



ASIAN DEVELOPMENT

Outlook 2010

Update

The Future of Growth in Asia

Asian Development Bank

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Contents

Foreword iv

Acknowledgments vi

Definitions viii

Acronyms and abbreviations viii

Highlights—*ADO 2010 Update* ix

Part 1: Shifting global economic fortunes 1

Wavering recovery in industrial economies 4

Solid recovery in developing Asia 23

Policy foundation for growth 25

Constraints to long-term growth 33

Part 2: The future of growth in Asia 35

Refocusing on the long term 37

Trade and growth 47

Human capital accumulation in economic growth 61

Infrastructure in economic growth 69

Financial development and economic growth 75

Key policy messages 81

Part 3: Economic trends and prospects in developing Asia 91

Subregional summaries 93

Bangladesh 127

People's Republic of China 132

India 138

Indonesia 144

Malaysia 148

Pakistan 153

Philippines 158

Thailand 163

Viet Nam 167

Statistical appendix 172

Statistical notes and tables 173

Foreword

The region's resilience and subsequent recovery from the recent global economic crisis underscored its growing influence in the world economy. Since the release of the *Asian Development Outlook 2010* in April this year, developing Asia's performance has strengthened further. This *Update* raises the 2010 growth forecast to 8.2% on the back of strong results in the first half of the year. Even amid the predicted slowdown of global growth in 2011, the region's robust momentum should deliver a healthy 7.3% expansion.

In contrast, the recovery of the major industrial economies is more tentative. The global economy continues to grapple with the challenge of stimulating aggregate demand. Labor markets are still weak, and unemployment rates have gone up, delaying households' consumption and firms' investment. Many fiscal stimulus measures were expected to wind down this year, but policy makers in the industrial countries are hesitating—even backtracking—on fiscal consolidation in light of fragile growth prospects. Monetary policies, too, remain expansive in the face of the stuttering recovery.

The uncertain momentum of the global recovery is vulnerable to downside risks. Mixed economic indicators have raised the specter of a second round of contraction—a “double dip”—among industrial countries. Moreover, continued weakness in the United States mortgage market, potential sharp movements in commodity prices, and the threat of sovereign default in the eurozone further cloud the global outlook.

Turning to developing Asia, the region is beginning to assert itself more on the world economic stage: the People's Republic of China, India, the Republic of Korea, and Indonesia have all joined the world's top 20 producers. Growth prospects for the region as a whole are compelling, suggesting it will play a more active role in the global recovery.

Extensive corporate and financial sector restructuring and reform during the 1997–1998 Asian financial crisis sowed the seeds of resilience to the recent global downturn, which developing Asia has now harvested. Decisive fiscal and monetary stimulus played a central role in cushioning the impact of the recent crisis on the region and laid the foundation for recovery. As aggregate demand weakened due to collapsing exports and weak private consumption and investment, the region stepped in as the consumer of last resort and set the region on its way back up.

With relatively sound financial systems, macroeconomic stability, and favorable growth prospects, developing Asia is attracting more and more investment from the rest of the world. Its challenge now is to sustain its recovery as countries within the region begin to normalize their macroeconomic policies.

Despite developing Asia's rapid growth and exceptional resilience, the region remains home to two thirds of the world's poor. Experience shows that there is simply no substitute for rapid, long-run growth—complemented by sound fiscal and social policies—for sustained poverty reduction. Short-run stabilization has paved the way for recovery, but medium- and long-run growth will reassert itself as the region's most pressing macroeconomic priority as the recovery gathers momentum. In the policy arena, structural supply-side policies that foster factor accumulation and stimulate higher productivity will come to the fore.

The theme chapter of this *Update* examines four areas that will be pivotal for medium- and long-run growth. First, trade will continue to be a leading component, with intraregional commerce gaining importance. Human capital investment linked to each country's development needs is another important factor. Infrastructure expansion will keep countries competitive and support urbanization. Finally, financial development will enhance investment efficiency when tempered with appropriate prudential regulation.

Progress in these four areas will jointly expand developing Asia's production capacity. As the dust thrown out by the crisis settles, sustaining this growth is developing Asia's key challenge.



Haruhiko Kuroda
President
Asian Development Bank

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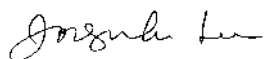
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Definitions

The economies discussed in *Asian Development Outlook 2010 (ADO 2010) Update* are classified by major analytic or geographic groupings. For purposes of *ADO 2010 Update*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** is composed of the 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member.
- **Central Asia** covers Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **East Asia** comprises the People’s Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei, China.
- **South Asia** is made up of the Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- **Southeast Asia** refers to Brunei Darussalam, Cambodia, Indonesia, the Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **The Pacific** consists of the Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Republic of Palau, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.
- Unless otherwise specified, the symbol “\$” and the word “dollar” refer to United States dollars.

ADO 2010 Update is generally based on data available up to **14 September 2010**.

Acronyms and abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
bpd	barrels per day
CPI	consumer price index
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
LPI	Logistics Performance Index
NIE	newly industrialized economy
OECD	Organisation for Economic Co-operation and Development
PRC	People’s Republic of China
SMEs	small- and medium-sized enterprises
TFP	total factor productivity
US	United States
VAR	vector autoregression
VAT	value-added tax
WTO	World Trade Organization

Highlights—*ADO 2010 Update*

Developing Asia is rebounding solidly from the global economic downturn. Growth is expected to reach 8.2% in 2010, underpinned by a rapid turnaround in exports, healthy private demand, and the lingering effects of expansionary fiscal and monetary policy measures.

In contrast, the major industrial economies—the United States (US), eurozone, and Japan—seem to be losing steam and are forecast to grow by only 2.2% this year. Weakness in US housing markets, the specter of eurozone sovereign debt default, and risks of commodity price spikes are clouding global prospects. A second contraction in the major industrial economies is unlikely, but cannot be ruled out.

As developing Asia's recovery progresses, policy makers must turn their focus from managing short-term macroeconomic fluctuations to ensuring strong and sustained medium- and long-term growth. This will require policies that expand the region's productive capacity through both factor accumulation and rising productivity. Trade, human capital, infrastructure, and financial development will be key elements of that growth.

Key Messages

- The global economy has passed through its worst economic downturn since the Great Depression. Part 1 of this *Update* to the *Asian Development Outlook 2010 (ADO 2010)*, released in April, sees improved prospects for 2010 gross domestic product (GDP) growth in the major industrial economies on the back of better than expected results in the first quarter. However, the rising investor confidence, upbeat consumer sentiment, and continued fiscal and monetary support that led to robust first-quarter growth have not been sustained. These economies' growth momentum slowed in the second quarter, and is forecast to remain moderate for the rest of 2010.
- Still, the global recovery remains shaky, and downside risks lurk. The possibility of a double-dip recession in the major industrial economies has not receded completely. For example, the US housing market is showing lingering frailty, especially since the withdrawal of the homebuyers' tax credit in April 2010. In the eurozone, the risk of insolvency and default in one or more members of the bloc has not disappeared, as debt sustainability is imperiled by high borrowing costs and uncertain growth prospects. Commodity price spikes remain a concern, especially as weather aberrations adversely affect food supplies.
- For its part, developing Asia has recovered from the global crisis with remarkable speed and vigor. Strong export recovery, robust private demand, and the sustained effects of stimulus policies allowed regional economies to record solid growth in the first half of 2010. This improved performance is broad-based and is projected to carry on for the rest of the year. The *Update* thus upgrades GDP growth projections this year for developing Asia and for each of its subregions.
- As the region's recovery takes an increasingly firm hold, short-term aggregate demand management will give way to structural policies that augment developing Asia's productive capacity. Now is therefore a good time to take stock of developing Asia's medium- and long-term growth prospects and to reconsider its pathways to growth. This is because the postcrisis world is likely to present a less benign global environment for the region's precrisis export-led growth paradigm. More fundamentally, policies that were effective in earlier years' low-income, capital-scarce Asia are likely to be less effective in today's middle-income, capital-abundant Asia, as a whole.
- In particular, productivity growth, through more efficient allocation of productive resources and faster technological progress, will play a bigger role in the region's economic growth. Therefore, structural policies that promote productivity growth hold the key to sustaining the region's medium- and long-term growth and to allowing the region to make further progress in reducing poverty and spreading the benefits of growth to wider segments of the population. Part 2 of this *Update* presents concrete policy recommendations in four specific areas: trade, human capital, infrastructure, and financial development.
- Although the four areas are examined separately, much interdependence exists among them such that progress in one area will facilitate progress in another. For example, a major impediment to intraregional trade is inadequate transport infrastructure, which prevents the full exploitation of gains from trade with neighboring countries. Therefore, more and better transport infrastructure, domestic and regional, can stimulate both intraregional trade and trade in general.

- Good governance and institutions also have significant positive effects on growth. Efficient public services raise productivity of firms and industries. In addition, regional cooperation and integration expand markets and promote connectivity. These, together with improvements in the four areas mentioned above, will help expand the potential for developing Asia's future growth.

Outlook for 2010 and 2011

- Encouraging macroeconomic developments in the first quarter of 2010 for the major industrial economies will boost the annual growth rate beyond what was projected in *ADO 2010*, and this *Update* revises the 2010 GDP growth projection for these economies to 2.2% from April's 1.7%. However, the recovery that looked promising early this year is starting to run out of steam, and moderation in growth is now seen for the remainder of this year. As the effects of the economic stimulus packages fade, uncertainty about the ability to sustain growth picks up. Growth in 2011 in the major industrial economies is thus expected to be more anemic than in 2010 and the forecast is maintained at 2.0%.
- Inflation remains subdued in the major industrial economies as restrained growth in oil prices and muted domestic demand keep inflation in check. Consumer price inflation in these economies is expected to average 1.2% in 2010 and 1.3% in 2011.
- Oil prices are expected to be less volatile in the next 2 years. Demand for oil from countries in the Organisation for Economic Co-operation and Development (OECD) is forecast to decline somewhat, but this will be tempered by a rise in oil demand from non-OECD countries, particularly the People's Republic of China (PRC). Given the countervailing oil demand trends and the strengthening of the US dollar, oil prices are seen fluctuating within a narrow band.
- Food and beverage prices are expected to be fairly stable in 2010. Recent rises in global wheat prices due to natural calamities and the export ban by the Russian Federation are unlikely to persist for long because overall global production and stockpiles provide enough cushion. With generally well-supplied markets, good crop prospects, and slow global growth, commodity prices are expected to be relatively steady in 2011.
- Downside risks to the wobbly industrial-country recovery remain. Slower second-quarter growth and signs of continued weaknesses in the US and Japan mean that their economic recovery is still frail. Shifting too quickly to fiscal and monetary tightening could heighten the risk of another contraction. There is also the danger that the eurozone will be unable to avoid eventual default or debt restructuring by one or more of its member economies. The lingering sovereign debt concerns have seen bond spreads widening in the bloc's peripheral economies. Spikes in commodity prices remain a downside risk.

- Developing Asia continues to benefit from growth momentum. Driven by buoyant exports, strong private demand, and the sustained effects of stimulus policy, economies in the region performed better than expected in the first half. GDP growth is now projected to rebound to 8.2% in 2010, revised up from the earlier forecast of 7.5%. The improved outlook is broad-based with projections lifted in all subregions. However, with growing concerns over the strength of the global economy, the sustainability of private domestic demand, and the challenge of managing capital inflows and exchange rates, the 2011 growth forecast is maintained, at a still robust 7.3%.
- Despite recent upward movements in food prices, inflation in developing Asia is generally within central banks' "comfort zones." It is expected to be subdued at 4.1% and 3.9% in 2010 and 2011, respectively. But monetary authorities will need to guard against spikes in global oil or food prices. The continued strength of domestic demand will keep the overall current account surplus in the next 2 years to an average of around 4%.
- Aggregate growth in the five economies of East Asia is now projected to rise to 8.6% in 2010, largely owing to recoveries that came in more strongly than forecast in April in the open economies of Hong Kong, China; the Republic of Korea; and Taipei, China. They were hit hard by the slump in world trade in 2009, and have shown a healthy bounceback in tandem with the recovery in trade. The PRC, as expected, grew at a double-digit rate in the first half of 2010. While that pace will ease in the second half, the PRC is still forecast to expand by 9.6% over the full year. In 2011, the impact of the phasing out of economic stimulus policies, slower growth in world trade, and the end of the low-base effect due to the slump indicate that East Asian GDP will increase at a more moderate 7.7%.
- East Asia's inflation forecast is lowered a touch to 3.0% this year, as price pressures in the PRC have been milder than anticipated. It is maintained at this rate for 2011. Current account surpluses equivalent to about 5% of East Asian GDP are still expected for this year and next.
- South Asia's growth prospects for 2010 have been lifted to 7.8% from April's forecast, mainly owing to stronger domestic demand conditions as consumer and business confidence is on the rise. India is experiencing a surge in economic activity, prompting the central bank to tighten its monetary stance in a series of policy rate adjustments starting in January to forestall overheating. India's growth projection is raised to 8.5%. All other economies but Nepal are seeing greater growth momentum than earlier expected, with *Update* revisions for economies generally in the range of 0.5–1 percentage points for 2010.
- For 2011, South Asia's growth forecast has been cut to 7.8%. The markdown is due to reductions in the outlook for Pakistan and Nepal: the former because of the devastating floods in August; the latter by an ongoing political impasse that has left government policy direction largely rudderless.

- South Asia's inflation forecast has been increased to 7.9% for 2010. This adjustment is entirely due to very high inflation in India, where food inflation soared after poor monsoon rains in 2009 stunted agricultural output. For 2011, this *Update* retains the earlier projections for relative price stability to prevail in most economies, though the subregional projection has been raised to 6.5%, owing to upward adjustments in Nepal and Pakistan.
- The projection of the 2010 current account deficit in South Asia is increased to 2.2% of GDP. The change is mainly due to a revision for India to 2.7% of GDP, reflecting strengthened growth and investment. Maldives, Pakistan, and Sri Lanka continue economic adjustment programs with the International Monetary Fund to reduce fiscal and external imbalances. The projection of South Asia's current account deficit in 2011 has been increased to 2.5% of GDP. Again, the change mostly reflects reworked estimates for India.
- Southeast Asia's bigger economies—Indonesia, Malaysia, Philippines, Singapore, and Thailand—have rebounded from last year's weakness at a much stronger pace than was foreseen in April. The growth spurt was sparked by a sharp upturn in exports, which fueled recoveries in consumption and private investment. Aggregate growth for the 10 subregional economies this year is now forecast at 7.4%.
- The pace of growth in several Southeast Asian economies will decelerate in 2011, due in part to the end of the low-base effect and moderation in the expansion of world trade. Aggregate growth is forecast at 5.4%, slightly better than foreseen earlier.
- Forecasts for subregional inflation are edged down to just over 4% for both 2010 and 2011, given moderate price pressures so far this year. Current account surpluses of 5.7% are projected for Southeast Asia in both years.
- Growth across Central Asia has revived—largely as anticipated in *ADO 2010*—because of higher oil prices and economic recovery in the Russian Federation, the region's major trade and financial partner. Macroeconomic policies and reform efforts have generally been both effective and sustained. Forecasts are now edged up or maintained for all but two economies in the subregion (Azerbaijan and the Kyrgyz Republic). Subregional growth is now nudged up to 5.1% in 2010. At 5.7%, the forecast for Central Asia in 2011 is essentially unchanged from that made in April.
- Inflation pressures in the subregion have been kept in check by a strengthened watch on the part of policy makers as well as by adequate food supplies. As a result, this *Update* marginally lowers the inflation forecast to 6.6% in 2010 and 6.4% in 2011.
- The overall Central Asian current account position is now forecast to strengthen to a surplus of 8.4% of GDP in 2010 from the earlier estimate of 7.0%, mainly due to a better outcome for oil exporters Azerbaijan and Kazakhstan. For 2011, an 8.3% of GDP current account surplus is forecast.
- Upgrades to 2010 growth forecasts for Solomon Islands and the Democratic Republic of Timor-Leste have raised the Pacific aggregate growth projection to 4.3% for 2010. However, the better performances by these resource-driven economies mask low levels of growth in most of the 14 subregional economies. Forecasts for several are revised down and two economies—Fiji Islands and Tonga—are expected to contract.

- Aggregate growth in the Pacific is seen picking up to 5.1% in 2011, slightly above the earlier forecast, largely owing to an upward revision for Timor-Leste, return to growth by Fiji Islands, and a vigorous expansion by Papua New Guinea spurred by a ramping up of construction for a large new gas project. The subregional inflation forecast is raised to 5.9% for this year, with price pressures expected to ease a bit in 2011.
- Overall, developing Asia's recovery seems to have taken firm hold. As the global crisis recedes, medium- and long-run growth will reassert itself as the region's top macroeconomic priority. Aggressive fiscal and monetary expansion limited the depth of the slowdown, and laid the foundation for a V-shaped recovery. The central challenge now facing the region is to transform this foundation into sustained medium- and long-run growth.

The future of growth in Asia

- Medium- and long-term growth matters hugely to developing Asia. Despite its rapid precrisis growth and resilience during the crisis, the region lags far behind the industrial economies in per capita income and remains home to two-thirds of the world's poor. Therefore, sustaining growth matters both for lifting the region's general living standards and making a further dent on its poverty.
- The return of long-run growth means that the region's policy makers must give higher priority to structural supply-side policies that improve the economy's productive capacity by fostering factor accumulation and productivity growth. While countercyclical fiscal and monetary policies can smooth temporary output fluctuations, they cannot sustain growth over a longer time horizon.
- Above all, developing Asia's continued transformation from a low-income capital-scarce region to a middle-income capital-abundant region may significantly affect the profile of its future growth. This growth is likely to be more balanced, where both factor accumulation and productivity growth are major contributors. Elements such as trade, human capital, infrastructure, and financial development are likely to be especially important for growth.
- Trade has been a core ingredient of the region's past success and will remain beneficial for both factor accumulation and productivity growth. Given their different levels of development and integration into the world economy, various parts of developing Asia need to pursue a range of strategies in order to leverage trade for growth.
- For East and Southeast Asia, the key challenge is for production and trade networks to take full advantage of potentially large domestic consumption and intraregional trade. For South Asia, the top priorities are trade facilitation and regional integration. For Asia's weaker economies, the urgent need is to expand the base of domestic production and diversify exports.
- Human capital promotes growth through improving labor productivity and facilitating technology adoption and innovation. Developing Asia has made significant progress in educational outcomes. The regional average, however, still falls below that of the industrial economies and masks considerable variations. Therefore, the region should continue to prioritize investments in human capital.

- However, simply raising average educational outcomes may not automatically translate into higher growth rates. For investments to be effective, the design of the education reform agenda will need to take account of how the educational system is able to produce outcomes that meet the standards and skill sets required by the labor market.
- Overall, physical infrastructure stocks in developing Asia have been growing fast. However, they remain well below world-class standards in both quantity and quality. But as the substantial infrastructure investments needed may be beyond the financial capacity of governments alone, facilitating arrangements, such as public–private partnerships, are likely to be required.
- Demand for infrastructure services is expected to soar in developing Asia’s cities due to rapid urbanization. In order to keep cities competitive, investments in infrastructure need to be designed to address congestion, environmental degradation, and other costs associated with urban agglomeration. In addition, closing the wide urban–rural infrastructure divide requires improving access to basic infrastructure services, such as the provision of potable water and sanitation, in rural areas.
- As the relative weight of productivity growth in developing Asia’s growth gradually rises, its financial systems will have to evolve accordingly. The role of these systems must no longer be limited to boosting the quantity of investment but must enhance the efficiency of investment and thus contribute to productivity growth. Such an evolution requires deeper, broader, and more liquid financial systems.
- As the global crisis showed, financial instability can have huge consequences for growth. Therefore, it is critical that the region safeguard financial stability through strong prudential regulation and bond market development. Another priority is to make financial services more accessible to small- and medium-sized enterprises and poorer households, so as to promote entrepreneurship and equality of opportunity.
- Good governance and institutions matter for growth as well. Competent and honest governments that efficiently deliver basic public services, such as administration, education, and health care, raise the productivity of all firms and industries. Such governments are also more conducive for political stability and a more benign overall investment climate. In addition, greater regional integration and cooperation expand markets and promote connectivity. A policy package that combines all these elements will help push developing Asia’s future growth potential.

Subregion/Economy	Table 1 Growth rate of GDP (% per year)					Table 2 Inflation (% per year)				
	2009	2010		2011		2009	2010		2011	
		ADO 2010	Update	ADO 2010	Update		ADO 2010	Update	ADO 2010	Update
Central Asia	2.7	4.7	5.1	5.9	5.7	6.1	6.7	6.6	6.6	6.4
Azerbaijan	9.3	9.5	3.8	9.7	3.5	1.5	5.8	5.0	6.0	4.0
Kazakhstan	1.2	2.5	4.8	3.5	5.2	7.3	6.8	6.8	6.5	6.5
East Asia	6.1	8.3	8.6	7.7	7.7	0.0	3.3	3.0	3.0	3.0
China, People's Rep. of	9.1	9.6	9.6	9.1	9.1	-0.7	3.6	3.2	3.2	3.2
Hong Kong, China	-2.8	5.2	5.8	4.3	4.3	0.5	2.2	2.6	2.8	2.8
Korea, Rep. of	0.2	5.2	6.0	4.6	4.6	2.8	3.0	3.0	3.0	3.0
Taipei, China	-1.9	4.9	7.7	4.0	4.0	-0.9	1.5	1.5	1.6	1.6
South Asia	6.7	7.4	7.8	8.0	7.8	5.6	6.0	7.9	6.0	6.5
Bangladesh	5.7	5.5	6.0	6.3	6.3	6.7	7.5	7.3	7.8	7.5
India	7.4	8.2	8.5	8.7	8.7	3.6	5.0	7.5	5.5	5.5
Pakistan ^a	1.2	-	4.1	-	2.5	20.8	12.0	11.7	8.0	13.0
Sri Lanka	3.5	6.0	6.5	7.0	7.0	3.5	6.5	6.5	8.0	8.0
Southeast Asia	1.3	5.1	7.4	5.3	5.4	2.6	4.5	4.2	4.5	4.2
Indonesia	4.5	5.5	6.1	6.0	6.3	4.8	5.6	5.2	6.2	5.7
Malaysia	-1.7	5.3	6.8	5.0	5.0	0.6	2.4	1.8	3.0	2.4
Philippines	1.1	3.8	6.2	4.6	4.6	3.2	4.7	4.5	4.5	4.4
Singapore	-1.3	6.3	14.0	5.0	5.0	0.6	2.3	3.0	2.0	2.0
Thailand	-2.2	4.0	7.0	4.5	4.5	-0.9	3.5	3.2	3.0	3.0
Viet Nam	5.3	6.5	6.7	6.8	7.0	6.9	10.0	8.5	8.0	7.5
The Pacific	3.7	3.7	4.3	5.0	5.1	5.4	5.1	5.9	5.4	5.4
Fiji Islands	-2.5	-0.5	-0.5	0.5	0.5	3.7	3.4	6.0	3.1	3.5
Papua New Guinea	4.5	5.5	5.5	7.7	7.7	7.6	7.1	7.1	7.7	7.7
Developing Asia	5.4	7.5	8.2	7.3	7.3	1.5	4.0	4.1	3.9	3.9

Notes: **Developing Asia** refers to 44 developing member economies of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; **East Asia** comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei, China; **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam; **South Asia** comprises Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and **The Pacific** comprises Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Republic of Palau, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India and Pakistan are recorded on a fiscal year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

^a In light of Pakistan's revisions to the GDP series in June 2010, ADO 2010 GDP growth forecasts are not comparable with current estimates and have been omitted.

1

Shifting global economic
fortunes

Shifting global economic fortunes

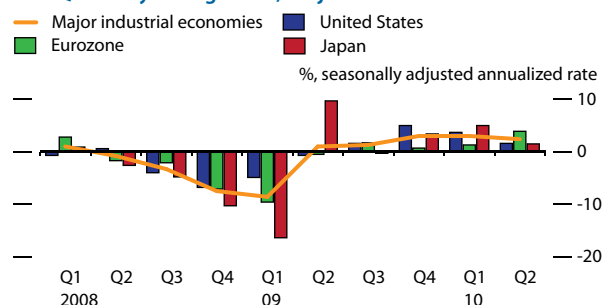
The world economy has passed through its worst economic downturn since the Great Depression. Yet many industrial economies are still struggling. Encouraging gross domestic product (GDP) growth rates in the first quarter of 2010 for the group of major industrial economies—the United States (US), eurozone, and Japan—decelerated in the second quarter (Figure 1.1.1). With signs of stagnant employment in the US, fiscal strains in parts of the eurozone, and pressures from currency appreciation in Japan, the gloom over the global recovery is mounting. Some analysts question the strength of recovery in these economies, even speculating that a “double dip” recession may be on the horizon.

The malaise of the industrial economies contrasts starkly with the dynamism in emerging markets. Brazil, the Russian Federation, India, and the People’s Republic of China (PRC)—the so-called BRICs—had strong growth results through the first half of this year (Figure 1.1.2). The expansion in these economies is attracting foreign investors. These four economies attracted \$194 billion in foreign direct investment (FDI) in 2009, or more than 17% of the global volume. Yet even here, the question remains how long this growth can be sustained without a firmer recovery of the major industrial economies.

In the continuing shift in the economic balance of power toward emerging economies, developing Asia stands out. The region’s rise has become clearer in the wake of the global contraction. While the tremor of the global financial crisis jolted the US and Europe—with the aftershocks from the Greek debt crisis further shaking confidence—developing Asia withstood the worst of the downturn when its export markets dried up. Through the nascent recovery, the region has enjoyed strong investor confidence. Moreover, some large regional economies still have scope to support growth with fiscal and monetary measures, if necessary.

While the region’s economies are still just a fraction of the combined economic strength of the US, eurozone, and Japan, the contrasting fortunes of developing Asia and the major industrial economies gives one pause for reflection. Is the region ready to lead the world on to a higher growth path? But before that question is discussed, an analysis of the industrial economies is made.

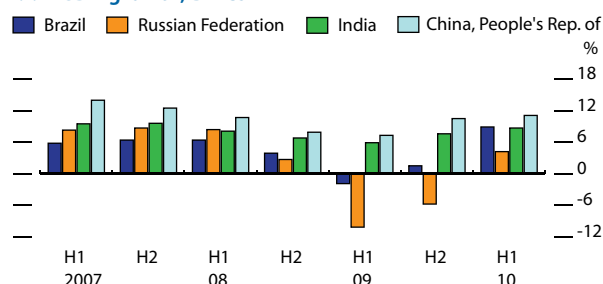
1.1.1 Quarterly GDP growth, major industrial economies



Sources: US Department of Commerce, Bureau of Economic Analysis. <http://www.bea.gov>; Economic and Social Research Institute, Cabinet Office, Government of Japan. <http://www.esri.cao.jp>; CEIC Data Company (all accessed 15 September 2010).

[Click here for figure data](#)

1.1.2 GDP growth, BRICs



Note: All data in calendar years.

Source: CEIC Data Company (accessed 13 September 2010).

[Click here for figure data](#)

Wavering recovery in industrial economies

The major industrial economies began 2010 on an optimistic note. Rising investor confidence, upbeat consumer sentiment, and the support of fiscal and monetary stimulus led to a rapid expansion of consumption and investment in the first quarter of the year. The rebound in emerging economies meant a revival of export markets as well.

As the second quarter progressed, however, the major industrial economies moved in unexpected directions. Growth momentum slowed in the US and Japan, which was only somewhat counterbalanced by a brighter outcome in the eurozone. While the stronger than expected performance in the first quarter of 2010 may be enough to lift GDP beyond what the *Asian Development Outlook (ADO) 2010* forecast in April, global growth prospects remain shrouded in uncertainty.

From optimism to pessimism

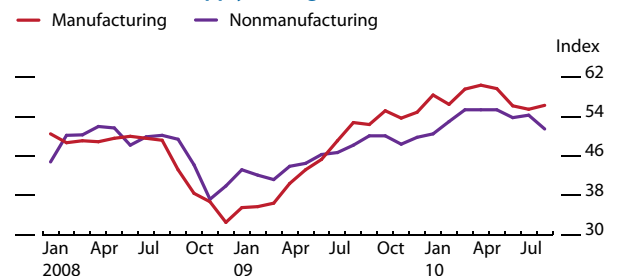
Signs of a weakening US recovery came early as growth decelerated from 3.7% in the first quarter of 2010 to 1.6% in the second quarter (quarter on quarter, seasonally adjusted annualized rate, or saar). The drop was led by a descent in net exports as export growth eased while growth of imports more than doubled, reflecting a greater degree of export deceleration than had been anticipated. This resulted in the largest quarterly drag from net exports in 6 decades. Similarly, weak performance of the service sector in recent quarters, eking out a measly 0.5% gain over the past year, has been atypical. On the positive side, manufacturing output grew strongly (8.5%, saar).

Looking ahead, the signals are mixed for the US. Institute for Supply Management index levels for August 2010 (though below their peaks of April 2010) suggest that moderate growth will continue (Figure 1.1.3).

Eurozone economic news has been dominated by the sovereign debt crisis that began when Greece's dire fiscal situation came to light in mid-2009 (Box 1.1.1). The impact of this loss of confidence spread to other countries in the eurozone's periphery, notably Portugal and Spain. The situation threatened to spread out of control, until interventions by the European Central Bank (ECB) and the International Monetary Fund (IMF) brought a measure of calm to the markets.

In an effort to reduce the lingering uncertainty about the health of the European banking sector since the onset of the global financial crisis, the Committee of European Banking Supervisors released the results of stress tests on 91 banks in July. These banks represent about 65% of total banking assets in the European Union. On the basis of macroeconomic and debt scenarios, only seven banks failed to reach the pass mark of a 6% Tier 1 capital ratio (the ratio

1.1.3 Institute for Supply Management indexes, United States



Note: An index over 50% suggests economic expansion; an index below 50% indicates a decline.

Source: Institute for Supply Management. <http://www.ism.ws> (accessed 15 September 2010).

[Click here for figure data](#)

1.1.1 Eurozone sovereign debt crisis

The global crisis has exacerbated the fragile state of government finances in several eurozone economies. Greece has been worst hit, not just by the global slump and falling receipts in the country's vital tourism and shipping sectors, but by years of government overspending. Already on the monitor, in mid-2009 its dire fiscal position came under severe market scrutiny as evidence arose of deliberate misreporting of its public finance statistics.

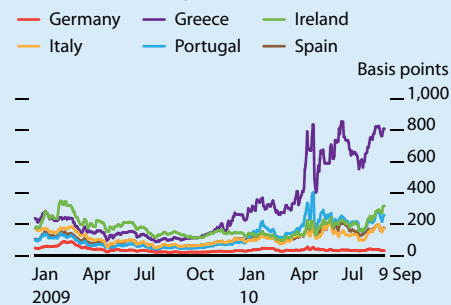
Investor nervousness and speculation—aggravated by eurozone governments' long hesitation to undertake concerted action—caused government bond spreads and borrowing costs to jump. These anxieties were quickly transformed into a crisis of confidence affecting some of the weaker, peripheral, eurozone countries. Rating agencies downgraded Portugal and Spain, and later Ireland, and countries took drastic fiscal retrenchment measures in an attempt to ensure continued access to capital markets.

In early May 2010, European Union finance ministers eventually agreed on a €110 billion rescue package for Greece after the country committed to a long and painful adjustment under the aegis of the International Monetary Fund (IMF). Against the backdrop of growing market nervousness over Ireland, Portugal, and Spain, the ministers also announced a €500 billion European Financial Stabilization Mechanism backed by an additional €250 billion IMF contribution.

On its side, the European Central Bank initiated a series of unprecedented measures of support, including a Covered Bond Purchase Program intended to buy up member countries' public and private debt in the primary and secondary markets. By June 2010, €60 billion had been purchased.

These interventions have averted an impending Greek default and contagion to other eurozone countries. However, they have not fully assuaged financial market nervousness. After coming down from their peak in May 2010, credit default swap spreads remain elevated and have been approaching a new peak in September, not just for peripheral eurozone countries, but for Italy as well (Box figure).

10-year euro-denominated government bond credit default swaps



Source: Datastream (accessed 10 September 2010).

Greece, in particular, has been making good progress in its adjustment program while drawing down emergency funds, but is yet to generate the structural basis of future growth rates high enough to avert possible insolvency further out. Financial markets also seem unconvinced about the future sustainability of countries like Ireland and Portugal in a context of high debt, steep borrowing costs, and low growth prospects. Unless creditors are willing to buy into their markets and premiums are not prohibitive, further eurozone bailouts or debt restructurings might, ultimately, be unavoidable.

of a bank's core equity to its total risk-weighted assets). The committee estimated the combined capital shortfall of the seven banks at €3.5 billion, a figure considerably lower than generally expected.

Despite concerns about the sovereign debt crisis, net exports from Germany proved a major boost to the second-quarter recovery in the eurozone, after detracting from first-quarter GDP growth. Driven mainly by external demand, industrial production and new orders continued to edge up in Germany during the first half of 2010. In response to the recovery in global activity and trade, first- and second-quarter growth in the eurozone was fueled by restocking of inventories. Eurozone GDP grew by 1.3% quarter on quarter, *saar*, in the first quarter, accelerating to 3.9% in the second.

Second-quarter data indicate that recovery is also slowly taking hold in the other core economies of the eurozone, including France (2.5%) and Italy (1.8%). Peripheral countries fared less well, with Greece's recession deepening (-6.8%), and subdued growth in Spain (0.7%) and Portugal

(1.1%). The scenario is one of widening differences between eurozone's core and peripheral economies.

After growth in the first quarter, GDP growth in Japan slowed more than expected in the second quarter—from 5.0% to 1.5% (quarter on quarter, saar)—due to weak domestic demand. Subsidies for certain environment-friendly durable goods (for example, energy-efficient flat-screen televisions) helped drive consumer spending through the first quarter, but their impact faded sharply in the second quarter once March's last-minute consumption surge—prompted by consumers' expectation that the subsidies would end—waned.

Deflation pressures in Japan are hurting business investment by weighing on firms' profits and increasing real borrowing costs. Weaker external demand in the second quarter dragged growth further down, a situation unlikely to be reversed soon.

Market response to the uncertainty

Stock markets reacted negatively to the slowing second-quarter growth in the US and Japan. The S&P 500, Nikkei 225, and Euro Stoxx 50 have all declined from their peaks reached in April 2010 (Figure 1.1.4). Many US stock indexes remain relatively low as fears of a double-dip recession there grow. Looking for a safer haven, investors flocked to buy US Treasury debt, pushing down yields. On 1 September 2010, benchmark 10-year Treasuries saw their largest monthly drop since the 2008 collapse of Lehman Brothers. In Japan, the Nikkei 225 fell to a 16-month low on 31 August, before regaining some lost ground.

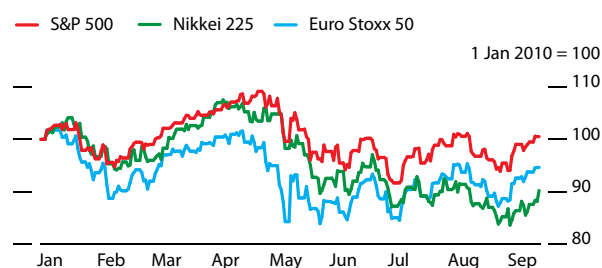
Currency markets turned volatile as well. As eurozone fiscal difficulties became more pronounced, the dollar gained against the euro, while many emerging market and “commodity” currencies succumbed to concerns about the sustainability of global recovery. The dollar appreciated by around 15% against the euro from end-December 2009 to mid-June of this year. Stronger than expected growth in the eurozone (particularly in light of the sovereign debt crisis there) and solid demand for euro bonds issued by core countries subsequently helped the euro to gain back some of its value against the dollar.

The publication of the European bank stress test results reduced uncertainty and helped calm financial markets. Although the assumptions underlying the stress tests were criticized for being insufficiently tough (notably, the sovereign risk shock scenario excluded sovereign bonds that banks will hold to maturity, hence effectively assuming away the possibility of sovereign default), the tests made the European banks' balance sheets more transparent.

Markets reacted positively with a moderate decline of interbank lending rates, narrower credit-default swap spreads, and an increase in bank stock prices. Nevertheless, credit standards have tightened again and lending to the private sector is subdued. Facing heightened capital costs, eurozone banks continue to impose tighter conditions on loans to nonfinancial firms, hence passing on the costs to the real economy.

The yen had appreciated by 21% in real trade-weighted terms from the onset of the global slowdown in September 2008 to August 2010.

1.1.4 Stock price indexes, 2010



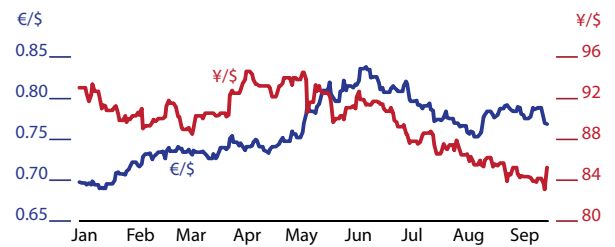
Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

Because the currency hovered around 15-year highs against the US dollar and showed recent peaks against the euro, the Bank of Japan made massive purchases of dollars on 15 September. The nominal rate depreciated by 3% against the dollar in one day (Figure 1.1.5), and the stock market reacted positively. As the intervention was not sterilized, the expansion of the money supply will help to ease deflation.

Yet the long-term impact of this intervention is seen limited. As long as Japan's real interest rates remain above those of the US and eurozone, unilateral intervention cannot stop flows into the yen for more than a brief period. Extended attempts to counteract these external inflows would be financially costly for the central bank.

1.1.5 Exchange rates, 2010



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

Delayed return to normal policy stance

While recovery seemed to be taking shape, calls for fiscal consolidation were gaining ground in early 2010. Plans to withdraw stimulus measures were based on the expectation that private demand was strong enough to stand on its own, but private consumers have remained reluctant to spend, particularly in the US and Japan. In light of the wavering prospects of recovery, fiscal retrenchment measures are not yet under way there.

In the US, homebuyers' tax credit ended in April 2010. The government has proposed fresh stimulus to promote business investments and support infrastructure. A \$50 billion stimulus plan to finance the renewing and expansion of the nation's roads, railways, and runways to help the economy grow and spur private sector hiring was announced on 6 September. It envisages leveraging private and public capital as against the current budgetary allocation for infrastructure. Two additional stimulus measures are targeted at businesses to encourage investment spending.

The budgeted amount for the subsidy for environment-friendly cars in Japan was fully spent by September 2010, though incentive schemes for other green goods such as consumer electronics and durable goods have been extended until March next year. In addition, a new child allowance program that started in June this year is aiming to encourage young families to have children and thus counteract the current trend of population aging in the country. The impact on consumption and GDP of all these schemes is, however, expected to be modest.

Only in the eurozone has the drive for fiscal consolidation been maintained. Fiscal austerity measures are planned across the eurozone even as the effects of crisis-related expenditure fade. Germany will cut the budget deficit by €80 billion over the next 5 years. The measures include a plan to slash €30 billion from the welfare budget, cuts in government jobs, and the abandonment of tax cuts scheduled earlier. France has announced plans to cut public spending by €45 billion over the next 2 years and raise its retirement age. Italy's cabinet approved an austerity package to cut the deficit by €25 billion in the 3 years to 2012. The package includes cuts in funding to city and regional governments, a 3-year freeze on public sector pay rises, and a crackdown on tax evasion and false benefit claims.

Greece, Ireland, Portugal, and Spain have already implemented tough austerity measures, drawing protests from the public. Greece is undergoing a severe IMF adjustment program, and rating agencies' downgrading of Portugal and Spain in May this year forced stringent fiscal retrenchment steps there.

Across much of the eurozone, austerity measures have angered workers and led to protests, signaling a limit to which tightening can be undertaken.

On the monetary front, policy is expected to remain expansive across the major industrial economies. The Federal Reserve is maintaining its target range of 0–25 basis points for the Federal Funds rate this year. Aside from the near zero interest-rate policy, it used nontraditional means to provide monetary stimulus, including direct purchases of mortgage-backed securities. In August, the Federal Reserve announced that it would continue to use its balance sheet to provide longer-term liquidity, using principal repayments from its holdings of mortgage-backed securities to purchase longer-term Treasury securities.

In early September, the ECB confirmed its 1% main policy interest rate, as well as its intention to continue meeting in full banks' demand for liquidity as long as it deemed it necessary. In Japan, the expansionary stance is expected to continue with nominal interest rates close to zero. In late August, the Bank of Japan introduced an additional stimulus measure in order to encourage a decline in market interest rates and further ease monetary conditions.

