

WORLD BANK EAST ASIA AND THE PACIFIC ECONOMIC UPDATE APRIL 2022

BRAVING THE STORMS: SUMMARY



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WORLD BANK GROUP

Summary

Just as the EAP region was weathering the recurrent COVID-19 storms, three clouds have gathered over the economic horizon, which will mean lower economic growth and higher poverty.

- Most recently, shocks emanating from the war in Ukraine are disrupting the supply of commodities, increasing financial stress, and dampening global growth.
- The war comes on top of not just the lingering pandemic, but two other developments.
 - US inflation ignited by the stimulus-led rebound and persistent supply disruptions could provoke faster-than-anticipated financial tightening, perhaps timely in the US but too early in many EAP countries where recovery is incomplete.
 - China's structural slowdown, deleveraging of the real estate sector and COVID-19 resurgence amidst zero-COVID policies, could dampen regional exports.

Set against these shocks, are some opportunities.

- *Shifts in the trade landscape* are creating new export niches: in manufacturing, for other EAP countries as some production moves out of China; in services, as digital delivery, renders tradeable a wider variety of tasks.
- *The diffusion of digital technologies* could boost productivity, not just of the few countries and firms close to the frontier, but also of the many in the inefficient interior.
- *The increased viability of green technologies* could allow EAP countries to cut carbon emissions and cope with the new energy insecurity without unacceptable cuts in consumption or growth.

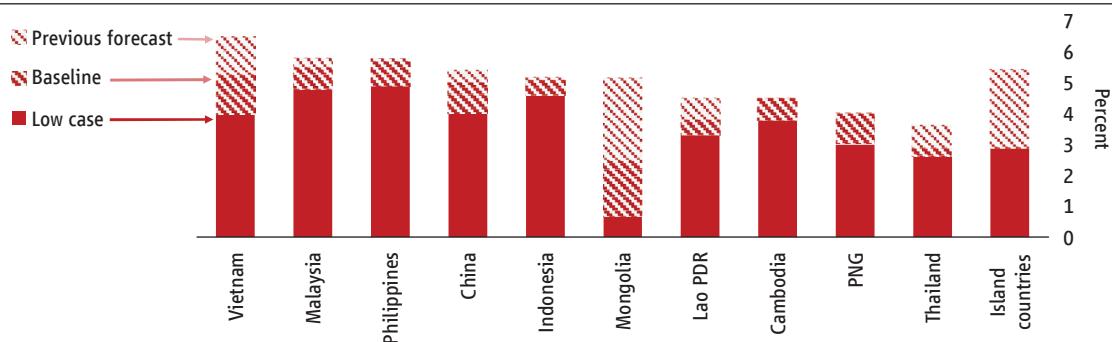
To mitigate the risks and grasp the opportunities, countries must take four steps:

- *Enhance efficiency of fiscal policy* for recovery and growth. More efficient and targeted support to households and firms would limit pain from the cumulative shocks and create space for investment in the infrastructure of trade, energy, and technology diffusion. Fiscal support implemented by entities like local governments and state-owned enterprises must not undermine their financial viability. Committing to fiscal rules and future reforms of revenue and expenditure would help reconcile spending needs with tightening budget constraints amidst growing debt.
- *Strengthen macroprudential policies* to mitigate risks from global financial tightening. Monetary policy must remain alert to new inflationary pressures but at present can continue to support recovery, because real interest rates are relatively high and core inflation relatively low. Stress-testing diagnostics are needed to help identify vulnerabilities that might fester behind the veil of regulatory forbearance and implicit guarantees. Measures could then be taken where needed to capitalize banks, hedge and extend the maturity of debt, and enhance liquidity buffers.
- *Reform trade-related policies* in goods and, especially, in still-protected EAP services sectors to take advantage of shifts in the global trade landscape. In addition, facilitating domestic labor mobility, as well as entry and exit of firms, would allow reallocation of resources in response to the global shocks. Refraining from national export restrictions in the face of rising global prices could help avert an even worse global outcome. Participation in deep trade agreements could catalyze reform at home and secure access to markets abroad.
- *Policy reform and assistance to encourage diffusion of technology*. Increased domestic and international competition could strengthen incentives for productivity-enhancing technology adoption. Enhancing managerial and technical skills, and improving access to finance as well as digital infrastructure would boost the capacity for technology adoption. Eliminating domestic distortions, such as those due to fossil fuel subsidies and local content requirements, could encourage the adoption of green technologies.

