

WORLD BANK EAST ASIA AND THE PACIFIC ECONOMIC UPDATE OCTOBER 2022

REFORMS FOR RECOVERY

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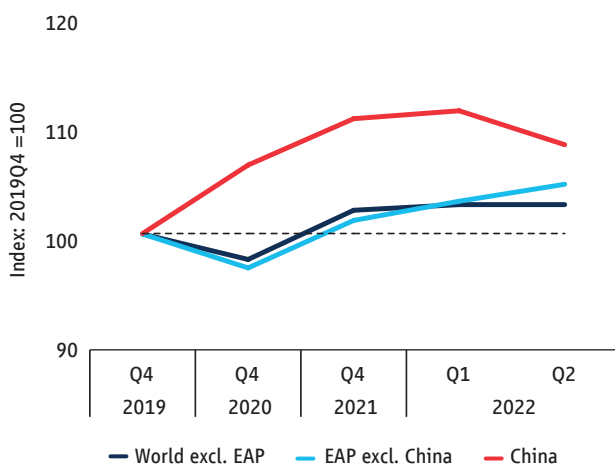
Overview

Growth in most countries in the East Asia and the Pacific (EAP) region rebounded in the first half of 2022, but China lost momentum (Figure O1A; table O1). In much of the region, domestic demand revived after the distress of the COVID-19 Delta wave. In China, the public health measures to contain outbreaks of the highly infectious Omicron variant inhibited consumption. Most of the region is projected to grow faster and have lower inflation in 2022 than other regions (Figure O1B).

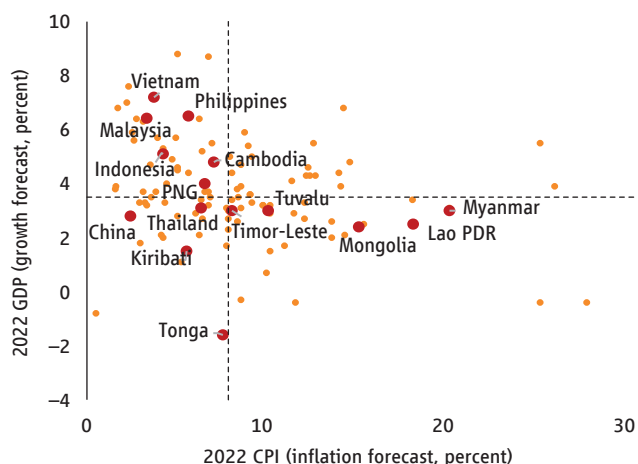
Beyond the end of 2022, three factors could be a drag on growth: global deceleration, rising debt, and policy distortions. Current measures to contain inflation and debt are adding to existing distortions in the markets for food, fuel and finance in ways that could hurt growth. In each case, more efficient measures could address current difficulties without undermining longer-term objectives.

Figure O1. Even as China's economy slowed in the first half of 2022, the rest of the region continued to grow; in major EAP countries, growth is projected to be higher and inflation lower than in the rest of the world

A. GDP relative to pre-pandemic levels



B. Inflation and GDP growth forecasts for 2022



Source: World Bank; Fitch.

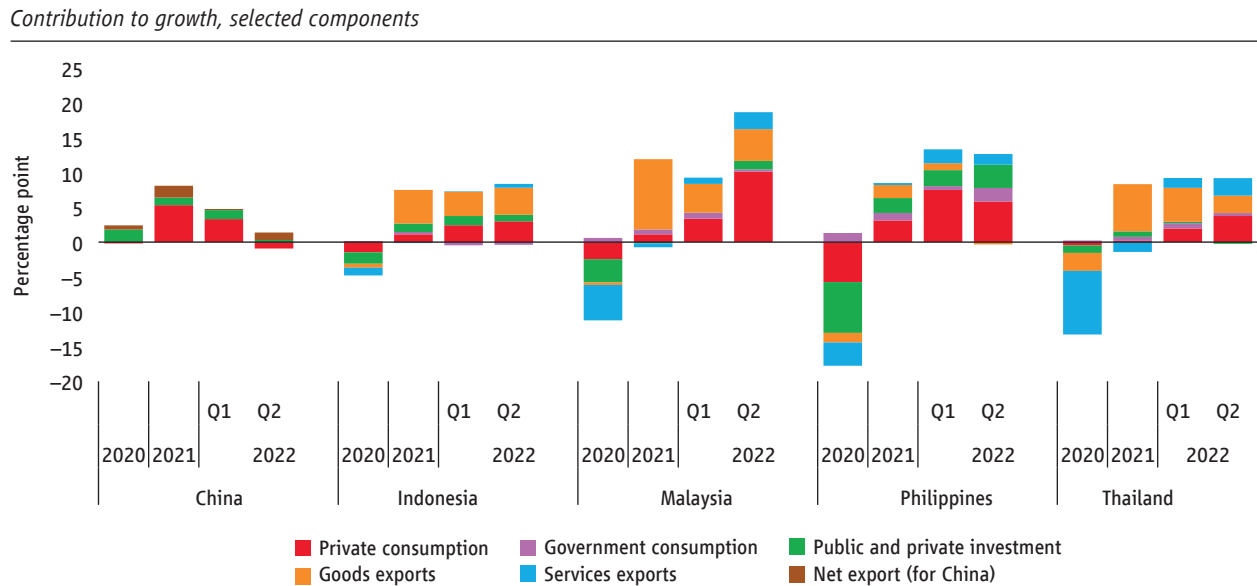
Note: A. Seasonally adjusted real GDP indexed to fourth quarter of 2019 (100). B. Dotted lines show median of emerging market and developing economies (EMDE).

What explains growth?

The relatively strong growth in most EAP countries during much of 2022 is for three reasons: the robust recovery of private consumption in the first half of 2022 from the Delta deprivation in the latter half of 2021 (Figure O2); the sustained global demand for EAP exports of manufactured goods and commodities, though signs of weakening have appeared (Figure O3); and the limited tightening so far of fiscal and monetary policy, though pressures to tighten may increase (Figure O4).