The global crisis has called for coordinated action on the global financial system so as to improve safeguard measures against risks that could jeopardize that system. Recently, leading international bank regulators agreed on new wide-ranging rules that would require banks to hold more ready capital and take fewer risks as part of an effort to make the world's banking system safer, while aiming to protect national economies from future financial crisis.

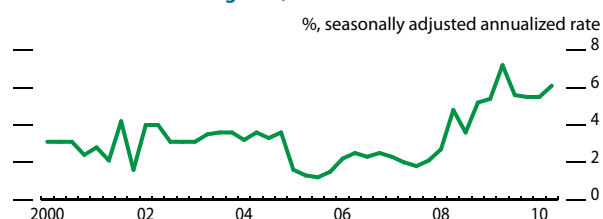
These "Basel III" regulations, which are about to be ratified by the G20, will gradually increase the ratio of reserve funds in a bank's assets from 2% to 7%. This stiffer ratio is expected to be phased in only from January 2013 and to be fully in effect from January 2018, partly in view of current global conditions.

The Basel III agreement is in line with the financial reform bill passed in the US in July. This landmark bill puts up new rules that govern how banks trade in (and protect consumers from) high-risk financial products, and imposes tighter scrutiny on large banks' cash reserves that are used to offset bad loans. The Basel agreement is also a significant step in global moves to reduce the incidence and severity of future financial crises in that it provides a more stable banking system that is both less prone to excessive risk taking and better able to absorb losses.

Revival of private demand

Given the uncertainties relating to the growth resurgence, until private demand takes a strong foothold, the implementation of exit policies in some countries is likely to be postponed.

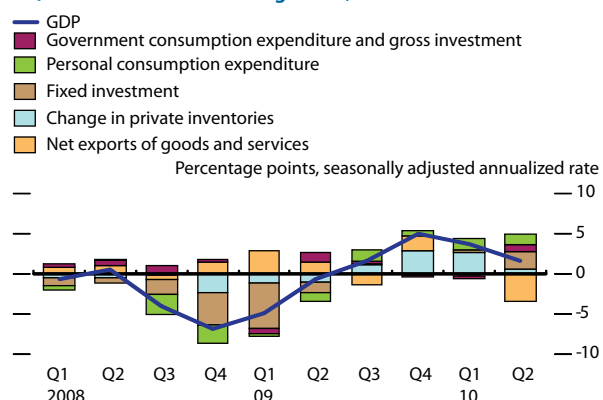
1.1.6 Household saving rate, United States



Source: Bureau of Economic Analysis. <http://www.bea.gov> (accessed 30 August 2010).

[Click here for figure data](#)

1.1.7 Contributions to GDP growth, United States



Source: Bureau of Economic Analysis. <http://www.bea.gov> (accessed 30 August 2010).

[Click here for figure data](#)

Domestic demand

One effect of the crisis has been an upward adjustment of US households' average saving rate from about 1.9% in 2005–2007 to 5.7% from the third quarter of 2009 to the second quarter of 2010 (Figure 1.1.6, above). Private consumption expenditure contributed 0.8 percentage point in the second quarter from 1.3 percentage points in the first (Figure 1.1.7, above). New car and light truck sales, a major household discretionary expense, rose. There was also 27% growth in private residential investment, but it reflected the effects of the homebuyers' tax credit and low mortgage rates (Box 1.1.2).

As these policies are withdrawn and unemployment remains high, housing demand may not continue in the same line. Gross private domestic investment maintained its double-digit growth rate, however, rising by 25%. The inventory-to-sales ratio has returned to its prerecession level, indicating certain completeness in this adjustment process at least.

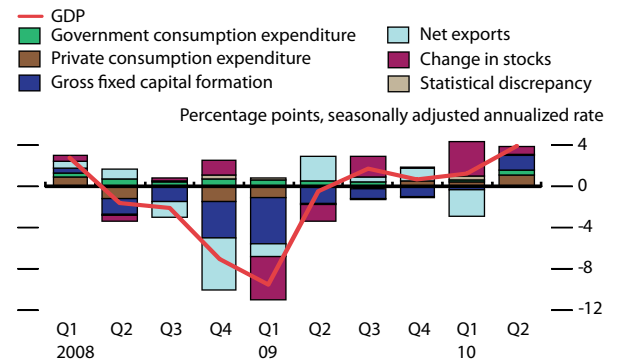
While jobless claims remain elevated in the US, the unemployment rate hovered at just under 10% from May to August 2010 (Box 1.1.3). In aggregate, over 100,000 jobs were lost in August and unemployment insurance claims declined. For the first time this year, manufacturing employment contracted (also in August). The latest jobs report does not paint a rosy picture on hiring, either. And though private sector salaries and wages grew by 0.5% in July, the personal saving rate declined to 5.9% from 6.2% in June.

In the eurozone, consumers stepped in to fill the void in consumption left by the retreat from fiscal expansion. Exports indirectly contributed to the rebound of the region by propelling gross capital formation and boosting confidence for consumption. Indeed, for the first time since the crisis hit, investment in the second quarter contributed substantially to GDP growth while household consumption recorded a large increase (Figure 1.1.8). Retail turnover, however, has yet to show a notable improvement (Figure 1.1.9). Driven mainly by external demand, new industrial orders in the eurozone continued to edge up during the first half of 2010, but are still far below precrisis levels.

Revamping private domestic demand continues to present a major policy challenge for the eurozone against a background of high unemployment. The eurozone unemployment rate appears to have peaked at 10% in March 2010, staying at that level until July 2010 (Figure 1.1.10). However, the disparities across labor markets of the eurozone are high and the challenges are country specific.

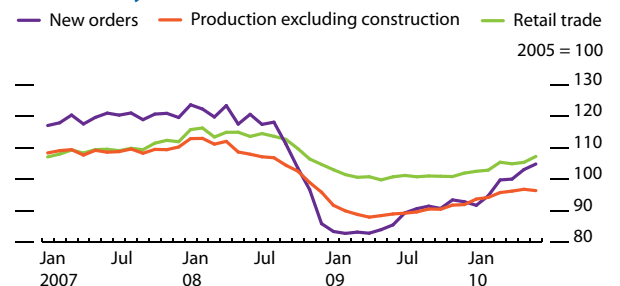
For example, in June 2010 Spain faced unemployment at 20.2%, with the prospect of further increases until the economy turns the corner. At the opposite spectrum within the eurozone, unemployment in Austria dropped to 3.9% in June (from 5.1% a year earlier), partly reflecting a 2.0% year-on-year rebound in economic activity during the second quarter.

1.1.8 Contributions to GDP growth, eurozone



Source: Eurostat. <http://epp.eurostat.ec.europa.eu> (accessed 2 September 2010).
[Click here for figure data](#)

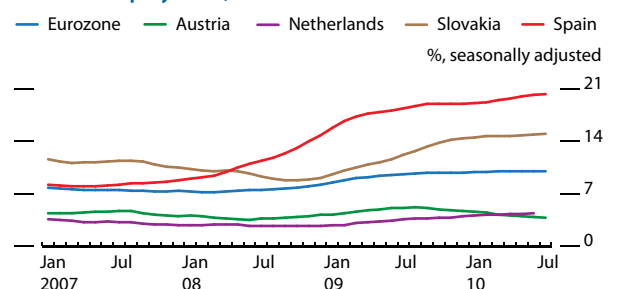
1.1.9 Industry and services indicators, eurozone



Note: May 2010 business surveys data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev. 2) causing a potential break in series at this date.

Source: Eurostat. <http://epp.eurostat.ec.europa.eu> (accessed 2 September 2010).
[Click here for figure data](#)

1.1.10 Unemployment, eurozone



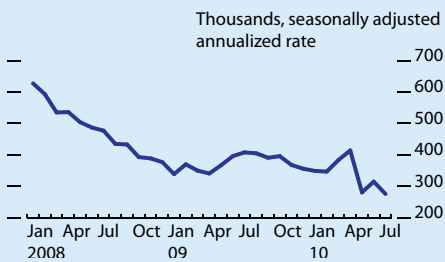
Source: Eurostat. <http://epp.eurostat.ec.europa.eu> (accessed 2 September 2010).
[Click here for figure data](#)

1.1.2 United States housing market

Poor labor market conditions in the United States reflect the current depression in the housing sector. Recent declines in mortgage rates (now around 4.5% for a 30-year fixed-rate mortgage) did little to revive housing demand, and increases in purchase applications from mid-August to early September are barely above the depressed June level.

Home sales increased in March and April, but this welcome break was driven mainly by home buyers advancing their purchases to benefit from the homebuyers' tax credit (a subsidy for first-time buyers worth \$8,000), which expired at the end of April (Box figure 1).

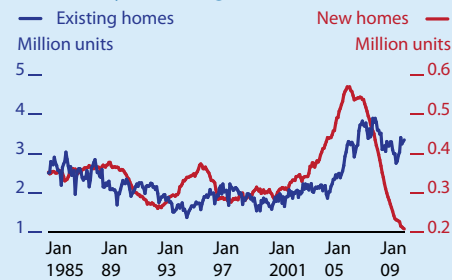
1 New home sales



Despite the early months' strong sales of new homes, the stock of unsold existing homes is still high and above prior-year levels (Box figure 2). The July level is equivalent to about 12.5 months of supply, well above the 4–5 months seen in a healthy market. In contrast, the low level of housing construction activity has caused the inventory of new homes to plummet by 24.8% over the previous year, bringing new homes for sale inventories to unusually low levels.

The excess supply of homes continues to exert downward pressure on prices. There was a short respite in the decline in March and April as a result of the homebuyers' tax credit but in May and June the boost in prices started to wane. According to estimates from

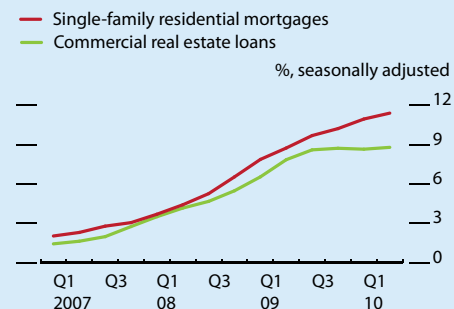
2 Inventory of existing and new homes for sale



CoreLogic, an analytic research firm, 11 million (or 23%) of all residential properties with mortgages were in negative equity by end-June 2010.

Delinquency rates for both commercial and residential real estate loans have been on a rising trend, and foreclosures remain at worryingly high levels, suggesting continued downward pressure on domestic banks' asset quality (Box figure 3).

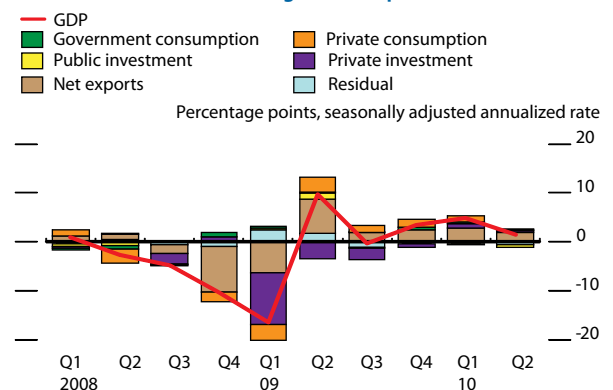
3 Delinquency rates on real estate loans



As public investment in Japan contracted in the second quarter this year, private investment showed only modest growth; private consumption was virtually flat. With export volumes close to precrisis levels—driven largely by exports to neighboring economies, particularly to the PRC—net exports contributed strongly to Japan's growth in the first and second quarters (Figure 1.1.11).

Japan's wage growth has picked up in recent months but unemployment has gone up, too. With deflationary tendencies in place, consumers are postponing purchases in anticipation of further price falls. Residential investment turned to contraction in the second quarter after growing in the first. Housing starts declined by more than 9% in the second quarter. The

1.1.11 Contributions to GDP growth, Japan



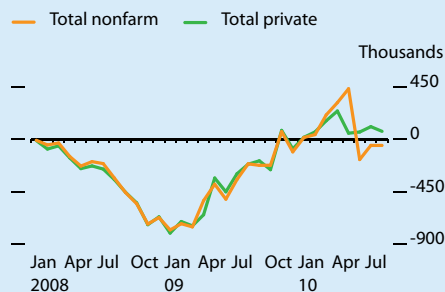
1.1.3 United States labor market

The labor market in the United States remains weak, but at least recent reports point to continued sluggish growth rather than further worsening.

While the August unemployment rate inched up to 9.6% from the 9.5% of the prior 2 months, the increase was due to more people entering the labor force—a turnaround from the post-May trend of a declining civilian participation rate.

More important, private sector employment rose by 67,000 in August (Box figure 1). Still, given the pace of the gains this year, it may well be a long time before the total number of jobs in the economy surpasses December 2007's level.

1 Monthly employment changes



Source: CEIC Data Company (accessed 13 September 2010).
[Click here for figure data](#)

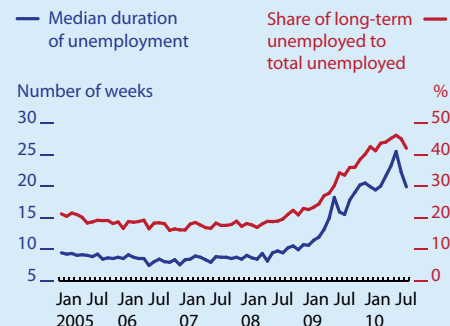
Employment gains in the private services sector present a nugget of hope. Of particular interest is the increase in temporary service workers of 16,800 in August. This figure is a good leading indicator of future employment trends. In a downturn, when firms see an uptick in demand, they will first assess if it is just a blip or a real recovery.

Wary, firms will first maximize their existing human resources instead of hiring new people to meet increasing

demand for labor. Indeed, average workweek remained at 34.2 hours, up from 33.8 a year ago. The second thing that firms will do is use temporary services—which is what they seem to have started to do. Only when firms are confident that business is on a solid footing do they make employees permanent.

Another glimmer comes from the median duration of unemployment (Box figure 2). That continued to fall in August, from a record high of 25.5 weeks in June, down to 19.9 weeks. Further, the percentage of workers unemployed for more than 27 weeks continued the downward trend that started in May, from 46% that month to 42% in August.

2 Unemployment



Source: CEIC Data Company (accessed 13 September 2010).
[Click here for figure data](#)

Still, the duration of unemployment remains at a worrying level compared to the 1997–2007 average of 8 weeks. It is pernicious because most people in their sixth month of joblessness have exhausted their savings. Also this time around, given the dire straits in the housing market, unemployed homeowners are less likely to be able to draw on their home equity to cope with their predicament.

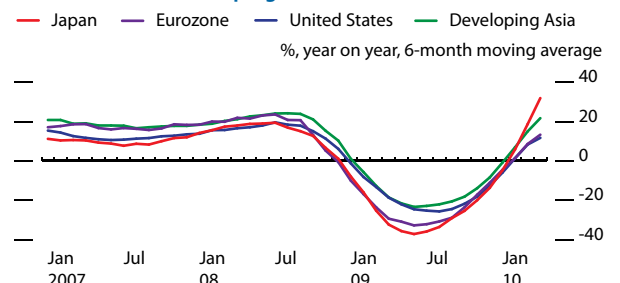
expected virtuous circle—more exports leading to investment and employment, and hence improved income conditions and private consumption—has not yet materialized. This trend may continue a while, and the speed of recovery may further slow.

External demand

Despite the recovery, world trade growth is far below the peak years of globalization in 2003–2007, but the level of trade is back to about what it was in 2008. Trade growth in industrial economies is recovering relatively strongly, but the pace is likely to remain well below the rate of growth seen in developing Asia (Figure 1.1.12).

In the US, for example, the goods and services trade deficit eased back in July to \$42.8 billion, the first narrowing

1.1.12 Growth in exports to the world, from major industrial economies and developing Asia



Source: International Monetary Fund. Direction of Trade Statistics online database (accessed 16 September 2010).
[Click here for figure data](#)

in the trade deficit after 3 consecutive months of widening (Figure 1.1.13). Net exports had sharply deteriorated in the second quarter of 2010, likely limited by the dollar's appreciation, subtracting 3.4% from GDP growth in their largest quarterly drag on growth since 1947. (Exports had begun picking up in the second half of 2009.) The inventory restocking cycle has caused imports to accelerate faster than exports in the first half of 2010. But with the inventory cycle phasing out in the second half and with consumer spending still anemic, the upward pressure on imports may be limited.

Eurozone external trade rose along with a strong rebound in global trade (Figure 1.1.14). A weakening of the euro against the dollar and the yen—on the back of European debt woes and fears about possible repositioning by major holders of euro-denominated foreign reserves—helped this performance. Germany, in particular, benefited from its diversified export structure and strong competitiveness, and saw its exports surging, manufacturing capacity on the rise, and business sentiment upbeat.

Japan's exports in July were 23% higher than a year earlier but slower than the 27% growth registered the previous month, continuing the declining growth trend since February (as the previous year's low base moves out of the frame) (Figure 1.1.15). Although rapid currency appreciation is further straining export growth (Figure 1.1.5, above), the trade surplus is expanding with slower import growth.

Slow progress in rebalancing

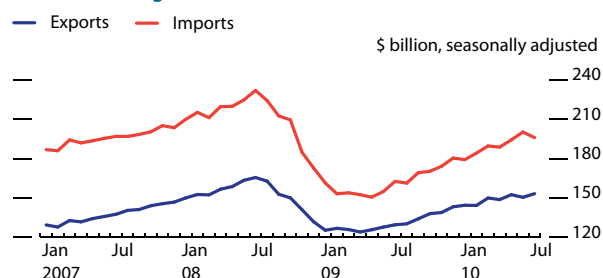
Global current account imbalances, which helped set the conditions that led to the recent global turmoil, showed some signs of abating during the depths of the contraction in international trade. The US current account deficit averaged 1.6% of world GDP in 2004–2006, the years immediately prior to the onset of the financial crisis. As trade volumes fell, global imbalances collapsed as well. By 2009, the US current account deficit was less than half its precrisis level (0.7% of world GDP) (Figure 1.1.16).

On the surplus-country side, much of the reduction in imbalances came from the oil-exporting countries (from a precrisis average of 0.4% of world GDP to less than 0.1% in 2009) and Japan (from an average of 0.4% to 0.2%).

Are the reversals in imbalances likely to hold? The rise in the US household saving rate is a positive sign. Quarterly household saving rates that had been at or below 2.5% of GDP during 2005–2007 (and as low as a paltry 1.2% of GDP), have been above 5% for the 7 quarters ending midyear 2010 (Figure 1.1.6, above). However, this will be partly offset by continued high fiscal deficits. If the recovery holds, surpluses for the oil-exporting countries in the Middle East will also likely expand.

The dollar value of the PRC's surplus dropped during the crisis, from its peak of \$371.8 billion (11% of GDP) in 2007 to \$297.1 billion in 2009 (6% of GDP), as trade slowed and domestic demand was boosted by huge

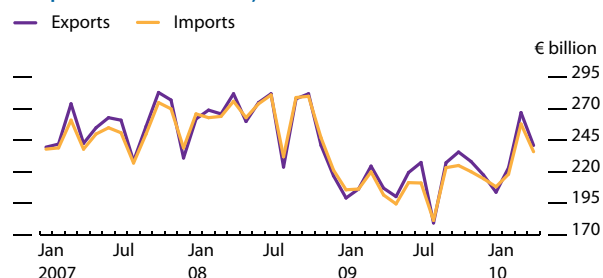
1.1.13 Trade in goods and services, United States



Source: Bureau of Economic Analysis. <http://www.bea.gov> (accessed 15 September 2010).

[Click here for figure data](#)

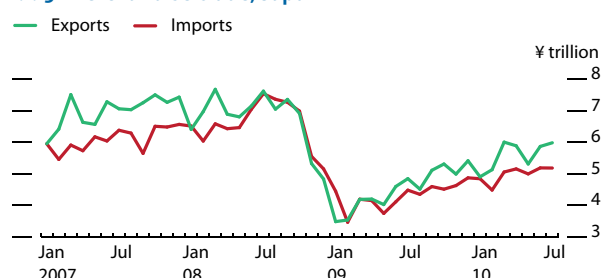
1.1.14 Merchandise trade, eurozone



Source: Eurostat. <http://epp.eurostat.ec.europa.eu> (accessed 2 September 2010).

[Click here for figure data](#)

1.1.15 Merchandise trade, Japan



Source: CEIC Data Company (accessed 15 September 2010).

[Click here for figure data](#)

fiscal stimulus packages. Yet this surplus has remained high as a share of world GDP (about 0.5%).

The rest of developing Asia also continued to run strong surpluses relative to global GDP. As the region maintains its growth lead (Figure 1.1.17), it should continue to attract significant capital flows. On the whole, progress in unwinding the unsustainable global current account imbalances looks fragile.

Global economic outlook

GDP growth rates

Output in the major industrial economies continues to expand, suggesting the world may have passed the worst of the global turmoil. But the steep drop in growth rates between the first and second quarters of 2010 exposed the fragility of the recovery. This *Update* forecasts somewhat stronger growth overall for the year when compared to the April *ADO 2010* forecasts (Table 1.1.1).

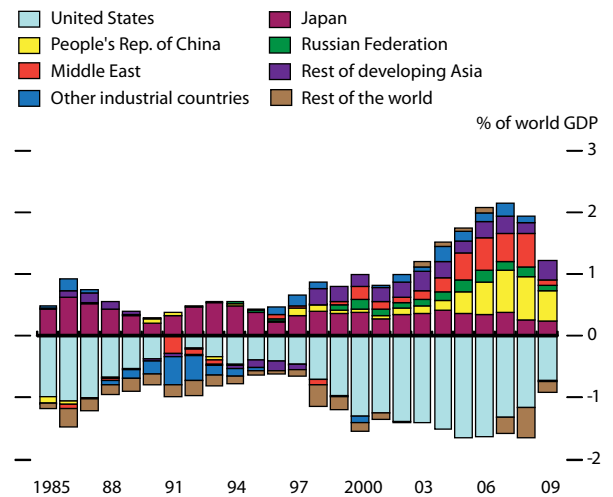
But while for the second half of 2010 and into 2011 there is considerable uncertainty, not all of the news is gloomy. The expansion in international trade seems to be more robust than earlier anticipated. Inflation remains subdued, which will give policy makers some flexibility in returning to normal monetary policy.

Fresh stimulus for businesses and infrastructure development in the US may temporarily boost domestic demand a bit longer. This prop may be aided by foreign demand for US exports, which are expected to be stronger in the second half of 2010, supported by growth in emerging market economies in Asia and Latin America. The surge in import growth is unlikely to be sustained against a backdrop of slowing US consumer spending and moderating industrial production growth. Together, these trends should result in a positive contribution of net exports in the second half.

The 2010 US growth forecast has been revised up to 2.8%, from 2.4% in *ADO 2010*, largely because of the relatively strong start to the year. Over the next year, the growth in consumer spending, which accounts for around 70% of the US economy, is likely to be restrained by slow growth in wages, weak gains in household wealth, and continuing credit restraint. High joblessness rates are likely to persist, despite some improvement in employment.

As the stimulus measures are withdrawn and incomes fail to rise significantly, private consumption will grow at only a subdued rate. Housing sales that were kept high through stimulus policies for first-time home buyers may see a decline even as delinquency rates remain high. A large excess supply of residential and commercial property will stymie the recovery of investment. Slow revival in external demand will

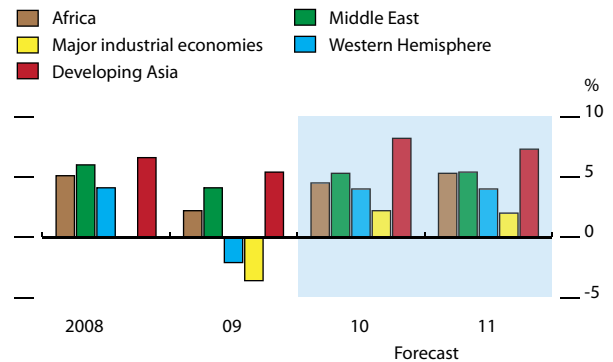
1.1.16 World current account balance



Source: International Monetary Fund, 2010. World Economic Outlook database. April. www.imf.org (accessed 7 September 2010).

[Click here for figure data](#)

1.1.17 World GDP growth



Africa: Composed of 50 countries: Algeria; Angola; Benin; Botswana; Burkina Faso; Burundi; Cameroon; Cape Verde; Central African Republic; Chad; Comoros; Congo, Democratic Republic of; Congo, Republic of; Côte d'Ivoire; Djibouti; Equatorial Guinea; Eritrea; Ethiopia; Gabon; Gambia; Ghana; Guinea; Guinea-Bissau; Kenya; Lesotho; Liberia; Madagascar; Malawi; Mali; Mauritania; Mauritius; Morocco; Mozambique; Namibia; Niger; Nigeria; Rwanda; São Tomé and Príncipe; Senegal; Seychelles; Sierra Leone; South Africa; Sudan; Swaziland; Tanzania, United Republic of; Togo; Tunisia; Uganda; Zambia; and Zimbabwe.

Middle East: Composed of 14 countries: Bahrain; Egypt; Iran, Islamic Republic of; Iraq; Jordan; Kuwait; Lebanon; Libya; Oman; Qatar; Saudi Arabia; Syrian Arab Republic; United Arab Emirates; and Rep. of Yemen.

Western Hemisphere: Composed of 32 countries: Antigua and Barbuda; Argentina; Bahamas; Barbados; Belize; Bolivia; Brazil; Chile; Colombia; Costa Rica; Dominica; Dominican Republic; Ecuador; El Salvador; Grenada; Guatemala; Guyana; Haiti; Honduras; Jamaica; Mexico; Nicaragua; Panama; Paraguay; Peru; St. Kitts and Nevis; St. Lucia; St. Vincent and the Grenadines; Suriname; Trinidad and Tobago; Uruguay; and Venezuela.

Sources: ADB calculations based on data from: International Monetary Fund, 2010. *World Economic Outlook*. April; World Development Indicators online database (accessed 15 September 2010); *Asian Development Outlook* database.

[Click here for figure data](#)

1.1.1 Baseline assumptions for external conditions

	2008	2009	2010		2011	
	Actual	Actual	ADO 2010	Update	ADO 2010	Update
GDP growth (%)						
Major industrial economies ^a	0.0	-3.6	1.7	2.2	2.0	2.0
United States	0.0	-2.6	2.4	2.8	2.6	2.6
Eurozone	0.4	-4.0	1.1	1.3	1.6	1.4
Japan	-1.2	-5.2	1.3	2.5	1.4	1.4
World trade (% change)						
Merchandise exports volume	2.2	-12.2	7.1	9.5	8.1	8.1
Prices and inflation						
Brent crude spot prices (average, \$ per barrel)	97.3	61.7	80.2	80.2	84.6	82.5
Energy price index (% change)	40.1	-36.9	28.0	25.0	8.1	-0.3
Food and beverage price index (% change)	23.3	-13.1	4.7	0.9	2.9	-1.0
CPI inflation (G3 average, %)	3.2	-0.2	1.4	1.2	1.3	1.3
Interest rates						
US Federal Funds rate (average, %)	1.9	0.2	0.3	0.2	1.3	0.5
EU refinancing rate (average, %)	3.9	1.3	1.1	1.1	1.5	1.5
Japan interest rate (average, %)	0.5	0.1	0.1	0.1	0.2	0.2
US\$ Libor ^b (%)	2.7	0.3	0.3	0.3	1.3	0.8

^a Average growth rates are weighed by GNI, Atlas method (current US dollars). ^b Average interbank quotations on 1-month loans.

Sources: US Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov>; Eurostat, <http://epp.eurostat.ec.europa.eu>; Economic and Social Research Institute of Japan, <http://www.esri.cao.go.jp>; World Trade Organization, <http://www.wto.org>; Consensus Forecasts; Bloomberg; International Monetary Fund, Primary Commodity Prices, <http://www.imf.org>; World Bank, Global Commodity Markets, <http://www.worldbank.org>; ADB estimates.

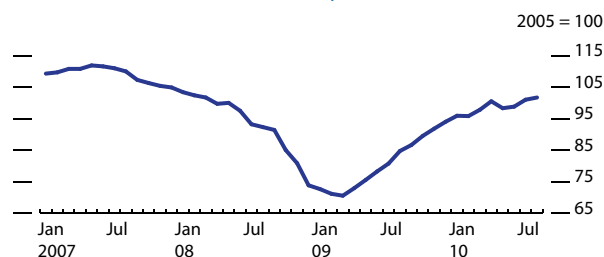
also pull down growth. In 2011, the pace of economic expansion is seen slackening to 2.6%.

Forward-looking indicators for the eurozone suggest that its momentum will be maintained through the second half of 2010. Unemployment is expected to come down slowly toward the end of this year, as the recent upswing in GDP growth starts to be reflected in the labor markets with the usual lag of 6 months or more. The economic sentiment index shows continued signs of improvement, mainly on account of the services sector, despite some signs of flattening since May (Figure 1.1.18).

GDP growth in 2010 is revised to 1.3%, up from the 1.1% anticipated in *ADO 2010*. However, fiscal consolidation announced across all eurozone countries will heavily dent 2010 growth during the second half, both through actual cuts and expectations. The effects will be felt more in 2011 if the policy announcements are carried through.

Against the prospects of a subdued demand for exports from the US and Japan during much of 2011, as recovery in both the regions itself hinges on external demand, sharply lower government spending and tax hikes in the eurozone risk suffocating the nascent domestic momentum needed for a sustained recovery. Moreover, by stifling growth excessively, widespread retrenchment could eventually undermine its purpose of achieving a

1.1.18 Economic sentiment index, eurozone



Note: May 2010 business survey data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev. 2) causing a potential break in series at this date.

Source: European Commission, Directorate General for Economic and Financial Affairs. <http://epp.eurostat.ec.europa.eu> (accessed 2 September 2010).

[Click here for figure data](#)

significant improvement of debt and fiscal deficit ratios, hence debt servicing capacity and market confidence.

The medium-term eurozone outlook for employment creation is likely to be of a slow and gradual recovery, largely due to the medium-term effects of some countries adopting “short work” practices, notably Germany and Italy. Such policies have prevented excessive labor shedding in the face of the downturn, but typically cause delays further out, for example in terms of the structural adjustments necessary for labor adjustment to occur across sectors and firms.

GDP growth in 2011 is now expected to be 1.4%, down from 1.6% projected in *ADO 2010*, reflecting continuing weakness in the global economy and fiscal austerity across the eurozone.

Japan’s economy has benefited from strong exports to the PRC and other regional economies during the recovery process so far, but domestic demand growth remains sluggish. Near-term prospects thus heavily rely on exports and the impact on business sentiment and incentives to invest. Private consumption is likely to stay weak unless labor market conditions improve substantially.

Given wobbly economic prospects both domestically and globally, expansionary policies are being continued to support Japan’s recovery. An increase in the consumption tax is unlikely soon, with any rise being preceded by cuts in corporate taxes. The current expansionary monetary stance is expected to continue because output remains below potential and inflation pressures are low.

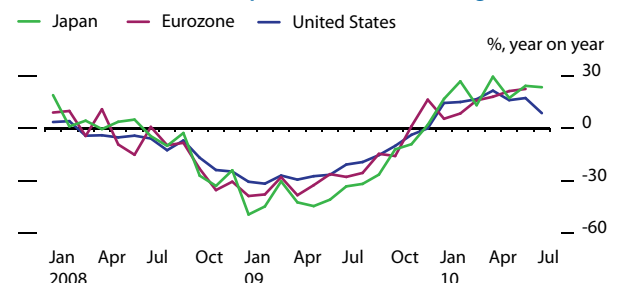
Real GDP in Japan is projected to grow at 2.5% in 2010—an upward revision from the *ADO 2010* projection of 1.3%—as private consumption had a boost in the first quarter backed by the changing subsidy scheme. However, fiscal policy can only play a limited role in supporting the recovery process as large fiscal deficits have pushed public debt to approaching 200% of GDP. A slowdown in export demand from the US combined with a rapidly appreciating currency pose a strain on exporting industries. As expansionary policies end, GDP growth in 2011 is expected to moderate to 1.4% as projected in *ADO 2010*.

In the aggregate, growth of major industrial economies in the second half of 2010 is likely to be weaker than in the first half. Still, the strong first quarter is expected to lift average annual growth in 2010 to 2.2%, a slight upward adjustment from the 1.7% growth projected in *ADO 2010*. As the slowing from the second quarter shows, however, the ability to sustain growth as economic stimulus packages are unwound remains uncertain. Growth in 2011 is expected to be more anemic than in 2010, at 2.0%. Given the policy compulsions, interest rates are likely to remain low in these economies this year and next.

International trade

World merchandise exports have begun to bounce back in 2010 boosted by the pickup in global economic activity. The JP Morgan Global manufacturing measure of new export orders increased from an average of 56.1% in the third quarter of 2009 to 60.3% in April (despite concerns of slow growth in major markets such as Europe). The index has tapered off from its April

1.1.19 Growth of new export orders of durable goods



Sources: US Census Bureau. <http://www.census.gov>; Ministry of Economy Trade and Industry. <http://www.meti.go.jp>; Eurostat. <http://epp.eurostat.ec.europa.eu>; CEIC Data Company (all accessed 15 September 2010).

[Click here for figure data](#)

peak. This is reflected in the continued but slowing rise in export orders of durable goods for the major industrial economies (Figure 1.1.19, above).

Accordingly, merchandise exports should grow by 9.5% in 2010 as against the *ADO 2010* projection of 7.1%. The projection for 2011 remains the same at 8.1% due to the uncertainty surrounding the continued strength of industrial economies' recovery.

Commodity prices

The OECD-FAO *Agricultural Outlook 2010–2019*, published in mid-2010, foresees higher global agricultural prices in the next decade relative to the decade before the 2007–2008 price spike (Figure 1.1.20). Recent rises in global wheat prices due to natural calamities and temporary export bans by, for example, the Russian Federation are unlikely to persist for long, given strong global production on average and comfortable world food stocks (Box 1.1.4).

Nonfuel commodity price developments in the near future will largely depend on supply conditions in major exporting countries. According to estimates from the US Department of Agriculture and the Food and Agriculture Organization of the United Nations, global wheat production in 2010/11 is expected to be only marginally lower than in 2009/10. For rice, all the top 10 producing countries are expected to reap larger harvests in 2010/11. This will support higher consumption even as global stocks are reduced.

Oil prices are likely to continue fluctuating within a narrow band, for reasons outlined in Box 1.1.5. The projected oil price for 2010 is retained at \$80.20 a barrel and slightly downgraded for 2011 at \$82.50 a barrel.

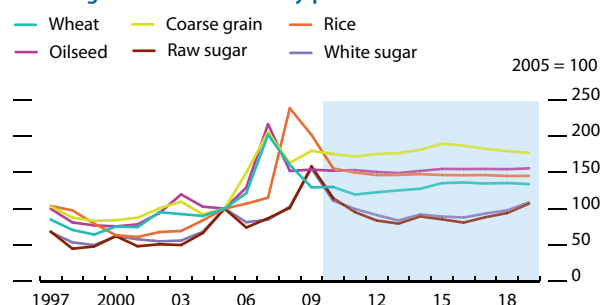
Nonfuel commodity prices (except fertilizers) have moved in unison with energy prices since early 2009 (Figure 1.1.21). On the back of significant declines in 2009, energy and nonenergy commodity prices have rebounded, and are expected to moderate again in 2011. The energy price index is projected to show an increase of 25% in 2010 and a minor contraction of 0.3% in 2011.

The food and beverages price index is expected to have risen by 0.9% in 2010 due to the resumption of economic growth (especially in developing countries), increased demand due to rising biofuel production, and anticipated higher costs of energy-related inputs. However, it will slacken by 1.0% in 2011 as global growth moderates.

Industrial-country inflation

Consumer price inflation in the major industrial economies is now very low, to the extent that Japan has deflation (Figure 1.1.22). The average for this group is 1.2% in 2010 and 1.3% in 2011 (the latter unchanged from *ADO 2010*), as demand remains low and an expansionary monetary policy stance is likely to be continued. External shocks may arise from food and oil price rises. But unlike developing economies, the food

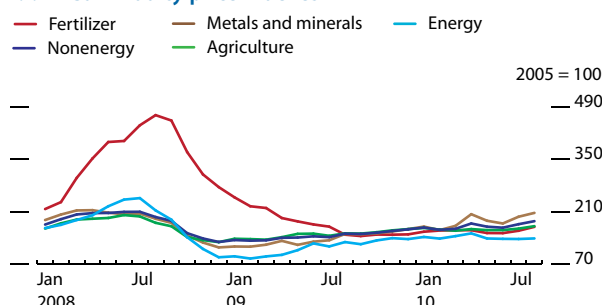
1.1.20 Agricultural commodity price forecasts



Source: OECD-FAO Agricultural Output 2010–2019 database. <http://www.agri-outlook.org> (accessed 15 September 2010).

[Click here for figure data](#)

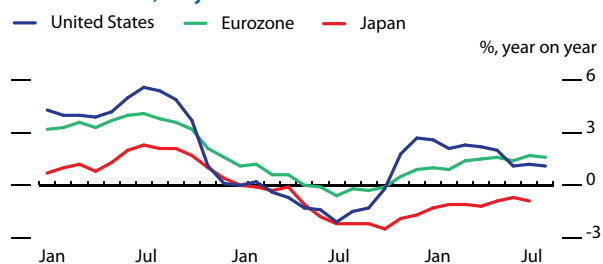
1.1.21 Commodity price indexes



Source: World Bank. Commodity Price data (Pink Sheet). <http://www.worldbank.org> (accessed 15 September 2010).

[Click here for figure data](#)

1.1.22 Inflation, major industrial economies



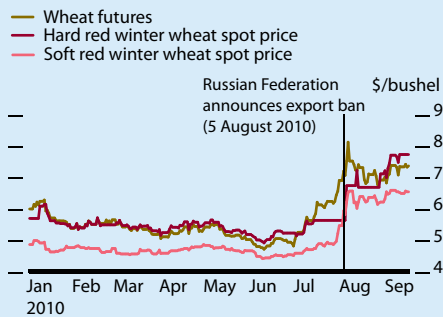
Source: CEIC Data Company (accessed 15 September 2010).

[Click here for figure data](#)

1.1.4 Natural disasters and high food prices

In early August 2010, wildfires fueled by high temperatures and the most severe drought in 130 years destroyed wheat and other crops throughout many parts of the Russian Federation. Amid fears of a 35% drop in wheat production, its government announced a temporary export ban to curtail inflation pressures. Given that the country accounts for about 13%–14% of global exports, the global wheat price reached a 23-month high. In addition, wheat futures gained and the December delivery wheat rose on the Chicago Board of Trade, touching a peak of \$8.41 a bushel and almost doubling since early June (Box figure 1).

1 Global wheat prices



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

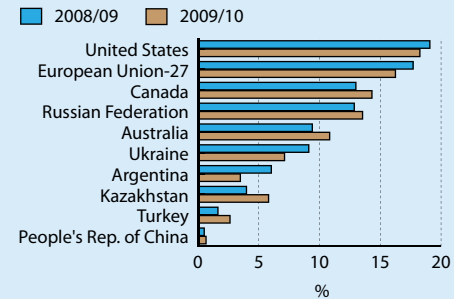
The international wheat price turned volatile as major producers lowered production estimates on weather aberrations. Due to dry weather, the wheat crop may suffer in Australia, which accounts for about 10% of global exports, while prolonged wet weather has reduced acreage in Canada, which supplies about 15% of world demand.

These developments have sparked fears that major importing countries may suffer from price increases as wheat-exporting firms apply force majeure clauses in their supply contracts for events beyond their control, freeing them from their obligations without penalty. The concern is mounting because Australia, Canada, Kazakhstan, the Russian Federation, and Ukraine account for about half of world wheat exports (Box figure 2).

Like the Russian Federation, the People's Republic of China has been severely affected by adverse weather conditions, namely, the worst flooding there since 1998. It produces one-third of the world's rice, an amount that might be reduced by 10%. However, sluggish demand and ample global supply have been tempering any upward movement of prices.

Against this backdrop, grain prices, including those for rice and corn (maize), remain well below their spikes in 2008. At the time of the highs of the 2008 price rally, wheat futures prices spiked to over \$13 per bushel amid fears of a global food crisis. In the current situation, the upward movement of the prices is a result more of market expectations than of demand and supply conditions. Despite the drought in the

2 Share in world wheat exports



Source: US Department of Agriculture. <http://www.fas.usda.gov> (accessed 10 August 2010).

[Click here for figure data](#)

Russian Federation and other Black Sea states, crop conditions elsewhere are favorable.

The overall global supply remains stable, providing enough cushion so that the natural disasters do not present an immediate threat of world grain shortage. Global grain stockpiles are about 50% higher than they were in 2008, following record harvests in 2008 and 2009. The wheat crop in the US, the world's largest exporter, has been strong this year. Next year, worldwide wheat production is expected to be only slightly lower than this year. Global production of rice in 2011 is projected to increase marginally relative to 2010.