Overview

At the beginning of 2022, the EAP countries appeared to be on the path of sustained recovery. The region had emerged from the difficult Delta wave and suffered relatively little from Omicron wave. External trade and financial conditions remained benign, and governments were contemplating fiscal consolidation. Since then, the acceleration in US inflation prompted faster-than-expected financial tightening, China saw a spike in COVID-19 infections and continued strains on overleveraged real estate firms, and Russia invaded Ukraine. While some larger countries may be better equipped to weather these shocks, the repercussions of these events will dampen the growth prospects of most in the EAP region. Projections for regional growth in 2022 have therefore been reduced from 5.4 percent in the previous Update to 5 percent. In a low case scenario, if global conditions worsen and national policy responses are weak, growth could slow to 4 percent. (figure O.1). However, the turmoil should not obscure the new avenues for growth through trade and innovation. Bold reforms of fiscal, prudential, trade and innovation policies could help EAP countries avert the many risks and grasp the few opportunities.

Figure O.1. Forecasts for growth in 2022



Source: World Bank staff estimates.

Notes: PNG stands for Papua New Guinea.

The backdrop

After the Delta-dip in 2021Q3, economic recovery in much of the EAP region resumed in 2021Q4 and continued in 2022Q1, despite the Omicron outbreak. Countries in the region grew on average by 7.2 percent and are projected to grow by 5 percent in 2022 (figure O.1). However, the revival has been uneven across countries and sectors. China, Indonesia, and Vietnam have already surpassed pre-pandemic levels of output, while Cambodia, Malaysia, Mongolia, the Philippines and Thailand are expected to do so in 2022. However, output in several hardest hit Pacific Islands is not likely to return to pre-pandemic levels even by 2023. While sectors like agriculture, finance, information, and communication technology have been resilient, output in transportation, accommodation and catering remains well-below pre-pandemic levels. The year 2021 saw no decline in poverty in countries other than China, but in 2022, 30 million people are projected to escape poverty, relative to the upper-middle income class poverty line of US\$5.50/day (2011 PPP).

Why?

The economic performance of countries is being shaped by how efficiently they contain the COVID shock, how they are affected by changing conditions in the rest of the world, and how much support governments provide. Natural disasters, notably the volcanic eruption which affected Tonga, and other idiosyncratic factors, like the unrest in the Solomon Islands, also played a role.

› COVID shock and containment strategy

Thanks to the increased immunity conferred by vaccination and Delta variant infections, most countries in the region have so far been less vulnerable to new spikes in infection by the Omicron variant and have therefore imposed fewer restrictions on mobility and economic activity. However, some countries, such as those in the Pacific, are yet to feel the full force of the Omicron wave and China has recently seen a spike in cases prompting strict lockdowns. The Delta variant in 2021 inflicted a much greater human cost on the region than the initial wave of COVID-19 in early 2020. But the economic contraction induced by the Delta variant was smaller than in the earlier wave. Nevertheless, across countries, the virus and related measures continue to dampen domestic consumption, private investment, and international tourism.

› Trade

Since demand in the rest of the world remained buoyant even in the face of the Omicron spike, and logistics constraints are beginning to ease, trade has continued to grow. The fear of saturating global demand for consumer electronics, which are important exports for countries like China, Malaysia, and Vietnam, has not yet materialized. However, the incoming data point to a slowdown of global trade growth in 2022. While trade in digitized services, which are important for countries like China and the Philippines, remains resilient, tourism, which is vital for several Pacific islands, Cambodia, the Philippines and Thailand, is recovering much more slowly.