The economic impact of COVID-19 may now be small in much of the world but it is still significant in China and in the Marshall Islands, Micronesia, and Palau. China has continued its zero-COVID approach, using mass testing and targeted mobility restrictions to contain outbreaks of the disease (Figure O5A). These restrictions disrupt supply chains, industrial and services production, domestic sales, and exports (Figure O5B).

Figure O2. Rebounding from the Covid-19 shock, private consumption is contributing to growth in EAP outside China



Source: Haver Analytics
 Note: China's private consumption includes government consumption.

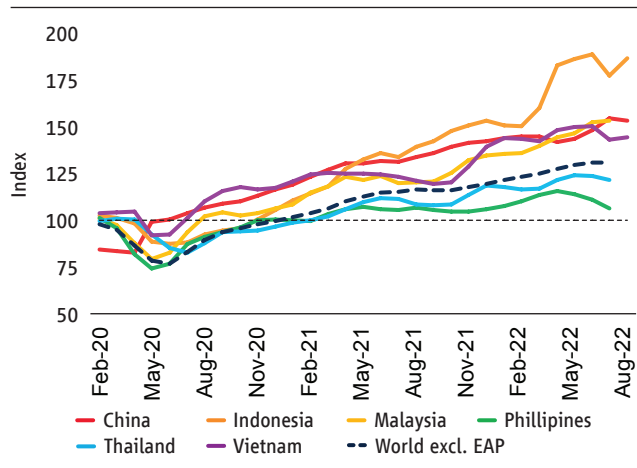
Three impediments to inclusive and sustainable growth

EAP countries are facing to a varying degree a combination of external and self-created problems: a slowing world economy that will dampen external demand; an increasing debt burden, already large in a few countries, exacerbated by increasing interest rates and depreciating exchange rates; and distortionary domestic measures taken by several countries to deal with current difficulties.

Deceleration. The global economic slowdown is likely to depress hitherto buoyant demand for the region's exports of manufacturing and commodities. At the same, the weakening of the pandemic is reviving hitherto dormant tourism. The slowdown in major economies could cut more than 1 percentage point off growth this year in the major EAP countries (Figure O6).

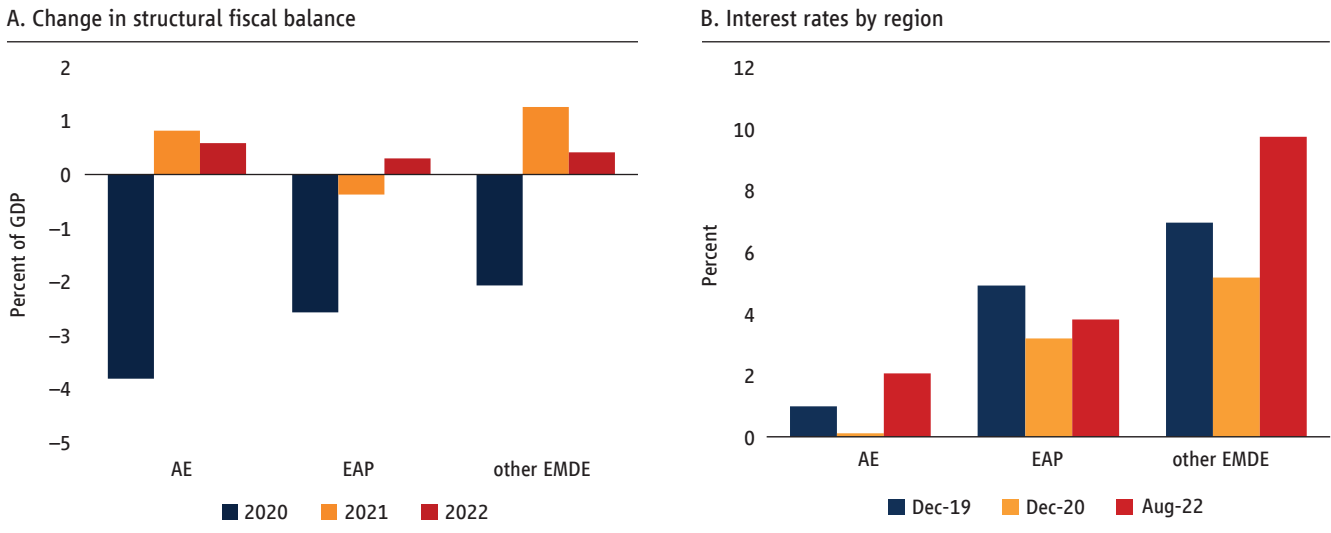
Debt. Inflation abroad is prompting an increase in interest rates, inducing capital outflows and exchange rate depreciation in EAP countries, all of which are raising the burden of servicing debt. The weakening exchange rate is also contributing to domestic inflation. Lao PDR and Mongolia are most vulnerable in these respects, because they were already struggling with high debt, and have large shares of debt at variable rates and denominated

Figure O3. Goods exports have grown strongly though now there are signs of weakening external demand



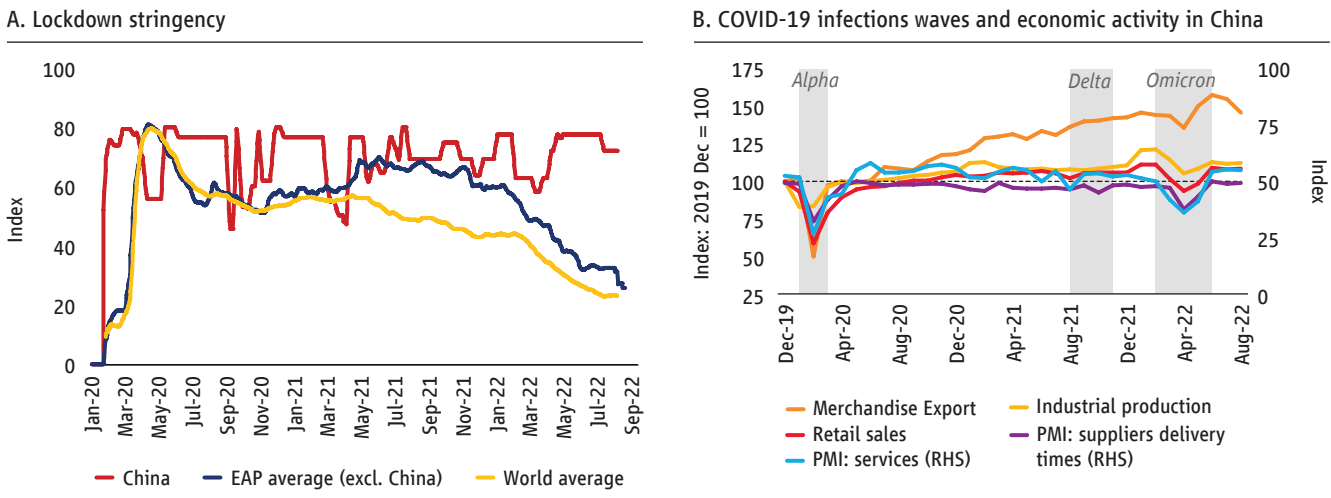
Source: Haver Analytics.
 Note: goods export value indexed to 2019 average (100). Seasonally adjusted. 3 month moving average.