Moreover, different production cycles worldwide are providing significant stability to world trade and prices. Sowing and harvesting at different times allow exporting countries to take action swiftly in response to changing market conditions. Most of the world's wheat is grown in winter in the northern hemisphere, but Canada, Kazakhstan, the Russian Federation, and the US have large spring wheat production, which is planted much later. This is followed by sowing in Australia and Argentina in the southern hemisphere.

The situation presents an opportunity for other countries to augment their exports as well, which should cool down global prices. Currently, Argentina plans to increase its wheat production by 20%. Additionally, India is considering removing the ban on its grain exports following the huge accumulation of about 60 million tons of rice and wheat in public storage.

The majority of rice production is not traded, and Asia controls over 90% of the world stock. Given the dominance of Asia for production, consumption, and stocks of rice, there is scope for Asian countries to collectively manage available rice at the regional level, instead of resorting to trade restrictions individually, in order to prevent potential price hikes.

High food prices have a negative short-run effect on poor households, as witnessed during the 2007–2008 food price crisis. That crisis showed that panic buying and protectionist policies only exacerbate the supply problems and artificially raise prices.

1.1.5 Recent global oil price trends and short-term and medium-term prospects

Introduction

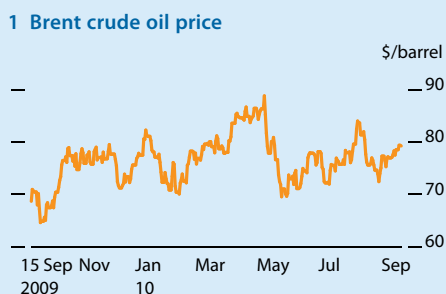
One major determinant of developing Asia's growth and inflation performance in the short run is the trajectory of global oil prices, which is influenced by a wide range of supply and demand drivers.

On the demand side, the speed and strength of global recovery will play a dominant role. On the supply side, persistently high levels of inventories and strong output growth provide the primary context. This box analyzes the recent pattern of global oil prices, along with the main drivers of their likely evolution in the short and medium term.

Stability of oil prices due to balance of upsides and downsides

After bottoming at around \$40 toward the end of 2008 during the trough of the global crisis, oil prices have gradually recovered along with the world economy. In particular, the robust and speedy turnaround of nonmembers of the Organisation for Economic Co-operation and Development (OECD) has driven the rebound in prices. Demand from OECD countries remains subdued, reflecting the fitful, fragile, and uncertain nature of their recovery.

During the past year, prices have remained fairly stable in the \$65–\$85 range (Box figure 1). This stability mirrors a fine balance between upside and downside pressures in the global oil market.



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

On the upside, discipline among members of the Organization of the Petroleum Exporting Countries (OPEC) on output quotas has been fairly tight, even though OPEC's current collective spare capacity is fairly large at around 7 million barrels per day (mb/d). This discipline has been maintained because the main holders of the spare capacity are Kuwait, Saudi Arabia, and the United Arab Emirates, which all adhere closely to their quotas.

Furthermore, if prices fall toward \$65, production from important but high-cost sources such as Canadian tar sands typically begins to slow. Demand from non-OECD

countries, in particular the People's Republic of China (PRC), also helps to set a price floor.

Conversely, ample global spare capacity exerts a significant downside pressure on prices. Significantly, the spare capacity is large enough to cushion even major geopolitical events, such as an embargo on the Islamic Republic of Iran, as well as natural shocks, such as hurricanes in the Gulf of Mexico. In addition, inventories remain exceptionally high in historical terms and uncertainty lingers about the global recovery.

Moderate oil price rise seen in 2011 amid limited volatility

The broad equilibrium between supply and demand, which limited volatility during the past year, is expected to continue through the rest of 2010 and into 2011. Oil prices averaged \$75–\$80 per barrel in the first 2 quarters of 2010 and this is likely to continue into the third and fourth quarters. For 2010 as a whole, the price is projected at \$80.20. In 2011, the range of prices is expected to shift up slightly. The average price will also rise moderately to \$82.50 in 2011.

On the demand side, robust growth from non-OECD economies will continue to be counterbalanced by subdued demand from the OECD, again reflecting stronger momentum in the former group. More specifically, total OECD demand in 2010 is likely to be almost identical to its 2009 level and about 2 mb/d lower than its 2008 level, although the gap is expected to narrow to around 1 mb/d in 2011.

In contrast, non-OECD demand has continued to grow despite the global crisis. After rising marginally in 2009, in 2010 it is expected to surpass its 2008 level by about 2 mb/d in 2010 and rise by a further 1 mb/d in 2011.

The big picture is that global oil supply will moderately exceed demand in both 2010 and 2011, leading to a slight inventory buildup. The supply and demand forecasts of various organizations are closely in line with each other and all point to a limited price increase combined with muted price volatility (Box table).

The broader contours of the global oil market make sharp price movements in either direction highly unlikely. Rising production, ample spare capacity, and high and climbing inventories militate against the type of spike witnessed during 2007–2008. On the other hand, the gathering pace of global recovery, combined with relatively high discipline within OPEC, render a price collapse equally implausible.

While price volatility has been limited, the market did experience \$5–\$10 price swings during the course of 2010. Those oscillations probably reflect the ups and downs of expectations about the prospects for a sustained recovery,

1.1.5 Recent global oil price trends and short-term and medium-term prospects (continued)

OPEC output and changes in global oil demand, 2009–2011

	2009	2010	2011
Actual and projected OPEC output			
FGE	28.2	28.5	29.1
IEA	28.4	29.1	29.4
EIA	29.1	29.4	30.3
OPEC	28.9	28.7	28.8
World oil demand, year-on-year growth			
FGE	-1.5	1.7	1.7
IEA	-1.3	1.8	1.3
EIA	-1.5	1.6	1.5
OPEC	-1.3	1.0	1.0

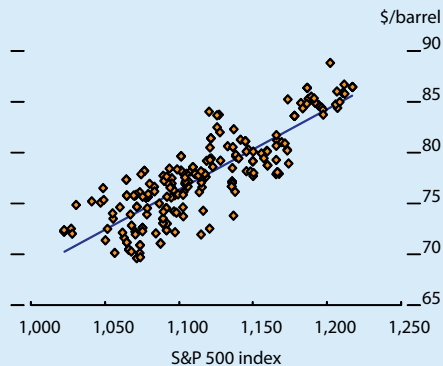
FGE = FACTS Global Energy; IEA = International Energy Agency; EIA = Energy Information Administration, US Department of Energy; OPEC = Organization of the Petroleum Exporting Countries.

Source: FACTS Global Energy (2010).

especially in the United States. Good news based on one indicator has been followed the next week by bad news based on another indicator, and so forth.

The very high correlation between the S&P 500 index and global oil prices during 2010 supports this conjecture about the source of volatility (Box figure 2).

2 Correlation between S&P 500 and oil price (Brent)



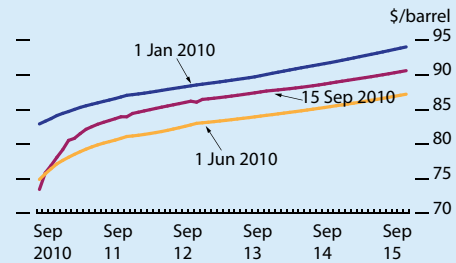
Source: Bloomberg (accessed 15 September 2010).

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Iraqi production a medium-term wild card

The basic assessment for the medium term remains largely unchanged from *ADO 2010*. Beyond the short term, strong demand from fast-growing non-OECD countries such as the PRC and India will overshadow OPEC's high spare production capacity as the dominant driver of price. NYMEX crude futures for 2015 are about \$10 above current spot prices and mirror the futures markets' expectation of higher prices in the medium term (Box figure 3).

3 NYMEX forward price, West Texas Intermediate



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

Against this baseline assumption, Iraqi production remains a wild card with big implications. It currently stands at about 2.5 mb/d but has a huge upside potential due to plans to develop new production capacity.

Iraq has recently entered into oil field development contracts with several major oil companies, including BP, ExxonMobil, and Shell. Those new developments can lift its potential output to as much as 10 mb/d by 2015–2020. A great deal of uncertainty hangs over Iraqi expansion since there are serious political and security risks as well as logistical constraints, even though Iraq has large proven reserves that are cheap to extract.

The exact impact of additional Iraqi output on OPEC will depend on when the country will be brought back into the quota system and at what level. However, more broadly, higher Iraqi output will substantially raise OPEC's spare capacity and constrain the scope for upward price pressures.

Benign short-term and more challenging medium-term environment

A further source of medium-term uncertainty is the evolution of global growth, in particular whether or not the world economy is able to fully recover the robust momentum that preceded the global crisis. Still, even allowing for various supply and demand shocks, the overall assessment of the global oil market remains the same as in *ADO 2010*. The scope for higher prices will be limited by ample OPEC spare capacity, which makes a sharp surge highly unlikely in the medium term, whereby the baseline forecast is still that of reemerging upward price pressures.

Asian governments should take advantage of the benign short term to prepare their economies for the more challenging medium term, for example, by removing policies that disconnect the price of oil products from their true, underlying marginal cost.

share of household consumption is relatively low in industrial economies, implying that any food-inflation impact is limited. The transmission of high global oil prices to domestic markets depends on government policy of regulating domestic prices.

Headline inflation for the US increased by 0.3% in August from the previous month. Consumer prices were boosted by a 2.3% increase in energy prices, a reversal of the situation in the April–June period when declining energy prices pulled headline inflation down. The core consumer price index (CPI), excluding food and energy, increased by less than 0.1%. Core CPI inflation has averaged only 1.1% year on year during the first 8 months of 2010.

Inflation pressure across the eurozone remains low, reflecting considerable slack in the economy. Headline consumer price inflation was estimated at 1.6% in August 2010, down from 1.7% a month earlier. Inflation is expected to hover at around 1.6% for the rest of 2010, and to fall to 1.3% in 2011 as the strength of recovery relents.

Deflation continues in Japan as the large output gap as well as structural factors put downward pressure on prices. There are signs of stabilization, however. Although core CPI inflation (excluding fresh food) fell to a negative 1.5% (year on year) in April 2010 as a result of a one-time administrative price change related to the introduction of high school tuition waiver, month-on-month inflation was virtually flat during the first half of this year.

Risks to the global outlook

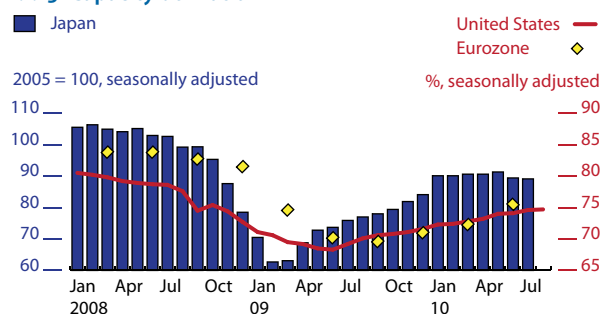
Financial constraints eased and leading indicators turned broadly positive in 2009 and early 2010. Since then, the recovery momentum in the major industrial economies has lost some steam (though new stimulus measures may revive the momentum for a time). Moreover, some critical downside risks further threaten this fragile outlook.

Double-dip recession

Although the more buoyant second quarter growth in the eurozone was encouraging, signs of weakness continue to dominate the global macroeconomic landscape. The unexpectedly slower second-quarter growth in the US and Japan means that the specter of a double dip recession cannot be fully discounted. As the recovery is still fragile, weak demand (both private domestic demand and export demand) continues to present a major policy challenge and the foremost risk to businesses over the coming months. With continuing excess capacity in major industrial economies (Figure 1.1.23), commodity prices remain low while asset prices have fallen back.

The decline in confidence and the continued market uncertainty have resulted in a postponement of the normalization of monetary policies in industrial economies and a slowing of the pace of policy tightening in other countries. Shifting too quickly to fiscal and monetary tightening could heighten the risk of a double-dip recession.

1.1.23 Capacity utilization



Note: Manufacturing operating ratio index is used for Japan.

Sources: Board of Governors of the Federal Reserve System. <http://www.federalreserve.gov>; Bloomberg; CEIC Data Company (all accessed 15 September 2010).

[Click here for figure data](#)

Continued weakness in US mortgage markets

The US housing market remains weak though signs of life have emerged in recent months, mostly as a reaction to the homebuyers' tax credit that ended in April 2010. Home sales and mortgage applications have been weaker than expected lately. The rebound in home sales seen in June was replaced by July's all-time low.

Mortgage purchase applications, though increasing, are still below their last year's average. Last year's surge in unemployment indicates the inability of many households to service their debt, and although the government has implemented programs to restructure mortgages to provide a respite, the problem is still not yet fully resolved.

Sudden rises in commodity prices

Agricultural markets, especially for rice and wheat, are prone to sudden weather changes or natural calamities, as the recent experiences from flooding in Pakistan, natural disasters in the PRC, and wildfires in the Russian Federation demonstrate. Such episodes may create rapid rises in domestic prices leading to export restrictions and even social unrest. They could also create an upward spike in global prices and exacerbate the situation of artificial scarcity, as seen during the food price rise of 2008.

While oil prices are expected to remain stable, much uncertainty hangs over expansion of oil production in Iraq, which has huge, proven reserves that are cheap to extract. However, there are serious political and security risks. The exact impact of additional Iraqi output on OPEC will depend on when the country is brought back into the quota system and at what level.

Insolvency and default in the eurozone

There is a risk that one or more eurozone members may be unable to avoid eventual default or debt restructuring. This possibility is most clear for Greece, which, despite undergoing a stringent adjustment program and drawing down emergency funds, is yet to generate the structural basis for future growth rates high enough to avert a situation of insolvency further out.

This possibility exists also for Ireland and Portugal, whose debt sustainability is being undermined by a combination of high debt, elevated borrowing costs, and low growth prospects. Unless creditors are willing to buy into these markets, even a further bailout by the European Union and emergency lending might ultimately prove insufficient to avoid default.

Ascent of emerging markets

The year began on an optimistic note for the major industrial economies. But with the pace of recovery slowing drastically in the second quarter, indicators are turning more somber. Labor markets remain weak and high unemployment persists. Low wage growth and poor incomes are keeping household savings and asset creation at bay. This is impacting households' spending decisions and firms' investment plans, putting a damper on growth. Despite recovering since the global crisis, external demand remains relatively subdued. Moreover, recent trends in current

account balances suggest limited progress in resolving the global imbalances that persisted before—and contributed to—the global economic downturn.

Government policies are being tailored to address the issues, which results in postponement of the exit from fiscal and monetary support in some economies. This is most evident in the US and Japan, which have announced new stimulus measures. Financial markets remain wary and have the potential to disrupt the recovery process.

In contrast, emerging markets seem to have maintained their buoyancy this year. Among emerging markets, the resilience of developing Asia stands out. A perceptible shift in global economic power toward developing Asia has been under way for decades. Yet the region's strength through the recent global crisis and its aftermath has helped establish the region as an important voice in international policy discussions. With the rebound of the industrial world still uncertain, the burden of carrying global growth forward may fall on developing Asia. The question is whether the region is prepared to take on this role.

Solid recovery in developing Asia

Driven by buoyant exports, strong private demand, and effects of stimulus policy, economies in the region performed better than expected in the first half of the year. The push given by expansionary fiscal and monetary policies propelled growth by raising consumer and business confidence, which in turn strengthened domestic demand.

Despite the sluggish global recovery, the region's growth momentum has sustained itself in 2010, and prospects are bright for most regional economies. GDP growth is now projected to rebound to 8.2% in 2010, revised up from the April forecast of 7.5% in *ADO 2010* (Figure 1.2.1). The improved outlook is broad-based with projections lifted in all subregions.

While the strengthening of the recovery is being felt across the region, the driving forces differ among economies (Figure 1.2.2). In the PRC, strong rebound in exports and resilient domestic demand has been lifting growth. In India, growth has continued to benefit from forceful expansion of domestic demand, corporate profits, and favorable financing conditions that have stimulated investment.

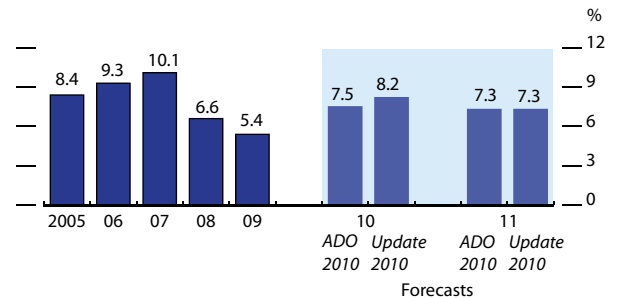
In tandem with the recovery in global trade, a sharp upturn in exports sparked growth in the larger ASEAN economies (Indonesia, Malaysia, the Philippines, and Thailand) and the newly industrialized economies (Hong Kong, China; Republic of Korea; Singapore; and Taipei, China), fueling recoveries in consumption and private investment. Central Asian economies have benefited from buoyant oil and metal prices and recovery in remittance inflows.

However, country-specific circumstances, such as devastating floods in Pakistan, the ongoing political impasse in Nepal, and political unrest in the Kyrgyz Republic will weigh on future growth. In the PRC, the impact of the phasing out of economic stimulus policies and a deceleration in the expansion of world trade will act to moderate growth somewhat. The opposite is the case with India where private consumption and investment demand will continue to be strong.

With growing concerns over the strength of the global economy, the sustainability of private domestic demand, and the challenge of managing capital inflows and exchange rates, the 2011 growth forecast is maintained at the *ADO 2010* level, at a still robust 7.3%.

The trend of strong growth in 2010 followed by a slowdown in 2011 is projected for all subregions with two exceptions (Figure 1.2.3). Growth is expected to continue to revive in Central Asia because of higher oil prices and sustained growth in the Russian Federation, the region's major trade and financial partner. Similarly, the resource-driven economies of Solomon

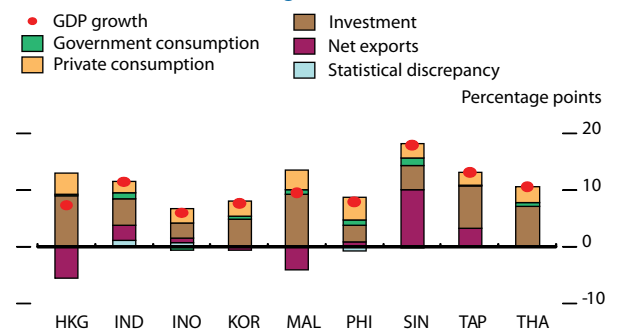
1.2.1 Growth rates for developing Asia, %



Source: Asian Development Outlook database.

[Click here for figure data](#)

1.2.2 Contributions to GDP growth (demand), H1 2010



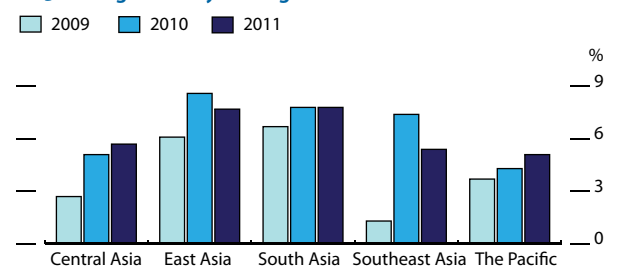
HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; SIN = Singapore; TAP = Taipei, China; THA = Thailand.

Note: India is based on GDP at constant market prices.

Source: CEIC Data Company (accessed 22 September 2010).

[Click here for figure data](#)

1.2.3 GDP growth by subregion



Source: Asian Development Outlook database.

[Click here for figure data](#)

Islands and Democratic Republic of Timor-Leste are likely to raise aggregate growth in the Pacific even as low growth is experienced in most of the remaining subregional economies.

The rebound in private demand is allowing some governments to wean their economies off the emergency measures introduced to counteract the effects of the global turmoil. India is gradually reducing the federal fiscal deficit to avoid an unsustainable buildup of public debt. Monetary authorities in the PRC increased bank reserve requirements to rein in private credit expansion. A few countries—including India, the Republic of Korea, Malaysia, Pakistan, and Thailand—have also increased policy rates to keep inflation in check (Figure 1.2.4).

Price pressures in the PRC this year have been milder than anticipated. However, India has faced very high inflation, largely because food inflation soared due to poor monsoon rains in 2009 and difficulties in food management. As part of policy reforms, India, Indonesia, and Pakistan have increased fuel prices while Bangladesh is expected to follow suit. Inflation in developing Asia on the whole is generally within central banks' "comfort zones."

In the aggregate, mild inflation is expected in the region, averaging about 4.0% in both 2010 and 2011 (Figure 1.2.5). However, monetary authorities still need to keep an eye on potential spikes in global oil and food prices.

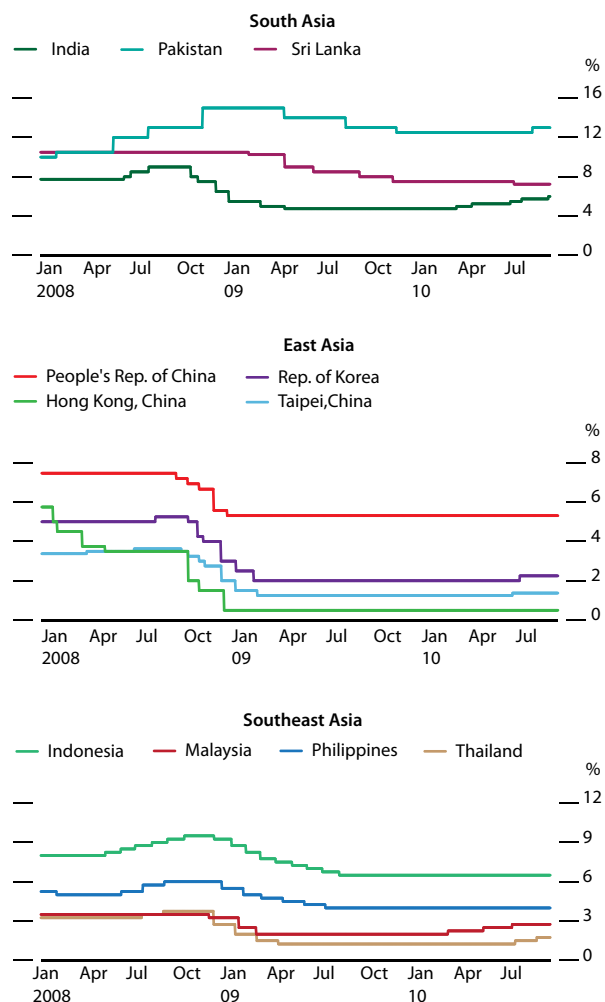
Continued strong domestic demand will limit the region's overall current account surplus to around 4.0% in the next 2 years (Figure 1.2.6). The surplus will be relatively high in East Asia, equivalent to about 5% of GDP both years. Likewise, current account surpluses of 5.7% are projected for Southeast Asia in both years. The overall Central Asian current account position is forecast to strengthen to a surplus of 8.4% of GDP in 2010 and 8.3% in 2011, mainly due to better outcomes for oil and gas exporters.

At the other end of the spectrum, the projection of the 2010 current account deficit in South Asia is increased to 2.2% of GDP, due mainly to India's strengthened growth and investment. The current account deficit will further widen to 2.5% of GDP in 2011, due in part to India as faster economic expansion draws in imports, but also Pakistan's flood-related relief and reconstruction.

Unlike the industrial world, strong revival in developing Asia's private consumption and investment suggests that the private sector is holding its own in the recovery. Even the slower growth expected in 2011 is in line with the average growth of 8.6% in 2003–2007, the 5 years immediately preceding the onset of the recent crisis.

Having withstood the worst of the global turmoil, the region must now face the challenge of playing a bigger part in the global recovery. The region can rely on the sound policy foundation that helped it survive the recent turmoil to provide a basis for its expanded role in the global recovery.

1.2.4 Policy rate movements, developing Asia



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

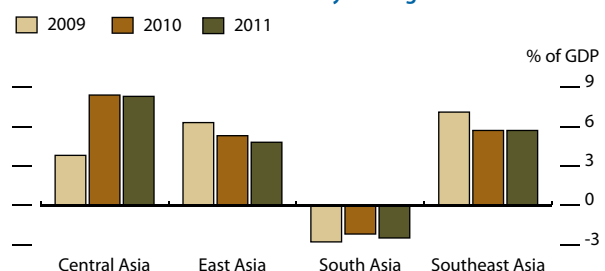
1.2.5 Inflation rates by subregion



Source: Asian Development Outlook database.

[Click here for figure data](#)

1.2.6 Current account balances by subregion



Source: Asian Development Outlook database.

[Click here for figure data](#)

Policy foundation for growth

The evidence of developing Asia's rising economic power covers many facets, allowing it to assert itself on the global stage through greater economic presence. One facet is seen in increasingly sophisticated production networks, which provide a platform for low-cost production. At the other end of the scale, developing Asia is also an acknowledged leader in production of high-end information technology (IT) goods and services.

Among individual economies, the PRC and Taipei, China have established themselves as worldwide suppliers of toys and electronics. The Republic of Korea is making its presence felt as an exporter of high-tech products such as phone handsets, automobiles, and IT products. India and the Philippines are among the most sought-after destinations for business-process outsourcing, computer software, and other IT services.

Those countries in Asia with large domestic markets are exploiting economies of scale to create home-grown multinational corporations, an evolution supported by the spending power of the region's expanding middle class. With its ability and willingness to pay a premium for higher-quality products, this burgeoning segment is becoming an important force to reckon with in global demand for goods and services. Yet even amid this rising affluence, the challenge of ensuring that the benefits of growth are broadly shared remains (Box 1.3.1).

These positive developments were not mere accidents but were supported by policy imperatives. The monetary and fiscal policies—in particular, fiscal restraint, anchored exchange rates, and stable prices—not only enabled the region's rapid growth but also gave it the space for fiscal and monetary expansion needed to fight the global crisis.

Financial sector reforms, particularly prudential norms for the banking sector—the backbone of Asia's financial system—helped the region to develop a resilient financial sector that is capable of better absorbing volatile capital flows and providing alternative sources of financing for domestic firms.

Policy reforms to strengthen intraregional ties in production, trade, and investment by reducing barriers to trade and cutting trade costs helped developing Asia to emerge relatively easily from the steep drop in global trade during the recent crisis.

Improved macroeconomic policies

The recent slowdown in the region's economic activity due to the sharp fall in demand for its goods from major industrial-country consumers required a bold response from authorities in the region. Most countries reacted by easing both monetary and fiscal policy to bolster demand. The policy reaction stands in sharp contrast to the Asian crisis when governments were obliged to tighten monetary policy and rein in public spending. The reactions were made possible by the marked strengthening in the fundamental position of Asian countries after the late 1990s, including strong financial sectors, better institutions, more anchored

1.3.1 Including the poor in the growth process

Growth is inclusive when coupled with equality of opportunity. A development strategy based on this approach will need to have high growth to create productive jobs and economic opportunities, but will also need social inclusion measures to ensure equal access to these opportunities. Even with sustained growth, social safety nets are needed to prevent people from falling into extreme poverty.

Developing Asia has made huge gains in terms of economic growth and poverty reduction. Between 1990 and 2008, average per capita gross domestic product in constant 2005 purchasing power parity terms increased from \$1,631 to \$4,430, for growth of 5.7% a year. This has led to huge reductions in the number of extremely poor (those living on less than \$1.25 a day), with more than 850 million fewer poor in 2005 than in 1990.

Yet progress has been uneven across the region. Countries such as the People's Republic of China and

Indonesia reduced poverty by more than 30 percentage points in this period, while poverty incidence in four former Soviet countries (Georgia, the Kyrgyz Republic, Tajikistan, and Uzbekistan) rose. In Bangladesh and Nepal, more than half the population still survives on less than \$1.25 a day.

Beyond the poverty incidence numbers lies deprivation in terms of basic social services—more than half of Asians live without basic sanitation, for example. Access to health services remains an issue, with women and children most vulnerable. In South Asia, malnutrition among children under 5 years old is a staggering 45%.

Such human impacts are a stark reminder of the need to ensure that the benefits of rapid economic growth are shared more widely within society.

Source:
Zhuang and Ali (2010).

exchange rates, lower inflation, strong fiscal positions, modest short-term foreign debt, and bigger foreign exchange reserves, without which a loss of confidence might have been triggered. These policies brought about the stable macroeconomic environment needed for countries to grow, and provided the capacity for authorities to respond to the massive external shock.

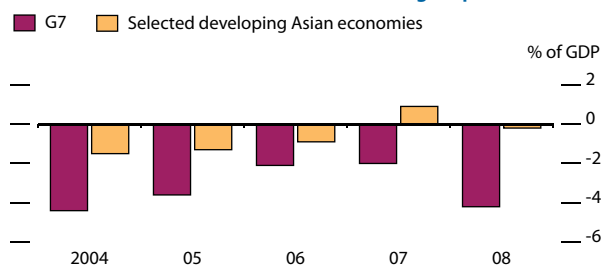
Fiscal policy

Most regional governments have, as a matter of policy, maintained healthy finances by keeping budget deficits at manageable levels or even running surpluses, allowing a high degree of fiscal freedom. In 2004–2008, fiscal balances in 10 major regional economies averaged -0.6% of GDP in contrast to -3.2% in the G7 economies (Figure 1.3.1). In line with this, the average debt-output ratio of these regional economies in 2007 was 24.7%, well below the G7 average of 79.5% (Figure 1.3.2).

As a widely watched indicator of the fiscal vulnerability a country faces, a high ratio of government deficit to GDP implies that the government must allocate a larger part of its expenditures on paying interest on its debt rather than on goods and services. By raising concerns about its debt sustainability, a high deficit also increases the risk premium and the cost of servicing the debt. In turn this could dent business confidence, crowd out private investment, and create adverse reactions in financial markets, thereby deterring foreign investors and leading to capital outflows.

One reason for developing Asia's recent resilience was that when the global crisis hit, its strong fiscal position allowed regional economies to accommodate costly fiscal expansions and support domestic demand to cope with the crisis (as noted, a markedly different response from that in the late 1990s).

1.3.1 Fiscal balance of selected economic groups



Note: Selected developing Asian economies comprise People's Rep. of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

Canada, France, Germany, Italy, Japan, United Kingdom, and United States constitute G7.

Source: ADB calculations using data from Oxford Economic Forecasting Model, September 2010.

[Click here for figure data](#)

In 2010, only a handful of regional economies are pursuing fiscal stimulus, representing a significant unwinding. Larger countries showing strong economic recovery, such as the PRC and India, are already on the way to normalizing their macroeconomic policies.

The region's experience during the global crisis highlights the fact that fiscal responsibility during normal times provides governments with the resources they need to support the economy during extraordinary times. Still, the current low level of public indebtedness in developing Asia should not lull the region into complacency about debt sustainability. Rather, the region's governments should closely monitor their public debt positions and implement a credible medium-term fiscal framework for maintaining or achieving debt sustainability.

Monetary and exchange rate policy

Given that high and volatile inflation is detrimental to growth, the most significant shift after the Asian crisis was the adoption of the inflation targeting framework in many developing Asian economies as their monetary policy tool. Particularly, losing a de facto dollar peg during the crisis was the motivation for the inflation targeting as a new anchor. Indonesia, the Republic of Korea, the Philippines, and Thailand adopted flexible inflation targeting, which gives the central bank a more stable target and induces inflation expectations to converge. Average inflation in the region declined significantly in the last decade, accompanied by high growth.

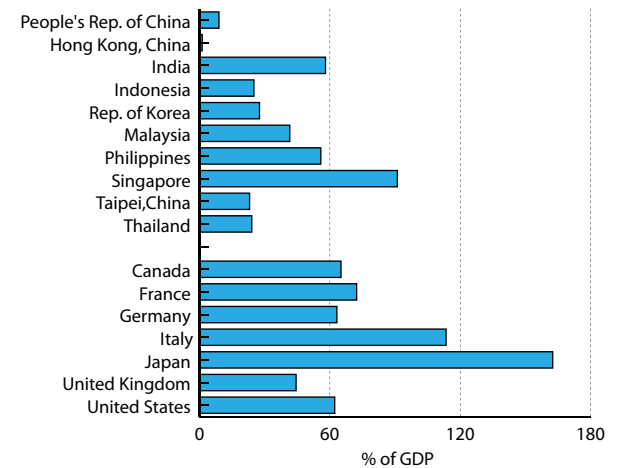
From 2000 to 2007, inflation rates in the region were reasonably low and stable (Figure 1.3.3), providing room for the easing of monetary policy when prompted by external shocks. When the global crisis struck, monetary authorities across the region proactively cut policy rates and boosted bank reserves to ensure adequate liquidity in the economies.

The region's accumulated foreign exchange reserves acted as an important buffer against the financial impacts of the crisis. Countries with higher reserves experienced smaller reductions in demand during the global crisis, and only a small portion of foreign exchange reserves were used to defend currencies. No speculative attacks occurred. As a result of the more muted foreign exchange outflows in the recent crisis, exchange rate movements were generally not a factor.

With the exception of Indonesia and the Republic of Korea, no countries in the region saw sharp exchange rate movements. But, as large economies, they are significant exceptions. Despite running current account surpluses, avoiding obvious overvaluation, and having quite large foreign exchange reserves and healthy financial sectors, both Indonesia and the Republic of Korea experienced large depreciations during the recent crisis (in the latter's case, the fall in 2008 was of similar magnitude to that in 1997).

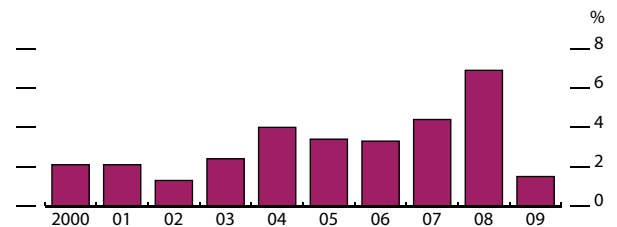
These two countries' experience adds another dimension to the use of reserves for intervention. In both cases, the starting level of reserves was comfortable in terms of the ability to repay foreign debt and to defend the

1.3.2 Public debt of selected economies, 2007



Sources: Oxford Economic Forecasting Model, September 2010; ADB calculations using data from CEIC Data Company (accessed 16 September 2010).

1.3.3 Inflation rate, developing Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

currency. But as soon as these reserves began to be used, financial markets focused on the fall in the reserves rather than the absolute level. In this context, swap lines with other central banks seemed to be effective in combating adverse market sentiment, and government backing for bank foreign borrowing appeared effective in countering market misperceptions. The effectiveness of this combination of swap arrangements and government backing in defending currencies therefore strengthens the case for the multilateralization of the Chiang Mai Initiative.

Beyond the crisis, more flexible exchange rates are desirable to reduce the region's current account imbalances. But unilaterally allowing exchange rate to appreciate will create the fear of losing export competitiveness. Developing Asia would benefit from a shift toward intraregional exchange rate policy coordination to promote greater exchange rate flexibility in the region, resulting in less concern over a loss of export competitiveness to neighboring economies. While price stability must remain the overriding objective of monetary policy, the global crisis highlights the need to prevent asset price bubbles through improved coordination between financial regulation and monetary policy.

Prudent financial management

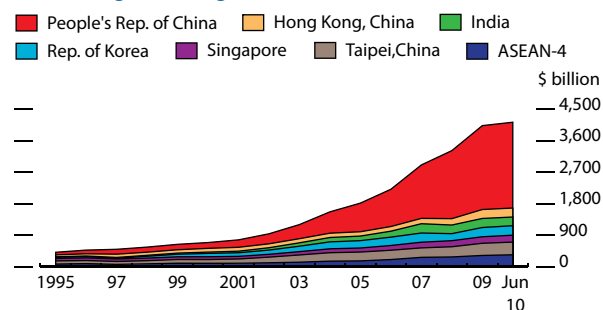
Following the Asian crisis, wide-ranging financial regulatory and supervisory reforms were implemented across developing Asia. Some Asian economies introduced prudential measures on their banking sectors to control short-term overseas borrowing in a precautionary move to guard against speculative capital inflows and associated currency volatility. Such resilience helped financial systems in Asia to absorb the impact of the global crisis more easily. No major banks failed in Asia during the recent crisis.

Foreign exchange reserves surged in the aftermath of the recovery from the Asian financial crisis, primarily as a result of large and persistent current account surpluses, coupled in some cases with strong net capital inflows (Figure 1.3.4). To some extent, the unprecedented reserves buildup reflected a precautionary self-insurance demand for international liquidity to prevent another Asian crisis.

The region's sizable foreign exchange reserves holdings were more than adequate to cover the rollover of short-term foreign currency debt as developing Asia headed into the recent crisis. These reserves have helped to maintain investor confidence and enhance regional economies' capacity to respond to external shocks. They also provided alternative policy options to stabilize currency and financial markets in the face of large swings in exchange rates.

Capital flows, particularly of short-term duration, have in the past disrupted the functioning of monetary policy and created financial instability with adverse consequences for growth. The experience of capital flight during the Asian crisis made governments wary of surges in capital inflows. Authorities are often concerned that these surges may exert undue pressure on the exchange rate to appreciate excessively. Sharp appreciation and high volatility in the exchange rate may cause longer-term damage to the competitiveness of the economy. For emerging Asian economies

1.3.4 Foreign exchange reserves, selected Asian economies



Note: ASEAN-4 comprises Indonesia, Malaysia, Philippines, and Thailand.

Source: International Monetary Fund. International Financial Statistics online database (accessed 22 September 2010).

[Click here for figure data](#)

where exports remain an important driver of growth, this consideration is particularly relevant. Capital inflows could also fuel a domestic lending boom, leading to asset price bubbles that eventually burst and instigate financial instability.

Private capital flows to emerging countries fell dramatically during the recent global crisis. However, flows to the Asian region were less affected than those to other emerging markets such as Eastern Europe. Although equity markets and borrowing costs were affected, relatively stable financial systems and a negligible exposure to the toxic assets emanating from the industrial world contributed to developing Asia's hardiness.

Following a dip in late 2008 and early 2009, capital inflows to the region have recovered (Figure 1.3.5). The return of investors' risk appetite for emerging market assets and the strong economic recovery have combined to bring a surge in capital flows to developing Asia.

The strong rebound in capital inflows has been driven by portfolio equity flows spurred by strong economic fundamentals. The region continues to attract sizable FDI on the back of its long-term growth potential, improved business environment, and commitment to economic reforms and macroeconomic discipline.

Availability of relatively cheap and skilled labor, good economic infrastructure, and extensive supply networks have also facilitated rapid growth in the share of FDI. These flows are, in general, more stable than portfolio flows since physical investments are not as easy to withdraw.

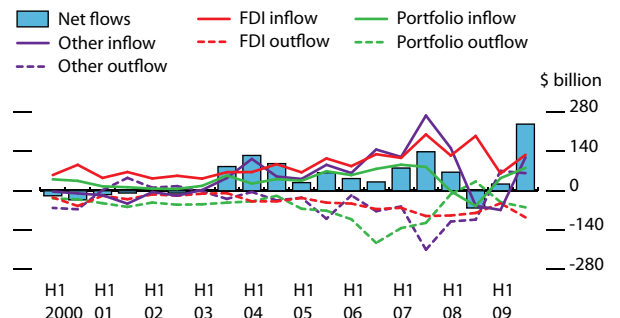
Other flows have been consistently more volatile and tend to be more susceptible to external shocks and currency instability compared to FDI and foreign portfolio investment flows. With ample local funding available, banks and nonbank corporations have shied away from foreign borrowing, thereby limiting net debt inflows.

While capital inflows bring benefits to recipient economies, spurring investment and economic growth, a gush can also carry significant challenges by posing a threat to financial market stability and undermining long-term strategies to strengthen economic fundamentals. By adding to reserves, significant flows to developing Asia are creating excessive liquidity and putting pressure on exchange rates to appreciate (Figure 1.3.6).

All this is complicating macroeconomic management by exacerbating trade and current account imbalances. Given developing Asia's rapidly growing reserves, attention has now shifted from reserve management to reform of the global reserve system (Box 1.3.2), in which developing Asia's policy makers need to take their part.