› Macroeconomic support

A combination of tightening intertemporal budget constraints and what had until recently seemed like diminishing need were leading to a reduction in fiscal support, from an average of 6 percent in 2020 to 5 percent in 2021. A further decline to 1.5 percent of GDP on average was projected in 2022, although China was projected to ease fiscal policy significantly to support growth. In 2021, average consumer price inflation remained within the central bank target ranges in all major economies, allowing central banks to keep an accommodative monetary policy stance over the course of the year.

New growth risks: Three international developments

Financial tightening, especially in the United States, changes in the growth and composition of economic activity, especially in China, and the war in Ukraine, are now shaping the external environment for EAP countries.

The rapid stimulus-led rebound in the United States has contributed to higher inflation. The earlier-than-expected monetary tightening in response could make recovery even harder in other countries. Financial conditions in the US are of particular significance for developing EAP countries, especially those like Malaysia which rely more on short term capital flows. The risk of capital outflows, which could put pressure on their currencies, could induce premature financial tightening. A monetary policy shock in the U.S., assumed to increase interest rates by at least 25 basis points, is likely to hurt growth

in developing EAP, by as much as -0.4 percentage points in Malaysia to -0.7 percentage points in Thailand (figure O.2).

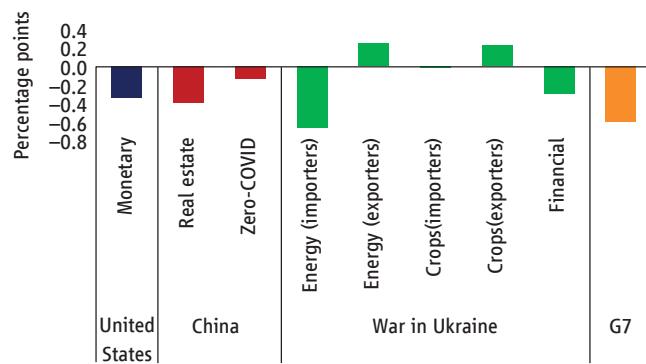
Growth is expected to slow down both in China, because of the structural slowdown and regulatory regime change, and in the US, because of the cyclical slowdown. Therefore, both are expected to make smaller contributions to global growth in 2022 and 2023 than in 2021—the year in which output rebounded from the COVID contraction. However, the absolute size of China and the US' contribution to growth, is estimated to be almost as large as in the pre-COVID years. A one percent slowdown in US growth is estimated to have a slightly larger impact (0.4 percentage points) on the EAP region than a comparable slowdown in China's growth (0.3 percentage points).

Specific shocks to economic activity in China, are likely also to affect EAP countries whose trade is increasingly oriented to China's markets. Construction, constrained by efforts potentially to reduce leverage, industry, by efforts potentially to reduce emissions; and services, constrained by efforts to control COVID-19 and monopolistic providers, are each a significant destination for EAP value added. The contraction in the real estate sector, assumed to match a projected decline in residential investment growth by 10 percentage points from 2020 to 2022, could reduce the EAP region's growth by 0.3 percentage points in 2022. China's zero-COVID policy, assumed to be equivalent to the impact of the Delta shock on consumption in China for only one quarter of 2022, could reduce EAP growth by 0.14 percentage points.

Shocks emanating from the war in Ukraine and the related sanctions could affect the EAP region most concretely by disrupting the supply of commodities, as well as by increasing financial stress and reducing global confidence. The region's direct dependence on Russia and Ukraine through imports and exports of goods, services, and capital, is limited. But the war and sanctions are likely to increase international prices of food and fuel, hurting consumers and growth. The number of poor in the Philippines, for example, could increase by 1 percentage point or 1.1 million measured at the lower-middle-class poverty line (\$3.2/day) if cereal prices rise by an average of 10 percent over the year. Real national income in commodity importers like Cambodia and Thailand could be reduced by 0.7 percentage points if fuel prices increase by an average of 10 percent over the year. Furthermore, with already heightened global inflationary pressures, the knock-on effects of the war may not be transitory and could de-anchor inflation expectations.