Figure O4. Recent fiscal and monetary tightening in EAP countries has been less than in other regions



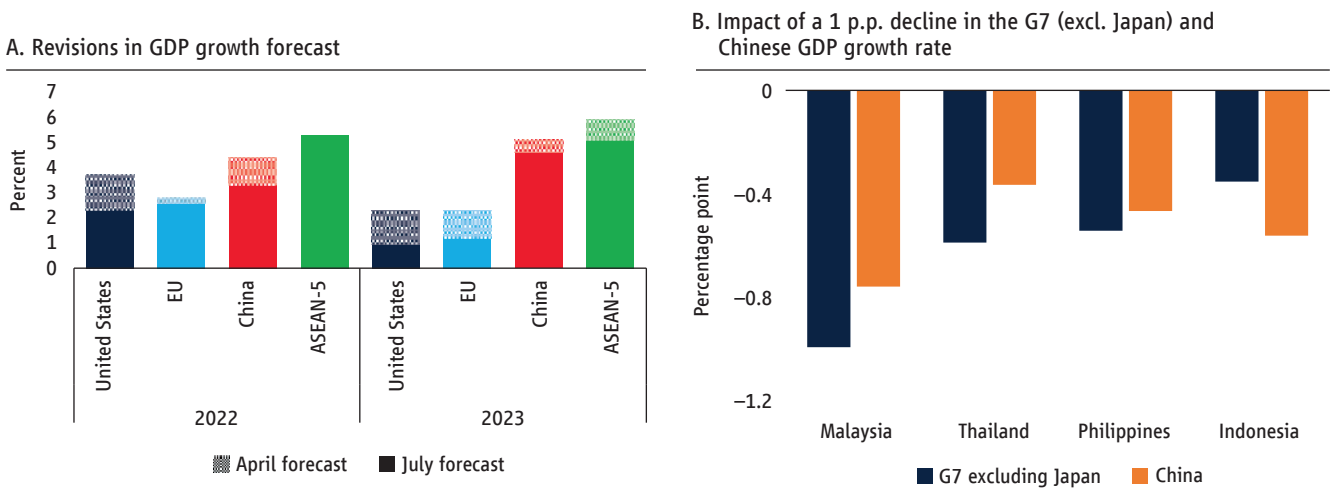
Source: Haver Analytics.
 Note: B. shows unweighted average interest rate of 10 EAP, 17 AE, 56 other EMDE countries.

Figure O5. Continued COVID-19 infections amidst China's zero-COVID policies are leading to disruptions in economic activity



Source: Haver Analytics, Johns Hopkins University Center for Systems Science and Engineering's COVID-19 Data.
 Note: B. Merchandise export, industrial production and retail sales indexed to December 2019; for suppliers' delivery times and services PMI, 50+ shows no delivery delay and expansion, respectively.

Figure O6. Slowing global growth will negatively affect growth in the region

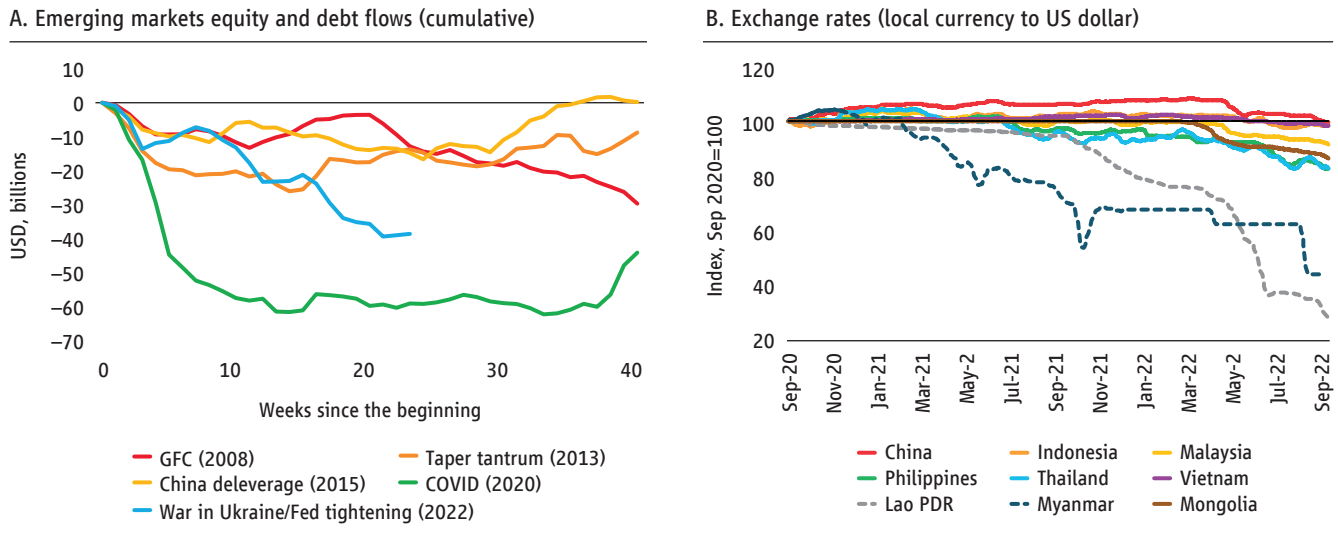


Source: International Monetary Fund; World Bank estimates
 Notes: B. Cumulative impact on growth after one year. Refer to main text for details.

in foreign currency, (Figure O7). Growing debt service is straining the finances of governments and firms and hence limiting public and private investment (Figure O8).