The prospect of reversal of inflows remains a possibility in the medium term as monetary tightening in the US and the eurozone narrow the interest rate differentials with developing Asia (Figure 1.3.7). Asian authorities should therefore consider

1.3.5 Capital flows in selected Asian economies

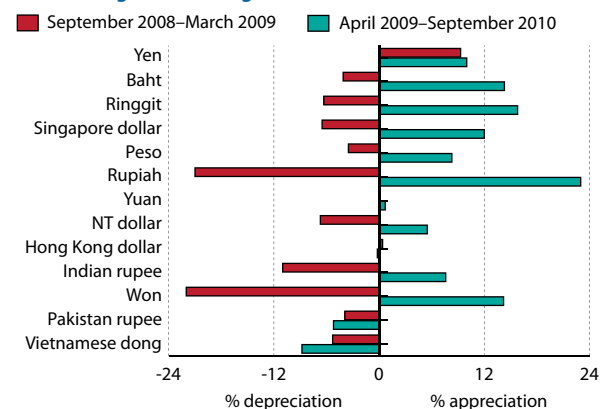


Note: Data used in this chart are for People's Rep. of China; Hong Kong, China; Indonesia; Rep. of Korea; Philippines; Singapore; Taipei, China; and Thailand.

Sources: ADB calculations using data from CEIC Data Company (accessed 22 September 2010); International Monetary Fund. International Financial Statistics online database (accessed 22 September 2010).

[Click here for figure data](#)

1.3.6 Change in exchange rates vs United States dollar

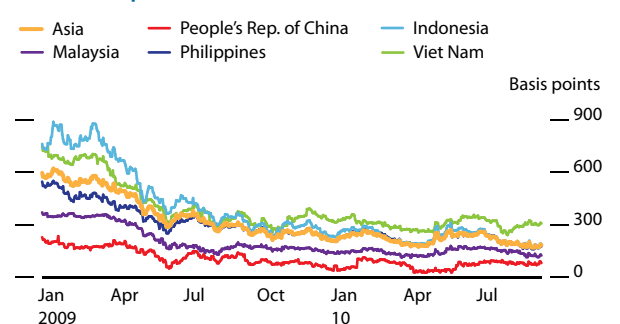


Note: Based on monthly average of \$ value of local currency as of 15 September 2010.

Source: ADB calculations using Bloomberg data.

[Click here for figure data](#)

1.3.7 Bond spreads



Note: Data for "Asia" refer to JP Morgan Emerging Markets Bond Index sovereign stripped spreads.

Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

appropriate policy measures to manage a surge in capital inflows and to encourage stable long-term capital flows. Economies such as Indonesia and the Republic of Korea have already responded by imposing capital controls. As investors from industrial economies still account for about half of the FDI inflows to developing Asia, prospects of global economic recovery are important for determining these movements. Nevertheless, should those investment flows become weak, a stronger base of intraregional trade and investment provides a cushion to developing Asia.

1.3.2 Reform of the global reserve system

The recent global crisis highlighted critical weaknesses in the current global reserve currency system. The crux of the problem is that the current system is dominated by a single currency: the United States (US) dollar. Despite the advent of the euro and its increasing use as a reserve currency, the dollar continues to dominate reserve holdings (Box figure). The dollar's preeminence is even more pronounced for developing Asian economies, which have stronger economic linkages with the US than with the European Union.

The main risk from relying on a single currency is the absence of binding mechanisms to ensure the soundness of the issuing country's macroeconomic and regulatory policies. It was concerns about the role of the dollar as a store of value that precipitated recent debate for an overhaul of the global reserve system and an expanded use of the special drawing rights (SDR) of the International Monetary Fund as a reserve currency.

The underlying fear was that unsound US policy would undermine the purchasing power of the dollar and thus impose large losses on Asia's huge holdings of dollar-denominated reserve assets. The fear was accentuated by large US fiscal deficits and growing public debt.

The global dominance of the US dollar inevitably creates a tension between US monetary policy and global monetary policy. The dollar would be strengthened if the US shifted from a balance-of-payments deficit to a surplus, but the rest of the world would lose its main source of reserves. The resulting shortage of international liquidity would jeopardize global trade, investment, and growth.

On the other hand, continuing US deficits would benefit the world economy through the expansion of international liquidity, but excessive deficits and debt would undermine confidence in the dollar and thus its role as the reserve currency. The dilemma here is that the US cannot simultaneously run a balance-of-payments surplus and deficit.

Shortcomings in the global reserve system that impede cross-border trade and investment would have serious repercussions for developing Asia's growth and stability. As a region that depends heavily on these international

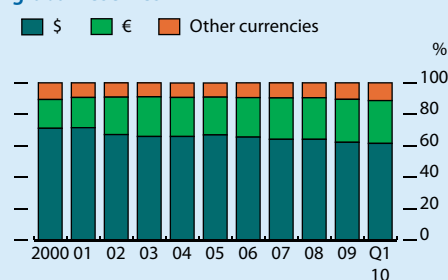
flows for its prosperity, developing Asia has a huge stake in a well-functioning global reserve system that provides international liquidity in a smooth, stable, and efficient manner, and is thus conducive for trade and investment.

The region holds close to half the world's total reserves. Yet despite being one of the three centers of gravity of the world economy, no currency from developing Asia is widely held as a reserve currency. It is, therefore, imperative for the region's policy makers to participate actively and constructively in the evolving dialogue on the reform of the global reserve system, which will impinge heavily on developing Asia's growth and stability.

A comprehensive reform agenda of the system would entail regional and global policy actions. Regional policy recommendations include the use of the region's reserves in stabilizing the global financial system, exchange rate coordination, temporary capital controls and their coordination across vulnerable countries, and country-specific economic surveillance and adjustment conditionality.

Proposals for global-level policy actions include strengthening prudential capital market regulations by standardizing regulatory frameworks across regions and countries; and convening a "brain trust" of independent international monetary experts to mitigate tension (such as that over exchange rate manipulation) among countries.

Share of major currencies in allocated global reserves



Source: Currency Composition of Official Foreign Exchange Reserves (COFER) database. International Monetary Fund. <http://www.imf.org> (accessed 21 September 2010).

[Click here for figure data](#)

Strengthened regional economic ties

After the Asian crisis, countries in developing Asia followed deliberate policy measures to strengthen economic ties within the region by reducing barriers to trade. Trade costs have declined as a consequence (Figure 1.3.8).

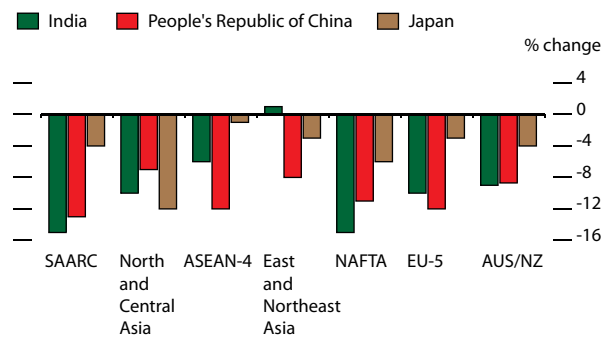
There is also increased macroeconomic interdependence among Asian economies as reflected in considerably higher comovement of GDP across Asia and more synchronized business cycles of the region's economies since that crisis. Output correlation among Asian economies, for example, has turned from being negative in the early 1990s to average 0.5–0.75 since 1997 (which is now comparable to that of European Union economies). In particular, interdependence between the fast-growing Asian economies has risen and is now similar to that between Asia and the European Union and US (Figure 1.3.9).

Better regional integration allows countries to pool their resources, produce on a larger platform according to their comparative advantage, and supply larger markets beyond their borders. The possibility of exploiting increasing returns to scale in large markets promotes expansion of intraregional trade. By lowering trade barriers and shifting the industrial structure of many economies from labor-intensive products such as textiles to more capital-intensive ones such as steel, electronics, and machinery, the region has witnessed enhanced trade, investment, and technology transfers across its borders. Particularly, East Asia has taken the lead (Table 1.3.1).

Apart from the intensification of trade in intermediate goods, dispersion of the production process across different countries strongly contributed to regional economic integration by stimulating FDI (Table 1.3.2). For instance, direct investment of Hong Kong, China and Taipei,China remains heavily focused on the PRC. Foreign investment has indeed been an important driver of trade in developing Asia, associated with the growth of efficient production networks. Along with the investment, FDI flows also bring the associated know-how, giving the recipient countries a chance to enhance their technical knowledge and skills and improve productivity.

The region's competitiveness has been further reinforced

1.3.8 Changes in trade costs between subregions and the People's Republic of China, India, and Japan, 2003–2007



Notes:

SAARC (South Asian Association for Regional Cooperation) comprises Bangladesh, India, Pakistan, and Sri Lanka.

North and Central Asia comprise Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, and Russian Federation.

ASEAN-4 comprises Indonesia, Malaysia, Philippines, and Thailand.

East and Northeast Asia comprise People's Rep. of China; Japan; Rep. of Korea; Macao, China; and Mongolia.

NAFTA (North American Free Trade Area) comprises Canada, Mexico, and United States.

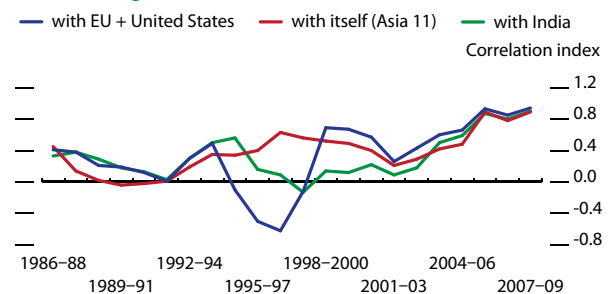
EU-5 comprises France, Germany, Italy, Spain, and United Kingdom.

AUS/NZ = Australia and New Zealand.

Source: UNESCAP (2010).

[Click here for figure data](#)

1.3.9 Output correlation of East Asia and India with selected countries/regions



Notes:

Asia 11 comprises People's Rep. of China; Hong Kong, China; India; Indonesia; Japan; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

EU (European Union) here comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Source: ADB (forthcoming).

[Click here for figure data](#)

1.3.1 Uneven economic integration in Asia and the Pacific

Subregion	Intermediate goods	Final goods	Services
East Asia	High	Moderate	Moderate
Central Asia	Low	Low	Low
South Asia	Low	Low	Low
The Pacific	Low	Low	Low

Notes: Intermediate goods refer to trade in parts and components. The assessment is classified as "high" if intraregional trade share is more than 50%; "moderate" if 20%–50%; and "low" if less than 20%. East Asia comprises the PRC; Hong Kong, China; Japan; Rep. of Korea; Mongolia; Taipei,China; Brunei Darussalam; Cambodia; Indonesia; Lao PDR; Malaysia; Myanmar; Philippines; Singapore; Thailand; and Viet Nam.

Source: Asian Development Bank (forthcoming).

1.3.2 Outward investment flows (net) by destination region, \$ billion

	Period	North America	Europe	China, People's Rep. of	Other Asia	Latin America	Others	Total
Hong Kong, China								
Direct investment	2008	1.9	-1.8	27.6	-0.9	19.1	4.7	50.5
Malaysia								
Portfolio investment	2008	9.6	23.6	0.0	37.7	0.0	7.7	78.6
	2009	5.9	15.0	0.0	14.3	0.0	4.7	39.9
Loans								
	2008	0.1	0.7	0.0	3.9	0.0	51.6	56.4
	2009	0.3	0.5	0.0	1.8	0.0	71.7	74.4
Taipei, China								
Direct investment	2008	0.4	0.0	9.8	1.7	-	0.0	12.0
	2009	1.1	1.0	6.1	0.7	-	-1.0	7.9

Source: Morgan (2010).

through cooperation on developing cross-border infrastructure, which supports development opportunities by improving market access and reducing losses of perishable goods. Regional connectivity provides access to regional populations who constitute a larger market for goods and services than markets within national boundaries.

Greater trade within developing Asia is perhaps a reason why the region managed to cope well with the sharp decline in global trade in 2008–2009. Compared to the 23% fall in world export volume (in current US\$) in 2009, exports from the PRC fell by 16% and ASEAN by 15%. Exports from these two economies combined account for more than half of all developing Asia's exports. Intraregional trade has rebounded quickly, which is notable since trade impacts of the recent global crisis in major Asian economies were more severe than in either Europe or North America in the 1930s or during the Asian crisis.

While relevant policy choices have enabled developing Asia to ride the storm of the global crisis with relative ease, the region cannot afford to rest on its laurels. A rapidly changing world requires developing Asia to move beyond its current policies.

Building on the foundations

The Asian financial crisis proved to be an eye opener for regional economies to the disastrous implications of external shocks and forced them to prepare for such future eventualities. Decisive policy actions undertaken in the aftermath of that crisis to lay strong and stable foundations for macroeconomic fundamentals have allowed developing Asia to emerge quickly with a robust recovery from the global recession. Indeed, riding on the strong base of the fundamentals, some economies are reaching close to the high-growth path they enjoyed in the pre-global crisis era.

Developing Asia has built solid policy foundations that have served it well in its development. Yet looking ahead, the region must reform its institutions and overcome critical structural impediments to unlock its long-term growth potential. Can the region build on its foundations to sustain rapid growth in the future?

Constraints to long-term growth

The growing economic size and financial power of Asian economies has changed the international economic and financial landscape. A few large Asian economies in particular are making their voices heard in global economic circles as part of the G20. The PRC, India, Indonesia, and the Republic of Korea join seven other developing country representatives in a group that has become the premier forum for international dialogue on economic and financial policy, replacing the exclusively industrial-country G7 in this role.

Yet the region will face many hurdles to sustain growth over the long term. The crisis has slowed the region's progress in raising the living standards of its people and put at risk its achievements in poverty reduction. Deeply embedded structural constraints prevent it from reaching its full production potential and attaining the maximum possible outputs that its vast resources are capable of producing. To accelerate growth and reduce poverty, the region must address the limitations it faces both in terms of resource use efficiency and raising productivity.

Continued reliance on expanding the factors of production—that is, a growing labor force and capital stock—is essential for increasing long-term supply. But more than simple accumulation of factors, using these resources more efficiently and spurring innovation hold the key to sustain high growth over the longer term.

The region's successful reliance on trade for its development will need to be seen in a new light as the region strives toward more balanced growth. With domestic demand emerging as a vital driver of growth alongside exports, Asian economies must become increasingly important markets for each other's final products. Expanding intraregional trade would also allow many of them to transition away from labor-intensive to capital- and knowledge-intensive manufacturing and put them on a higher growth profile.

Developing Asia supplies cheap labor to industrial economies but its poor educational systems and archaic labor laws are hurdles to further progress. Overhauling the educational system would contribute to the quality and quantity of its rich resource base of highly skilled professional and educated workforce.

Poor infrastructure—within nations and across borders—and high infrastructure costs present key binding constraints to sustained regional growth. By creating and strengthening economic corridors, regional infrastructure reduces trade costs, attracts FDI, and has a direct impact on productivity and trade.

Notwithstanding the region's strong performance in financial markets during the global crisis, decades of bank-dominated financial intermediation and government-directed lending have left domestic financial systems underdeveloped. Complex institutional and regulatory frameworks have limited the scope further for expanding growth continually. Modernizing their financial systems would take developing

Asian economies far in their quest for a higher-growth path as the future unfolds.

As the crisis recedes and recovery gathers momentum, these challenges present developing Asia with a daunting task. The next section analyzes the extent of the region's capacity and preparedness in four critical areas: improving human and physical capital through better education systems and infrastructure facilities, enhancing regional trade, and developing the financial sector.

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2

The future of growth in Asia

The future of growth in Asia

Refocusing on the long term

As the global financial crisis recedes and recovery gathers momentum, medium- and long-run growth will reassert itself as the overriding concern of the region's policy makers. Understandably, these policy makers were preoccupied with stabilizing short-run output during the depths of the crisis, as exports plummeted and growth decelerated. Aggressive fiscal and monetary expansion, however, limited the adverse effects of the slowdown and enabled the region to mount a V-shaped recovery.

In consequence, developing Asia can now build on these gains and return to its unfinished growth agenda. For, while boosting public spending and cutting interest rates may help counteract the negative impacts of short-run downturns, they cannot sustain growth over a longer time horizon. Indeed, continuing expansionary policies could be harmful for future growth: The buildup of public debt would impair fiscal sustainability, and the overhang of excess liquidity would trigger inflation and asset bubbles.

While short-run output fluctuations are determined primarily by aggregate demand, long-run growth depends largely on supply-side factors, which augment an economy's productive capacity. Long-run growth reflects the combined effects of the accumulation of production factors, such as capital and labor, and productivity improvements (Box 2.1.1), rather than the short-run ups and downs of the business cycle. True, the distinction between long-run growth and short-run business cycles is not always clear-cut, as severe recessions can lower an economy's growth potential. Still, the distinction matters because policies for sustaining growth are different from policies for minimizing

2.1.1 Growth decompositions and total factor productivity

The aggregate output of an economy may be characterized as the product of all employed inputs, usually categorized into capital and labor (Solow 1957). These inputs are posited to be combined and transformed into output, given the state of production technology and the larger institutional framework. Based on this description (and under certain technical assumptions of the relationship between output and inputs and the output shares of the inputs), the growth of aggregate output is decomposable into the relative contributions of the growth of each production factor.

Specifically, the growth accounting procedure breaks down output growth into shares accruing to the growth of capital and of labor and to a portion that is not accounted for by increases in the use of these inputs. This unexplained part of output growth is usually considered as the growth in total factor productivity (TFP), and is taken to represent productivity improvements or to be a measure of broadly defined technological progress that explains the growth in output over time, while holding input levels fixed.

The intangible nature of TFP has provoked long debate on the role that it plays in promoting overall economic growth. After all, it is a residual that drops out of the growth accounting procedure, representing

the difference between overall economic growth and the sum of the contributions of growth of the input factors. Still, empirical evidence indicates that it accounts for an increasingly large share of output growth as countries develop. Moreover, numerous cross-country studies show that it is correlated with many indicators of growth and development.

Efforts to better explain what TFP is and the role that it plays in economic growth have thus become important exercises in growth theory and development economics.

On the one hand, endogenous growth models point to improvements in, say, the quality of physical infrastructure and human capital stocks as well as broader and deeper financial development as possible ways by which the rate of innovations (or TFP growth) can be accelerated.

On the other, accounts in the new institutional economics literature suggest that institutional change that promotes broad-based property rights or solves coordination failures in an economy enhances that economy's overall efficiency and its growth prospects.

From both interpretations of TFP, however, the message is clear: A better understanding of the determinants of TFP growth is important for designing better policies to strengthen and sustain future economic growth.

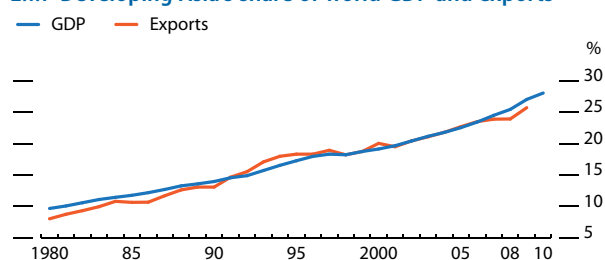
cyclical fluctuations. The former involve structural supply-side strategies that enable individuals, firms, industries, and the entire economy to become more productive on a sustained basis; the latter involve fiscal and monetary actions for temporarily influencing the level of aggregate demand.

For developing Asia, sustaining growth in the medium and long run is important for at least three reasons. First, despite the region's remarkable growth performance during the last half of the 20th century and its resilience during the recent global crisis, living standards remain well below those of the industrial economies. And while the region's shares of world output and trade have been rising fast (Figure 2.1.1), a large chasm still separates the region from those economies in terms of per capita output (Figure 2.1.2).

Despite growth-concomitant massive reductions in poverty, it remains widespread in the region: Two-thirds of the world's poor still call the region home; more than 1.8 billion Asians subsist on less than \$2 a day; and 903 million survive on less than \$1.25 a day. Sustaining the region's growth momentum will thus be key to raising living standards and making further inroads into poverty.

Second, there is no guarantee that the region's excellent growth record will carry over into the postcrisis period. Indeed, the

2.1.1 Developing Asia's share of world GDP and exports



Notes: 2009 and 2010 GDP data are estimates. GDP is based on purchasing-power-parity valuation.

Source: ADB calculations based on data from International Monetary Fund, World Economic Outlook database, April 2010; and World Trade Organization Statistics database. <http://www.wto.org> (accessed 31 August 2010).

[Click here for figure data](#)

postcrisis global economy may prove to be a less benign environment for the region's export-led growth paradigm. Weaker demand from industrial economies, which were disproportionately affected by the crisis and which are now undergoing a period of economic restructuring, implies that export-dependent developing Asia cannot rely on its traditional markets, at least over the medium term. In turn, this means that a key challenge for the region will be to find new growth drivers.

Third, the region's long-term growth potential is not predetermined. It is by no means certain that the rapid historical economic growth will automatically continue in the next 2 decades. Standard growth models predict the "conditional convergence" of income—meaning that a country with a low initial income level relative to its potential level will tend to grow faster than a country that is closer to that potential.

Controlling for the factors that determine the potential income level, this implies that faster-growing Asian economies will tend to grow less fast as they are already likely to have large stocks of factors of production and fairly high technological levels. Developing Asian economies must undertake policy reform measures to prevent the power of convergence from slowing their future growth.

Toward a new Asian growth paradigm?

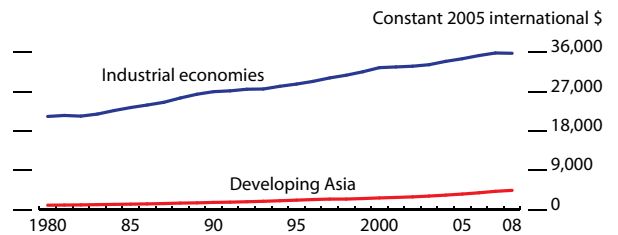
But does developing Asia really need a new growth paradigm? After all, the region has stood out for its remarkable growth performance, which outpaced the rest of the world for decades. Moreover, as a result of strong fundamentals, developing Asia is recovering more quickly and strongly than other regions, essentially leading the world out of recession. Indeed, many core ingredients of the region's precrisis performance will continue to serve it well in the postcrisis period. These include its high saving and investment rates, prudent fiscal and monetary policies, and openness to foreign trade and technology.

The feature of the region's precrisis growth paradigm that proved vulnerable to the global crisis was its export-dependent strategy, which was premised on strong external demand from the industrial countries. This strategy, though, was not without its merits: Exports enabled producers in developing Asia to overcome the limitations of small domestic markets and forced them to become efficient in order to survive, if not thrive, in competitive international markets.

Moreover, the problem that the global crisis exposed was not the risks of openness per se, but the costs of neglecting the potential contributions of domestic demand to growth. Absent structural distortions that impeded domestic demand or production intended for domestic markets, such markets would have been an additional source of growth and dynamism for the region's economies (ADB 2009a). In turn, robust domestic economies would have fostered stronger intraregional trade, thereby further diversifying the sources of growth (ADB 2009b).

Nonetheless, revisiting developing Asia's growth paradigm is important for the following reason: Sustained rapid growth has

2.1.2 GDP per capita (purchasing power parity-adjusted), developing Asia versus industrial economies



Note: Industrial economies comprise eurozone, Japan, and United States.

Source: ADB calculations based on data from World Bank, World Development Indicators online database (accessed 31 August 2010).

[Click here for figure data](#)

transformed—and is still transforming—developing Asia from an agricultural, low-income region to an industrial, increasingly middle-income powerhouse.

Certainly, countries have not all figured uniformly in this transformation, but growth has diffused over ever-wider areas—from the four newly industrialized economies (NIEs) of Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China, to members of the Association of Southeast Asian Nations (ASEAN), to the People's Republic of China (PRC), and to India—in the process lifting hundreds of millions of Asians out of poverty. As may be expected, some elements that were important for the growth performance of the Asia of earlier years may become less relevant for tomorrow's Asia.

A key structural change, for instance, has been that developing Asia has metamorphosed from being a major net importer of capital to being the world's biggest net exporter of capital. This is a consequence of the years of high saving and investment that have transformed the region from a capital-scarce region to a capital-abundant one.

A stylized fact of modern economic growth is that, as countries grow richer and accumulate more capital per worker, the relative importance of productivity rises while that of capital accumulation falls, as diminishing marginal returns to capital set in. Indeed, this has been the general historical experience of the industrial economies.

For developing Asia, a long-running debate concerns whether the region's growth has been driven by factor accumulation or by productivity growth (Box 2.1.1, above). The empirical evidence generally indicates that factor accumulation accounted for much of the region's growth, as confirmed by Lee and Hong (2010) (Box 2.1.2). Furthermore, these authors' simulations suggest that, at least for some countries in the region, productivity improvements are likely to play a larger role in future growth, a point supported by the analysis of Park and Park (forthcoming) (Box 2.1.3).

Drivers of developing Asia's future growth

In the context of developing Asia's transition to a new pattern of growth, in which factor accumulation and productivity growth are expected to play more equal parts, four elements in particular are likely to come to the fore—trade, human capital, infrastructure, and financial development. Trade features because the sector had such a central role in developing Asia's precrisis growth model, and the rest because they represent the important supply-side factors for further growth. These four elements—individually or together—can potentially open pathways to growth through both factor accumulation and productivity improvements.

Trade not only has a positive impact on investment—for example, much of the region's capital flows into export-oriented industries—it also forces domestic firms and industries to improve their efficiency. Human capital is at once a factor of production, which directly raises the level of output, and a positive influence on the productivity of physical capital and other inputs. Infrastructure such as roads, ports, and power plants are forms of capital, which raise the productivity of

2.1.2 How fast can developing Asia grow in the next 20 years?

Over nearly 3 decades, developing Asian economies recorded impressive growth.¹ The region's income grew from about \$3.3 trillion in 1980—in 2005 purchasing power parity (PPP) terms—to an estimated \$24.5 trillion in 2009—an expansion of 7.5 times. During the same period, the world economy managed to record an expansion of less than three times, while the incomes of the industrial economies increased just about two times.

Per capita income in developing Asia is still lower than the global average, but it is also rising fast. From just over a quarter of the world average in 1980, it had increased to nearly two-thirds in 2009.

The Asian growth “miracle” was widely discussed in the 1990s (for example, World Bank 1993), but is one that can be explained. Empirical studies have highlighted the role of investment, human resources, fertility, and institutional and policy variables in this “miracle”.

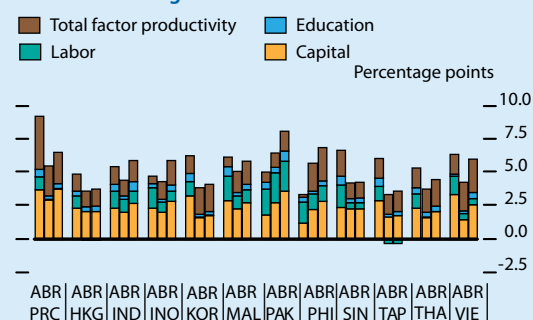
Between 1980 and 2007, rates of per capita income growth across developing Asia varied. Hong Kong, China; the Republic of Korea; Malaysia; Singapore; and Taipei, China, which started off with relatively high per capita incomes in 1980, recorded slower average growth rates through 2007, compared with the People's Republic of China (PRC), which had the lowest initial level of per capita income.

Using a growth accounting framework, the sources of developing Asia's GDP growth in 1981–2007 are decomposed into growth in the different factors of production—labor, human capital, and physical capital—as well as in total factor productivity (TFP).² The box figure shows that Asia's rapid economic growth in nearly 3 decades has been mainly due to robust growth in physical capital accumulation. In 10 out of the 12 Asian economies studied, average growth in physical capital stock was more than 5.8% per year between 1981 and 2007, which contributed more than 2.3 percentage points to average GDP growth.

The contributions of human capital and TFP growth to GDP growth during the same period were relatively limited. Specifically, the maximum recorded growth in human capital was 1.3% per year, which contributed about 0.8 percentage points of GDP growth. Except for the PRC, TFP growth in 1981–2007 did not exceed 2.0% per year in developing Asia.

A system of equations was set up to estimate the parameters of the growth model described above (see Lee and Hong 2010 for details). The results were

Sources of GDP growth



PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; TAP = Taipei, China; THA = Thailand; VIE = Viet Nam.

A: 1981–2007 actual; B: 2011–2030 baseline projection; R: 2011–2030 reform scenario projection.

Source: Lee and Hong (2010).

[Click here for figure data](#)

then used to generate projections of GDP growth for 2011–2030 for each of the 12 economies, which are shown in the “baseline” column of the box table. In general, the resulting baseline forecasts of annual GDP growth are lower than the historical averages in 1981–2007 (5.5% vs 9.3% for the PRC, and 4.5% vs 5.5% for India, for example). Only the projections for Pakistan and the Philippines are higher than the historical averages (by 1.4 and 2.3 percentage points, respectively). These results are largely driven by the cross-country catch-up

Average annual growth rates (%), 1981–2030

Economy	Projections		
	Actual 1981–2007	Baseline 2011–2030	Reform scenario 2011–2030
China, People's Rep. of	9.3	5.5	6.6
Hong Kong, China	4.9	3.6	3.8
India	5.5	4.5	6.0
Indonesia	4.8	4.4	6.0
Korea, Rep. of	6.3	3.9	4.2
Malaysia	6.2	5.2	5.9
Pakistan	5.1	6.5	8.2
Philippines	3.4	5.7	7.0
Singapore	6.8	4.3	4.3
Taipei, China	6.1	3.1	3.3
Thailand	5.4	3.8	4.5
Viet Nam	6.4	4.3	6.1

Source: Lee and Hong (2010).

1 Developing Asia here comprises the 12 economies shown in the box table. Since they account for about 95% of the region's GDP, they are representative of regional trends.

2 It is assumed that the share of physical capital is 0.4 and the labor share is 0.6. Growth in physical capital must thus be multiplied by 0.4 to get its contribution to GDP growth. The contribution of labor and human capital is similarly calculated, multiplying their growth rates by the 0.6 labor share. TFP is calculated by subtracting the contributions of capital, labor, and human capital from GDP growth.

2.1.2 How fast can developing Asia grow in the next 20 years? (continued)

phenomenon, where the lower-income economies of the region are expected to grow faster than the higher-income economies.

The box figure also shows the contributions of growth in capital, labor, education, and TFP to GDP growth in 1981–2007 and 2011–2030. The first bar confirms that capital was generally the most significant source of GDP growth. While labor was also a consistently large contributor, the role of education was more modest. TFP growth was also a reliable source of growth across the region, but its contribution was very varied.

The second bar shows that in the next 2 decades, the contribution of labor growth in projected GDP growth is set to fall largely as a result of fertility decline and population aging. Exceptions are those economies which have not yet fully reaped the demographic dividend, such as India, Indonesia, Malaysia, Pakistan, and the Philippines. The contribution of education is also forecast to decline as economies move closer to best practice enrollment and completion rates.

Growth in capital stock is projected to contribute less to GDP growth in 2011–2030 than it did in 1981–2007. This is because capital was the major source of growth in the past, and as the marginal productivity of capital declines, the contribution of growth in capital stock to GDP growth tends to fall. Pakistan and the Philippines are the exceptions, since they started off with lower growth in capital stock. TFP growth is projected to contribute more to GDP growth in the coming 20 years as developing Asian economies progressively increase their efficiency.

These results generally support the conditional convergence theory. Faster rates of factor accumulation and technology diffusion narrow the gap with potential income, leaving little room to grow further. But, does

convergence imply that as Asia becomes more prosperous, it cannot keep growing fast in the future? Not so.

Institutional and policy variables can expand the potential income of a country, widening the gap with the initial income level, and allowing for the achievement of a higher growth path.

The potential impacts of policy reforms on GDP growth are thus tested here. Improvements in years of schooling (which will affect human capital and TFP), expanded research and development activities (which will affect TFP), and property rights (which will affect physical capital) are considered simultaneously. GDP growth projections under the reform scenario are reported in the last column of the box table, and the decomposition of the GDP growth projections is shown in the third bar of the box figure.

The results confirm that policy improvements in education, research and development, and property rights can significantly increase GDP growth relative to the baseline specification. Considerable gains can be achieved especially by those economies with low initial levels of these three policy variables.

For instance, GDP growth is projected to increase by at least 1 percentage point in the PRC, India, Indonesia, Pakistan, the Philippines, and Viet Nam. A decomposition of the increase in average annual GDP growth shows that improvements in TFP, education, and capital can add 0.02–0.49 percentage points, 0.02–0.50 percentage points, and 0.01–1.14 percentage points, respectively.

These figures suggest that if developing Asia adopts growth-friendly policies, the region can continue to expand at robust rates in the next 2 decades.

Source

Lee and Hong (2010).

all firms and industries. Financial development mobilizes saving for investment, while channeling capital to its most productive uses and greasing the gears of innovation.

Trade

International trade has the potential to increase a country's income as a result of better resource allocation through specialization according to comparative advantage and the exploitation of economies of scale. The static gains from trade—that is, the welfare benefits accrued when relative-price distortions are removed—rarely exceed 2 or 3 percentage points of GDP (Bhagwati 1993). By contrast, the dynamic gains from trade can be substantial. These gains accrue indirectly through the effect of international trade on an economy's growth capacity, both from factor accumulation and innovation.

2.1.3 The recent evolution of the sources of developing Asia's growth

How much of developing Asia's recent growth can be accounted for by increases in productivity? To address this issue, 12 economies in a sample for three subperiods—1992–1997, 1997–2002, and 2002–2007—are analyzed in three groups. These are the four newly industrialized economies (NIEs) of Hong Kong, China; Republic of Korea; Singapore; and Taipei, China; the People's Republic of China (PRC); and seven Asian developing economies—India, Indonesia, Malaysia, Pakistan, Philippines, Thailand, and Viet Nam (“Others” in the box table).

The calculation of total factor productivity (TFP) growth assumes a two-input neoclassical production function with constant returns to scale. Two separate cases are analyzed—with and without adjustment of labor for human capital.

The box table reports the estimated TFP growth and its relative importance in GDP growth for the three subperiods for the case when labor is adjusted for human capital. For example, for the NIEs, since the contribution of TFP growth to output growth is 1.93% and output growth is 6.99% in 1992–1997, the relative contribution of TFP growth is 27.6% ($=1.93/6.99$). The results of the identical growth accounting exercise for the case when labor is not adjusted for human capital are broadly similar.

The most striking result from the box table is that the estimated size of TFP growth and its relative contribution to developing Asia's growth rose markedly after 2002. This implies a shift in the sources of the region's growth from capital accumulation to TFP growth. This shift is evident for all three groups.

Prior to 2002, expansion of the capital stock was the main source of output growth in the region; after 2002, TFP growth accounted for a larger share. However, the sharp drop in GDP during the Asian crisis period of 1997–2002 and the strong pickup in growth in the recovery that followed may be distorting the results. Essentially, because TFP is measured as a residual, business cycle effects (that is, the economy's move below potential growth during the recession and back to the production frontier during the recovery) may be mixed with productivity growth effects.

Still, the results are consistent with the Lee and Hong (2010) result of the rising relative importance of the contribution of productivity growth to output expansion. This, in turn, lends some support to the notion that, in the future, productivity growth will become an increasingly influential driver of developing Asia's growth.

Source

Park and Park (forthcoming).

Contribution of total factor productivity to output growth, 1992–2007 (labor quality adjusted for human capital)

	NIEs (%)	China, People's Rep. of (%)	Others (%)
1992–1997			
Growth in output	6.99	9.79	5.64
Contribution of TFP to output growth	1.93	3.91	0.65
(Relative contribution of TFP)	27.60	39.96	11.46
1997–2002			
Growth in output	2.57	7.69	3.16
Contribution of TFP to output growth	-0.71	3.09	-0.31
(Relative contribution of TFP)	-27.41	40.19	-9.78
2002–2007			
Growth in output	5.48	12.20	6.58
Contribution of TFP to output growth	2.60	7.01	2.74
(Relative contribution of TFP)	47.47	57.45	41.62

Note: Growth in capital and labor, contribution of capital to output growth, and contribution of labor to output growth are reported in the source.

Source: Park and Park (forthcoming).

International trade integration and openness facilitate factor accumulation because the larger scale of demand from international markets allows export-oriented firms to exploit scale economies in production, delaying the onset of diminishing returns to factor inputs. For example, diminishing returns to capital during the investment-driven “growth miracle” of Asia's NIEs in the 1970s and 1980s were largely

averted through international trade and the concomitant reallocation of resources from sectors that were labor intensive and domestic oriented to those that were capital intensive and trade oriented, which raised the demand for capital and kept its marginal product from falling significantly over an extended period (Ventura 1997).

An economy, however, is still subject to diminishing returns to capital. The growth-enhancing role of international trade in the long run depends on the rate at which it improves a country's productivity through technological progress or institutional change. The World Trade Organization points to five main channels along which trade can support the process of technological and institutional innovation (Box 2.1.4).

Human capital

There are multiple avenues by which human capital—the ability and efficiency of people to transform raw materials and capital into goods and services—affects economic growth. The accumulation of human capital improves labor productivity and increases the returns to capital. A well-educated workforce also facilitates the adoption and diffusion of technology.

Less often noted is that a critical threshold for human capital stock may be a precondition for growth because low education levels may act as a barrier to imitation, which may prevent the diffusion of technology. Larger and deeper stocks of human capital may also have spillover benefits. A prime example is that more educated mothers tend to have children with better health and education outcomes.

Education increases an individual's probability of being employed in the labor market and improves earnings capacity. Since human capital encompasses skills that can be acquired through the educational system, at the micro level it is considered the component of education that contributes to an individual's labor productivity and earnings while being an important component of firm production. That said, human capital development is welfare enhancing and important for its intrinsic value, not only for its instrumental value.

Infrastructure

Infrastructure has a major role to play in development outcomes because it provides both final consumption services to households and key intermediate inputs for production.

From a demand perspective, infrastructure provides people with services they need and want, such as water and sanitation, power, telephone and computer access, and transport. For this reason, the unavailability or lack of access to basic infrastructure services is an important dimension of poverty. Increasing the level of infrastructure stock thus has a direct impact on poverty reduction.

On the supply side, there is both a direct channel, in which infrastructure capital stock serves as a production factor, and an indirect channel, by which improved infrastructure affects output through technological progress. An increase in the stock of infrastructure capital increases the marginal productivity of other production factors—a positive externality. These indirect effects operate through various channels, such as labor productivity gains resulting from enhanced

2.1.4 How trade promotes innovation

Five channels are as follows. First, there is a scale effect from expanded market size through trade liberalization. Increased opportunities and profitability raise the incentives of firms to invest in research and development. More innovation then translates into higher long-term growth.

Second, trade liberalization increases competition and, in turn, the pressure on domestic firms to either innovate or perish. Theory and the empirical evidence show, however, that the effect of international competition on innovation is not clear cut. Rather, there are nonlinear and sector-specific effects, depending on how far industries are from the world technology frontier.

Third, trade liberalization may increase returns to research and development spending when there are international spillovers from innovation.

Fourth, international trade gives rise to an “international product cycle” involving the transfer of technology by imitation, from the advanced to the developing countries. Optimal intellectual property rights regulation embedded in World Trade Organization and preferential agreements needs to strike a balance between the incentives to innovate and the speed of technology diffusion and rent dispersion.

Fifth, international trade can have a positive role in promoting growth by improving the quality of a country's institutional framework and economic policy.

Source

WTO (2008).

information and communications technology (ICT), reductions in stress and in time wasted commuting to work, betterment of health and education, and improvements in economies of scale and scope of production throughout the economy.

The corollary is that there are many ways in which shortfalls in infrastructure translate into losses in productive efficiency. For example, access to markets and interactions with potential clients depend crucially on reliable transport and telecommunications networks. When these are faulty or nonexistent, firms face fewer market opportunities, incur higher logistical costs, carry larger inventories, and suffer information losses. Similarly, investment and technological choices may be affected by the efficiency of electricity networks, in that frequent power outages and voltage fluctuations raise the maintenance costs and risks of machinery breakdowns of capital-intensive technologies.

Hence, having critical levels of quality infrastructure that are consistent with a country's level of development may be an important precondition for further growth. Failing to achieve these levels may result in infrastructure services having no significant impact on long-term growth and productivity.

Financial development

Financial development promotes economic growth by improving the efficiency, stability, and accessibility of the financial system. An efficient financial system reduces information and transaction costs by performing the following five core functions well: producing ex ante information about possible investment and allocating capital; helping to monitor investment and provide corporate governance after providing finance; facilitating the trading, diversification, and management of risk; mobilizing and pooling saving; and easing the exchange of goods and services.

In turn, an efficient financial system enhances a country's growth prospects by channeling resources to their most productive uses, thereby fostering a more efficient allocation of resources. It also helps boost aggregate saving and investment rates, thus speeding up the accumulation of physical capital. Finally, it enhances growth by strengthening competition and stimulating innovative activities, so promoting dynamic efficiency.

Financially sound firms and efficient markets jointly provide strength and resilience to the financial system, allowing it to weather adverse shocks. A stable financial system is characterized by an effective prudential regulatory and supervisory framework, judicious risk management capacities in banks, and sound market infrastructure in bond and equity markets. It also facilitates the smooth and efficient functioning of the economy.