These three shocks could have both offsetting and reinforcing aspects. On the one hand, the financial shock from the war in Ukraine may lead to a slower-than-planned tightening of US monetary policy despite the stronger inflationary pressures. Similarly, the increase in commodity prices due to the war may offset the decline in prices due to real estate contraction in China, though the commodities affected would not be the same. On the other hand, each shock will adversely affect global growth by hurting economic activity in the directly affected countries as well as indirectly in the rest of the world. A slowdown in the growth of G7 countries by 0.9 percent would imply weaker export demand for EAP countries and hence a decline in their average growth by as much as 0.6 percent.

Figure O.2. The estimated impact on EAP countries' growth of international developments



Source: World Bank staff estimates.

Notes: This chart provides a rough sense of the impact of alternative hypothetical shocks. The specific assumptions underlying each shock are presented in the text. Effects of US monetary shocks are estimated using the sign-restricted structural VAR methodology. China real estate, zero-COVID, and global financial shocks from the war in Ukraine are modeled and estimated using the Oxford Economics Model. Shocks to energy and crops in the aftermath of the war in Ukraine war are modeled and estimated using the GTAP computable general equilibrium model. The G7 shocks is estimates using a structural VAR methodology.

These shocks are likely to magnify existing post-COVID difficulties. Struggling regional firms, more than 50 percent of which reported payment arrears in 2021, will be hit by new supply and demand shocks. Households, whose 8 million members fell back into poverty during the pandemic, will see real incomes shrink even further as prices soar. The microeconomic misery will have to contend with macroeconomic miserliness. Indebted governments, who have seen their debt as a share of GDP increase by 10 percentage points since 2019, will struggle to provide economic support. Financial tightening and increased inflation, at least one percentage point above previous expectations due to the oil price shock alone, will shrink room for monetary easing. And overexposed banks, with credit as a share of GDP about 10 percent higher than before the pandemic, will have to cope with new financial stresses and increased risks to loans.

Some countries in the region may nevertheless be more resilient than others in the face of these shocks because of their attributes and prior prudence. Commodity exporters, like Indonesia and Malaysia, may absorb international price increases with less difficulty than commodity importers, like Fiji and Thailand. Countries that exercised fiscal and monetary policy restraint in the early phases of the pandemic have the policy space to counteract shocks. For example, China reduced its structural fiscal balance by as much 2.6 percentage points of GDP in 2021, allowing it to plan an increase of 2.8 percent in 2022 to meet its growth target. In contrast, Mongolia, with government debt equal to nearly 80 percent of GDP and annual inflation running at over 14 percent, has little room to soften the adverse impact. But all countries in the region, by virtue of their openness to trade and finance, face serious economic risks if global conditions significantly worsen. Regional growth in 2022 could decline from the 5.4 percent projected in the October 2021 Update, to 5 percent in the present baseline scenario and in the low case scenario to 4 percent.

New growth opportunities: Trade, digital technology, and green production

The incentives to diversify production and imports, already strong because of the dependence aversion in the aftermath of COVID-19, will be magnified by the current war and sanctions. Incentives to relocate production were already strengthening because of the increase in China's real wages, driven by growth and demographic change, and the China-US trade tensions. The share of EAP countries other than China in US final good imports increased from 10 percent in early 2018 to 14 percent in mid-2021 before the Delta shock, while China's share fell over the same period from 33 percent to 25 percent. However, the growing scope for automation is narrowing the window of opportunity for other countries to engage in GVCs by specializing in labor intensive tasks. The extent to which individual countries benefit from the reconfiguration of value chains depends on their production and trade costs. But developing EAP countries' advantage in terms of low labor costs is offset to varying degrees by low labor productivity.