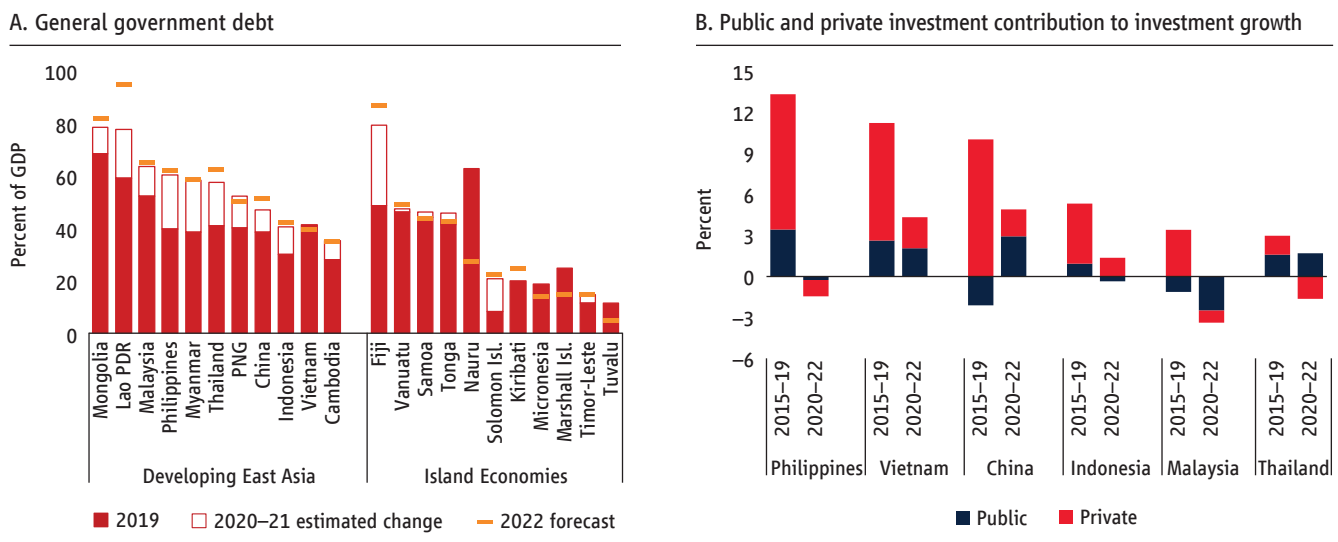
Distortions. EAP governments are striving to protect households from the increased cost of living and firms from the increased cost of production. Inflation has eroded purchasing power, by between 2 percent in Vietnam and 11 percent in Mongolia. Governments also need to alleviate the increased burden of servicing public and private debt. Current

Figure O7. Rising international interest rates are leading to capital outflows from EAP countries and creating depreciation pressures . . .



Source: Haver Analytics, Institute of International Finance.
 Note: A. sample of selected emerging market countries.

Figure O8. . . . which are increasing the burden of debt, and hence inhibiting the revival of investment



Source: International Monetary Fund, Haver Analytics, World Bank.
 Notes: B. Shows decomposition of real investment growth. 2015-19 and 2020-22 refers to average during each respective period. Decomposition of investment growth for 2020-22 represents team's forecast and assessment

policy measures, intended as a response to short-lived shocks, provide much-needed relief but add to existing policy distortions.

- Controls on prices of food and fuel supported by subsidies dampen inflation (Figure O9), but distort consumer and producer choices, assist not just the poor and the SMEs but also the affluent and large firms, and swell public deficits and debt.
- Measures to deal with the growing burden of debt – in the absence of faster growth or greater revenue mobilization – may lead to repression in financial markets and hence distort economy-wide savings and investment decisions.

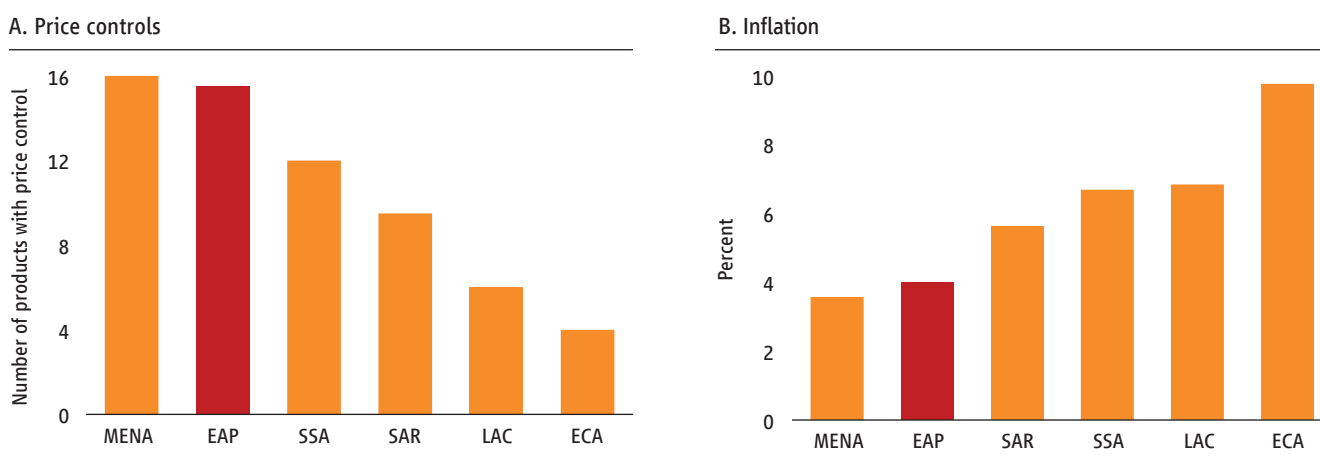
Current policy choices are being made in the face of difficult trade-offs shaped by limited implementation capacity, weak economic institutions, and strong political imperatives. The trade-offs also depend on the duration of shocks. With weak implementation capacity and temporary shocks, price subsidies may help consumers and firms avoid serious disruption with limited fiscal costs.