A financial system is accessible when financial services are available to a wide range of clients, including investors, entrepreneurs, and consumers. Lack of access to finance can be a serious barrier to investment and business activity. In particular, lack of financing often impedes setting up new businesses. This entrepreneurial activity is essential for a vibrant private sector that constantly renews itself and creates new firms, industries, and jobs.

A strategy for future growth

The four elements—trade, human capital, infrastructure investment, and financial development—will augment the region’s growth through their effects on increasing the available factors of production and supporting more efficient use of all factors. But what is the current state of these elements in developing Asia and how has each affected growth in the region thus far? And how can they be used to promote future growth?

Trade and growth

Prospects for trade and growth in developing Asia

International trade has been the engine of growth of developing Asia. Its significance in raising living standards across the region has been widely substantiated. (Box 2.2.1 explores the impact of trade on incomes in developing Asia.) Through integration with the global economy, many countries in the region achieved prolonged periods of rapid growth, lifting millions of their citizens out of poverty.

Still, as seen in Table 2.2.1, such growth was far from uniform among subregions. East Asia and Southeast Asia stand out as being very open to trade. Their shares of exports to GDP increased significantly from late-1990 levels, and were instrumental in raising the average for developing Asia as a whole. Jointly, East Asia and Southeast Asia accounted for almost the entire region's share of world exports. In addition, their export products were the most diversified, and they scored well on the World Bank's Logistics Performance Index (LPI), which gauges the costs of poor logistics to country competitiveness.¹ Furthermore, East Asia had the lowest tariffs in developing Asia.

By contrast, South Asia's trade share contracted and its export share is still far below the regional average, despite the leaven in the form of a fast-rising Indian economy. Moreover, its tariff barriers remained the highest in the region,² and it ranked poorly on the LPI.

2.2.1 Trade indicators

	Openness		Global market share		Export concentration		Tariff barriers		Logistics performance	Economic growth
	(Exports as share of GDP, %) ^a		(Share to world exports, %)		(Export diversification index) ^b		(Applied tariffs) ^c		(Logistics Performance Index) ^d	(Average GDP growth rate, %) ^a
	1999	2008	1999	2008	1999	2008	1999	2008	2009	1999–2008
Developing Asia	35.6	46.4	16.9	21.4	66	67	13.9	6.9	2.7	6.7
Central Asia	32.3	54.4	0.2	0.8	74	75	5.1	3.5	2.6	9.6
East Asia	38.8	49.2	8.6	12.9	54	58	7.5	3.1	2.9	7.3
China, People's Rep. of	20.4	38.1	3.4	8.8	46	45	15.0	4.1	3.5	9.6
Pacific Asia	58.2	66.1	0.0	0.0	70	77	15.6	9.3	2.3	2.4
Southeast Asia	50.5	62.7	7.1	6.3	63	63	9.5	5.5	3.0	5.2
South Asia	13.2	21.5	1.0	1.4	65	65	25.8	11.9	2.5	6.8
India	11.4	21.9	0.6	1.1	60	53	28.6	6.1	3.1	7.1
Vulnerable economies^e	21.9	20.9	0.2	0.2	68	73	17.8	10.6	2.4	3.9

^a Weighted by GNI, Atlas method (current US dollars).

^b Ranked 0–100, with 100 = most concentrated export basket.

^c Weighted mean of all product lines; no data for Pacific Asia and Vulnerable economies in 1999 but assumed equal to 1998.

^d 1 = lowest, 5 = highest.

^e Afghanistan; Bangladesh; Bhutan; Cambodia; Cook Islands; Fiji Islands; Kiribati; Lao PDR; Maldives; Marshall Islands; Micronesia, Federated States of; Myanmar; Nauru; Nepal; Palau; Papua New Guinea; Samoa; Solomon Islands; Timor-Leste; Tonga; Tuvalu; and Vanuatu.

Sources: ADB calculations based on data from UNCTAD Handbook of Statistics online, <http://stats.unctad.org>; World Bank. World Development Indicators online database, <http://data.worldbank.org/indicator> (both online databases accessed 21 August 2010); and *Asian Development Outlook* database.

2.2.1 Trade and income in Asia: Evidence from instrumental variable regressions

Has international trade raised living standards in developing Asia? This box explores this issue using panel data analysis for the period 1990–2007.

The dataset covers 157 economies, 29 of which are in developing Asia. To identify the direction of causation between trade and income, geographic characteristics (such as size, distance, and common borders) involving nearly 30,000 country pairs are used to derive an instrument that correlates with economies' trade share but not with other determinants of income (Frankel and Romer 1999).¹

The instrument is then used for instrumental variable (IV) regression to estimate the effect of international trade on income, controlling for the size of the domestic market. The results are compared with those of ordinary least squares (OLS) regressions, which are based on actual rather than instrumented trade shares (Trade/GDP), and hence do not address the simultaneity between trade and income.

The analysis confirms the exceptionally strong role that international trade has had in raising incomes in Asia, on the one hand, and the region's underreliance on production for domestic markets to spur growth, on the other.

Put differently, there is much scope for developing Asia to exploit the growth potential of domestic and regional markets, if necessary to compensate for a slowdown in growth deriving from international trade.

The box table summarizes the regression results.² Column 1 presents the IV regression estimates of log of income per person on log of instrumented trade shares using the entire sample. It indicates that, on average, a 1% rise in the international trade share raises a country's per capita income by almost 1.4%. In comparison, the effect of domestic market size is smaller, at about 0.2%.

Column 2 reports the estimation results with a sample

that is restricted to developing Asia. It suggests that international trade has a much stronger role in lifting income in these economies (by a factor of more than 1.6), but that the impact of domestic market size is negligible.

These findings are confirmed by the results of a regression specification that interacts an Asia dummy variable with the international trade variable and with the domestic trade variable.

As shown in columns 3 and 4, the OLS results mirror the IV findings qualitatively. By failing to account for the endogeneity of actual trade shares, however, OLS regressions are fraught with a severe downward bias in measuring the impact that international trade has had on incomes, compared to domestic market size. This confirms the findings of Frankel and Romer (1999) and their argument in favor of the IV approach.

Income and trade regressions, 1990–2007

Dependent Variable	(1)	(2)	(3)	(4)
ln (Income per person)	IV-All	IV-Asia	OLS-All	OLS-Asia
International Trade ln(Trade/GDP)	1.384	1.647	0.336	0.541
	<i>0.07***</i>	<i>0.29***</i>	<i>0.02***</i>	<i>0.07***</i>
Domestic trade (ln Population)	0.232	0.068	0.737	0.109
	<i>0.05***</i>	<i>0.07</i>	<i>0.04***</i>	<i>0.05**</i>
Observations	2,513	393	2,513	393
Number of countries	157	29	157	29

Standard errors in italics; ***significant at 1%, **significant at 5%.

Notes: All variables are in logarithmic form. Trade is trade share, actual (OLS) or derived (IV).

Source: Ferrarini (forthcoming).

Source

Ferrarini (forthcoming).

¹ The first stage of analysis involved the regression of the log actual trade share on log distance between country pairs, their populations, the existence of a common border, interaction terms between the border dummy and the other explanatory variables, as well as a constant term. All the coefficient estimates are statistically significant and take their expected signs—the only exceptions being the coefficient estimates of the interaction terms involving the common border dummy variable, which reflect the low prevalence of country pairs that share a common border in the regression sample. The correlation between the instrumented and actual trade share is high, at about 0.57.

² The results refer to fixed-effects panel regressions. The endogeneity of the actual trade share was tested with the Durbin-Wu-Hausman procedure. For both the full and Asia regressions, the test results confirm endogeneity. See the source for detailed regression results.

In the case of Central Asia and the Pacific, the two subregions managed to increase their export-to-GDP ratios, but only marginally (the nominally large increase in Central Asia's ratio was buoyed up by high commodity prices). The global market shares of their exports also remained negligible. Perhaps of greater concern because of the implications on vulnerability to trade shocks, the export products of these subregions, already of limited range in the 1990s, became even more concentrated, while logistics costs remained high.

An analysis of the recent trade performance of developing Asia is not complete without any mention of the region's two emerging giants. As may be expected, the indexes in Table 2.2.1 (above) register the very impressive strides made by India and the PRC in trade. In little more than a decade, India almost doubled its exports' share in GDP and in global markets (although both came from very low bases and are still far below regional averages).

Moreover, India outperformed South Asia in all dimensions of trade. For example, the state of India's export diversification is closer to that of the average East Asian rather than South Asian country. It has cut average tariff rates to levels that are far below the averages in South Asia (although tariff protection remains high relative to the rest of developing Asia). India also scores much higher in the LPI and it is more open than South Asia as a whole.³

Strong as India's trade performance is, it pales when juxtaposed with that of its East Asian neighbor. The PRC recorded higher shares of exports in both GDP and global markets, almost doubling the former and more than doubling the latter in the last decade. Its exports were also more diversified, its average tariff rates were lower, and it had a higher LPI score. (Box 2.2.2 also suggests that India's broader trade costs fell by less and remain significantly higher than those of the PRC.) By all measures, the PRC's economy is thus more integrated with world markets than India's, and not coincidentally, its growth performance has been the highest in developing Asia.

The foregoing findings on trade performance are consistent with trends that suggest that the subregions of developing Asia can be grouped into three subsets, depending on the key challenges they face in international trade.

First, there is the cluster of highly interdependent, open, and vibrant economies in East Asia and Southeast Asia that include the NIEs, the PRC, and the more advanced countries of ASEAN. With the PRC at the center of the assembly process and with exports going mainly to the US and Europe, production in and trade among these economies have been increasingly organized through vertical specialization in networks, with intense trade in parts and components, particularly in the ICT and electrical machinery industries. Against the prospects of an extended postcrisis period of reduced demand from developed-country markets, the key challenge for these countries is to adjust their production structures to be more responsive to domestic and intraregional demands.

Second, there is South Asia, which has remained relatively isolated trade-wise from the rest of the region. Limited participation in Asia's production networks, exacerbated by high protection and elevated trade costs, has hampered South Asia's integration with the vibrant economies of developing Asia. Even for India, deeper regional integration and further efforts at trade facilitation are crucial to fully leverage the potential of closer economic ties and network trade with East Asia and Southeast Asia. To pave the way for broad regional integration across developing Asia, the key challenge for South Asia is to integrate more strongly as a subregion, by removing the remaining trade barriers and substantially lowering the cross-border costs of trade.

2.2.2 Trade costs of the People's Republic of China and India

Trade costs comprise the whole range of regulatory, transportation, and distribution costs involved in the transfer of goods both from foreign producers to domestic consumers and from domestic producers to foreign consumers.

Most trade cost components are difficult to quantify, which limits the scope for direct measurement and for making international comparisons. A comprehensive measure of trade costs, however, can be derived from a theory-based gravity model of international trade, which is implemented on the basis of observed bilateral trade flows and GDP data (Jacks, Meissner, and Novy 2008).

Based on this approach, the analysis of trade costs involving merchandise trade between the People's Republic of China (PRC) and India during 1980–2008 leads to five main findings.

First, there has been a substantial reduction in trade costs between the PRC and India, particularly since the early 1990s. In tariff equivalent terms, trade costs fell from 117.0% in 1990 to 44.3% in 2008 (Box figure).

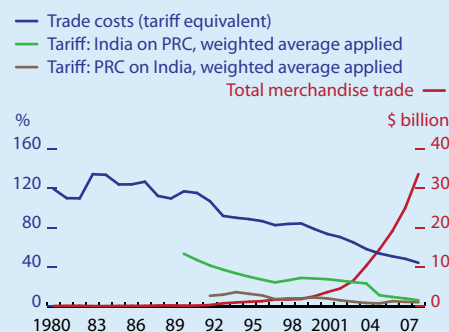
Second, falling trade costs were accompanied by a substantial increase in trade volume between the PRC and India. From virtually no trade until the late 1980s, trade between the two countries really took off only in the late 1990s, as trade costs declined steeply (Box figure). Total trade flows accelerated throughout the 2000s, from \$2.6 billion in 2000 to \$33.6 billion in 2008.

Third, the decomposition of factors accounting for growth in trade points to lower costs as a determining factor. This appears to be the case both for trade flows between the PRC and India (Box table 1) and for these countries' trade with the United States, Europe, Japan, and the ASEAN countries.

Fourth, the bulk of trade cost reduction appears to be on the account of the PRC. Indeed, besides reducing its trade costs with India, the PRC managed to do so with most of the other trade partners or regions considered in this study (Box table 2).

Fifth, India's bilateral trade costs with the partner countries appear to have fallen by proportionally less than the PRC's. Even after accounting for PRC's generally lower trade costs than India's at the outset, the fall in trade costs involving PRC as a trading partner is consistently more pronounced than that of India, in relation to all the trading partners (Box table 2).

Bilateral trade, trade costs, and tariffs, People's Republic of China and India



Source: Brooks and Ferrarini (2010).

[Click here for figure data](#)

1 Sources of trade expansion between the People's Republic of China and India (%)

Period	Trade expansion	Due to GDP growth	Due to lower costs
1981–1990	137.0	71.4	28.6
1991–2000	1,025.7	26.8	73.2
2001–2008	852.0	15.1	84.9

Note: Based on averages of export and import data reported by the PRC and India.

Source: Brooks and Ferrarini (2010).

2 Bilateral trade costs (calculated as tariff equivalent, %)

Year	Between PRC and:					Between India and:			
	IND	JPN	US	EU3	AS4	JPN	US	EU3	AS4
1980	119.3	43.1	65.9	67.3	62.8	67.3	72.0	66.0	78.5
1985	124.0	39.8	64.9	61.5	65.6	66.0	73.9	62.8	80.8
1990	117.0	52.9	58.2	60.9	56.7	74.7	73.5	63.7	69.7
1995	88.7	46.1	49.6	54.5	50.5	78.6	71.2	59.6	64.6
2000	78.7	41.2	46.9	48.8	39.8	79.4	70.5	57.7	52.2
2005	53.8	30.3	37.3	39.3	28.4	75.9	64.2	50.4	47.8
2008	44.3	25.7	33.6	31.3	27.0	64.3	56.9	39.5	42.3

AS4 = ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand); PRC = People's Republic of China; EU3 = France, Germany, and United Kingdom; IND = India; JPN = Japan; US = United States.

Source: Brooks and Ferrarini (2010).

Source

Brooks and Ferrarini (2010).

Third, there is the vulnerable group of countries (Table 2.2.1, above). A highly heterogeneous subset, their common characteristic is that they are the region's least developed economies. Although some of them have managed to diversify their exports into higher value-added manufactures and services, these countries generally remain vulnerable to commodity price fluctuations and to sudden demand disruptions. Any such shock

carries the risk of setting back development and poverty reduction initiatives, thereby worsening the prospects for long-term growth.

The key trade challenges differ by circumstances. East Asia and Southeast Asia need industrial restructuring to accommodate a gradual shift in the distribution of demand toward domestic consumption and regional trade. South Asia requires greater economic integration among countries within the subregion as well as closer ties with the rest of the developing Asian region. Finally, vulnerable economies will need support to develop the capacity to benefit from greater openness to international trade.

Industrial restructuring to accommodate domestic and regional demand

For East Asia and Southeast Asia, the key challenge is how the international production networks that are centered on the PRC will adjust to a prolonged period of reduced demand from traditional export markets.⁴ Recovery from the global financial crisis in the US and in Europe (as well as Japan) is slow and tentative. More significantly, the policy agenda of these economies well into the medium term will be to rebalance their macroeconomic and external accounts, which will pay little heed to import demand.

Some recent policy discussions have thus prescribed that developing Asia in general—and East Asia and Southeast Asia in particular—should reorient its growth strategy and accord a larger role to domestic and regional demand (ADB 2009a, for example). Not only would this provide additional engines of growth, it would also reduce the region's vulnerability to shocks from the global economy.

For the East Asian economies in particular (Box 2.2.3), the recommendation is to stimulate household consumption both by transferring corporate saving to households and by reducing precautionary saving by, say, providing insurance and expanding social safety nets. Additionally, on the supply side, support could be provided to sectors and industries that cater to domestic markets, notably small- and medium-sized enterprises (SMEs) and service industries (ADB 2009b).

Little attention, though, has been devoted to the problem that the value chains of the PRC-centered international production networks will have to undergo structural adjustments in response to a different composition of demand. But a restructuring is inevitable for as long as exports to developed-country markets remain sluggish and if a gradual shift toward more domestic and regional demand is to be accommodated, for several reasons.

First, there is the issue of production specificity. PRC final-goods exports tend to be specific to foreign markets, and much of the PRC's physical and human infrastructure is linked to a manufacturing sector that is geared for exports rather than for domestic consumption. For many of the PRC's East Asian and Southeast Asian intermediate-goods suppliers, the problem may be worse, as the parts and components that they produce are not likely to have domestic uses, specific as these are to the regional production network. For the same reason, it is unlikely that

these intermediate-goods exports can be easily diverted from the PRC to third markets.

Second, it is generally acknowledged that the production networks have excess plant capacity. If so, the excess capacity is likely to increase with the slowdown of exports to developed-country markets (and until

2.2.3 East Asian networks of production and trade

Global and regional production sharing has become part of the economic landscape of developing Asia. Since the late 1990s, production and trade between countries in the region have been characterized increasingly by vertical specialization in networks, with intense intra-industry trade in parts of components, particularly in the information and communications technology and electrical machinery industries.

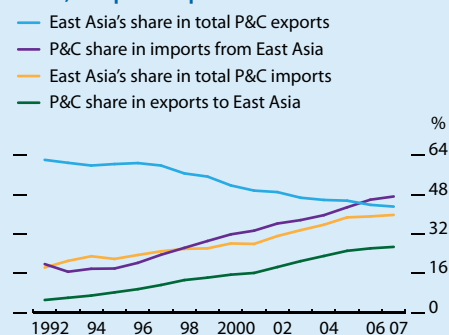
With the People's Republic of China (PRC) as the network hub of regional assembly and the jump-off point of final-goods exports predominantly to the United States (US) and Europe, intraregional trade—mainly Japan, the newly industrialized economies (NIEs) and the more advanced Association of Southeast Asian Nations (ASEAN) economies as suppliers of intermediate goods—has grown even faster than the region's trade with the rest of the world.

In 2008, the share of intraregional trade in parts and components accounted for more than 55% of total trade by East Asia and Southeast Asia combined. By contrast, the share of intraregional trade in final goods was just about 43%. This reflects the region's strong bias toward network trade in parts and components, rather than trade in final goods consumed in the region. Indeed, for Asia including Japan, trade in final goods is predominantly accounted for by demand outside the region—71%; 46% goes to the US and Europe (Box figure 1).

Box figure 2 illustrates the PRC's spectacular ascension as the central hub of final assembly, linking East Asia with

the rest of the world through global production networks. Indeed, the PRC has been sourcing a growing share of parts and components from other countries in the region, including Japan, while exporting the bulk of final goods to the rest of the world. As a share of PRC's total manufacturing imports from East Asia, parts and components imports grew from 18% in 1994/95 to more than 46% in 2006/07. Vertical integration and network trade appear to have increased—rather than reduced—Asia's dependence on external demand (Athukorala and Menon 2010).

2 Parts and components in manufacturing trade, People's Republic of China

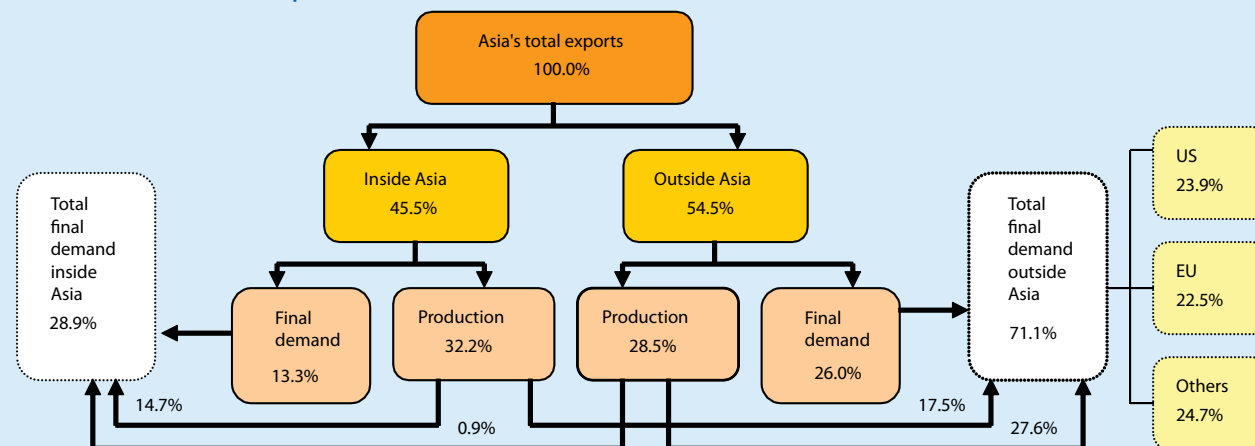


P&C = Parts and components.

Source: Athukorala and Menon (2010).

[Click here for figure data](#)

1 Final demand for Asia's exports



Note: Asia includes the 13 developing Asian economies for which data are available plus Japan. These are as follows: Bangladesh; People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

Source: ADB (forthcoming).

domestic demand and intraregional trade increase), which in turn will increase the pressure for plant and firm closures.

Third, while domestic and regional consumption levels do not offset the shortfall in export demand, lower aggregate demand in East Asian and Southeast Asian economies is likely to lead to vertical consolidation in the production networks. Increased competition will drive out high-cost producers, reducing the number of parts and components suppliers. Similarly, import substitution (of intermediate goods) in the PRC may well reduce the scope for specialization in production and the number of segments in value chains.⁵ However, establishing final goods-producing firms in the intermediate goods-exporting countries may not be an option if the latter lack the endowments to produce the entire value chain.

Affording larger roles for domestic consumption and regional demand in East Asia and Southeast Asia in particular and in developing Asia in general, will thus require a gradual move away from vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final goods, in a manner similar to the sequential “flying geese” pattern of division of labor. This strategy not only corrects imbalances between investment and consumption, on the one hand, and profits and wages, on the other; it also allows wages and private consumption both to march in step with productivity improvements and to underpin the expansion of productive capacity by expanding domestic and regional markets in final goods.

For the PRC, the strategy implies that there will be increased pressure to phase out labor-intensive manufactures and allow them to move to less developed countries. Rather than retaining such industries by keeping wages behind productivity and holding the value of the currency down, the PRC must eventually become an importer of such goods.

A benefit of this restructuring is that, for countries at similar levels of industrial development and technological maturity as the PRC, a shift from vertical to horizontal specialization in the long term will promote the kind of intra-industry trade that underpinned the rapid expansion and integration of Western Europe when countries were producing and trading similar products, such as passenger cars, consumer electronics, and other household durables.

In the process of reorientation toward horizontal specialization, foreign direct investment (FDI) from more advanced economies in developing Asia will play a key role in relocating labor-intensive industries to the region’s less developed countries, thereby helping to deepen regional integration through both trade and investment. This was the course taken by Japan and subsequently the NIEs in the process of industrial upgrading and productivity growth.

Closing the gap between wages and productivity in the PRC will not only help to accelerate the growth of domestic consumption and demand for final goods, it will also encourage firms in certain labor-intensive industries to relocate gradually to poorer countries through FDI in Southeast Asia and South Asia. Recent data from the United Nations Commodity Trade Statistics Database (UNCTAD) show that intraregional FDI has been growing since the mid-2000s and now accounts for about half the region’s total inward FDI stock. Most notably, the PRC’s outward FDI to ASEAN has accelerated during the global crisis, expanding almost

threefold between 2007 and 2009 alone and contributing to industrial upgrading broadly across the region, including in least developed countries such as Cambodia and the Lao People's Democratic Republic (the Lao PDR).

For the relatively more advanced economies in ASEAN—Indonesia, Malaysia, the Philippines, and Thailand—the key challenge will be how to reanimate private investment in high-productivity, skill-intensive sectors. Many of the sectors vacated by the NIEs have been captured by the PRC rather than by these higher-wage ASEAN economies. To avoid falling into a middle-income trap with the fragmentation of regional production networks, these countries need to move up the industrial ladder. They have ample domestic resources to do so, but lack the entrepreneurial expertise and investment needed (despite the recent increase in intraregional FDI) for such a restructuring. Boosting private investment will thus serve the dual purpose of accelerating the growth of domestic demand as well as industrial restructuring in these countries.

Indeed, new investment⁶ will mainly be needed to achieve the industrial restructuring necessary for a change in the product mix to match domestic and/or regional demand in East Asia and Southeast Asia. However, the new incentive structure associated with the rebalancing of domestic and external demand, including changes in wage–productivity configurations and exchange rates, may not be sufficient to drive investment toward areas that need to expand in order to meet a faster growing domestic market. Therefore, government action toward higher domestic demand needs to be accompanied by industrial and investment strategies for dovetailing the structure of production to the pattern of domestic and regional demand.

In sum, it would be difficult to envisage a change in the configuration of demand (with larger shares accounted for by domestic consumption and regional trade in final goods) without accompanying adjustments to the industrial structure characterizing East Asia's production networks. The pace and scope of industrial restructuring will be determined by the rate at which domestic and intraregional demand grows over time as well as by developments in US and European markets.

Although there is evidence⁷ that the share of final goods in the PRC's imports from the region has been rising in recent years, the momentum is not yet enough to trigger the supply-side responses discussed in this section. Relevant in this regard will be India's emergence as the second pole of high growth and demand in the region, as its involvement in a broad and inclusive pan-Asian integration process can be expected to generate the momentum necessary for domestic and regional demand to play a greater role in driving growth.

Growth potential from tighter integration

South Asia is probably the most heterogeneous subregion in Asia in terms of trade development.⁸ The giant Indian economy dominates the subregion, with an emerging manufacturing sector (with strengths in labor-intensive manufactures, automotive, iron and steel, and pharmaceuticals) and a distinct competitive advantage in services, particularly ICT and financial services. Bangladesh, Pakistan, and

Sri Lanka have developed a manufacturing base in textiles and garments to augment competitiveness in primary products. Bhutan, Maldives, and Nepal are more oriented toward services, particularly tourism, although Nepal has agriculture and Maldives has fisheries.

Compared to East Asia and Southeast Asia, however, South Asia trades less, receives less investment, and is less integrated with other countries inside and outside the region (Figure 2.2.1). Trade costs, including tariff and nontariff protection, are well above the regional average. The intraregional trade share is but a fraction of East Asia's. The extent of network trade is negligible.

Among the South Asian countries, only India stands out as a dynamic pole of economic growth that has been deepening its integration with the rest of Asia. Its "Look East" policy and gradual lowering of trade costs and protective barriers have served to establish India as one of the most thriving economies in developing Asia.

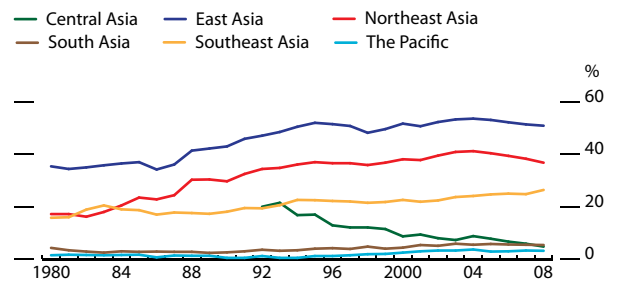
India represents an opportunity for growth through trade for the rest of South Asia. The sheer size of its market means that India can be a haven for exports from other countries in the subregion. In addition, its tighter integration with East Asia implies that India can serve as a subregional springboard for pan-Asian integration: India has already concluded several free trade agreements (FTAs), including with ASEAN and the Republic of Korea. Moreover, India has taken a leading role in promoting deeper economic integration in the subregion through the SAARC⁹ Preferential Trading Arrangement and the South Asian Free Trade Area (SAFTA). These can be the bases for South Asia to integrate initially within the subregion and later with East Asia and Southeast Asia, leaving no country to suffer from exclusion (Box 2.2.4).

A prerequisite for South Asia's integration will be the reduction of trade costs. High tariff and nontariff trade protection, poor physical connectivity, and cumbersome, behind-the-border procedures have long been identified as major hurdles. A recent assessment by ADB and the Federation of Indian Chambers of Commerce and Industry (FICCI) points to the importance of targeted issues for improving the business environment in South Asia in the short and medium terms (ADB-FICCI 2010). Examples of priority actions for private sector-led integration are expanding the SAARC visa exemption scheme to business travelers, dealing with nontariff barriers, improving customs stations on land, and promoting intraregional investment. South Asia's integration with the rest of developing Asia, in turn, faces three problems.

First, broad-based support for new trade agreements may be hard to secure in South Asian countries and the vulnerable economies that are likely to be adversely affected by the erosion of preferential tariff rates and by altered discrimination patterns. Comprehensive strategies that address adjustment costs in this regard will thus be needed. An example is the Aid for Trade Initiative, particularly the parts with a regional focus, which will play an important role in supporting integration in South Asia.

Second, the benefits from regionwide integration are likely to be unevenly distributed across countries and subregions. The still-large

2.2.1 Intraregional trade shares



Notes: Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Rep., Tajikistan, Turkmenistan, and Uzbekistan. East Asia comprises Northeast and Southeast Asia. Northeast Asia consists of People's Rep. of China; Hong Kong, China; Japan; Rep. of Korea; Mongolia; and Taipei, China. South Asia consists of Afghanistan, Bangladesh, India, Maldives, Pakistan, and Sri Lanka. Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam. The Pacific comprises Fiji Islands, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu.

Source: ADB (forthcoming).

[Click here for figure data](#)

2.2.4 Free trade agreements

Free trade agreements (FTAs) are playing an increasingly prominent role in the process of gradual integration between South and East Asia. Examples of FTAs already in effect are the Asia-Pacific FTA, the Comprehensive Economic Partnership Agreements between India and ASEAN and India and the Republic of Korea. (See www.aric.adb.org for a comprehensive list of FTAs in effect and under negotiation.)

Against the backdrop of stagnating global talks in relation to the World Trade Organization's Doha Round, however, policy makers in developing Asia must ensure that the proliferation of FTAs between South and East Asian countries do not represent stumbling blocks that undermine the prospects of establishing a more comprehensive regional arrangement and of making further progress in world trade liberalization.

Rather, policy makers should pursue "open regionalism" with its emphasis on inclusiveness and on the compatibility of regional integration with multilateralism. This requires that developing Asia strive for the most far-reaching and comprehensive agreement, including all countries in all subregions, thereby boosting regional trade and incomes, while limiting the adverse effects on the countries excluded.

differences in most-favored-nation (MFN) applied tariff levels, for instance, imply that some countries and subregions have lower trade costs and are more open to trade. In turn, these countries handle larger trade volumes. More specifically, at 11.9% in 2008, the average tariff level of South Asia was considerably higher than those of East Asia and Southeast Asia, at 3.1% and 5.5%, respectively (Table 2.2.1, above). Being more open, East Asia is thus preferred as a trading partner to South Asia and, potentially, will benefit more from regionwide integration.

Third, the substantial reduction of MFN tariffs in East Asia and Southeast Asia, and in India more recently, has diminished the trade-enhancing potential of preferential tariff arrangements. This shifts the policy emphasis to reducing trade costs. Put differently, the benefits of pan-Asian integration will be greatest if regional tariff liberalization in trade of goods and services goes hand in hand with substantial improvements in trade-related infrastructure and trade facilitation. Trade infrastructure and facilitation initiatives, however, are either costly or administratively difficult to implement.

A recent study (Francois and Wignaraja 2009) explored the income effects of various regional integration scenarios. Based on a global computable general equilibrium model of 35 country groups and 36 sectors, benchmarked to the year 2017, and premised on zero tariffs in goods and services and substantial improvements in trade facilitation and trade-related infrastructure, the study compared the outcomes of a narrow South Asia FTA; an FTA between ASEAN, Japan, the PRC, and the Republic of Korea (ASEAN+3); an ASEAN+3 FTA that also includes India; and a pan-Asian integration scenario between ASEAN+3, India, and all the other countries of South Asia. Table 2.2.2 summarizes the simulation results in terms of income changes in East Asia (including Japan), South Asia, and the rest of the world.

2.2.2 Income effect of free trade agreement scenarios (at constant 2001 prices)

	Value (\$ million) ^a			
	South Asia	ASEAN+3	ASEAN+3 and India	ASEAN+3 and South Asia
East Asia^b	-540	226,855	239,097	241,485
Japan	-9	74,825	78,080	78,650
China, People's Rep. of	-157	41,502	43,289	43,454
Other East Asian economies	-374	110,528	117,728	119,381
South Asia^c	3,695	-3,620	16,199	22,423
India	1,138	-2,371	17,779	18,240
Other South Asian economies	2,557	-1,249	-1,580	4,183
Rest of the world^d	361	-9,316	-3,934	-3,001
World	3,516	213,919	251,363	260,907

ASEAN+3 = Association of Southeast Asian Nations plus People's Rep. of China, Japan, and Rep. of Korea.

^a Values relative to 2017 baseline.

^b East Asia comprises Brunei Darussalam; Cambodia; Hong Kong, China; Indonesia; Rep. of Korea; Japan; Lao PDR; Malaysia; Myanmar; Philippines; Singapore; Thailand; and Viet Nam.

^c South Asia comprises Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

^d Rest of the world includes all other countries not shown on the table.

Source: Francois and Wignaraja (2009).

Among all the scenarios, the gains are largest for Asia including Japan (about \$260 billion) and the losses smallest for the rest of the world under the broad pan-Asian integration (ASEAN+3 and South Asia FTA) scenario. Reflecting relative size, East Asia (Japan in particular) stands to gain the most in absolute terms. In proportion to regional incomes, however, the gains for South Asia and East Asia are comparable, at 2.0%–2.3%.

Individual South Asian countries—and South Asia as a subregion—stand to gain substantially from being part of broad pan-Asian integration. Similarly, the South Asia FTA benefits all its members, albeit India's gains will be a fraction of those that it gets from integration with East Asia. Although India stands to benefit the most by looking east—with or without the rest of South Asia—it is in the interest of both India and the other South Asian countries to jointly pursue integration with East Asia. This would yield the largest gains for India and the happy prospect that no South Asian country suffers the consequences of exclusion.

South Asia has the potential to become an economic power in the next 2 decades. For the region to live up to its potential, India may have to grant unilateral tariff concessions to its neighboring countries, thereby providing access to its huge market. In turn, South Asian countries will need to lower trade costs, which would enable them to exploit the economies of scale of a large production base made possible by an expanded (because integrated) market. Only by standing together will the countries of South Asia reap the largest benefits from integration with the rest of Asia.

Asia's vulnerable economies and the role of aid for trade

Asia's vulnerable economies are characterized by small market shares, extreme export concentration, relatively high tariff barriers, poor logistics, and economic growth rates that are far below the regional average (Table 2.2.1 above).¹⁰ There is much heterogeneity among these countries in terms of the sources of vulnerability and key impediments to trade.

Some are least developed countries, like Bangladesh and Cambodia, which through infrastructure investment and policy reforms (that brought about greater integration with external markets) made use of their cheap labor endowments to partially shift out of primary commodities and into labor-intensive manufactures, particularly in textiles and garments. The key challenges for these countries are how to sustain the levels of textiles and garments exports in an increasingly competitive global market; and how the range of export products can be extended into related goods, such as footwear and soft toys.

Others are small economies, such as the Pacific islands, Bhutan, the Lao PDR, and Maldives. These economies are disadvantaged by their small size, limited skill base, geography, and distance from international markets. Factor costs in these economies tend to be high, ruling out competitiveness in manufacturing. The key areas of development are services (particularly tourism), fishing, and agriculture.

A few are conflict or postconflict economies, such as Afghanistan and Timor-Leste, facing particular stabilization and reconstruction challenges.

A prime source of vulnerability for all these economies is the limited range of commodities and services that form the base of production and exports. The combination of small domestic markets, insignificant global markets shares, and volatile export receipts constrains the operational size of production, which in turn precludes firms from exploiting scale economies, undermining their competitiveness. The consequent low productivity worsens the output effect of scarce physical and human capital stocks. Volatility in global market prices and other external demand shocks add further difficulties. The ultimate effect is that countries are unable to move into higher value-added, downstream processing and manufacturing industries.

As for trade capacity of these vulnerable economies, this is constrained by the limited availability of resources, whether in terms of infrastructure, institutions, or policies. Basic trade-related infrastructure, such as transport and storage or energy supply, are rarely adequate and inhibit export sectors from successfully competing in foreign markets. Progress in policy reform and macroeconomic management tends to be slow and erratic, institutions are often weak, and state ownership in key sectors of the economy still prevails in many countries. The effectiveness of foreign aid in support of these economies is also often undermined by “Dutch disease,” in which the domestic currency appreciates as a result of foreign exchange inflows, thereby weakening the competitiveness of export sectors.

Against this background, the international community of donors has increasingly come to recognize that firms in many developing countries may be unable to benefit from the market access opportunities that the multilateral trading system or regional trade agreements offer. Policy reforms and trade liberalization alone will not provide the solution for these countries. Development assistance will have to be tailored to address the specific constraints on the countries’ supply-side capacities in order to enable them to fully exploit the potential of enhanced market access, and compensation will have to be provided for the costs of prospective trade reforms (such as preference erosion or loss of tariff revenues).

Such impetus for trade-related aid gained momentum in the context of the ongoing World Trade Organization Doha Round negotiations, formalized through the launch of the Aid for Trade Initiative at the sixth ministerial WTO conference in Hong Kong, China, in December 2005 (Box 2.2.5). Multilateral development banks have endorsed the initiative and the work plan to implement it.

The need for aid for trade has grown in the postcrisis economic environment, as external demand has weakened and domestic vulnerability has sharpened. Vulnerable Asia is not yet sufficiently integrated with the rest of Asia to benefit from the region’s swift recovery and sustained growth, and continues to suffer from the sluggish and uncertain recovery of the global markets. This has increased the urgency of aid for trade, lest the gap with the more dynamic economies of developing Asia widen even further. More and better targeted aid for trade will be needed in the future to support vulnerable Asia’s economic recovery and long-term goal of economic diversification and integration with the global economy.

2.2.5 Aid for Trade Initiative

Successive rounds of multilateral trade negotiations have successfully expanded market access. Reforms intended to liberalize trade that were undertaken by developing countries over the past 2 decades have been associated with rapid growth, particularly in Asia. Export-oriented policies and the increase in per capita incomes have helped lift millions of people out of poverty.

These gains notwithstanding, many developing countries, and particularly the least developed ones, remain unable to take advantage of the potential benefits from market access opportunities. Governments and firms in these countries lack the capacity to compete effectively in global markets, because of considerable infrastructure and other supply-side constraints, as well as flaws in policy and procedures.

In recognition of these challenges, the 2005 Hong Kong World Trade Organization (WTO) Ministerial Declaration called for the Aid for Trade (AFT) Initiative to set in motion a process to mobilize more and better aid to help developing countries overcome structural limitations that undermine their ability to reap the benefits from trade opportunities.

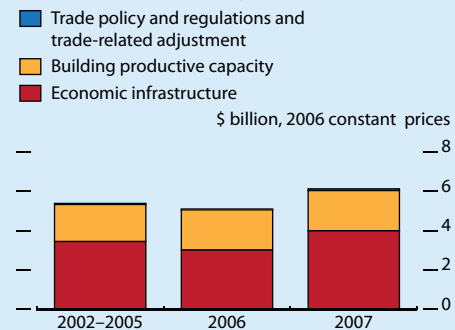
The WTO Task Force on Aid for Trade aims to enable developing countries (particularly the least developed), to use trade more effectively to promote growth, development, and poverty reduction. This includes helping them to build supply-side capacity and trade-related infrastructure, as well as facilitating, implementing and adjusting to trade reform. Assisting regional, global integration, as well as implementation of trade agreements, are also Task Force objectives, as is the need for bridging the demand for AFT and donors' response at all levels.

The joint OECD–WTO *Aid for Trade at a Glance 2009* report highlights that the Initiative has achieved remarkable progress so far. Recipient countries increasingly mainstream trade through operational priorities and action plans in their national development strategies. Among the most binding constraints they identify are network infrastructure, competitiveness, export diversification and trade policy analysis, negotiation, and implementation.

Donors are responding by scaling up aid resources, building in-house expertise, and undertaking more joint and cooperative initiatives and cooperation with other donors. According to the OECD Creditor Reporting System, AFT flows have grown by about 10% per year since 2005. In 2007, AFT accounted for 32% of total aid spent on specific economic or social sectors. Asia has been the largest recipient of AFT flows, with the majority spent on economic infrastructure, including transport and storage, communications, and energy supply and generation (Box figure).

Regional integration processes can be important drivers for AFT. The AFT Initiative has had an important impact on funding for regional programs, which more than

Aid for Trade in Asia, by sector



Source: Organisation for Economic Co-operation and Development. Creditor Reporting System. <http://stats.oecd.org> (accessed 13 September 2010).