Technology is a key driver of productivity and the COVID-19 shock has accelerated the diffusion of digital technologies. In the EAP countries, frontier firms tended to adopt better technologies more quickly than in the past, but these technologies diffused more slowly to other firms. While the COVID shock has led to convergence in the use of basic consumer-facing technologies, such as ecommerce, it has been associated with divergence in the use of more sophisticated productivity-enhancing technologies, such as data analytics.

The pandemic-induced diffusion of technologies is also changing the structure of services trade. While tourism and travel have been disrupted, trade in data-intensive services has grown. Irreversible investments in digital delivery made by firms and consumers during the pandemic are durably reducing the costs of international trade relative to domestic transactions. The result will be increased opportunities for trade in digitized services even as tourism and travel recover more slowly.

High fossil fuel prices could increase incentives to switch to renewable energy. And the adoption of green production technologies would allow EAP countries to cut carbon emissions and cope with the new energy insecurity without unacceptable cuts in

consumption or growth. But not all current changes will favor green technologies. The high fuel prices could also induce more investment in the production of fossil fuels. And the war in Ukraine could reduce availability of key inputs in the production of green goods, like palladium and nickel.

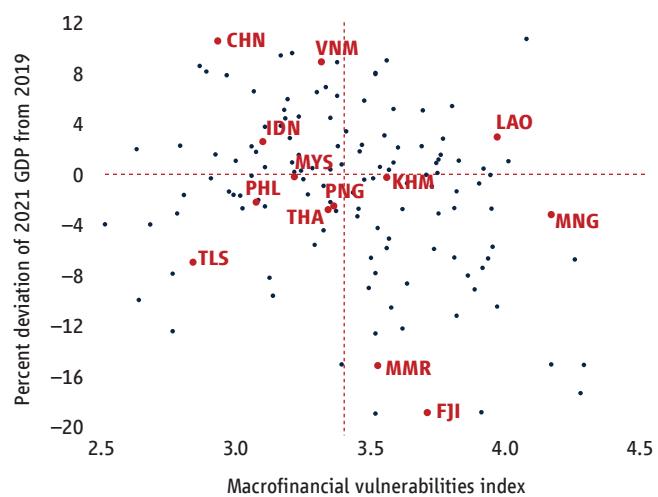
What must be done?

Fiscal policy. EAP countries were already struggling to reconcile fiscal support, for relief, recovery, and growth, with shrinking fiscal space. For example, the growth in debt—by more than 10 percentage point of GDP in most EAP countries and by more than three times as much in Fiji—is increasing pressure for fiscal consolidation even where recovery is incomplete (figure O.3). Furthermore, fiscal support implemented by entities like local governments and state-owned enterprises risks undermining their financial viability. The new shocks will sharpen the trade-offs, and lower investment in the infrastructure of trade, energy, and technology diffusion—which are needed to harness the new growth opportunities by enhancing domestic capacity and international connectivity.

Three measures can help. First, more efficient social protection would free fiscal space for other ends. EAP countries have shielded households from recent COVID-related income shocks through a broad-based increase in social protection and from price shocks through a combination of price controls and subsidies (or tax cuts). Both types of measures may be the only form of assistance that is feasible in the short term, but neither is efficient or fiscally sustainable. Direct transfers to poor households and firms, once the relevant digital infrastructure is in place, would alleviate the pain from the cumulative shocks without distorting price signals or subsidizing the wealthy. For example, a means-based transfer could deliver a 2 percentage point greater reduction in poverty rates than a universal transfer in a typical middle-income country. Second, public resources combined with investment policy reform could encourage greater private investment in the creation of public infrastructure. Finally, governments should reconcile spending needs with tightening budget constraints, by committing (a) to restoring fiscal discipline through the (re)introduction of fiscal rules, as Indonesia is planning to do in 2023; and (b) to fiscal reform through enactment of legislation to be implemented conditional on objective measures of recovery. For example, new tax reform legislation in Indonesia is expected to raise revenue by 1.2 percent of GDP in the medium term.