The implications of new and old distortions

The muddying of price signals in food, fuel, and finance, as well as other long-standing policy-induced distortions in these markets described below, will inhibit efficient reallocation in a post-COVID world.

In both food and fuel, EAP governments must meet the triple goals of *affordability, security, and sustainability*. In both cases, the political imperative today is to prioritize affordability for consumer and firms. This goal is being pursued by keeping prices low through food and fuel subsidies as well as export restrictions. These measures provide relief to consumers and producers, and may be the only immediately feasible measures, but they have economic costs even when they are temporary. They shrink fiscal space, inhibit switching of consumption to cheaper commodities, may help the rich and large firms more than the poor and SMEs, and draw tax payers' money away from expenditure on infrastructure, education and health.

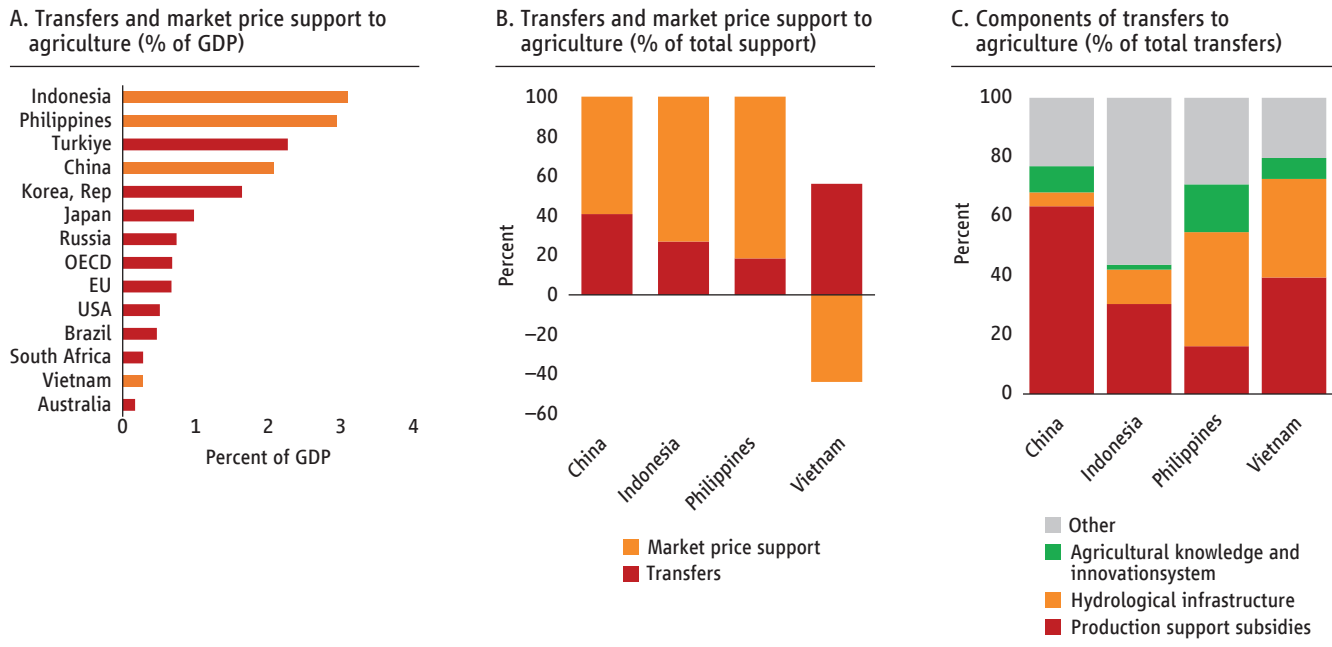
Figure O9. Price controls are one reason for lower inflation in the EAP countries



Source: A. WTO Trade Policy Reviews (TPRs) B. World Bank's Global Economic Monitoring (GEM).

Note: Median. A. Latest available number of products with import price controls pre-COVID, collected from TPRs. B. Median of CPI inflation in 2022 year to date. Seasonally adjusted.

Figure O10. EAP countries provide high and growing support to agriculture, primarily through market price support as well as transfers for production subsidies and irrigation



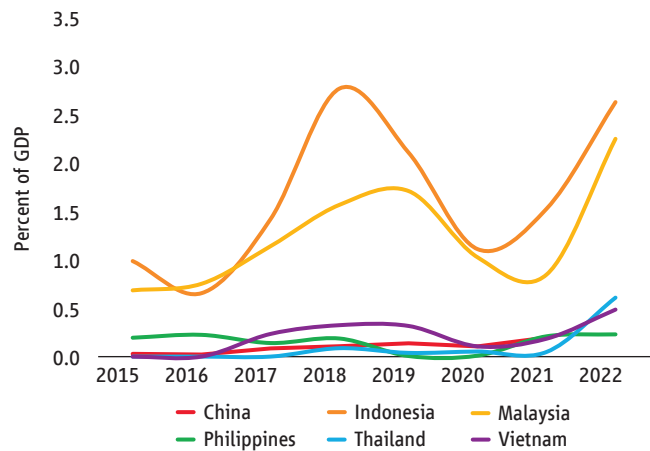
Source: World Bank estimates from OECD (2022).
 Note: Figures show 2010–2020 average.

In food, the temporary crisis measures taken to keep prices low run against a general trend in EAP countries to support production, especially of food grains. Among the existing producer-supporting policies, market price support (MPS) (through import restrictions and government procurement) and transfers to producers (through subsidies, irrigation and other supporting services) are both high and growing for some EAP countries. MPS is 1.5 to 4 times higher than transfers across countries and heavily biased toward production of grains, especially rice even as domestic consumption is diversifying to include more vegetables, fruit, and meat. The mismatch means greater import dependence, higher food prices, and longer-term nutritional insecurity. Between 40 and 70 percent of transfers to agriculture is spent on production and irrigation subsidies (Figure O10). These measures entrench input-intensive food production patterns that are economically inefficient and insufficiently attuned to the challenges of land degradation, environment pollution and greenhouse gas emissions.