[Click here for figure data](#)

doubled between 2005 and 2007. The regional development banks have been central to catalyzing AFT and economic integration processes at the regional level, such as through the establishment of the Inter-American Bank's Aid for Trade Strategic Fund, or the Regional Technical Group for Asia and the Pacific of the Asian Development Bank.

The latter provides an important platform for helping mobilize and channel AFT funds effectively, through increased lending to trade-related infrastructure at country, subregional, and regional levels. It also helps to coordinate the activities of many AFT donors, shares cross-border experiences, and provides technical expertise on AFT activities.

The global economic downturn has added a new urgency to the development challenges and opportunities faced by low-income countries. Remittances and global foreign direct investment inflows have declined, growth in international tourism dropped sharply, and commodity prices have been highly volatile. More than ever before AFT is needed to provide the additional stimulus, while addressing the underlying vulnerabilities that keep producers in recipient countries from effectively participating and competing in local, regional and international markets.

What matters most for international support to be effective in the postcrisis environment are the speed, scale, and quality of AFT initiatives. This will require reinforcing the country and regional component, strengthening on a country-by-country basis the identification of binding constraints, and aligning the aid response through a sustained dialogue among governments, civil society, private sector, and donors.

Sources

ADB (2009c); OECD–WTO (2009).

Summary

To boost their growth prospects through international trade, countries in developing Asia need to pursue different strategies depending on their circumstances. For economies in East Asia and Southeast Asia, the key challenge is for production and trade networks to undertake the adjustments necessary to accommodate increased domestic consumption and expand the volume and scope of intraregional trade. In particular, these economies may need to shift from vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final goods.

For non-Indian South Asia, the priority is to continue down the track of further economic integration with the subregion's dominant economy; for the subregion as a whole, to reduce excessively high trade costs and integrate more closely with the rest of Asia. Trade facilitation and regional integration are critical to speed up South Asia's participation in regional production networks. In this endeavor, India stands out as a huge market for exports from neighboring countries and as a subregional springboard for pan-Asian integration.

Asia's vulnerable economies need to build the supply-side capacity necessary to reap the benefits from trade integration. Those that managed to break into basic manufacturing find it difficult to move up the value chain and integrate with the region's production networks. For these countries, aid for trade as a special conduit for donor support has a crucial role to play.

Trade is of course only one of the four drivers of developing Asia's future growth. The region's success in the last few decades has also depended on its educational prowess—debatable to its degree, though undeniable in its fact. But is the system that worked in the past, still the system for the region's future?

Human capital accumulation in economic growth

Developing Asia's stock of human capital—its well-educated labor force—is often cited as one of the critical factors in the region's rapid economic growth. This impression is supported by the region's record in educational attainment over the past 4 decades. In 2010, its population aged 15 years and over has an average of 7.8 years of schooling, from just 4.1 years in 1970.

By contrast, the mean years of schooling of the high-income countries for the same population group is 10.7 years, from 7.5 years in 1970, while that of the rest of the world is 7.4 years, from 3.4 years in 1970 (Figure 2.3.1). Nonetheless, progress in educational attainment has not been uniform across countries and subregions, and the links between education, on the one hand, and productivity and income growth, on the other, have not been always clear.

Room for improvement

Developing Asia's record in educational attainment is due mainly to achievements in primary and secondary schooling. Average schooling years for primary and secondary schooling increased by 1.6 and 1.9 years, respectively, between 1970 and 2010. This increase accounts for almost 90% of the 3.7 year increase in schooling overall. In particular, the average length of secondary schooling increased from 1.2 years in 1970 to almost 3.1 years in 2010. Tertiary education has grown rapidly as well, increasing from almost zero in 1970 to 0.3 years in 2010.

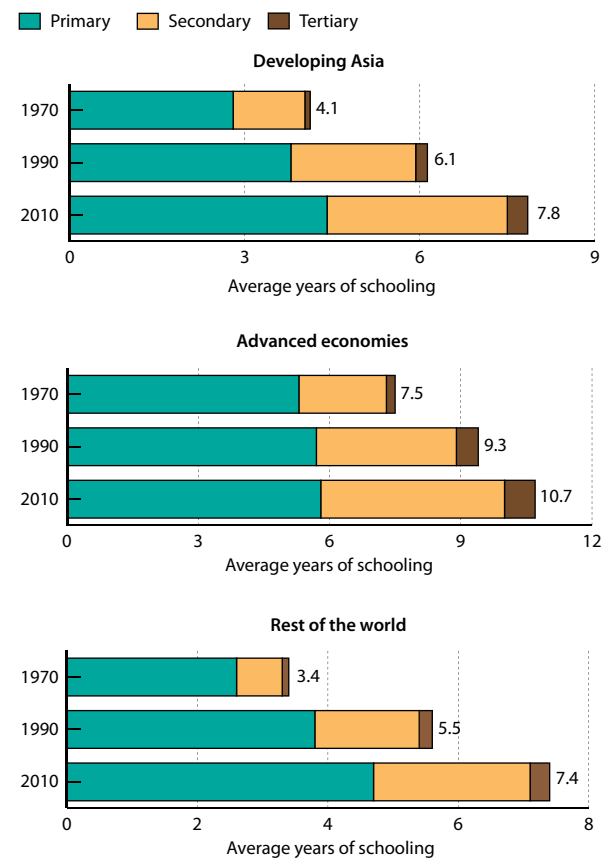
Still, substantial variation remains (Figure 2.3.2). In 2010, the average level of educational attainment in East Asia is comparable to that of the advanced economies (10.7 years), and those of Taipei, China (11.3 years) and the Republic of Korea (11.8 years) are higher. In contrast, average educational attainments in South Asia and Southeast Asia are lower.

Although India and Pakistan made rapid progress in education in the past 40 years, lengths of schooling, on average, remain below 6 years. The records of Indonesia (6.2 years) and Viet Nam (6.4 years) are not much stronger. The following characterization puts these statistics in stark relief—the average educational attainment of developing Asia in 2010 is where the advanced countries were half a century ago.

Population structure and enrollment

The persistently high educational attainment of younger cohorts is the primary reason for developing Asia's significant educational progress, and

2.3.1 Educational attainment, total population 15 years and above



Source: ADB calculations based on data from Barro and Lee (2010).

[Click here for figure data](#)

stems from the fact that the age structure of developing Asia's population is still pyramidal. In 1970, persons aged 15–24 years represented 31.2% of the total population, the same as the average of developing countries generally, but well above the 23.7% of the advanced countries.

A pyramidal age distribution for the population implies that improvements in educational outcomes for younger cohorts contribute more to the population average (because of their larger population shares) than similar achievements for older cohorts. Indeed, for India, Malaysia, and Pakistan in particular, the age structure will continue to be an important determinant of the rate of educational progress beyond 2010 (Lee and Francisco 2010). For these countries, it is estimated that every percentage point increase in the proportion of 15–24-year-olds who reach the tertiary education level translates to a 0.3 percentage point increase in the proportion of the population 15 years and above who achieve that level.

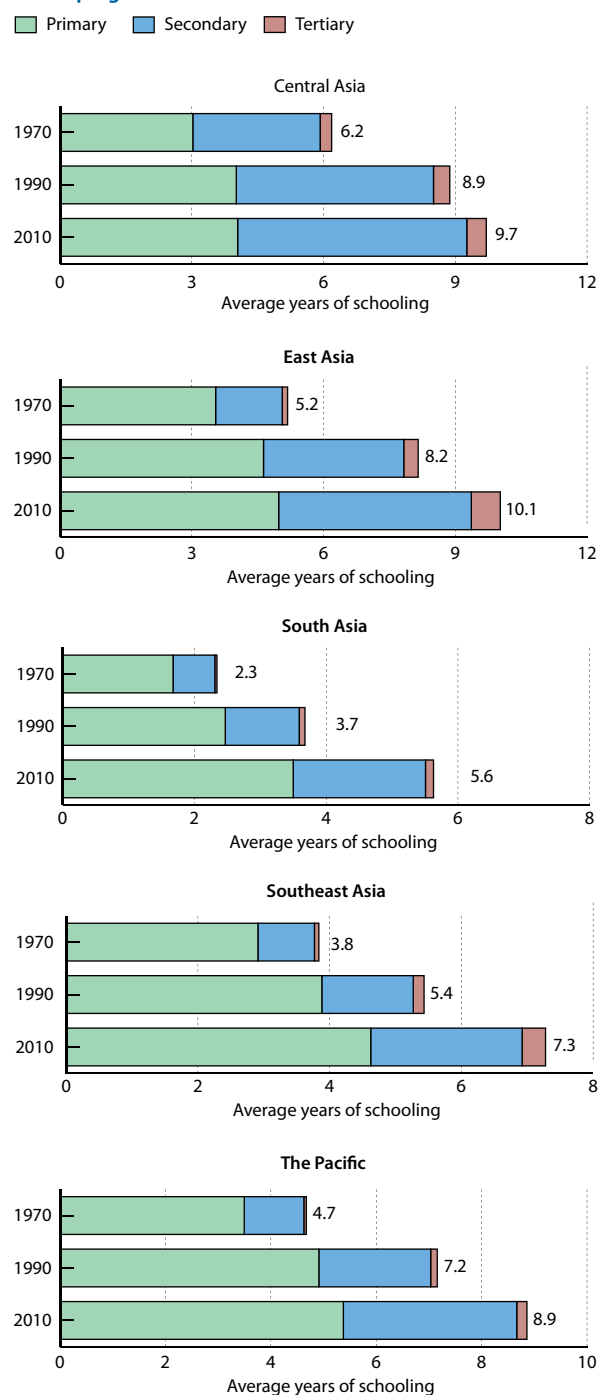
In developing Asia as a whole, the proportion of young people with no schooling declined by almost 20 percentage points from 1970 to 2010, as enrollment rates increased in all levels (Figure 2.3.3). Completion rates of these population segments also improved significantly, especially at the primary level for South Asia and secondary level for all subregions. Nonetheless, these improvements vary across countries. The secondary completion rate in the PRC; the Republic of Korea; and Hong Kong, China was 85% and above; India's was lower than 2%.

A long catch-up path ahead

Developing Asia has made excellent progress in increasing average years of schooling over the last 4 decades. In particular, years of schooling in South Asia grew by 2.2% annually.¹¹ This expansion was due to the rapid growth in the schooling of females, although gender disparity remains a significant issue in South Asia (Box 2.3.1). In contrast, the growth rate of human capital stocks in advanced countries has been modest at about 1%, suggesting eventual convergence in educational attainments, since people cannot study forever. If so, how many years will it take developing Asia to catch up with the current level of human capital of the advanced countries?

Estimates vary depending on the assumptions adopted. If future growth rates in years of schooling are set at the average rates recorded over the past 6 decades, it will take about 3 decades for South Asia and 10 years or so for Central Asia to achieve current levels of schooling in industrial economies (Son 2010). Even this scenario, however, may be too optimistic, given that growth rates are likely to decelerate as the average education level increases, and these figures may be better thought of as the lower bound for time convergence.

2.3.2 Educational attainment (15 years and above), developing Asia



Source: ADB calculations based on data from Barro and Lee (2010).

[Click here for figure data](#)

2.3.1 Gender disparity in educational attainment in South Asia

The worldwide average number of years of schooling is 8.1 years, with males having 8.4 years and females 7.8 years. Measured as the ratio of female-to-male average years of schooling, gender disparity in educational attainment is therefore small (0.93), if not negligible.

This worldwide mean, however, hides considerable variation in the gender distributions of educational attainment. When countries are grouped by per capita GDP deciles, lower income deciles are associated with wider gender disparity in educational attainment (Box figure, top panel).

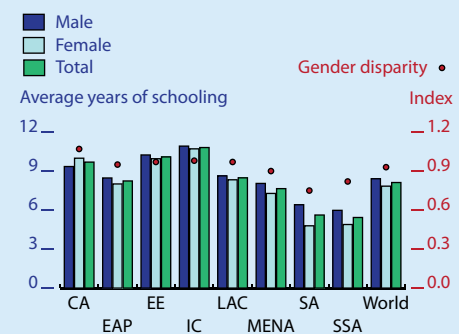
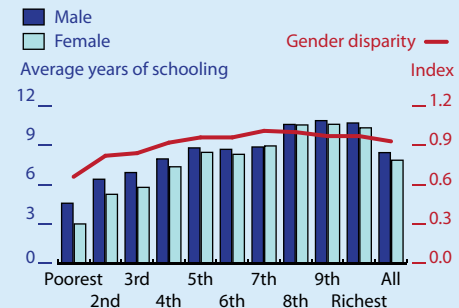
Among developing Asian subregions, Central Asia stands out for the longer length of time that females stay in school compared to males (Box figure, bottom panel). Possibly, this reflects the legacy of equal educational opportunities from the Soviet era, though this trend may be weakening since independence. In stark contrast, South Asia shows the largest deficit in the educational attainment of females compared to males, which is worse than even Sub-Saharan Africa's.

In South Asia, Afghanistan has the worst record: On average, females only have a quarter of the length of schooling of their male counterparts. The gender disparity is generally high in the rest of South Asia, too—in India, Nepal, and Pakistan. The exception is Sri Lanka, where the average number of schooling years is 8.6 for males and 8.3 for females.

That gender disparity is in a bad state in South Asia is not surprising. Das Gupta (1987) notes that South Asia has higher mortality rates among females than males due to gender discrimination, and documents a persistent bias for sons and discrimination against daughters in Punjab, despite the region's relative prosperity. Likewise, Filmer, King, and Pritchett (1998) report lower human capital outcomes for females in South Asia in various measures of human capital such as mortality rates, medical treatment, school enrollment, and literacy.

Gender disparity in South Asia may be the consequence of a confluence of factors, including gender discrimination,

Years of schooling and gender disparity, 2010



CA = Central Asia; EAP = East Asia and the Pacific; EE = Eastern Europe; IC = Industrial countries; LA = Latin America and the Caribbean; MENA = Middle East and North Africa; SA = South Asia; SSA = Sub-Saharan Africa.

Notes: The gender disparity index is defined as the ratio of female to male average years of schooling. Thus, if this index is less than one, then females are deemed to suffer deprivation due to the shortfall in their years of schooling relative to males. Income decile in the top panel is based on 2008 GDP per capita, purchasing power parity (constant 2005 international dollars).

Source: Son (2010).

[Click here for figure data](#)

cultural beliefs, biological differences, and economic conditions. A strong policy thrust is needed if gender discrimination and disparities in human capital are to be addressed within a reasonable amount of time.

Source

Son (2010).

Lee and Francisco (2010) estimate enrollment rates and project educational attainments by taking into account the likely changes in per capita income, parental education, and fertility rates over the next 2 decades for 12 developing Asian economies. Their projections show a rather modest increase in average years of schooling: 0.54 years. This is a significant deceleration from the 2.1-year increase that the countries registered between 1990 and 2010. In effect, without substantial policy interventions, developing Asia's deficit relative to the educational capital stocks of industrial economies will remain quite large as far into the future as 2030.

Technology absorptive capacity and human capital accumulation

Education has long been posited to be a key determinant of economic growth. The central role of technology in growth models provided the impetus for the focus on education; after all, an educated population is necessary for technological innovation and adoption. In an early study, Nelson and Phelps (1966) made the link explicit in what they termed “investment in humans.” Some 3 decades later, Benhabib and Spiegel (1994) showed that income growth is not correlated with the *growth* of human capital but with its *level*. This implies that human capital is not just a production input; because of technology–skill complementarities, it is important for technology adoption and creation as well.

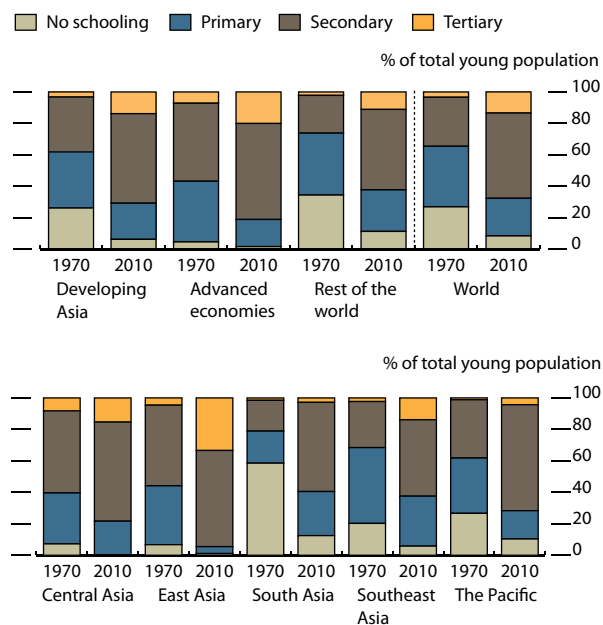
Numerous cross-country empirical studies have established the positive correlation between human capital, on the one hand, and output and economic growth, on the other. Most recently, Barro and Lee (2010) find that schooling has a significant positive effect on output. Barro (1991) found that primary and secondary school enrollment rates were positively linked to economic growth and investment, but were negatively related to fertility rates. In the same vein, Hanushek and Woessmann (2009) obtain the result that a unit increase in a country’s average cognitive test scores in math and science increases per capita GDP growth by more than the unit increase in its average total cognitive test scores (which includes reading). Generally, education is significantly and positively correlated with economic growth, and that causation runs from education to growth in line with human capital growth models.

Workers need education both to improve their productivity and to enable them to work with or create new technologies. The accumulation of human capital through basic education and on-the-job training fosters economic growth by improving labor productivity and by facilitating technological adoption and diffusion. Tertiary schooling, on the other hand, is more relevant for spurring technological innovation.

Did lower illiteracy rates and higher primary and secondary schooling rates in developing Asia enhance the region’s technology absorptive capacity? A simple scatter plot of initial human capital levels and subsequent total factor productivity (TFP) growth over the period between 1970 and 2005 addresses this issue (Figure 2.3.4). The raw correlation between these two variables is positive, suggesting that economies with larger initial human capital stocks tended to exhibit higher TFP growth.

The capacity to adopt technology is vital for countries that are technologically behind. Benhabib and Spiegel (1994) maintain that the more technologically behind a country is, the greater technology spillovers are likely to be. Hence, if the level of human capital stock is positively correlated with the rate of adoption of new technology, a country with a large

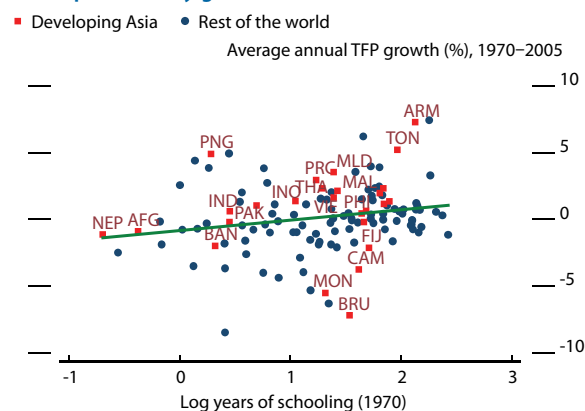
2.3.3 Young population (aged 15–24), by highest level of educational attainment



Source: ADB calculations based on data from Barro and Lee (2010).

[Click here for figure data](#)

2.3.4 Initial human capital levels and subsequent total factor productivity growth, selected economies



AFG = Afghanistan; ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; BRU = Brunei Darussalam; CAM = Cambodia; FIJ = Fiji Islands; GEO = Georgia; HKG = Hong Kong, China; IND = India; INO = Indonesia; KAZ = Kazakhstan; KGZ = Kyrgyz Rep.; KOR = Rep. of Korea; JPN = Japan; LAO = Lao PDR; MAL = Malaysia; MLD = Maldives; MON = Mongolia; MYA = Myanmar; NEP = Nepal; PAK = Pakistan; PHI = Philippines; PNG = Papua New Guinea; PRC = People’s Rep. of China; SIN = Singapore; SRI = Sri Lanka; TAJ = Tajikistan; TAP = Taipei, China; THA = Thailand; TIM = Dem. Rep. of Timor-Leste; TON = Tonga; US = United States; and VIE = Viet Nam.

Note: Data cover 134 economies.

Source: ADB calculations based on data from Barro and Lee (2010) and Park (2010).

technology gap but with a large stock of human capital as well would be able to achieve more rapid growth than a comparator country that is not similarly endowed in human resources.

Some economies in developing Asia have in fact benefited from technological spillover effects over the past few decades. The PRC and Thailand, for instance, were far behind the US in TFP in 1970 (Figure 2.3.5). But productivity in both countries grew impressively since, reaching an average TFP growth of above 2%. More to the point, economies with more educated workforces in 1970 (including Hong Kong, China; Malaysia; and Taipei, China) registered rapid productivity growth between 1970 and 2005, conditional on their distance to the technological frontier, in effect confirming the Benhabib–Spiegel hypothesis.

On the other hand, a counterexample was the Philippines. Endowed with a relatively well-educated labor stock in 1970, the country did not perform particularly well in productivity growth. Son (2008) explains that this may be due to mismatches between skills learned in school and labor market requirements (Box 2.3.2).

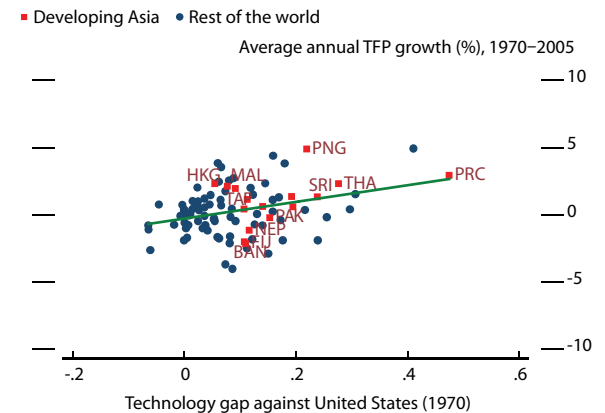
Low-income growth stagnation

Examples of the converse proposition, that a low stock of human capital is associated with economic stagnation, are Bangladesh, Nepal, and Pakistan. With their populations having less than 2 years of schooling in 1970, these countries saw their TFP levels worsen between 1970 and 2005.

One interpretation of the common experience of these countries is that a critical level of education is required for technology diffusion to take place. Benhabib and Spiegel (2005), for example, argue that the diffusion process depends on barriers to imitation (such as that posed by workers with low levels of schooling). In this light, Bowman and Anderson (1963) hypothesize that a literacy rate of 30%–40% is a precondition for rapid growth. Below this critical level of human capital stock, technological diffusion does not occur. The effect then is that the country falls in a steady state of a poverty trap without economic growth. This seems to be the case for some countries in South Asia. While population with no schooling declined significantly over the last 4 decades, those with no schooling was as high as 80% of the young population in Pakistan and 66% in India in 1970.

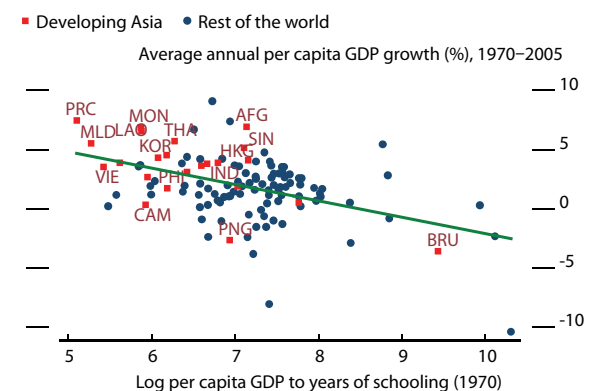
Figure 2.3.6 plots average annual growth rate of per capita GDP from 1970 to 2005 against a measure of relative human capital in 1970, the ratio of per capita GDP to education attainment. The key observation is that no data points appear in the upper right-hand side of the chart, a finding that is consistent with a weaker form of the threshold hypothesis argued above: No country was able to grow quickly during the sample period without the benefit of a highly qualified labor force. And all those that did grow quickly (the PRC, the Lao PDR, Maldives, Mongolia, and Viet Nam) in developing Asia

2.3.5 Technology gap against the United States and subsequent TFP growth, selected economies



Notes: For full form of acronyms, see Figure 2.3.4. Data cover 98 economies. Source: Park (2010).

2.3.6 Per capita GDP growth and human capital, selected economies



Notes: For full form of acronyms, see Figure 2.3.4. Data cover 125 economies. Source: ADB calculations based on data from Barro and Lee (2010) and Heston Summers and B. Aten, Penn World Table Version 6.3, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, August 2009.

2.3.2 Human capital and the labor market mismatch—The case of the Philippines

Skills learned in the educational system should be used by firms in the production of goods and services so that workers are paid wages commensurate with their productivity. Without this link, even educated workers will realize lower returns from their educational investment, and the economy will not reap the benefits of investment in education through higher productivity. Son (2008) observes the missing link for the Philippines, where the proportion of employed household members with secondary and tertiary education increased, while that with only primary education decreased over 1997–2003.

Son (2008) argues that this observation might be due to the structural shift in employment from agriculture to the service sector, especially among female workers. The service sector includes low-productivity jobs like housemaids and drivers as well as high-productivity jobs like lawyers and financial advisers. The same paper calculates that real labor productivity declined by 4.76% in 1997–2000, and by 1.42% in 2000–2003.

Concurrently, the real returns to education declined by 23.5% for secondary education—from P6.75 per hour in 1997 to P5.16 per hour in 2003—and by 16.3% for tertiary education—from P19.80 per hour in 1997 to P16.57 per hour in 2003. Therefore, workers with secondary or tertiary education were increasingly accepting low-productivity jobs, resulting in lower productivity and rates of return to education.

The above observations clearly show that the labor market in the Philippines is not able to effectively utilize the country's increasingly educated workforce. Despite having a greater proportion of workers with secondary or tertiary education, the average productivity of workers is on the decline. The labor market is not generating enough quality jobs for the educated workers, so workers end up taking up low-productivity jobs or looking for more

gainful employment overseas. The decrease in productivity may also indicate cream-skimming in the country's labor force, where workers with higher skill are able to find overseas employment while lower-skilled workers stay to work at home.

Either way, this indicates that the educational system is not teaching the skills needed by the country's labor market, either because of a mismatch between skills supplied and demanded or because of poor quality of education. Thus, educational attainment is not leading to high productivity in the Philippines, and therefore economic growth remains slow.

As also pointed out in *Asian Development Outlook 2008*, these labor market mismatches are a challenge for many other developing Asian economies, including Cambodia (Sakellariou 2008); Mongolia (Pastore 2009); the People's Republic of China (Li, Morgan, and Ding 2008); and Taipei, China (Hung 2008). Governments in developing Asia need to address the mismatches in order to accelerate productivity and sustain economic growth.

While each country's needs and conditions are different, education policy in general must be closely tied with labor and economic policy. If the country seeks to develop its information technology sector, then the quality of math and science education will need to be improved. Likewise, if a country needs to improve governance and institutions, then civics and history cannot be neglected in the curriculum. The educational system must not exist in a vacuum; rather, decisions on priorities, curricula, and budget allocation need to be made in line with medium- and long-term development plans.

Source

Son (2008).

possessed workforces that were exceptionally well-qualified, given the starting levels of their per capita incomes.

Figure 2.3.6 (above) also displays a “frontier” of economic performance. On this frontier, or close to it, lie countries whose growth rates are the highest given their ratio of per capita GDP to education or, more generally, their development stage. Some economies, such as Hong Kong, China; Singapore; and Thailand, have data points that are close to the frontier. But quite a number in developing Asia, such as Cambodia, Papua New Guinea, and the Philippines, are a good distance below it. In effect, the GDP of these latter countries have been expanding much more slowly than the qualifications of their working populations warrant. Some countries are apparent laggards in the sense that their workers' average educational outcomes have not reached the critical threshold to enable them to reap the growth benefits of increases in the stock of

human capital. Others, such as the Philippines, which have already high stocks of human capital, seem to be suffering from other factors, such as noncompetitive markets and/or technology–skill mismatches.

Extent of need for higher education

There are two sources of technological progress—adoption and creation of new technologies. These two sources require different types of human capital. Low-skilled human capital is better suited to technology adoption, while high-skilled human capital is more apt for technology creation.

The appropriate composition of human capital for economic growth and the impacts of each type of human capital on growth therefore depend on a country's development stage, which may be proxied by its distance from the technological frontier, as argued by Krueger and Lindahl (2001), among others.

Using data on 19 countries in the Organisation for Economic Co-operation and Development (OECD) between 1960 and 2000, Vandebussche, Aghion, and Meghir (2006) empirically show that, as a country moves closer to the technology frontier, tertiary education becomes increasingly more important for growth than primary and secondary education, and that the effect of high-skilled human capital on growth becomes stronger in countries that are closer to the technology frontier.

Similarly, Acemoglu, Aghion, and Zilibotti (2006) show that, as a country's distance to the technological frontier narrows, technology creation, more competitive market policies, and the supply of skilled entrepreneurs become more important for growth. In particular, a noncompetitive environment created by the state intervention, long-term relationships between firms and banks, and/or lobbying need to be minimized to increase productivity. They warn that when markets are persistently protected, an economy can get stuck in a nonconvergence trap.

Basic literacy skills and “rocket scientists”

An important policy question concerns whether education resources ought to be concentrated on gifted students or spread out more uniformly to achieve universal basic education. On the one hand, allocating more resources toward developing the skills of high-aptitude students can provide an economy with a pool of highly skilled professionals and scientists, and increase the likelihood of generating technological innovations. The downside is that a greater proportion of the workforce would be poorly educated and unskilled, rendering them incapable of working with existing technologies.

On the other hand, spreading basic education resources uniformly can generate a workforce with the requisite basic technical skills. But this lowers the likelihood of generating growth-spurring technological innovations. In graphic terms, the question may be cast as follows: Should a country devote significant resources to developing an elite group of “rocket scientists,” or should these resources be used instead to teach basic skills to all students?

Hanushek and Woessman (2009) find that both “rocket scientists” and “basic-skills students” contribute positively to growth, although

the former have a much stronger impact. Moreover, the impact of the share of “rocket scientists” is significantly stronger for countries that have a long way to catch up with developed countries. Thus, developing countries with a high share of “rocket scientists” but with low initial GDP per capita are able to catch up faster with the industrial economies. Nonetheless, investment in human capital cannot be exclusively allocated for the development of rocket scientists: The same study finds that a country needs to have both an elite pool of “rocket scientists” to generate technological innovations as well as a workforce with basic literacy skills that can use these technologies in production.

Summary

Developing Asia has achieved much in improving educational outcomes over the last 4 decades. Its remarkable progress has been due mainly to increases in average years of schooling at the primary and secondary levels, which account for almost 90% of the overall increase in average schooling years. The gap in the human capital stocks of the industrial economies and developing Asia, however, remains wide. Estimates of time to convergence indicate that developing Asia’s educational capital will remain lower than those of advanced countries well into the future, unless substantial investment is made to buck the decelerating rate of growth of the human capital stock.

Human capital accumulation enhances the capacities of countries to absorb or create technology (or both). As a country’s distance to the technology frontier narrows, technology creation, more competitive market policies, and the supply of skilled human capital become more important. Correspondingly, tertiary education becomes more important for growth than primary and secondary education. Countries well below the technological frontier, however, have to surmount a critical threshold of human capital stock so as to avoid falling into a poverty trap. For these countries, reducing illiteracy rates and increasing average years of schooling are of paramount importance.

Still, simply increasing a country’s stock of human capital may not automatically translate into higher rates of economic growth. For human capital investment to be effective, the education reform agenda has to take cognizance of the standards and skill sets required by the labor market, and by the pattern of education required for the level of the country’s infrastructure.

Infrastructure in economic growth

Infrastructure's impact on economic growth

The traditional perspective is that, being a component of physical capital, infrastructure affects economic growth through factor accumulation. Moreover, this infrastructure-growth nexus is bolstered by the stylized fact that differences in firm productivity across countries and regions are due, in part, to variations in the availability and quality of infrastructure services.¹²

But the link between the infrastructure and economic growth or at least between infrastructure quality and productivity is not clear from the data. Whether the availability and the quality of infrastructure stocks exert positive effects on economic growth and productivity is, therefore, still subject to debate (Box 2.4.1).

Still behind the advanced economies

While some developing Asian countries have far better infrastructure than others, overall, the region remains below the world average in terms of both quantity and quality. Quality of infrastructure and access to infrastructure services are also uneven across subregions and countries. Except for five relatively advanced economies—Hong Kong, China; the Republic of Korea; Malaysia; Singapore; and Taipei, China (the Asia-5)—the quality of infrastructure in developing Asia lags behind that of the industrial economies (Figure 2.4.1).

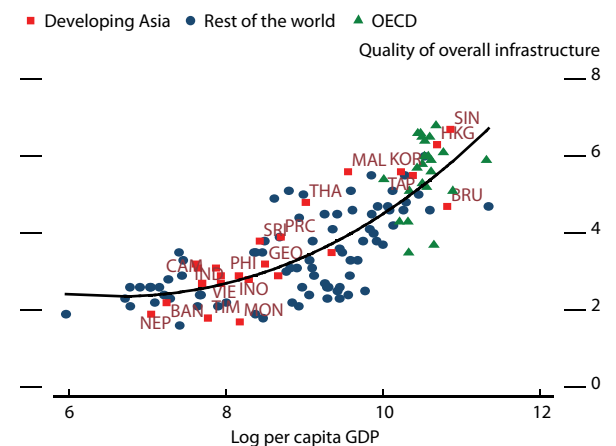
Aggregate measures of infrastructure stock are not systematically available. A survey conducted by the World Economic Forum (WEF 2009) of over 130 economies, however, suggests that, in general, the perceived quality of infrastructure stocks for 25 Asian economies considerably improved in the previous 4 years. In particular, significant upgrades in the quality of transport, telephony, and energy infrastructures were reported for Cambodia, Georgia, and Sri Lanka.

But the survey results also turned up certain issues of concern. For instance, some countries, such as Bangladesh and Mongolia, registered declines in overall infrastructure quality over reference period of the survey, even though, given these countries' low levels of infrastructure stocks, there should have been nowhere to go but up (Figure 2.4.2).

Another worrisome finding was that close to half of the surveyed economies reported a worsening in the quality of electricity supply since 2005. The situation appeared to be particularly severe in some South Asian economies including Bangladesh, Nepal, and Pakistan.

A closer look at different types of infrastructure capital over a longer period reveals a similar trend—growth that is robust but uneven across

2.4.1 Quality of overall infrastructure and GDP per capita, selected economies, 2008



Notes: For full form of acronyms, see Figure 2.3.4. Per capita GDP is based on purchasing-power-parity (PPP) in current international dollars. Quality of overall infrastructure refers to assessments of the quality of general infrastructure (e.g., transport, telephony, and energy) in an economy. 1 indicates extremely underdeveloped while 7 indicates extensive and efficient by international standards. Data cover 132 economies.

Source: ADB calculations based on data from World Economic Forum (2009) and International Monetary Fund, World Economic Outlook database (April 2010).

2.4.1 Impact of infrastructure stock on economic growth in developing Asia

The literature explores the infrastructure–growth nexus from both micro and macro perspectives. On the micro side, firm-level surveys on the investment climate provide indications of the extent to which infrastructure deficiencies constitute barriers to entrepreneurial development. For example, the World Bank's Enterprise Surveys suggest that a large proportion of respondents (between 20% in East Asia and the Pacific and 55% in the Middle East, North Africa, and Latin America) view the state of electricity, telecommunications, or transport networks as a major or severe obstacle to doing business (<http://www.enterprisesurveys.org/>).

In Asia, electricity supply is considered a major constraint by, for example, 78% of surveyed firms in Bangladesh, 76% in Nepal, 75% in Pakistan, 68% in Afghanistan, 61% in Timor-Leste, 44% in Samoa, 32% in India, and 30% in the People's Republic of China (PRC). For transport, high proportions of firms that find it a major problem are found in Nepal (33%), Afghanistan (30%), Samoa (29%), and Thailand (21%). These findings highlight the importance of both availability and quality of infrastructure in promoting economic growth.

On the macro side, the literature uses growth regressions, augmented by measures of infrastructure capital. Previous studies, however, provide mixed evidence—at least for East Asia. Using a panel dataset consisting of 16 East Asian economies with time periods grouped into 5-year intervals, Seethepalli, Bramati, and Veredas (2008) find a positive growth effect for all dimensions of infrastructure stocks (including telecommunications, electricity, roads, water and sanitation).

They also conclude that these significant effects vary with country-level characteristics. For example, telecommunications and sanitation are found to have a greater effect in economies with better governance, higher income levels, and low inequality in access to infrastructure.

In contrast, Straub, Vellutini, and Warlters (2008) obtain much weaker results, based on a sample of 93 developing or emerging economies, which include 16 East Asian economies. Although they find that the number

of phone lines has a positive effect on growth and obtain some evidence of an above average effect for East Asia and high-income economies, most of their results are not robust to the different estimation methodologies used in the study. Straub, Vellutini, and Warlters (2008) also perform a growth accounting exercise on five East Asian economies and find few significant results. Telecommunications investment contributes to total factor productivity (TFP) growth more than other types of capital in Indonesia and the Philippines, while roads have a positive influence on TFP growth only in Thailand.

Straub and Terada-Hagiwara (forthcoming) revisit the macro approach and extend the analysis in Straub, Vellutini, and Warlters (2008) by including more economies in the analysis and specifying interactions between infrastructure stocks and several subgroups of Asian economies.

This later sample covers the period 1971–2006 and consists of 102 developing or emerging economies, of which 16 (the PRC; Fiji Islands; Hong Kong, China; Indonesia; the Republic of Korea; the Lao PDR; Malaysia; Mongolia; Myanmar; Papua New Guinea; the Philippines; Singapore; Thailand; Tonga; Vanuatu; and Viet Nam) belong to the East Asian and Pacific subregions and five (Bhutan, India, Nepal, Pakistan, Sri Lanka) to the South Asian subregion.

Specifically, Straub and Terada-Hagiwara (forthcoming) explore the effects of physical infrastructure indicators for energy, telecommunications, transport, and water supply on the growth of per capita GDP, while controlling for standard growth regression explanatory variables, such as initial per capita GDP (to take account of the conditional convergence hypothesis) and education and investment variables. They find that each of the four sets of the infrastructure indicators is a positive correlate of per capita GDP growth for economies in East Asia and the Pacific and South Asia.

Their findings, therefore, highlight the need for further investment in infrastructure to promote growth in Asia.

Source

Straub and Terada-Hagiwara (forthcoming).

countries and subregions. Electricity-generating capacity in developing Asia grew by 4.4% annually (Figure 2.4.3) and more than doubled between 1990 and 2007. In particular, some lower-income countries, such as Cambodia, PRC, and Viet Nam, recorded robust expansions in generating capacity in the 2000s. But countries in Central Asia showed only marginal growth, if not contractions. Even for the Asia-5, capacity growth slowed by 2000, as the economies of these high performers matured.

Expansions in other infrastructure stocks, as in telecommunications or the number of internet connections, have also been significant. The proportion of internet users in the population more than tripled, from five users per 100 persons in 2000 to 17 users per 100 persons by 2008 (Figure 2.4.4). Growth in this area, however, is largely due to the Asia-5, and the current level lags far behind that of the Latin American economies, for example, where 28 out of every 100 people had access to the internet in 2008, a level comparable to the world average.

The share of paved roads (as a share of all roads) increased from less than half in 1990 to almost 71% by 2006 (Figure 2.4.5). But again the country estimates are quite dispersed. In Bangladesh, Cambodia, Mongolia, and Papua New Guinea, the roads are hardly paved; in Armenia; Hong Kong, China; Kazakhstan; and Singapore, almost all roads are.

The all-important question, however, is: Are these infrastructure developments sufficient to improve productivity? WEF (2009) finds that the inadequate supply of infrastructure is a problem for doing business in countries such as Bangladesh, Nepal, and Viet Nam. Despite recent improvements, the overall infrastructure quality in these economies remains limited, and it is unlikely that the low levels of infrastructure stocks are able to enhance productivity there.