Macroprudential policy. EAP countries must guard against the risk of financial instability in the face of financial tightening in major markets. Monetary policy must remain alert to new inflationary pressures, but can at present continue to support recovery in most EAP countries, because real interest rates are relatively high and core inflation relatively low. While banks in most EAP countries are well-capitalized and reported levels of non-performing loans are low, stress-testing diagnostics can help identify vulnerabilities that might fester behind the veil of regulatory forbearance. Then, depending on circumstances, countries must ensure adequate capitalization of banks with large loans at risk; hedge and extend the maturity of debt to address currency mismatches and rollover risk; enhance liquidity buffers and secure lines of credit to anticipate potential

Figure O.3. State of recovery and macrofinancial vulnerabilities



Source: World Bank staff estimates.

Note: y-axis shows the latest quarterly/annual real GDP level compared to 2019. The macrofinancial vulnerability index comprises four dimensions: government finances; external financing needs; financial sector health; and macroeconomic volatility. The scale 1-5 refers to quintiles compared to a sample of all emerging market and developing economies.

increases in external financing needs. Countries with unsustainable external debt, like Lao PDR and some of the Pacific Island Countries, would benefit from the development of a more effective international debt resolution framework.

Trade: policy and infrastructure. Comprehensive trade-related reforms would enable EAP countries to take advantage of shifts in the global trade landscape. First, liberalizing and facilitating trade, rather than retaliating in response to reshoring policies abroad, could lead to a net increase in real incomes by as much as 3 percent. Also, global restraint on export restrictions in the face of commodity price shocks would avoid creating price spirals and an even worse global outcome. Second, looking beyond goods trade, reforming still-high restrictions on trade in transport, communication, and other business services, could reduce trade costs and boost economy-wide productivity. Third, implementing measures to facilitate domestic labor mobility, such as retraining and placement assistance, would allow resources to move to new areas of comparative advantage, also boosting productivity and incomes. Finally, participation in deep trade agreements could both catalyze reform at home and secure access to markets abroad. For example, China joining is estimated to quadruple the global income gains from the CPTPP to around \$630 billion compared to the current gains of about \$150 billion. Deep agreements could include not just trade liberalization, but regulatory cooperation and infrastructural coordination that further deeper economic integration.

Technological diffusion: policy and infrastructure. The rapid diffusion of technology in the post-COVID period could boost productivity. But harnessing technology will require policy reform and assistance. First, enhancing competition, by eliminating barriers to entry and exit for both domestic and foreign firms, as well as reforms of the business environment, would strengthen incentives for technology adoption and diffusion. Second, measures to enhance relevant managerial and technical skills as well as access to the necessary finance, would enable firms to embed productivity-boosting technologies in their businesses. Third, while digital infrastructure for basic technologies is often available, broadband access, which is widespread for example in China's Eastern provinces, needs to be widened in countries like Indonesia and the Philippines to facilitate the use of more advanced technologies. Finally, eliminating domestic distortions, such as those due to fossil fuel subsidies and local content requirements, could encourage the adoption of green technologies.

Table 0.1. GDP growth forecasts

	<i>October 2021 forecast for 2022</i>	<i>April 2022</i>	
		<i>Baseline</i>	<i>Lower case</i>
East Asia & Pacific	5.4	5.0	4.0
East Asia & Pacific (excluding China)	5.2	4.8	4.2
ASEAN-5	5.2	4.9	4.3
Pacific Island Countries	5.4	2.9	
China	5.4	5.0	4.0
Indonesia	5.2	5.1	4.6
Malaysia	5.8	5.5	4.8
Philippines	5.8	5.7	4.9
Thailand	3.6	2.9	2.6
Vietnam	6.5	5.3	4.0
Cambodia	4.5	4.5	3.8
Lao PDR	4.5	3.8	3.3
Mongolia	5.2	2.5	0.7
Myanmar		1.0	
Papua New Guinea	4.0	4.0	3.0
Timor-Leste	3.7	2.4	
Palau	12.0	7.2	
Fiji	7.8	6.3	
Solomon Isl.	4.5	-2.9	
Tuvalu	3.5	3.5	
Marshall Isl.	3.5	3.0	
Vanuatu	3.0	2.0	
Kiribati	2.6	-1.8	
Tonga	2.6	-1.6	
Samoa	1.5	-0.3	
Micronesia	1.0	0.4	
Nauru	0.9	0.9	

Source: World Bank; World Bank staff estimates and projections.