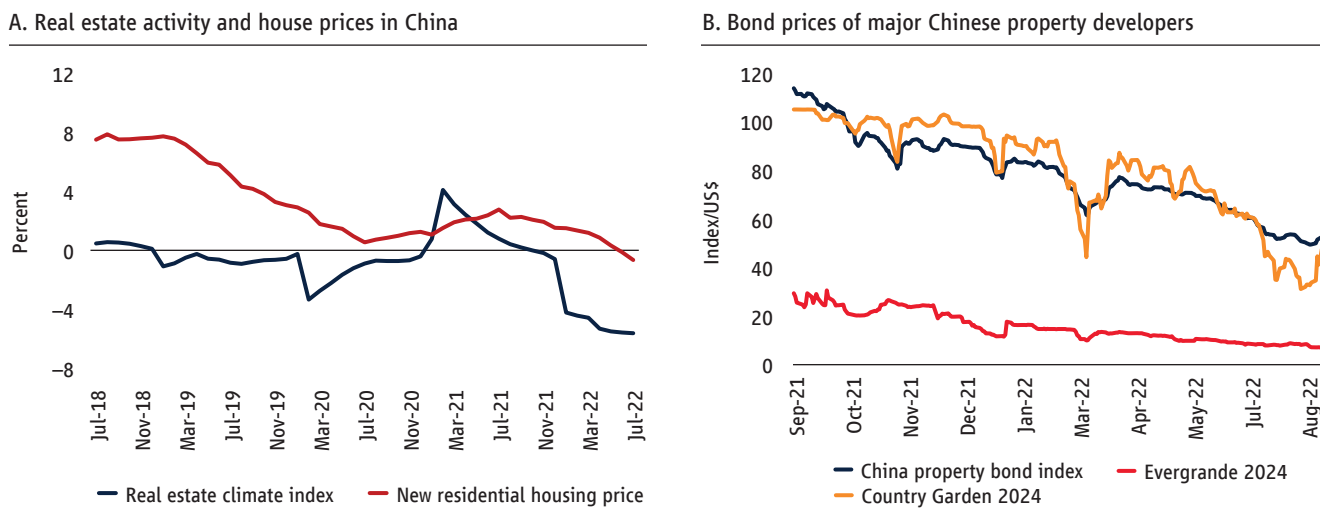
In fuel, the temporary crisis measures to keep prices low run counter to the efforts in major EAP countries in the last few years to reduce fuel subsidies. Fuel subsidies are growing in most countries, including in Indonesia and Malaysia which had significantly reduced them (Figure O11). At the same time, production of coal is being revived even in countries that were beginning to shut down coal mines. These actions

Figure O11. Regional fossil fuel subsidies have recently increased

Fuel subsidies in EAP countries



Source: IMF data for 2015–2021. World Bank estimates for 2022.

Figure O12. Declining house prices in China are further straining the finances of property developers

Sources: Bank for International Settlements; Bloomberg; Consensus Economics; Haver Analytics; World Bank.
 Note: A. Figure shows annual percentage changes. The climate index measures the aggregate business activity in land sales and real estate

today could compromise emission reduction commitments as well as perpetuate dependence on imported fossil fuels and hence vulnerability to future energy price shocks.

In finance, governments also have three goals: controlling inflation while maintaining financial stability and supporting growth. Today higher interest rates are being thrust on the region by the twin fears of inflation and capital flight which could weaken currencies. These developments increase the burden of servicing pandemic-bloated private and public - especially variable interest rate debt and debt denominated in foreign currencies. Debt distress in the corporate sector hurts the banks and may threaten financial instability. China's real estate sector turmoil is an example of pre-existing difficulties that are accentuated by financial tightening though the direct exposure of systemically important banks to property sector loans is limited (Figure O12).

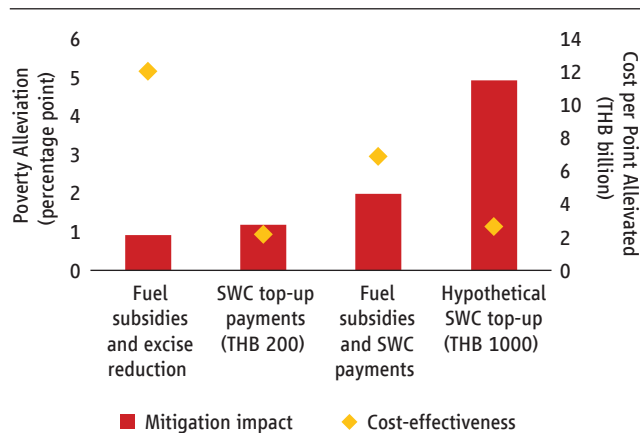
When financial institutions, as a consequence of pandemic-induced regulatory forbearance or debt moratoria, continue to support zombie borrowers, the availability of finance is reduced for more productive firms, resulting in lower investment and employment growth. At the same time, debt strains on the government can induce it to seek privileged access to domestic savings through measures that also crowd out productive private investment and hurt growth.

