distribution of poverty, the main correlates of poverty and how market opportunities, public policies and participation affect the well-being of poor households. Exhibit 7 shows preliminary results from ongoing work to develop detailed poverty maps for Vietnam.

Poverty in the *Philippines* is also likely to have fallen in the last couple of years, but at a slower pace than in Thailand and Vietnam, falling at the \$2 level from an estimated 47 percent in 2000 to about 45 percent in 2002. However disparities in poverty incidence across sectors remain significant. While urban poverty has declined, poverty in the rural areas remains obstinately high, with three-quarters of poor families still residing in the provinces. Poverty incidence among the ten poorest provinces ranges from 53-63 percent. These provinces are mostly found in Mindanao, Cordillera, and the Bicol region. In comparison, the least poor provinces had poverty incidence ranging from 5-12 percent. Mostly, these are cities and provinces located in the NCR and the CALABAR zone area. Economic isolation is an important correlate of poverty incidence at the regional level.

East Asia also contains small low income economies like Cambodia, Laos and Papua New Guinea, where the absolute numbers of poor are fewer than elsewhere, but where the incidence of poverty in the population is much higher, generally above 70 percent at the \$2 a day level. In *Cambodia*, for example, quite rapid per-capita GDP growth has been concentrated in the garment and tourism sectors, which employ only a small part of the labor force. On the other hand agricultural output growth has averaged only 1-2 percent a year, holding back income gains for rural households, which comprise 90 percent of the poor. Poverty at the \$2 level is estimated to have hardly fallen from 80 to 79 percent between 2000 and 2003. In terms of geographic breakdown, the Poverty Map in the National Poverty Reduction Strategy shows pockets of deep poverty spread throughout the country.

By contrast, there has been considerable progress in reducing poverty in *Lao PDR*. While *Lao PDR* remains a desperately poor country with more than three-quarters of population living on less than US\$2 a day (the highest incidence of poverty in the region), poverty levels have fallen rapidly in the last decade. Based on the preliminary results of the 2002/03 LECS III survey and using the national poverty line, the poverty headcount rate fell to 31 percent from 39 percent in the last survey in 1997/98. Progress in national poverty reduction was driven largely by declining numbers of rural poor while poverty seems to have slightly edged up in urban areas since 1997/98. Five years ago poverty in rural areas was twice as high as in urban areas but the recent data shows that this gap has now declined to 30 percent. Lower inequality also contributed to reduced poverty – the Gini coefficient declined from 0.35 to 0.33 - suggesting that economic growth has become more pro-poor. The continuing decline in rural poverty reflects a gradual improvement in the agricultural policy environment through greater market orientation. Diversification of

production systems, a higher share of livestock production and continuing regional specialization have led to a pick up in agricultural growth since 1997/98 (5.3 percent). There has been also continuing improvement in value added per worker in the sector, although productivity levels continue to lag behind those of neighboring countries. Attainment of the Millennium Development Goal of halving poverty by 2015 seems to be well within *Lao PDR*'s reach.

Finally, it is important to remember that poverty is a multi-faceted concept that includes not just lack of income but also deficiencies of specific attributes such as education, health and access to services like water and sanitation. Making progress on these dimensions cannot rely entirely on income growth. As the accompanying Special Focus on "Making Services Work in East Asia" in this report observes, a one percent increase in per-capita income among low income countries is associated with only about a 0.5 percent decline in under-five infant mortality, and, more importantly, there is a very wide range in how far an extra dollar of income is associated with better health outcomes. While East Asia has in general enjoyed spectacular income growth over the decades, its progress in specific areas of health care, access to water and sanitation has often been much slower. As the Special Focus observes, there may be many valuable cross-country experiences as to how public policy can foster better service delivery poor in an economically efficient manner.

International environment – better but still uncertain

A slowdown in the developed world in late 2002 and early 2003 contributed to slower export and overall GDP growth in East Asia in the second quarter of the year. Exhibit 8 shows that, while China's export growth was little affected by the global slowdown, export growth in other economies fell through the first half of the year. The export slowdown was especially severe for South East Asian economies, where it continued into the third quarter. In some of these countries a downshift in electronics exports led the overall slowdown. This may be partly a matter of time lags, so that continued recovery in the developed world should be reflected in East Asian export numbers in due course. There could also be a lagged effect of disruptions to import orders from China because of SARS.

World recovery gathers strength - again

After a six month 'soft spot' in the last quarter of 2002 and the first quarter of 2003, when growth slowed sharply all over the developed world, recent data point once more to improving confidence, demand and activity, notably in the United States and Japan, underpinned by the very supportive monetary and fiscal policies adopted by many governments to offset the global slowdown.