Notes: Percent growth of GDP at market prices. Values for 2022 represent forecast. Values for 2021 for the small island economies refer to GDP growth estimates. 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. Given the lack of high-frequency data, we have not produced forecasts for the low case scenario for Myanmar, Timor-Leste and the Pacific Island countries.

Table O.2. Growth, the disease, trade and financial exposure, and fiscal and monetary policy space

Country	GDP growth estimates (2022)	COVID-19		Commodity dependence		Trade and financial exposure		Macroeconomic policy space	
		COVID-19 cases per million (March 2022)	Restriction index (March 2022)	Net energy export (% of GDP, 2015-19)	Net food export (grains) (% of GDP, 2015-19)	Gross goods & services export (% of GDP, 2015-19)	External financing needs (% of GDP, 2022 est.)	General government debt (% of GDP, 2021)	CPI inflatin (Feb 2022 or latest)
China	5.0	1	64	-1.4	0.0	20	6	45	0.8
Indonesia	5.1	67	61	1.4	-0.3	19	9	41	2.1
Malaysia	5.5	818	54	3.6	-0.4	78	29	63	2.2
Philippines	5.7	5	78	-3.1	-0.6	30	8	55	3.0
Thailand	2.9	346	48	-3.5	0.9	66	11	58	5.3
Vietnam	5.3	2267	65	-2.9	0.0	99	5	45	1.4
Cambodia	4.5	13	23	-9.6	1.3	72	36	35	3.7
Lao PDR	3.8	84	82	-4.7	0.2	34	20	78	7.3
Mongolia	2.5	124	12	10.0	-0.3	57	43	80	14.3
Myanmar	1.0	18	71	2.4	0.7	29	3	57	9.9
PNG	4.0	1	51	14.7	-0.8	42	-9	52	5.7
Timor-Leste	2.4	4	36	0.8	-1.4	7	18	25	5.4
Fiji	6.3	20	65	-5.6	-1.1	45	14	86	2.7
Kiribati	1.8	55	76	-7.7	-2.8	11		21	3.0
Marshall Is.	3.0	0			-1.0	29			14
Micronesia	0.4	0		-9.2	-1.1	30		15	2.5
Nauru	0.9	0		-26.2	-0.1	32		28	2.0
Palau	7.2	463		-4.7	-0.3	54			3.0
Samoa	-0.3	60		-4.6	-0.3	35	10	50	8.5
Solomon Is.	-2.9	204	87	-3.7	-1.9	40	21	21	3.3
Tonga	-1.6	1460	87	-6.7	0.0	20	12	46	6.0
Tuvalu	3.5	0		-22.1	-0.7	20		6	2.8
Vanuatu	2.0	159	41	-4.1	-0.6	44	14	28	4.5

Source: UN Comtrade; Fitch Solutions; Haver Analytics; International Monetary Fund; Oxford Covid-19 Government Response Tracker (OxCGRT), WHO Coronavirus (COVID-19) Dashboard; World Development Indicators; World Bank.

Note: Restriction index refers to a measure of COVID-19-related government restriction policies, rescaled from 0 to 100 (100 = strictest). For countries missing March 2022 data, February 2022 data were used. Net energy export includes mineral fuels, oils and waxes (HS code 27) less electrical energy. Net food export (grain) includes cereals and grains (HS code 10). CPI inflation of Kiribati, Micronesia, Nauru, Palau, Samoa, Solomon Is., Tonga, Tuvalu and Vanuatu show 2021 end-of-period estimates. Color scale represents quintiles relative to the group of emerging markets and developing economies, with red denoting the worst exposure and green the least. General government debt of small island economies is not color scaled because debt tolerance of small island countries is lower than larger EMDEs.

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