More efficient choices

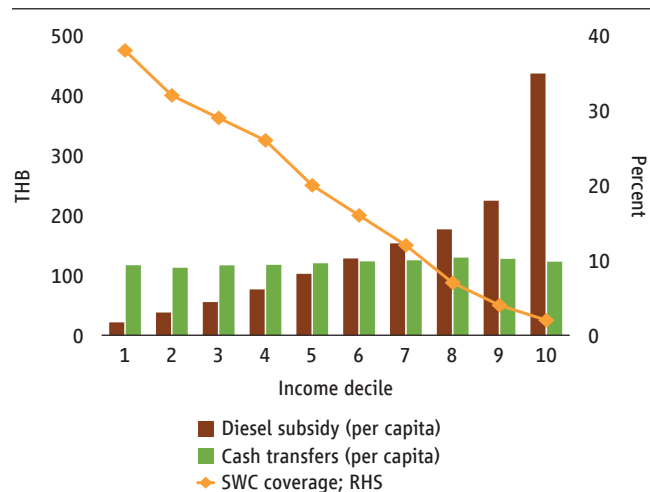
The *welfare or profit losses* associated with inflation can be significant. Price controls supported by subsidies are motivated by the desire to protect consumers or to avoid disruptions in production. However, support through income transfers is preferable to price regulation, because transfers do not distort choices and can be targeted to those most in need. In Thailand, both fuel subsidies and cash transfers are mitigating the poverty impacts of price increases, but targeted transfers are more cost effective (O13A). Reducing poverty by one percentage point would require THB11.2 billion worth of fuel subsidies, five times more than the THB2.2 billion worth of cash transfers. Therefore, more targeted measures that offer support to vulnerable households (or even firms) would be cheaper for governments; in Indonesia, replacing explicit and implicit energy subsidies with targeted support for vulnerable groups would save the government 0.6 percent of GDP. Fiscal costs are likely to be smaller if shocks are short-lived.

Figure O13. Transfers are more cost effective at reducing poverty, but governments may still choose fuel subsidies for social welfare, political economy or macro-policy reasons

A. Poverty reduction and cost effectiveness of Thailand's responses to food and fuel price shocks



B. Average monthly benefit, if received



Source: World Bank estimates based on the 2019 Socioeconomic Survey for Thailand.

Note: A. Fuel subsidy scenario uses a net THB 10 per liter fiscal cost, which represents a combined impact of fuel subsidies and price controls as well as reduced excise duties. Cost-effectiveness is THB billions of spending per percentage point of poverty averted. B. SWC: Social welfare card. Average monthly per capita benefit of diesel subsidy and SWC top-up, if received (THB, LHS); value of diesel subsidy and SWC top-up relative to market income (percent, RHS) and coverage of SWC by decile (percent, RHS).

But governments may still choose price subsidies over targeted transfers for four reasons. First, from a *social welfare perspective*, in practice a significant proportion of the poor do not receive transfers because many countries do not have adequate delivery infrastructure, such as comprehensive social registries. For example, in Thailand, less than half the poor possess the necessary social welfare card. Second, from a *political perspective*, targeted transfers do not in principle benefit the majority who are above the poverty line and who feel the pinch of inflation. Third, from an *industrial policy perspective*, price controls can shield firms from increases in costs of production that could disrupt recovery from the COVID-19 shock. Finally, from a *monetary policy perspective*, price controls can help keep inflation in check in countries where the monetary authority lacks credibility or inflation expectations are not well-anchored (Figure O13B).

How soon governments can transition from less to more efficient policy measures will depend on how soon they can relax constraints posed by implementation capacity, economic institutions, and political considerations. For example, efficient social protection requires:

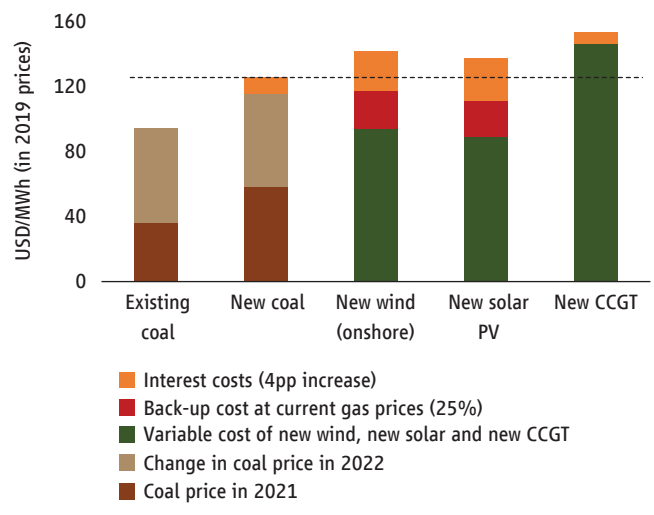
- developing the infrastructure of social registries, bank accounts and mobile connectivity, to make timely income transfers to those in need;
- devising strategies to win broad political support for desirable reforms, for example by making equal but still progressive transfers to all those who are adversely affected;
- creating mechanisms to help firms and farms to cope with temporary shocks, including through longer term improvements in productivity;
- anchoring inflationary expectations by creating central banks that have both the capacity and the autonomy to make sound and credible policy choices, as in most large ASEAN countries.

To achieve the *food goals* – affordability, security, and sustainability – governments must begin by shifting focus from rice-centric food security to nutrition security. The implication would be to encourage diversified production of nutritious foods, like livestock products, fruits and vegetables, by reducing policy distortions that currently favor production of rice. Where support to producers is deemed necessary, it would ideally take the form of direct transfers decoupled from production, which would enhance the efficiency of resource use. Additionally, food costs could be significantly reduced by lowering trade barriers. In the longer term, the goal must be to increase agricultural productivity and resilience without undermining sustainability. This goal requires a move away from input-intensive to knowledge-intensive technologies and production practices, involving, for example, improved and resilient breeds/varieties and precision agriculture. Long-term resilience to shocks is best ensured through ex-ante preparedness (better risk assessments and early warning systems) and improved ex-post management systems (well-resourced, reliable, and flexible reserves and contingency funds) which also involve the private sector. These shifts will enhance affordability of and secure access to a more nutritious consumption basket, contribute to higher incomes for farmers, and protect the natural resource base (land, water, and air quality).

In achieving the similar *energy goals*, policy responses must help meet the immediate need for affordable energy without compromising energy security and sustainability. Some governments are expanding existing fossil fuel sources as they are seen as the most economical way to alleviate the current crisis, but encouraging investment in renewables can reduce exposure to fossil fuel price volatility and help meet emission reduction commitments. In addition to the necessary policy reforms to encourage private sector participation, providing affordable access to finance at-scale and green public procurement would help support low-carbon technologies and accelerate the clean energy transition. At current energy prices, cheaper finance could make investing in wind and solar more attractive than in new coal power plants (Figure O14). Such support would be justified if it helped avert the risk of locking development into a high-carbon future or creating potentially stranded assets, thus contributing to both national energy security and global sustainability. When energy prices eventually fall, the introduction of carbon prices would improve the viability of renewables and finance support for vulnerable households.