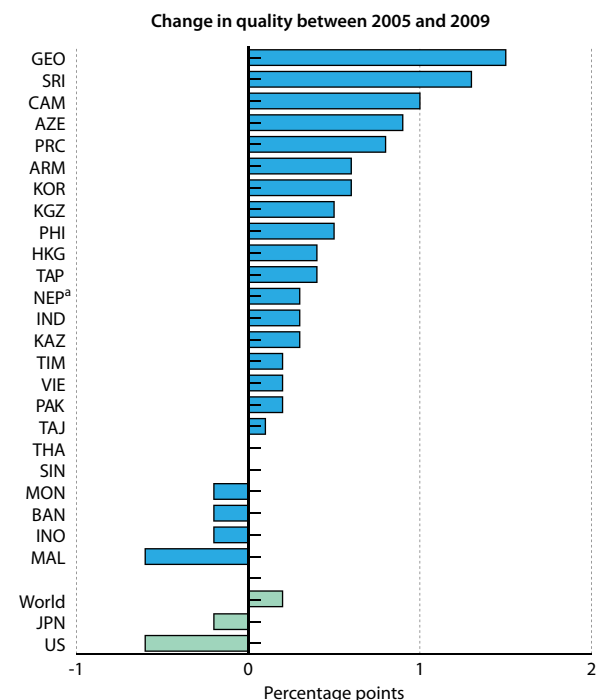
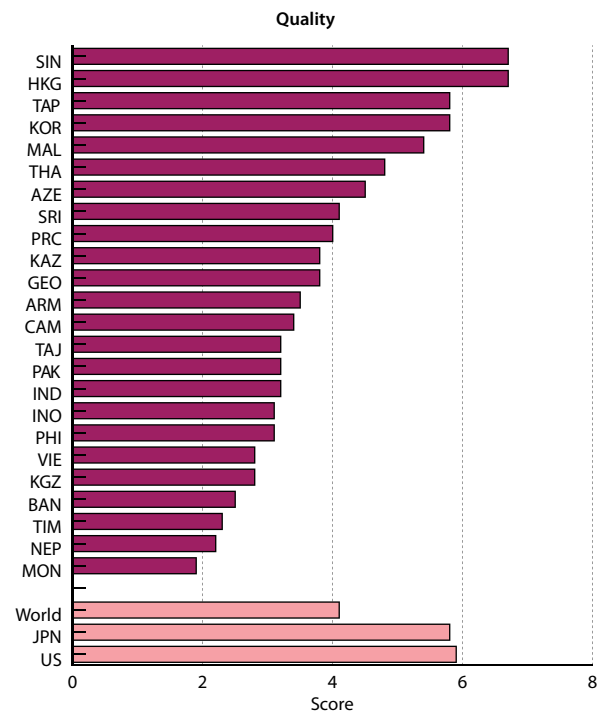
Rising infrastructure demand in cities

Except for Hong Kong, China; the Republic of Korea; and Singapore, where more than 80% of the population live in urban areas, the majority of people in developing Asia still reside in rural areas. The population share of a country's urban residents, however, tends to be highly correlated with its level of income (Bloom et al. 2008). As countries in developing Asia have been growing rapidly, the fraction of people living in urban areas has correspondingly risen significantly (Figure 2.4.6). The share of the urban population in developing Asia went from 17.5% in 1960 to 33.8% in 2000, and it is expected to be 51.7% in 2030.¹³

Urban areas provide markets for output, inputs, labor, and other services, and they allow firms to profit from economies of scale and scope, specialization, and rapid diffusion of knowledge and innovation. Moreover, there is strong evidence that workers in urban areas are individually more productive and earn more than rural workers.

Rapid urbanization, however, tends to be associated with overcrowding, environmental degradation, and other impediments to productivity. In order to keep cities in developing Asia competitive, investment in infrastructure will need to be designed to take account of these problems.

2.4.2 Quality of overall infrastructure, developing Asia



^a Between 2006 and 2009.

Note: For full form of acronyms, see Figure 2.3.4. For the definition of quality of overall infrastructure, see Figure 2.4.1.

Source: World Economic Forum (2005, 2006, 2009).

[Click here for figure data](#)

Needs of the rural poor

While developing Asia is rapidly urbanizing, the majority of people (62% or 2.3 billion in 2008) still live in rural areas. Moreover, poverty in developing Asia is overwhelmingly rural, and rural–urban disparities—in incomes and access to services—provoke political outcries, but also legitimate demands for inclusion in economic development.

In rural areas, poverty tends to be associated with poor access to infrastructure services. The generally poor condition of rural roads, for instance, restricts the mobility of entire communities both within and between towns. Lack of readily available and reliable supplies of potable water increases health risks as well as the time and travel costs of transporting such supplies.

A telling statistic is that, in 2006, 90% of the urban population in developing Asia had improved drinking water sources, while only 68% of the rural population enjoyed the same service. Moreover, the urban–rural gap was particularly significant in the Lao PDR, Mongolia, Papua New Guinea, and Vanuatu.

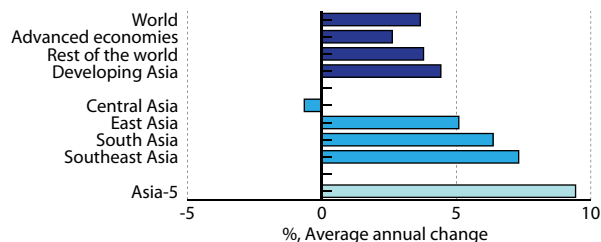
Institutional and financing requirements

Many parts of Asia—inland and remote areas, landlocked countries, distant islands—are isolated economically and geographically. Hence, connecting them through regional infrastructures, such as communication networks and trans-Asian transport systems (such as highways, railroad systems, sea and air links), can potentially bring enormous economic benefits. Studies of the economic impacts of such infrastructure, however, are rare, although a few do show that the benefits, which often pass through various channels, are large particularly in the long run; tend to be widely distributed; facilitative in nature; and often help the poor.

Of particular importance is the effect of regional connectivity on regional trade costs, income, and consumption. Warr, Menon, and Yusuf (2010) analyzed the regional economic impact of the Second Mekong International Bridge between Mukdahan Province in Thailand and Savannakhet Province in the Lao PDR. They showed that transport costs between the two countries fell, which in turn increased trade volumes and real consumption levels in both. Menon and Warr (2008), through a multi-household general equilibrium modeling approach, showed that rural road improvement in the Lao PDR also reduced poverty incidence.

But while regional infrastructure projects are expected to bring big economic and welfare gains in the long run, possible negative effects, such as traffic and other congestions, displacements of people, asymmetric distribution of costs and benefits, and environmental damage, have to be recognized. To mitigate these negative consequences and to make

2.4.3 Growth in electricity production, 1970-2007

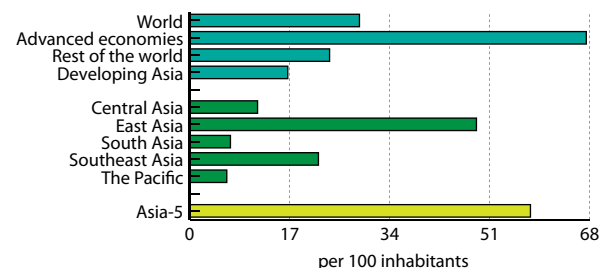


Note: Asia-5 comprises Hong Kong, China; Rep. of Korea; Malaysia; Singapore; and Taipei, China.

Source: ADB calculations based on data from World Bank. World Development Indicators online database (accessed 19 August 2010).

[Click here for figure data](#)

2.4.4 Internet usage, 2008

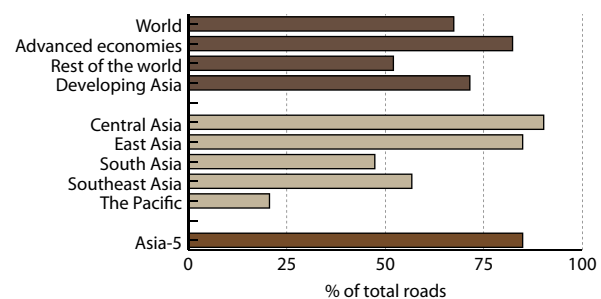


Note: Asia-5 comprises Hong Kong, China; Rep. of Korea; Malaysia; Singapore; and Taipei, China.

Source: ADB calculations based on data from World Bank. World Development Indicators online database (accessed 19 August 2010).

[Click here for figure data](#)

2.4.5 Paved roads, 2006



Notes: Asia-5 comprises Hong Kong, China; Rep. of Korea; Malaysia; Singapore; and Taipei, China. Data for the Pacific pertain to share in 2000. Paved roads are those surfaced with crushed stone and hydrocarbon binder or bituminized agents, with concrete, or with cobblestones, as a percentage of all the country's roads, measured in length.

Source: ADB calculations based on data from World Bank. World Development Indicators online database (accessed 19 August 2010).

[Click here for figure data](#)

2.4.2 Alternative financing for infrastructure investment: Making public–private partnerships work

Infrastructure investment tends to be large and lumpy, with long implementation periods and relatively low direct financial revenue (especially when the infrastructure is a public good). It also tends to be associated with sovereign risks that create uncertainties about future costs and revenue streams.

Given such characteristics, Brooks and Zhai (2008) and ADB and ADBI (2009) argue that the public sector has to play a dominant role in developing and funding infrastructure. Governments, however, may not have the fiscal capacity to fund infrastructure projects. Consequently, public–private partnerships (PPPs) and foreign direct investment may be needed to supplement the public spending.

Weaknesses in legal, regulatory, and institutional frameworks, however, can be stumbling blocks to broader private participation in infrastructure. Brooks and Zhai (2008), for instance, report that private sector involvement in the People’s Republic of China and India

is still in its nascent stage, and they argue that this may be because of institutional impediments.

Sanghi, Sundakov, and Hankinson (2007) identify common institutional problems, which they call “government failures”—poor procurement incentives, lack of coordination and skill in managing PPP programs, high transaction costs, and lack of information. They argue that establishing a PPP unit in the government may help to address these failures.

Designed to promote or improve PPPs, a PPP unit has to have a lasting mandate to manage multiple PPP transactions, often in multiple sectors. The unit has to be able to provide services that a government needs if it is to manage PPPs, offer value for money as measured against public provision of the service, and comply with general standards of good governance. International experience suggests that the unit needs to be strongly endorsed by its government and have the capability to identify government failures and correct them.

infrastructures more environmentally friendly, infrastructure projects need to have well-designed plans. Moreover, an institutional framework is needed to foster better coordination and cooperation among as well as strong commitments from development partners.

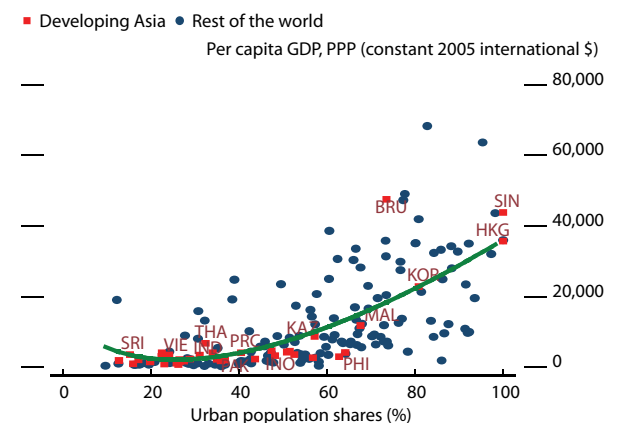
Considering these factors and given the current level of infrastructure stock, developing Asia’s overall national infrastructure investment needs between 2010 and 2020 may amount to \$8 trillion for both new capacity and maintaining and replacing existing infrastructure (ADB and ADBI 2009). The needs vary across economies, yet they are well beyond the financing capacity of many governments in the region, and hence often require facilitating arrangements (Box 2.4.2).

Summary

Infrastructure stocks in developing Asia have been increasing at a significant pace. Their levels, however, remain well below world averages in terms of both quality and quantity. Since recent empirical evidence suggests that infrastructure stocks have positive impacts on economic growth, massive investment is needed to promote economic growth, but these may well be beyond the financing capacities of many governments. Facilitating arrangements with donor organizations may therefore be required.

The provision of infrastructure services is failing to keep up with the challenges posed by rapid urbanization. To keep cities in developing Asia competitive, investment in infrastructure has to be designed to take account of congestion, environmental degradation,

2.4.6 Urbanization and income per capita, selected economies, 2005



Notes: For full form of acronyms, see Figure 2.3.4. Data cover 181 economies. Source: World Bank. World Development Indicators online database (accessed 19 August 2010).

and other impediments to productivity that are associated with urban agglomeration.

Urban–rural disparities in infrastructure services detract from the inclusiveness of growth. Improving access to basic infrastructure services, such as the provision of potable water and sanitation, in rural areas is crucial for poverty reduction. Though physical infrastructure may be low, the recent global financial crisis suggests that developing Asia is somewhat better placed in terms of its financial infrastructure.

Financial development and economic growth

Importance of financial development

Financial systems in developing Asia remain far below industrial-country standards and lag substantially behind its dynamic real sectors, in particular manufacturing, which is world class in many parts. This explains why much of the region's huge pool of saving is intermediated by more advanced financial systems outside the region. Crucial for developing Asia's future growth, however, will be to allocate those savings to their most efficient and productivity-improving uses in the region. Thus, for developing Asia, financial development means the establishment of sounder and more efficient banks, equity markets, and bond markets.

As the global financial crisis highlighted, financial innovation that runs ahead of regulation can generate instability both for the financial system itself and the real economy. Serendipitously, the relative lack of financial sophistication of banks in developing Asia limited their exposure to subprime assets and protected them from the worst aspects of the global financial crisis.

But then, as the Asian crisis underscored, financial underdevelopment can have large costs as well. That crisis was ultimately the consequence of a gradual deterioration in the quality of investment which, in turn, resulted from large capital inflows into underdeveloped financial systems that could not allocate them efficiently. For a region that had grown rapidly on the back of high investment rates, the Asian crisis served as a reminder that the quality of investment matters.

Developing Asia has made significant strides in building more robust and efficient financial systems as a result of extensive post-Asian crisis reform and restructuring. In particular, the health and performance of Asia's commercial banks, which continue to play a dominant role in Asian financial systems, have improved markedly. This is reflected in their lower incidence of nonperforming loans, higher capital-adequacy ratios, and more competitive rates of return compared to precrisis levels.

Asian banks have also moved into new business areas such as investment banking, consumer lending, and real estate, in addition to providing a wider range of new financial products and services. Furthermore, prudential supervision and regulation have been strengthened and are more forward looking and risk based.

Equity markets have also rapidly developed, as have bond markets though to a less significant extent. A more diverse financial system is more robust and resilient to adverse shocks. Equally important, vibrant capital markets are the primary source of long-term capital for financing long-term investment needs.

The fundamental reason that sound financial systems, which efficiently channel capital to its most productive uses, are pivotal to

sustaining growth beyond the recent crisis is this: developing Asia needs healthy investment for strong future growth. In the past, when the region was a low-income, capital-scarce region, the primary contribution of the financial system to economic growth was to mobilize large pools of saving to augment investment and capital stocks.

But rapid growth is transforming developing Asia into an increasingly middle-income, capital-abundant region. As noted earlier, this implies that productivity improvements are becoming increasingly important for growth. As such, the primary role of the financial system in the region's growth will evolve from mobilizing saving and boosting the quantity of investment to fostering productivity growth by enhancing the efficiency of investment.

Such a role requires deeper, broader, and more liquid financial systems, which move the region closer toward the frontier of global finance. Financial development can promote not only static efficiency, which leads to a more efficient allocation of resources, but also dynamic efficiency. By facilitating entry of new producers into the market, improved financial access stimulates a competitive environment which is conducive for productivity growth. In particular, expanding financial access to SMEs and would-be entrepreneurs is vital for dynamic efficiency in which new products, services, and industries bring about structural change and deliver large welfare gains over time.

Nevertheless, the trajectory of financial development will inevitably be country-specific, given the heterogeneity of development levels within the region. While some elements of a robust and efficient financial system, such as sound prudential regulation and supervision, are relevant for all countries, other elements, such as well-functioning corporate bond markets, are more relevant for the more developed countries.

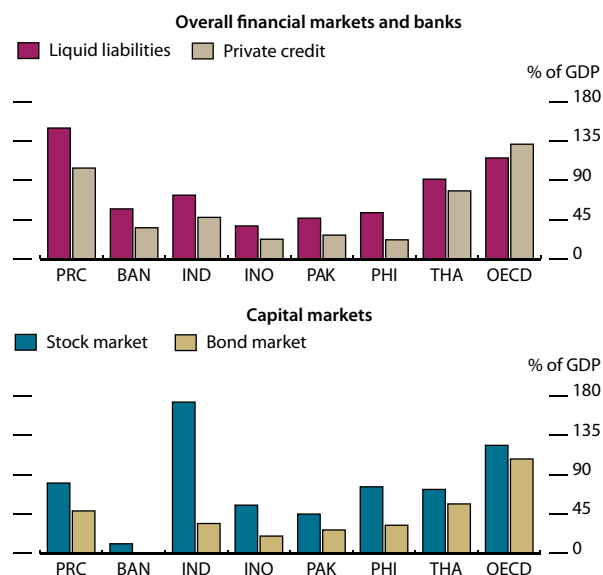
Growth from financial development?

At a broad level, the literature on the relationship between financial development and growth explores two channels of impact. The first is the *depth* of the financial system, as measured by indicators such as the ratio of total liquid liabilities to GDP, the ratio of bank credit to GDP, or the ratio of stock market capitalization to GDP. The second is the *structure* of the financial system, as measured by indicators such as the ratio of bank credit to stock market capitalization.

According to a comprehensive review of the empirical literature by Demirgüç-Kunt and Levine (2008), on balance the empirical evidence indicates that financial depth has a significant positive effect on growth whereas the financial structure does not have any appreciable effect on growth. They also find that countries with capital-market-based financial systems do not perform better than those with bank-based systems (refuting the claim that a shift from banks to capital markets is evidence of financial development).

The dominant strand of the empirical literature on the finance–growth nexus, pioneered by King and Levine (1993), seeks to explain

2.5.1 Financial depth, selected Asian and OECD countries, 2008



PRC = People's Rep. of China; BAN = Bangladesh; IND = India; INO = Indonesia; PAK = Pakistan; PHI = Philippines; THA = Thailand; OECD = Organisation for Economic Co-operation and Development.

Notes: Data on stock market and bond market refer to total market capitalization. OECD comprises high-income OECD countries but excludes Rep. of Korea, Poland, and Slovenia.

Sources: ADB calculations; Beck, Demirgüç-Kunt, and Levine (2010); CEIC Data Company (accessed 30 June 2010).

[Click here for figure data](#)

economic growth in a cross-section of countries with financial depth indicators and standard nonfinancial determinants of growth, such as initial income level and education. This strand involves growth regressions that use either cross-country data for a single time period or panel data that looks across countries and multiple time periods.

Using data for 77 countries over the period 1960–1989, King and Levine find a statistically significant positive relationship between financial depth, measured by liquid liabilities of the financial system, and three measures of growth—real per capita GDP growth, real per capita capital stock growth, and total productivity growth. Levine and Zervos (1998) find that both bank development and stock market activity have a positive effect on growth. Using panel econometric techniques to address potential biases, Levine, Loayza, and Beck (2000) and Beck and Levine (2004) re-confirm a significant and positive effect of finance on growth.

Regardless of the econometric techniques and dataset employed, the balance of evidence indicates a positive relationship between finance and growth, with a caveat on the inadequacy of the traditional indicators (such as the ratio of bank credit to GDP) of financial depth. These indicators are at best highly imperfect measures of how well the financial system performs the five specific growth-promoting core functions mentioned above.

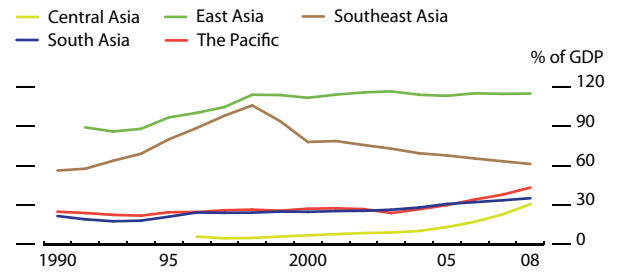
State of Asia’s financial development

As said, developing Asia’s financial systems substantially lag behind its dynamic real economies, despite much progress in recent years. As shown in Figure 2.5.1, it also remains financially underdeveloped relative to the industrial economies. The figure compares financial development—as measured by total liquid liabilities, bank credit, stock market capitalization, and bond market capitalization—of some major developing Asian countries with that of high-income OECD countries.

In particular, the region’s bond markets are the least developed. Only recently have they expanded rapidly, and this rise stems from official measures to develop local currency bond markets, including regional efforts such as the Asian Bond Markets Initiatives and the Asian Bond Funds.¹⁴

An increase in financial depth (the size of the financial system relative to GDP) is usually viewed as evidence of financial development. Financial breadth measures the relative importance of banks relative to capital markets—that is, equity and bond markets. A rising relative importance of capital markets would indicate that the financial system is becoming less dependent on banks and more diversified. Indicators for both depth and breadth are available for a large number of countries across several years in the Financial Development and Structure Database of Beck, Demirgüç-Kunt, and Levine (2010).

2.5.2 Private credit

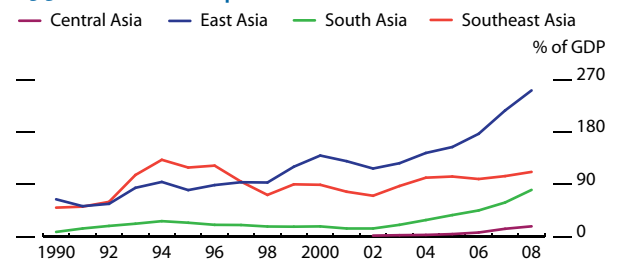


Notes: Central Asia consists of Armenia, Georgia, Kazakhstan, and Kyrgyz Republic. East Asia covers People’s Rep. of China; Hong Kong, China; Rep. of Korea; and Taipei, China. Southeast Asia is made up of Indonesia, Malaysia, Philippines, Singapore, and Thailand. South Asia is composed of India, Pakistan, and Sri Lanka. The Pacific comprises Fiji Islands, Papua New Guinea, Samoa, Solomon Islands, and Tonga.

Source: ADB calculations based on data from Beck, Demirgüç-Kunt, and Levine (2010) and CEIC Data Company (accessed 30 June 2010).

[Click here for figure data](#)

2.5.3 Stock market capitalization

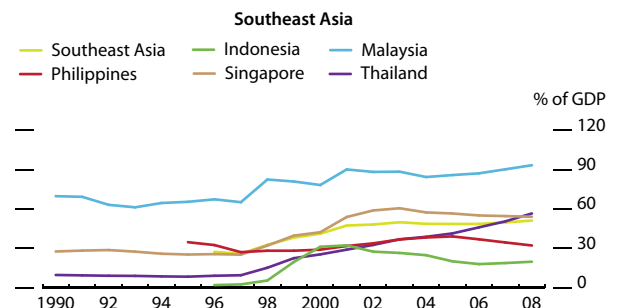
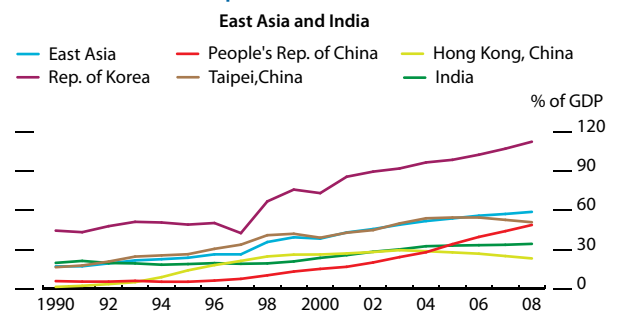


Note: See Figure 2.5.2.

Source: See Figure 2.5.2.

[Click here for figure data](#)

2.5.4 Bond market capitalization



Source: See Figure 2.5.1.

[Click here for figure data](#)

Figures 2.5.2, 2.5.3, and 2.5.4 (above) clearly show that developing Asia's aggregate financial depth in the region has increased since the 1990s. This deepening has been driven primarily by the expansion of capital markets, in particular equity markets. In contrast to the fast-growing capital markets, bank credit has remained subdued since the Asian crisis and this probably reflects, at least to some extent, a correction of precrisis excesses.

Alongside a deepening of its financial markets, the region has witnessed changes in its financial structure, as seen in the strengthening of capital markets relative to bank credit. Figure 2.5.5 indicates that, since the Asian crisis, the ratio of the total capital market to bank credit has increased for most countries in East Asia and Southeast Asia, as well as in India. While both equity and bond markets have improved across countries in the region, it is the growing equity markets that have largely contributed to the rising importance of capital markets relative to bank credit. Overall, therefore, the region appears to be moving toward a more broad-based financial system.

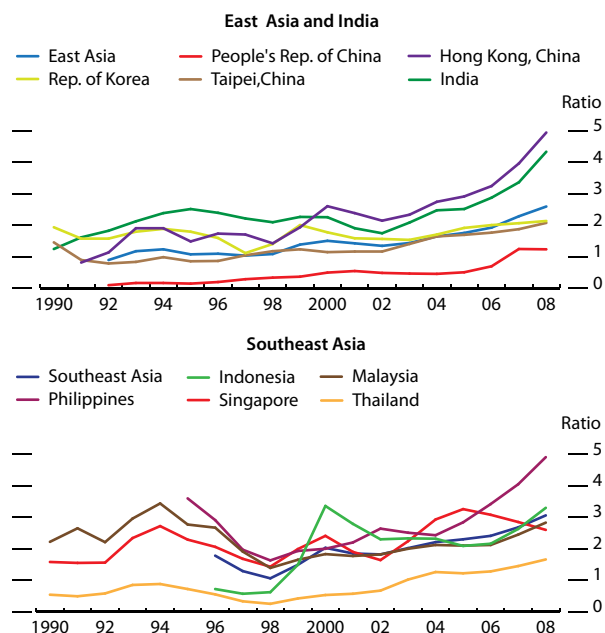
Beyond the issue of the establishment of a wider variety of financial institutions, is the question of access to those services. Broad access to financial services is important for at least two reasons. First, it may help to reduce poverty, since credit constraints prevent the poor or those with no collateral from engaging in profitable businesses. Second, it facilitates the entry of new and innovative firms that may be capital constrained, thereby fostering the creation and adoption of new technology (Beck, Demirgüç-Kunt, and Peria 2007).

Figure 2.5.6 shows that financial access, as measured by bank branches and automated teller machines per 100,000 people, varies widely across selected developing Asian countries. Overall, financial access in these countries lags behind high-income OECD countries. According to the World Bank's Enterprise Surveys, SMEs find access to financing more difficult compared to large firms in Indonesia, the Republic of Korea, Malaysia, Philippines, Thailand, and Viet Nam (World Bank 2008). Across countries, survey data also indicate that less than 20% of small firms surveyed use external finance, about half the rate of large firms (World Bank 2008).

Empirical analysis of the finance–growth relationship

Estrada, Park, and Ramayandi (forthcoming) explore the relationship between financial development, on the one hand, and economic growth and productivity improvements, on the other. They use a panel dataset that covers 116 economies, including 22 developing Asian economies, and has four nonoverlapping 5-year periods from 1987 to 2008. The study uses three indicators of financial development: total liquid liabilities relative to GDP, which measures the relative size of

2.5.5 Ratio of capital markets to private credit

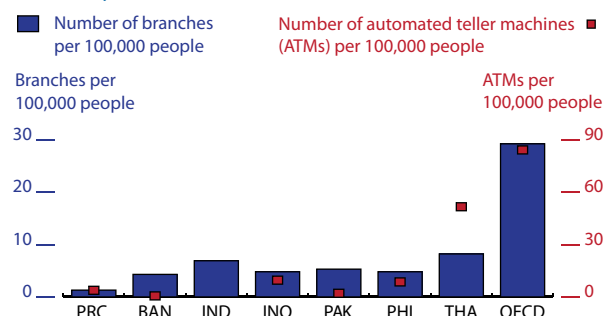


Note: Capital markets refer to the sum of stock market capitalization and bond market capitalization.

Source: See Figure 2.5.1.

[Click here for figure data](#)

2.5.6 Access to banking services, selected Asian and OECD countries, 2008



PRC = People's Rep. of China; BAN = Bangladesh; IND = India; INO = Indonesia; PAK = Pakistan; PHI = Philippines; THA = Thailand; OECD = Organisation for Economic Co-operation and Development.

Notes: Data for the PRC are based on Beck, Demirgüç-Kun, and Peria (2007). OECD comprises high-income OECD countries but excludes Rep. of Korea, Poland, and Slovenia.

Source: ADB estimates based on data from Beck, Demirgüç-Kun, and Peria (2007); International Monetary Fund. Financial Access online database. <http://www.imf.org>; and World Bank. World Development Indicators online database (both online databases accessed 31 August 2010).

[Click here for figure data](#)

overall financial depth; private credit by deposit money banks relative to GDP, which isolates the impact of the banking sector; and stock market capitalization relative to GDP, which gauges the relative size of the equity market in the economy.

In addition, some regression specifications used an indicator of financial openness, namely capital inflows relative to GDP, which measure the relative size of the total direct investment and portfolio investment in an economy. Following previous studies in this area, Estrada, Park, and Ramayandi also control for initial income, years of schooling, trade openness, inflation, government consumption, and the quality of governance.

Table 2.5.1 presents the results of baseline per capita GDP growth regressions in the study. All three financial-development indicators are found to have positive and significant effects on per capita GDP growth. Moreover, the estimates are robust across different specifications. Interestingly, liquid liabilities interacted with a developing Asia dummy variable turns out to be statistically significant. This implies that overall financial development has a bigger impact on growth in developing Asia than elsewhere.

In contrast to the foregoing results, the study finds no evidence that financial depth affects TFP growth. This suggests that the primary contribution of financial development is through mobilizing saving for investment rather than through fostering efficiency and innovation. In light of the fact that growth for the developing countries used in the estimates—which make up the majority of the sample—would have been driven mainly by factor accumulation, this result is plausible. An important caveat to this interpretation, though, is that the traditional indicators of financial depth used in the estimates may not adequately capture the mechanisms by which financial systems improve productivity—by, for example, addressing information asymmetry and reducing transaction costs.

As mentioned, some regression specifications in the study by Estrada, Park, and Ramayandi include an indicator of financial openness. While financial openness and financial development are separate concepts, financial openness may influence financial development. For example, the entry of world-class foreign banks forces domestic banks to become more competitive. On the downside, short-term capital inflows are a

2.5.1 Income and financial indicator regressions, 1987–2008

Dependent variable (real per capita GDP growth)	Financial indicator		
	Total liquid liabilities	Bank credit	Stock market capitalization
Financial indicator, % of GDP	2.036 <i>0.84**</i>	1.586 <i>0.66**</i>	1.233 <i>0.358***</i>
Financial indicator x developing Asia dummy	3.139 <i>1.413**</i>	0.893 <i>1.017</i>	-0.341 <i>0.372</i>
Observations	385	385	287
Number of countries	116	116	92
Adjusted R-squared	0.43	0.423	0.404

Robust standard errors in italics. *** significant at 1%; ** significant at 5%.

Note: Refer to Estrada, Park, and Ramayandi (forthcoming) for the full regression results, including results for the nonfinancial control variables.

Source: Estrada, Park, and Ramayandi (forthcoming).

major source of potential instability in the financial markets. For the real economy, foreign investment brings in new technology and skills, and forces domestic firms and industries to become more efficient.

Financial openness, according to the study, has a positive and significant effect on both per capita GDP growth and TFP growth. This may be because foreign investment, especially FDI, often brings in new technology and management techniques that boost the host economy's productivity and efficiency.

Notably, the inclusion of financial openness does not alter the basic thrust of the results for financial development, as the coefficient estimates for the financial development indicators are positive and significant for per capita GDP growth, but not for TFP growth. Therefore, the evidence indicates that both financial development and financial openness are beneficial for economic growth.

Summary

Developing Asia's financial systems have become more robust and efficient since the Asian crisis. That crisis exposed the high costs of financial underdevelopment. Commercial banks, which are still the backbone of the region's financial systems, strengthened their balance sheets and improved their performance. Furthermore, the rapid growth of capital markets—equity markets in particular—has created a more broad-based financial system.

But the region's financial systems still lag behind their counterparts in industrial economies and their own dynamic real economies. This matters because financial development has a positive effect on economic growth. More specifically, what matters for growth is the overall depth of financial development rather than the structure of the financial system.

Consequently, policy makers should prioritize their efforts on deepening the financial system as a whole, instead of achieving better balance between its different components. Therefore, the most effective institutions and policies for promoting financial development are those that have a positive influence on both banks and capital markets.

One highly influential and beneficial policy reform in developing Asia's financial sector in the post-Asian crisis period is that prudential regulation and supervision procedures have been significantly strengthened and have become more forward looking and risk based. They have also become more flexible. As a result, the region's banks and financial institutions have become better at managing risk.

A critical issue facing developing Asia's authorities overseeing these procedures in the wake of the global financial crisis is the extent to which they ought to allow the entry of new financial products, services, and technologies—essentially, the speed and scope of financial innovation. It is not financial innovation itself but rather the complete failure of prudential regulators to identify and control the risks stemming from innovation, along with their failure to provide incentives for financial institutions to exercise proper risk management, which triggered the global crisis. Therefore, regulatory authorities should continue to strengthen their capacity to effectively monitor innovation and keep ahead of innovation.

Key policy messages

Developing Asia has recovered from the global crisis. As the crisis recedes, medium- and long-run growth will reassert itself as the region's priority concern. Short-term aggregate demand management will give way to structural policies that augment the economy's productive capacity.

It is thus a good time to take stock of developing Asia's growth prospects further out and to reconsider its pathways to growth. Policies that were effective in earlier years' low-income, capital-scarce Asia are likely to be less effective in today's increasingly middle-income, capital-abundant region. Developing Asia's transformation is changing the relative importance of the ingredients of its past success.

In particular, productivity growth will play a bigger role as a driver of economic growth. Structural policies that promote productivity growth therefore hold the key to sustaining the region's growth that, in turn, will reduce the numbers of the poor and spread the benefits of economic progress to more people.

Four specific areas—trade, human capital, infrastructure, and financial development—are significant in this respect.

Although the four areas were examined separately, much interdependence exists between them, and progress in one area will facilitate improvements in another. For example, a major impediment to trade in many parts of the region is inadequate transport infrastructure. Improvements in this area, both domestic and regional, can stimulate and catalyze intraregional trade and trade in general.

Similarly, financial development, especially the development of bond markets, which provide a stable and secure source of long-term financing, will have a positive impact in addressing the region's need for transport, communications, and energy infrastructure.

Financial development can also promote the accumulation of human capital by channeling resources to individuals who want to invest in their own education. Progress in the four areas will thus be mutually reinforcing and jointly push out developing Asia's production frontier.

The regionwide analysis of developing Asia's growth drivers paints a broad picture of the future pattern for the region as a whole as well as of the kinds of policies that will promote future growth. However, developing Asia is composed of countries at different development stages and with diverse structural characteristics and endowments. Therefore, the specific constraints to growth and the specific policy options for overcoming those constraints will necessarily differ.

With respect to investment, for example, the growing primacy of efficiency over quantity is more relevant for the more developed countries. In contrast, countries such as the Philippines and Viet Nam need to boost investment levels and build their capital stocks. As for the two Asian giants, an important distinction is that the PRC's infrastructure is relatively well developed, whereas India's is a major constraint to its sustained growth.

Regional cooperation and integration have been progressing in

developing Asia, especially among East Asian and Southeast Asian countries, but the global crisis has added a sense of urgency to the process. What is especially important in this context is intraregional trade, which can complement domestic demand as an additional source of dynamism in the postcrisis world. While tariffs and nontariff barriers to trade have come down sharply across the region as a result of liberalization, obstacles to trade at the border and behind the border still impede the flow of goods among the region's countries.

Steps that take the region toward a truly single market will foster competition and generate dynamic efficiency gains. Regional integration will not only benefit the region's goods markets, but its financial markets as well. In particular, greater integration of the region's bond markets can help to make them broader, deeper, and more liquid. Regional cooperation is required for building regional infrastructure, such as cross-border roads or railways, which promotes regional connectivity.

Finally, good governance and institutions matter for growth. In particular, government effectiveness and control of corruption have significant positive impacts. In addition, governance has a bigger effect in developing countries where the government tends to play a larger role in the allocation of resources. Competent and honest governments that efficiently deliver basic public services, such as administration, education, and health care, raise the productivity of all firms and industries.

Such governments are also more conducive for political stability and a more benign investment climate. Increasingly, an important dimension of strong governance and institutions will be the capacity to deliver inclusive growth which spreads the fruits of growth to the wider population. As conditional cash transfers show, well-designed inclusiveness-promoting programs can make a big dent on poverty at manageable fiscal cost. By promoting social stability, such programs can foster a more conducive environment for growth.

What follows are the specific policy messages that arise from the four sectors: trade, human capital, infrastructure, and financial development.

Trade

- To boost their growth prospects through international trade, countries in developing Asia need to pursue different strategies depending on their current circumstances. For those in East Asia and Southeast Asia, the key challenge is to adjust production and trade networks to take greater advantage of domestic consumption and to expand the volume and scope of intraregional trade (while continuing to exploit the gains from trade openness and integration with global markets). For South Asian countries, the top priorities are to reduce excessively high trade costs and to integrate more closely with the rest of developing Asia. For the vulnerable economies, the need is to expand the base of domestic production and diversify exports, so as to stabilize and then raise incomes.
- *ADO 2009* and *ADO 2009 Update* (ADB 2009a and b) made a case for developing Asia to explore producing more for domestic and regional markets (not only because of the prospect of an extended period of reduced demand from the rest of the world, but also to diversify the sources of demand). This proposal, however, may need

to be complemented by industry and investment strategies that reorient production toward meeting this demand-side restructuring. In particular, East Asian and Southeast Asian economies may need to shift from vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final goods.

- Trade facilitation and regional integration are crucial to speed up South Asia's participation in regional production networks and further secure its market as the second large dynamic source of regional demand. In this enterprise, India stands out both as a possible magnet for exports from neighboring countries and as a subregional springboard for pan-Asian integration—the former because of its market size and the latter because of its closer trade ties with the rest of Asia. ASEAN, in turn, stands to benefit from its potential to act as a bridge between East Asia and South Asia.
- Developing Asia's weaker economies are incapable of reaping the full benefits from international trade. Many are primary-commodity exporters or tourism-dependent small-island nations that produce only a limited range of goods and whose export earnings are subject to price fluctuations in the global markets. Those that have broken into basic manufacturing find it difficult to move up the value chain and integrate with the region's production networks. For these vulnerable countries, aid for trade as a special conduit for donor support has a crucial role to play.

Human capital

- There are many pathways by which human capital affects economic growth. Thus, investment in human capital will be crucial for sustaining developing Asia's future growth prospects. While the region has made significant progress in educational outcomes, its average, however, still falls below that of the industrial economies and masks considerable variation across both countries and subregions. Moreover, projections suggest that, at current growth rates, average educational attainments in developing Asia will take decades to come abreast of the current average of the rich countries. Developing Asia therefore needs to invest more in human capital.
- Simply expanding human capital (i.e., raising average educational outcomes), however, may not automatically translate into higher rates of economic growth. For such investments to be effective, the education reform agenda will need to take account of how the educational system is able to produce the type and quality of skills required by the labor market.
- A threshold level of human capital may be a precondition for economic growth. The evidence suggests that a country with a large technology gap grows faster when it has better human resources because human capital facilitates technology diffusion. Poor economies will need to invest more in literacy and basic education programs to enhance their technology absorptive capacities.
- In contrast, middle- and high-income economies will increasingly rely on innovation and technology creation as the driver of long-term growth (as these economies approach the technological frontier). As this happens, the accessibility and quality of tertiary education will become an important factor in economic growth.

Infrastructure

- Overall, infrastructure stocks in developing Asia have been growing at a significant pace. Their levels, though, remain well below corresponding world averages in terms of both quantity and quality. As infrastructure-stock accumulation has a positive impact on economic growth, a massive buildup of these stocks is needed, but may well be beyond the financing capacities of many governments, which will require facilitating arrangements.
- Demand for infrastructure services is expected to soar in cities due to rapid urbanization. In order to keep cities in developing Asia competitive, investment in infrastructure needs to be designed to take account of congestion, environmental degradation, and other impediments to productivity that are associated with urban agglomeration.
- The urban–rural divide in access to infrastructure services detracts from the inclusiveness of growth in developing Asia. Improving access to basic infrastructure services in rural areas is crucial for poverty reduction.

Financial development

- As developing Asia gradually shifts from a growth regime that is spurred largely by factor accumulation to one that has a greater role for productivity improvements, its financial systems will have to evolve from a mode that primarily mobilizes saving and boosts the quantity of investment to one that enhances the efficiency of investment. In this new role, financial systems will need to be deeper, broader, and more liquid. This will require them to furnish timely and accurate information, facilitate the effective exercise of corporate governance, and provide adequate risk management. Accordingly, the region will need to strengthen the requisite institutional infrastructures, along two axes: effective legal and regulatory frameworks; and high-quality accounting and auditing standards and practices.
- As the global financial crisis demonstrated, financial stability is crucial for sustaining medium- and long-run growth. To safeguard the health of financial institutions and ensure the smooth functioning of financial markets, developing Asia's governments need to further strengthen their prudential regulatory and supervision frameworks. In addition, they should undertake initiatives that further diversify the structure of their financial systems. One way to do this is to accelerate the development of the region's bond markets.
- A key policy in promoting financial development in the region is to make financial services more accessible to small and medium-sized enterprises and households. Lack of access to finance can be a serious barrier to investment and business activity. Entrepreneurship—essential to a vibrant private sector that constantly renews itself and creates new firms, jobs, and industries—needs finance as its indispensable lubricant. Moreover, extending the reach of finance promotes equality of opportunity that fosters inclusive growth and reduces poverty.