Figure O14. At current fuel prices, existing coal is the cheapest source of energy, but favorable access to finance could make renewables less costly than new coal

Simulated impact of fuel price and interest rate increases on the levelized cost of energy



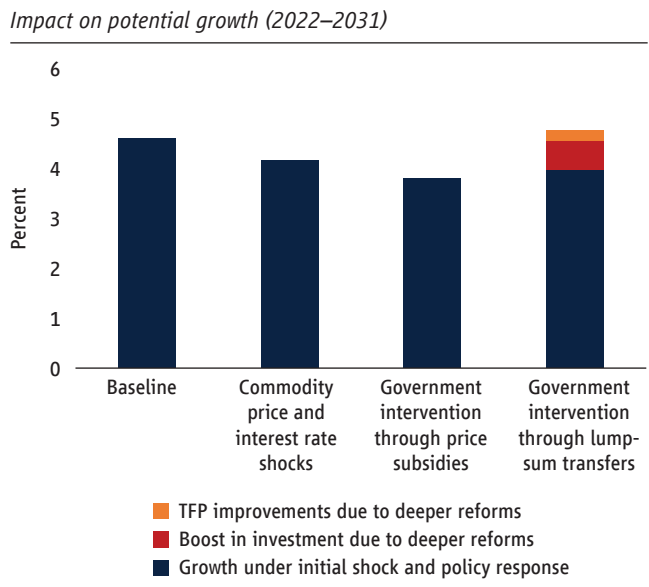
Source: IRENA and World Bank estimates
 Note: The Figure shows 'levelized' cost calculations of the average unit price of generation using each technology.

To achieve the *financial goals*, authorities will need to strengthen prudential measures and enhance the financial sector’s ability to allocate resources efficiently. Supervisory authorities must ensure that banks maintain sound capital positions and provision adequately for loan losses on a forward-looking basis. Jurisdictions where NPLs were high and remained unresolved typically experienced deeper and more protracted recessions and slower recoveries than those where NPL problems were speedily addressed. Ensuring transparent and timely reporting of bank asset quality is necessary to assess and manage NPL problems and address the risks of credit misallocation arising from pandemic crisis support measures, like regulatory forbearance and repayment moratoria. Effective insolvency frameworks also help mitigate the risks of credit misallocation. Government efforts to mobilize revenue, as Indonesia has recently done through reform of its tax system, and increase efficiency of spending, will also limit the need for government borrowing which could deprive the private sector

of investment funds. In the longer term, developing deeper and more diversified financial systems would help achieve development goals.

Policymakers must consider not only current costs of inefficient instruments, in terms of diverted revenues, diluted assistance, and distorted choices, but also the risk of undermining longer-term goals of growth, security and sustainability. Recent price and interest rate shocks could reduce EAP growth by 0.4 percentage points; inefficient instruments would soften the impact on current welfare but magnify the growth cost; more efficient intervention and deeper reforms – not just in the three areas discussed above but also in services and factor markets – could even offset the growth impact of recent shocks (Figure O15). Addressing the infrastructural, institutional, and political constraints would allow a transition to more efficient policy instruments.

Figure O15. Inefficient interventions could magnify the growth costs of recent price and interest rate shocks; more efficient interventions and deeper reforms could offset the negative growth impact



Source: World Bank estimates.

Table O1. GDP growth forecast

	2020	2021	April 2022	October 2022 forecast	
			forecast for 2022	2022	2023
East Asia & Pacific	1.2	7.2	5.0	3.2	4.6
East Asia & Pacific (excluding China)	-3.6	2.6	4.8	5.3	5.0
ASEAN-5	-3.8	3.4	4.9	5.4	5.1
Pacific Island Countries	-9.5	-3.3	2.9	5.3	5.7
China	2.2	8.1	5.0	2.8	4.5
Indonesia	-2.1	3.7	5.1	5.1	5.1
Malaysia	-5.5	3.1	5.5	6.4	4.2
Philippines	-9.5	5.7	5.7	6.5	5.8
Thailand	-6.2	1.5	2.9	3.1	4.1
Vietnam	2.9	2.6	5.3	7.2	6.7
Cambodia	-3.1	3.0	4.5	4.8	5.2
Lao PDR	0.5	2.5	3.8	2.5	3.8
Mongolia	-4.4	1.6	2.5	2.4	5.5
Myanmar	3.2	-18.0	1.0	3.0	
Papua New Guinea	-3.5	1.0	4.0	4.0	4.2
Timor-Leste	-8.6	1.5	2.4	3.0	3.0
Palau	-9.7	-17.1	7.2	6.0	18.2
Fiji	-17.2	-4.1	6.3	12.6	7.8
Solomon Isl.	-3.4	-0.2	-2.9	-4.5	2.6
Tuvalu	-4.9	0.3	3.5	3.0	3.5
Marshall Isl.	-2.2	-2.5	3.0	1.5	2.2
Vanuatu	-5.4	0.5	2.0	2.2	3.4
Kiribati	-0.5	1.5	1.8	1.5	2.3
Tonga	0.5	-2.7	-1.6	-1.6	3.2
Samoa	-3.1	-7.1	-0.3	-5.0	2.0
Micronesia	-1.8	-3.2	0.4	-0.5	3.0
Nauru	0.7	1.5	0.9	0.9	1.9

Source: World Bank; World Bank estimates and projections.

Notes: Percent growth of GDP at market prices. ASEAN-5 comprises Indonesia, Thailand, the Philippines, Malaysia, and Vietnam. Values for Timor-Leste represent non-oil GDP. For the following countries, values correspond to the fiscal year: Federal states of Micronesia, Palau, and Republic of the Marshall Islands (October 1–September 30); Nauru, Samoa, and Tonga (July 1–June 30). Myanmar growth rates refer to the fiscal year from October to September.