Endnotes

- 1 For information on LPI, see <http://info.worldbank.org/etools/tradesurvey/modelb.asp>
- 2 South Asia's applied MFN tariff was 11.9%, East Asia's 3.1%.
- 3 The difference between India and the rest of South Asia is even starker than the figures of Table 2.2.1 suggest, because the subregion's performance is bolstered by the better than average record of the dominant country, India.
- 4 This section draws heavily on Akyüz (2010).
- 5 As an aside, significant restructuring and consolidation along these lines will restrict the growth of exports and incomes of the intermediate-goods-supplying countries, regardless of the state of domestic consumption in the PRC.
- 6 The prospects from merely reshuffling existing production capacity are limited, since skills, capital equipment, and organizational structures are often industry-specific and even product-specific.
- 7 See Athukorala 2008; Kim, Lee, and Park 2009; and ADB 2009a.
- 8 This section draws on Francois, Rana, and Wignaraja (2009). Additional comments from Ganesh Wignaraja, Office of Regional Economic Integration, ADB, are acknowledged.
- 9 South Asian Association for Regional Cooperation (SAARC).
- 10 This section draws on ADB (2007) and ADB (2009c).
- 11 ADB calculations based on data from Barro and Lee (2010).
- 12 See Morrison and Schwartz (1996) in the context of US states.
- 13 Estimated using data from the Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2006 Revision and World Urbanization Prospects: The 2007 Revision*, <http://esa.un.org/unup> (accessed 14 September 2010).
- 14 The Asian Bond Market Initiative (ABMI) and Asian Bond Funds (ABF I and II) are parallel initiatives to promote bond market development in East Asia. ABMI was endorsed by ASEAN+3 finance ministers in August 2003. ABF I was launched in the same year, and ABF II in the following year by the Executives' Meeting of East Asia and Pacific Central Banks.

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3

Economic trends and prospects in developing Asia

Subregional summaries

Central Asia

East Asia

South Asia

Southeast Asia

The Pacific

Bangladesh

People's Republic of China

India

Indonesia

Malaysia

Pakistan

Philippines

Thailand

Viet Nam

Economic trends and prospects in developing Asia

Subregional summaries

Central Asia

Subregional assessment and prospects

The *Update* revises upward the gross domestic product (GDP) growth projections included in April's *Asian Development Outlook 2010* (ADO 2010) for four countries (Armenia, Georgia, Kazakhstan, and Tajikistan) of the eight in Central Asia. These four countries benefited from the recovery of the global economy through buoyant metal prices and the rebound of exports. Kazakhstan additionally benefited by stronger oil prices while the other three gained from a marked recovery in workers' remittance inflows.

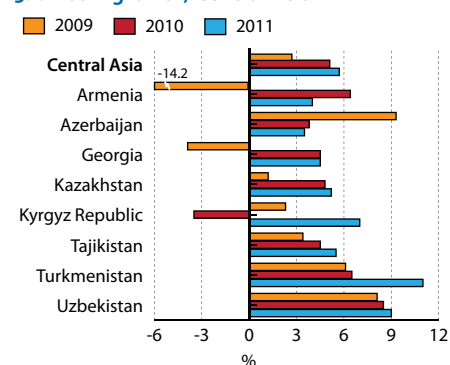
The *Update* maintains the GDP forecasts for Turkmenistan and Uzbekistan, while revising downward projections for Azerbaijan and the Kyrgyz Republic. Growth in Azerbaijan's oil production has slowed, and the Kyrgyz economy suffered from political unrest.

On balance, these developments contributed to a higher GDP growth forecast in 2010 for the subregion to 5.1% from 4.7% (Figure 3.1.1). In 2011, the GDP growth forecast for Central Asia is 5.7%, little changed from 5.9% expansion estimated in *ADO 2010*.

Economic indicators in the first half of 2010 signal that all economies that suffered from low growth in 2009 (except the Kyrgyz Republic) are experiencing higher growth following the recovery of the global economy. Exports have picked up in all countries. Particularly, buoyant gas and oil prices greatly benefit the four hydrocarbon exporters (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan).

In Armenia, Georgia, and Tajikistan, prices for their major exporting commodities, especially metals, increased, which helped to narrow their current account deficits. In the Kyrgyz Republic, the

3.1.1 GDP growth, Central Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

positive economic outlook of early 2010 was soured by widespread political instability and civil unrest in April and June. Largely as a result, that economy is now projected to contract by 3.5% in 2010. All these four countries (which are nonhydrocarbon exporters) are undertaking economic adjustment programs supported by International Monetary Fund (IMF) credit facilities.

The Russian Federation has been on a recovery path since the second half of 2009. Reflecting its extensive economic relations with Central Asia, trade, investment, and workers' remittances from that country to the subregion came back strongly. According to data from the central bank of the Russian Federation, aggregate remittances to the eight countries increased on an annual basis by about 16% during the first half of 2010. The increase in remittances was a main factor stimulating domestic consumer demand in recipient countries.

Until the global recession started, remittances were a leading factor boosting growth for Armenia, the Kyrgyz Republic, and Tajikistan for years. These economies were severely affected by the decline in remittances during the global recession. Armenia saw a sudden drop, which halted many construction projects. In the Kyrgyz Republic, though, in the first half of 2010, recovery of remittances boosted private demand and moderated the current account deficit. In Tajikistan, anecdotal evidence indicates that about half the labor force is working abroad, and one-third of them in the Russian Federation.

In Azerbaijan, the rapid expansion of oil production has been the main source of high growth. Since oil production is approaching a plateau, expansion in the non-oil sector will now largely dictate the pace of overall GDP growth.

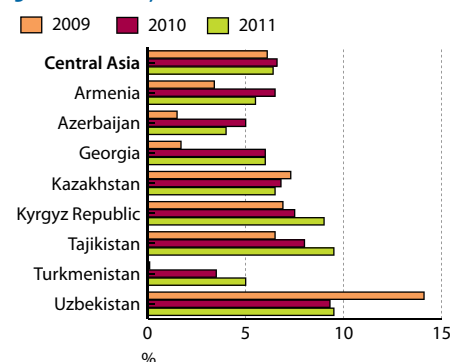
Due to the slow recovery of domestic demand, inflation in most countries will generally remain subdued in 2010–2011, and well below the double-digit levels experienced during earlier years of very rapid growth. In Armenia, inflation increased between the last quarter of 2009 and the first quarter of 2010 due to higher international commodity prices, pass-through effects from depreciation in early 2009, and the recovery of remittance-driven consumer demand. These factors have prompted an upward revision in the inflation forecast.

In Uzbekistan, the rapid growth of bank credit as well as pass-through effects from continuing local currency nominal depreciation induced inflation pressures and higher inflation is now forecast for 2011. Slower growth in Azerbaijan and the Kyrgyz Republic are mitigating price pressures and projected inflation.

Subregionally, the *Update* slightly reduces the inflation projections of *ADO 2010* from 6.7% to 6.6% in 2010 and from 6.6% to 6.4% in 2011 (Figure 3.1.2).

While energy exporters are exhibiting strong current account surpluses, energy importers will see pressures on their current account deficits. Exports from the four hydrocarbon-exporting countries grew fast between end-2009 and the first half of 2010 due to higher oil and gas prices and buoyant demand. Projections of current account surpluses have been raised for Azerbaijan and Kazakhstan. Export growth is picking up across the energy-importing countries in the subregion, though it is accompanied by higher import demand, thereby limiting improvements

3.1.2 Inflation, Central Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

in current account deficits. The narrowing of the current account deficits in Georgia and Tajikistan from *ADO 2010* projections is mainly explained by the strong recovery of remittance inflows.

The subregion's current account surplus is projected to increase from 3.8% to 8.4% of GDP in 2010 and decline a touch to 8.3% in 2011 (Figure 3.1.3).

Country highlights

Armenia

The economy is coming out of a severe economic downturn as the improved global economy has boosted major exports, such as copper, chemicals, and jewelry. Industry, construction, and services were the main drivers of the recovery in GDP growth to 6.7% in the first half of 2010. Domestic consumption also increased as remittance inflows picked up, particularly from the Russian Federation, the biggest source. Given the strength of the GDP rebound, the *Update* revises growth forecasts upward from 1.5% to 6.4% for 2010 and from 3.0% to 4.0% for 2011.

Inflation moved above the central bank's target band ($4\pm 1.5\%$), in part owing to the lagged pass-through of the large devaluation in 2009. Inflation in the first half of 2010 averaged 7.6%; however, it eased over the period in response to a tightening in monetary policy. The *ADO 2010* inflation forecast of 4.5% is revised upward to 6.5% in 2010, while the 2011 forecast is lifted from 5.0% to 5.5%.

Countercyclical fiscal policies as well as declining revenues in 2009 led to an increase in the budget deficit, which reached 7.9% of GDP. With recovery under way, the government responded with a 3-year medium-term spending program calling for the suspension of public sector salary increases (through 2013) and a cap on public spending. The budget deficit was reduced to 4.0% of GDP in the first half of 2010 and it is expected to narrow further as the plan is implemented.

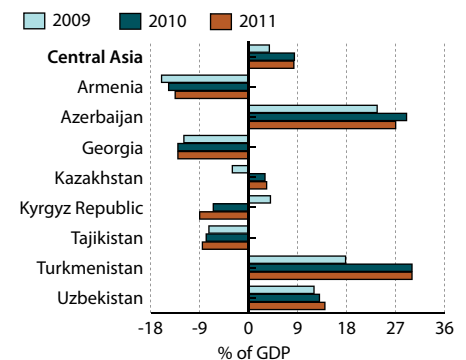
Soaring international metal prices helped to push up exports by 57.4% in the first half of 2010 compared to a year earlier. Imports, though slower, still grew handsomely by 25.1% during the same period. However, because they are about four times as large as exports, the trade deficit widened in the first half of 2010, as did the current account deficit in the first quarter. The balance-of-payments adjustment was expected to be protracted as structural imbalances were large. In view of the unexpected strength of the rebound, the *Update* raises forecasts for the current account deficit to 14.7% of GDP in 2010 and 13.5% in 2011.

Azerbaijan

In the first half of 2010, GDP growth slowed to 3.7%. The oil sector (as recorded in national accounts rather than gross production, and accounting for about 55% of GDP), grew by only 2.3% despite higher global oil prices and improving external demand. After a 15% expansion in 2009, oil production is officially expected to grow by around 4% in 2010 as existing oil fields (except Azeri-Chirag-Gunashli) reach their production capacity.

The non-oil sector grew by 4.7% in the first half of 2010, mainly reflecting strength in manufacturing and construction, as output

3.1.3 Current account balance, Central Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

contracted in the relatively small agriculture sector because of floods. Taking account of a leveling off in oil production and expected growth of the non-oil sector, this *Update* revises the growth forecast from 9.5% to 3.8% in 2010 and from 9.7% to 3.5% in 2011.

Despite the strong pressures stemming from depreciations in the country's major trading countries, the Central Bank of Azerbaijan successfully maintained the de facto exchange rate peg to the United States (US) dollar. Citing slowing inflation, it set an accommodative monetary policy in the early months of 2009 to bolster the non-oil economy, and has maintained this stance. The moderate expansion in credit, a stable exchange rate, and few commodity price pressures kept inflation at 4.9% in the first half of 2010. Reflecting moderation of domestic demand and commodity price pressures, this *Update* adjusts inflation forecasts down from 5.8% to 5.0% in 2010 and from 6.0% to 4.0% in 2011.

The current account balance ran a surplus of 32% of GDP in the first quarter of 2010. With higher oil and gas earnings than projected, the *Update* revises its current account surplus forecasts from 23.0% to 29.0% in 2010 and from 21.7% to 27.0% in 2011.

Georgia

Robust growth in key sectors such as manufacturing, transportation, and trade during the first quarter of 2010 pushed GDP growth positive at 4.5%, and preliminary estimates indicate a further strengthening in the second quarter to 8.4%. The global recovery substantially raised exports and remittance earnings, underpinning a strengthening in domestic incomes and demand. Given the strong rebound in the first half of the year, the *Update* revises the GDP growth forecast from 2.0% to 4.5% in 2010 and from 4.0% to 4.5% in 2011.

Due to stronger than expected economic growth, as well as to the anticipated passage of a new tax code in September 2010, fiscal revenue is projected to be above target in 2010. As a result, the government adjusted down the estimated fiscal deficit from 7.4% to 6.3% of GDP in 2010, and expects it to be under 5% of GDP in 2011.

Inflation was a low 2.8% through the first half of 2010, in part due to revision in the consumer price index methodology that gives less weight to food and non-alcoholic beverages. The National Bank of Georgia moved to tighten monetary policy by gradually increasing its policy rate by 150 basis points to 6.5% from June to August 2010, to stem the inflation impact from an expansion in the money supply and to reduce pressures in the foreign exchange market. Inflation is expected to pick up in the second half of the year due to the strong recovery in domestic demand and rising global commodity prices. However, there is no apparent need to revise the 6.0% inflation forecasts for 2010 and 2011.

The growing demand for and higher prices of the main export commodities—gold and base metals—as well as moderate import growth, are now expected to narrow the 2010 current account deficit to 13.0% of GDP from 14.0% of GDP given in *ADO 2010*. For 2011, a continued positive outlook for the Russian Federation, still the major source of remittances to Georgia, will likely allow the current account deficit to stay unchanged from 2010.

Kazakhstan

The economy rebounded with robust 8% growth in the first half of 2010. In addition to the low-base effect, the main drivers of strong growth include the oil and minerals sectors and international trade. However, construction registered a slight contraction. The launch of over 100 large-scale investment projects under a 5-year accelerated industrial and innovative program will expand diversification of the economy from its concentration in mining and hydrocarbon operations as well as provide medium-term stimulus.

Due to higher export demand, strong oil prices, and the increase in foreign direct investment, growth of the oil economy is projected to accelerate, while the non-oil economy will grow modestly. Limited credit availability due to the banking sector difficulties will damp domestic demand in 2010, though credit availability should improve somewhat in 2011 as banks have been making progress in strengthening their balance sheets. Overall, owing to a robust growth in the first half of 2010, and expected strong demand in 2011, the *Update* revises its growth forecasts upward from 2.5% to 4.8% in 2010 and from 3.5% to 5.2% in 2011.

Monthly consumer price index inflation for the first half of 2010 remained stable, ranging from 6.8% to 7.4% year on year. In September 2009, the National Bank of Kazakhstan reduced the refinance rate (its main policy rate) by 50 basis points to 7% (as inflation tumbled) as part of the efforts to strengthen the sagging economy. The central bank has kept it on hold since then. The exchange rate, too, has been stable.

Inflation is expected to remain at around 7%, within the government's defined inflation corridor of 6%–8%. The current monetary policy stance is expected to continue though the impact of drought in Kazakhstan and the Russian Federation on wheat prices could temporarily boost inflation pressures. Accordingly, the *Update* maintains its inflation forecasts of 6.8% for 2010 and 6.5% for 2011.

Fueled by an approximate 50% increase of oil and metals price indexes, exports registered about a 70% year-on-year increase in the first half of 2010. The upgraded Aktau International Sea Port facilitated a 77% increase in hydrocarbon and mineral exports. Imports were little changed during the same period due to weak domestic demand. A trade surplus of \$16.5 billion in the first half of 2010 was registered, four times as high as the same period in 2009.

In 2011, import growth will narrow current account surplus as domestic demand is projected to gradually rise. The *Update* revises its current account surplus forecast for 2010 from 2.3% of GDP to 3.0% in 2010 but maintains its forecast of 3.3% in 2011.

Kyrgyz Republic

The positive outlook at the beginning of 2010 was clouded by widespread political instability and civil unrest in April and June. First quarter GDP growth rebounded to 16.4%, recovering from a depressed quarter a year earlier. The recovery was largely driven by strong gold production, a pickup in industrial production, and a step-up in construction activity. The civil unrest, however, has disrupted agriculture, trade, and other services. Agricultural output, particularly, is expected to suffer and decline by 12% due to insecurity in the south and lack of inputs.

The *Update* revises GDP growth forecast from an expansion of 5.5% to a contraction of 3.5% in 2010. However, a strong rebound to growth of 7.0% in 2011 is now forecast due to donor-supported reconstruction activities, some recovery in investor confidence, and resumption of trade with and growth in Kazakhstan and the Russian Federation, the main trade and financial partners. To assist the Kyrgyz Republic with the aftermath of the violence in the south, a donors' conference in July pledged \$1.1 billion in grants and concessional loans.

As a result of the contraction of the economy in 2010 as well as the April reversal of an earlier increase in electricity tariffs, inflation is expected to be 7.5%, lower than *ADO 2010* projection of 8.5% for 2010. Toward the end 2010 and in 2011, higher domestic consumption demand because of improving remittances in the face of decreased production capacity due to the destruction will raise domestic prices. The *Update* maintains its inflation forecast of 9.0% in 2011.

The *Update* revises the current account deficit forecast from 12.0% of GDP to 6.5% of GDP in 2010, mainly due to the disruption in trade, services, and investment activities caused by the unrest. The current account deficit forecast for 2011 is also lowered from 12.0% to 9.0% of GDP given expected stronger grant and remittance inflows.

Tajikistan

Higher global prices for aluminum and cotton, 20% stronger remittance inflows, and an agriculture sector growing by 9.2% supported robust growth of 7.4% in the first half of 2010. Industrial output grew by 12% mainly due to higher aluminum production, the country's main export. With robust GDP growth in the first half of the year in part reflecting a depressed period a year earlier, the outlook for the remainder of 2010 nevertheless is cautiously optimistic. Therefore, the *Update* revises GDP growth projections in *ADO 2010* from 4.0% to 4.5% in 2010 and from 5.0% to 5.5% in 2011, anticipating that global prices for aluminum and cotton as well as remittance inflows will remain high.

Inflation remained moderate during the first half of 2010 at 5.3%, despite fast-growing remittances. In this period, many employees, particularly in the public sector, were required to purchase shares to fund restarting of the construction on the Roghun hydroelectricity project, which substantially lowered the disposable incomes of the population, though this policy was relaxed in the later part of the year. Reflecting these developments, inflation is projected to be contained, and the *Update* revises down the inflation forecast for 2010 from 10.8% to 8.0%. The 2011 forecast at 9.5% is maintained.

Exports registered a significant increase of more than 35% year on year during the first half of 2010 due to the recovery of aluminum and cotton export volumes and prices. Despite higher remittances, mainly due to disruptions with rail cargo transit through Uzbekistan, imports declined by 6.1% in this period. Trade disruption is expected to narrow country's trade deficit, and on this basis the *Update* reduces the 2010 projection of the current account deficit from 8.3% GDP to 7.8% of GDP. With normal transit conditions and the expected strengthening in growth in 2011, higher imports would boost the current account deficit, which the *Update* raises to 8.5% of GDP, from 7.1% in *ADO 2010*.

Turkmenistan

Economic growth in 2009 was robust despite the global recession. Even though a technical accident in the main gas pipeline to the Russian Federation in 2009 halted gas exports, the impact on the economy turned out not to be large because other gas export routes were expanded. In late 2009, the People's Republic of China (PRC) started to import gas from Turkmenistan through a newly constructed gas pipeline through Kazakhstan and Uzbekistan. Gas exports to the Islamic Republic of Iran also increased and a second new pipeline was opened in January 2010. The *Update* maintains the growth forecast in *ADO 2010*, of 6.5% in 2010 and 11.0% in 2011, which mainly reflected the phase in of higher hydrocarbon exports.

No change is made to the inflation forecasts of 3.5% for 2010 and 5.0% for 2011.

ADO 2010 estimated that the current account surplus narrowed to 17.8% of GDP in 2009 mainly due to a sharp decline in gas exports to the Russian Federation. As the global economy rebounded, energy demand in general increased in 2010 broadly in line with expectations in *ADO 2010*. Reflecting export earnings made possible by the newly opened pipelines, the April forecasts of the current account surplus of 30.0% of GDP for 2010 and 2011 are maintained.

Uzbekistan

The economy grew by 8.0% in the first half of 2010, with construction and services providing the main impetus. Favorable weather boosted agricultural growth to 6.9%. Construction benefited from increased public infrastructure investment undertaken as part of the anticrisis program. Foreign direct investment was buoyant in the first half of 2010, amounting to a record \$1.6 billion—a 150% year-on-year increase. A one-third increase in bank lending, mainly to industrial enterprises and small and medium-sized enterprises (SMEs), helped to underpin the expansion. With the economy running according to plan, the *Update* maintains growth forecasts of 8.5% for 2010 and 9.0% for 2011.

The government reported inflation for the first half of 2010 at 4.0%, significantly lower than its announced target of 9.0% for the year, which has not been revised. Lower import prices of consumer goods and a government cap on utilities prices were major contributing factors containing inflation pressures. Given the increased pace of nominal depreciation of the local currency and an accommodative credit policy by the monetary authority, inflation pressures will build. The *Update* maintains the April 2010 inflation forecast at 9.3%, while edging up the 2011 projection from 9.0% to 9.5%.

Exports increased by 14.3% year on year in the first half of 2010 due to the economic recovery in the Russian Federation and strong global demand for metals. Imports were lower by 18.9% during the same period, as imports of machinery and equipment declined apparently reflecting completion of investment projects, however they are likely to rise in the second half of the year. Since growth in the economy and exports are in line with forecasts in *ADO 2010*, the *Update* maintains the earlier forecast of the current account surplus of 13.0% of GDP in 2010 and 14.0% in 2011.

East Asia

Subregional assessment and prospects

The forecast for aggregate economic growth in East Asia this year is raised to 8.6%, which if realized would make it the strongest expansion of any of the five subregions of developing Asia. In large part, this represents a rebound from a weak prior-year performance in four of the five subregional economies.

The export-oriented economies of Hong Kong, China and Taipei, China contracted last year owing to the global recession. Mongolia's GDP also declined in 2009, as global prices fell for its copper exports and foreign investment in mining dwindled. Trade-reliant Republic of Korea barely avoided a contraction last year—its GDP rose by just 0.2%.

These four economies were expected to rebound in 2010 as world trade recovered, but the first-half bounce was higher than anticipated. Taipei, China's GDP shot up by 13.1% year on year in January–June, propelled by surging demand for manufactured exports, particularly electronics. Benefiting from improved global demand for manufactures such as automobiles and semiconductors, the Republic of Korea's GDP rose by 7.6%. Hong Kong, China returned to growth with a 7.2% increase in GDP. This economy depends heavily on exports of trade-related and business services, as well as tourism, all of which have recovered this year from slumps. Mongolia's important mining industry benefited from the restoration of global investment flows in the first half, and from a recovery in prices for copper.

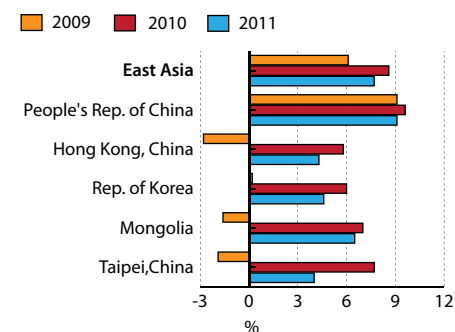
One reason for the sharp GDP gains was double-digit economic growth in the PRC, the major trading partner of the other four East Asian economies. PRC imports surged by 45.8% in the first 8 months of this year.

Rising exports prompted a burst of investment in Hong Kong, China; the Republic of Korea; and Taipei, China, so that investment contributed most of these economies' first-half GDP growth. That generated jobs, which supported higher rates of growth in private consumption. Forecasts for GDP growth in 2010 are raised for Hong Kong, China (to 5.8%); the Republic of Korea (6.0%); and Taipei, China (7.7%).

As for the PRC, its 11.1% pace in the first half of 2010 was underpinned by expansionary monetary and fiscal stimulus that kept it growing through the global recession in 2009, coupled with the recovery in world trade. The trajectory of the PRC economy has been broadly in line with *ADO 2010* expectations, and the GDP growth forecasts are unchanged (9.6% for 2010 and 9.1% for 2011).

The PRC's stimulus programs are being gradually withdrawn, and economic growth will moderate in the second half of 2010 and in 2011. Growth is expected to also slow in Hong Kong, China; the Republic of Korea; and Taipei, China in the second half of 2010 as export growth moderates, base effects from the slump in early 2009 fade, and some stimulus is unwound (particularly in the Republic of Korea). The subregional GDP forecast for next year is maintained from *ADO 2010* at 7.7%, with growth stepping down in all five economies from the speedy 2010 pace (Figure 3.1.4).

3.1.4 GDP growth, East Asia



Source: Asian Development Outlook database.
[Click here for figure data](#)

Current account surpluses in relation to GDP are projected to decline from 2009 levels in all economies through the forecast period (except in Mongolia, where imports of capital equipment for mining projects will widen its external deficit). Imports will likely rise in tandem with domestic demand and increases in oil prices, while export growth will moderate. The subregional current account surplus is seen moderating to 5.3% this year and 4.8% in 2011, little changed from *ADO 2010* (Figure 3.1.5).

Inflation in East Asia has generally been mild this year. The subregional forecast is trimmed to 3.0% in 2010 (Figure 3.1.6), mainly owing to a downward revision for the PRC. This rate is also projected for the subregion next year. Policy interest rates, lowered during the global financial crisis, have started to rise in the Republic of Korea; Mongolia; and Taipei,China.

Three economies have experienced steep increases in housing prices in major cities, in part a result of monetary stimulus and capital inflows. The authorities in the PRC; Hong Kong, China; and Taipei,China have taken steps to cool demand for housing (especially speculative demand), and to increase the supply of land for construction of apartments and, in some cases, low-cost housing.

Country highlights

People's Republic of China

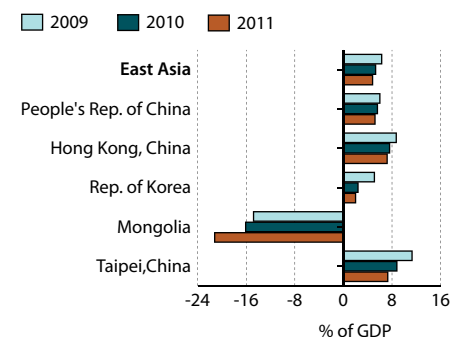
Expansionary fiscal and monetary policies, together with recovery in world trade, drove rapid economic growth of 11.1% in the first half of 2010. Investment, much of it funded by stimulus programs, increased at a strong pace and private consumption continued to grow, supported by a tightening labor market and rising incomes and subsidies. Net exports turned positive in the second quarter.

GDP growth moderated a little in the second quarter from the first, and is forecast to ease through the third and fourth quarters. Monetary officials started to rein in the expansionary monetary stance adopted during the global recession, in view of the strong economic growth, sharp rise in property prices, and risks that funds would be diverted into unproductive purposes. Among other measures, they raised the reserve requirement for banks three times and set monthly credit quotas for banks. New bank lending decelerated in the first 8 months of this year from 2009, although it remains well above 2007–2008 levels.

Fiscal stimulus is being phased down as well, and is expected to be fully disbursed by end-2010. Growth in government spending has pulled back this year compared with 2009. The budget deficit as a share of GDP will probably be smaller than targeted in 2010, and the deficit is likely to narrow further in 2011 in relation to GDP.

Consequently, growth in fixed-asset investment has moderated and this trend is expected to continue, tempering demand for industrial products. Government plans to reduce excess capacity in steel and to reduce carbon emissions will also cool growth of the industry sector through the forecast period. Export growth, too, is likely to ease owing to fading base effects from the slump in early 2009 and to more subdued demand from some export markets. Given that these developments are

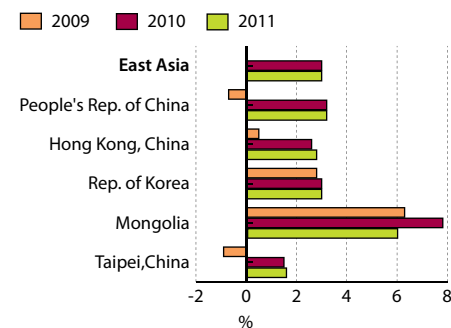
3.1.5 Current account balance, East Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.1.6 Inflation, East Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

broadly in line with *ADO 2010* expectations, the GDP growth forecasts are maintained at 9.6% for 2010 and 9.1% next year.

Merchandise exports rose by 35.4% in the first 8 months of 2010 and imports even more steeply, by 45.8%. Although the trade surplus narrowed, sizable capital account surpluses are still expected in the forecast period (5.6% of GDP this year and 5.2% in 2011). The authorities said in June that they would gradually allow greater flexibility in the yuan exchange rate against a basket of currencies. By mid-September, the yuan had appreciated by 1.5% against the US dollar from the start of 2010. The adjustment is unlikely to have much of an impact on trade flows in the near term.

Consumer prices have turned up, after declining for most of last year. Flooding in summer led to increases in food prices, but this impact is expected to be temporary. The forecast for average inflation in 2010 is trimmed to 3.2%, and that rate is also projected for 2011.

Housing prices, however, have climbed steeply in major cities, spurred by the expansionary monetary stance and investment demand. The government has taken steps to cool the property market. For example, it raised downpayments required for a second home and directed many central government-owned enterprises to stop participating in the property market. To increase supply, it increased the availability of land for residential purposes and the supply of low-income housing.

Hong Kong, China

Strong growth in external trade, linked to rapid expansion in the PRC and to the global recovery in trade, contributed to a stronger than expected 7.2% rebound in Hong Kong, China's GDP in the first half of 2010, from a contraction in the prior-year period. Increases in private consumption and investment also contributed to the expansion.

Merchandise exports in nominal terms rose by nearly 25% year on year in the first half. Exports of services increased by 28%, reflecting a rebound in trade-related and business services, as well as in inbound tourism, particularly from the PRC. An even stronger increase in imports (up by nearly 32%) more than offset the bounceback in exports, so that net exports fell.

Investment expanded by about 12% in real terms as business sentiment improved, and it made a major contribution to total GDP growth. Sharp rises were seen in private sector machinery and equipment investment and in public sector building investment. Private consumption spending rose by nearly 6%, sustained by a better labor market (the unemployment rate fell to 4.6% in April–June 2010 from 5.1% at end-2009).

GDP growth is likely to moderate in the second half, to about 4.5%, given base effects as well as a slower pace of growth in several major export markets, including the PRC. That would put full-year GDP growth at 5.8%, higher than was forecast in April. Growth is still expected to step down to 4.3% in 2011, taking into account base effects and the phasing out of stimulus policies this year in the PRC. Current account surpluses exceeding 7% are still expected for this year and next.

Inflation quickened to average 2.1% in the first 7 months of 2010 owing to the rebound in domestic demand and higher import prices. The full-year inflation forecast is raised to 2.6% and the 2011 projection

is maintained at 2.8%. The government has made further efforts to damp rapidly rising prices for housing, caused in part by ample liquidity and low interest rates associated with the Hong Kong dollar's link to the US dollar, coupled with some spillover from the PRC's expansionary monetary policy.

Republic of Korea

This economy rebounded by 7.6% in the first half of 2010, after contracting in the prior-year period. A surge in exports of manufactured goods such as automobiles and semiconductors drove the recovery; in the second quarter exports in nominal terms not only exceeded the prior-year period by nearly 35% but also exceeded exports in the second quarter of 2008, before the global recession.

Rising exports prompted a surge of investment in semiconductor manufacturing equipment and other machinery. Total investment contributed more than 5 percentage points of GDP growth in the January–June period. Most of the remaining growth came from private consumption, which got support from a stronger labor market (the unemployment rate fell to 3.7% in July from 5.0% in January 2010), offset in part by high household debt and a soft property market that weighed on consumer sentiment.

Based on this stronger than expected rebound, the growth forecast for 2010 is revised up to 6.0%. Growth will likely moderate to about 4.5% in the second half, as the low-base effect from 2009 fades and the government unwinds fiscal stimulus implemented during the recession. The leading composite index has decelerated from a peak reached early this year, which suggests an easing in economic activity. In 2011, the economy is expected to grow by 4.6%, still above trend, as the pace of equipment investment eases to more sustainable levels.

Merchandise imports, fueled by demand for investment equipment and consumer goods, rose by 42% in the first half of 2010, outpacing the 34% rise in exports. The surplus in goods trade fell from the year-earlier period and the deficit in services trade widened, contributing to a smaller current account surplus of \$11.6 billion. For all 2010, the current account surplus is projected at \$24 billion, or 2.4% of GDP, revised up from *ADO 2010* mainly due to the strong export performance and a likely moderation of import demand in the second half. The current account surplus is seen easing a touch to about 2% of GDP in 2011.

Inflation averaged 2.6% in the first 7 months of 2010, and is edging higher. Full-year inflation forecasts for this year and next are maintained at 3.0%. The Bank of Korea, after lowering interest rates during the global recession, has started to move rates back toward more normal levels. It raised the policy rate by 25 basis points in July to 2.25% and further gradual increases are expected. The won, which depreciated by 1.2% against the US dollar in January–August 2010, may well strengthen over the rest of the year, which would help to put some downward pressure on imported inflation.

Mongolia

GDP rose by 5.0% in the first half of 2010, coming out of a 1.6% contraction in 2009. Mining, construction, and services expanded in

the first half. Agriculture, however, which supports some two-fifths of the population, suffered from a very harsh winter that reduced livestock numbers by 8.8 million, or 20%, of the herd that consisted mainly of goats, sheep, and cattle.

Economic growth is getting a lift both from construction of the Oyu Tolgoi copper and gold project—which will be one of the world's biggest copper–gold mines when it starts production in 2013—and from increased public spending. Government outlays and net lending rose by 27% in the first 7 months of 2010, much of it channeled into subsidies and cash transfers. In July, Parliament approved budget amendments that allow for further spending hikes. The authorities also propose to raise state-sector wages and pensions this year.

The revenue side of the budget is being bolstered by the recovery in global copper prices. In June 2010, Parliament enacted a fiscal stability law that aims to improve the management of revenue inflows from minerals, so as to avoid boom–bust cycles in the budget and the economy.

Taking these factors into consideration, forecasts for GDP growth are maintained at 7.0% for this year and 6.5% for 2011.

Growth in the value of exports, including coal and copper, has been driven by strong demand from the PRC, Mongolia's major trading partner, as well as by higher global prices for copper and other commodities. Imports of capital equipment needed for mining projects will contribute to widening the current account deficit to a projected 16.1% of GDP this year, and to 21.2% in 2011. The gap is expected to be financed primarily by foreign direct investment, particularly in mining, and by official development assistance. International reserves, at \$1.4 billion in June, were slightly above end-2009 levels.

Inflation accelerated to 9.8% year on year in July from 5.7% in January. Livestock losses pushed up meat prices, and prices rose for other food and for electricity. Stronger domestic demand and a surge in broad money (M2) supply (up by 41% year on year in July) contributed to inflation. In response to the price pressures, the Bank of Mongolia raised its policy interest rate in May to 11.0% from 10.0%. The inflation forecast is kept at 7.9% for this year and 6.0% in 2011.

Taipei, China

Surging demand for manufactured exports, particularly electronics products, propelled a 13.1% rebound in GDP in the first half of 2010, from a period of contraction a year earlier. Manufacturing generated most of the growth (about 9 percentage points) on the production side. This recovery prompted a 39% rise in private investment, so that total investment contributed over half the growth in GDP on the demand side. Private consumption picked up by nearly 4%, and net exports also contributed to growth.

Merchandise exports in US dollars surged by just over 47%, with shipments to the PRC and Hong Kong, China up by 62% in the first half. Imports, spurred by recovery in exports and investment, shot up by 61%. Nevertheless, the economic rebound has been uneven, and while the unemployment rate declined to 5.2% in July 2010, it was above trend. Delays in implementation of some government infrastructure projects early in 2010 likely hurt employment creation.

Economic growth is projected to moderate in the second half of 2010, reflecting fading base effects, slower expansion in the PRC (the biggest export market for Taipei,China), and the likelihood of only modest growth in industrial economies. The momentum of export orders and industrial production started to slow in mid-2010 as inventory rebuilding phased down both domestically and globally. For all of 2010, GDP is forecast to grow by 7.7%, revised up from April because of the stronger than expected expansion in the first half. GDP growth is seen moderating to about 4% in 2011, close to its trend rate.

Consumer prices, after declining in 2009, have edged up this year. The monetary authorities raised the policy interest rate by 12.5 basis points in June, to 1.375%, and issued certificates of deposit to drain liquidity from the financial system. The authorities are concerned about speculative capital inflows, which have put upward pressure on the NT dollar exchange rate (it appreciated by 1.0% against the US dollar in the first 8 months of 2010) and could spark asset price bubbles. In response, they have taken steps to curb bank lending for second homes and housing speculation.

Inflation forecasts for this year and next remain unchanged (at 1.5% and 1.6%, respectively). Strong demand for Taipei,China's exports has led to upward revisions in forecasts for the current account surplus, to 8.8% of GDP in 2010 and to 7.3% in 2011.

South Asia

Subregional assessment and prospects

South Asian economies are on the rebound. Robust and well-timed fiscal and monetary policies succeeded in sustaining growth at relatively high levels in 2009 and laid the basis for a solid recovery in 2010. While rising inflation and enlarged fiscal deficits are prevalent in South Asia, policy adjustments are already under way in most countries.

Over the first half of 2010, industrial production markedly increased in three of the four larger countries—India, Pakistan, and Sri Lanka. Activity in Bangladesh was crimped by weak activity in the large readymade garment sector. Moreover, credit to the subregion's private sector is staging a strong revival, as is business confidence, indicating that investment activity is beginning the transition to replace government spending as the mainstay for sustaining rapid growth. GDP grew by 7.1% and 8.5% in Sri Lanka, while India posted 8.6% and 8.8% expansions in the first 2 quarters of calendar 2010.

Since late 2009, inflation has crept into double digits in India, Nepal, and Pakistan, in part on rising food prices, especially in India where a weak monsoon depressed production. Bhutan and Nepal (countries with a pegged currency to the Indian rupee and close trade links with that country) endeavored to find a steady footing as inflation pressures mounted. In Afghanistan, Maldives, and Sri Lanka, inflation remained low. High food inflation in the subregion usually quickly translates into higher nonfood prices, as low wages prevail. Increases in energy prices (as governments struggle to lower heavy subsidies) and public sector wage hikes are significant inflation pressures.

Monetary authorities in high-inflation countries are facing the dilemma of either raising policy rates (to limit price increases) or, under strong pressure from the public, maintaining low interest rates (to stimulate growth). The Reserve Bank of India, for example, has as of mid-September increased its policy rate four times since mid-March. In August, Bangladesh Bank and the State Bank of Pakistan increased their rates. The Central Bank of Sri Lanka, in contrast, continued an accommodative stance in a context of declining inflation, reducing its policy rates in July and August.

The majority of South Asian economies are seeing better foreign exchange earnings. Exports in India, Pakistan, and Sri Lanka started expanding from late 2009, though Bangladesh's garment exports (about 75% of total exports) turned up only in March 2010. Tourist arrivals have also picked up, with India, Maldives, Nepal, and Sri Lanka posting double-digit growth in arrivals in the first half of 2010 relative to the same period in 2009.

Although the growth of net emigration has slowed, workers' remittance inflows remain strong, especially compared to other sources of foreign exchange. Albeit slower than the 20%–40% expansions in 2008, most subregional countries are seeing workers' remittances grow by 10%–20%. Remittances are sustaining private consumption in Bangladesh, Nepal, Pakistan, and Sri Lanka, while offsetting much or all of the trade deficits in these countries.

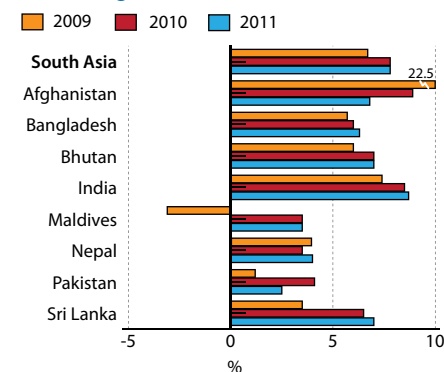
While expansionary fiscal policies were the key factor in mitigating the effects of the global economic crisis, South Asian authorities are now exploring the timing of withdrawal of fiscal stimulus measures to avoid an unsustainable buildup of public debt. India's government is targeting a gradual decrease in the federal fiscal deficit to 3.0% of GDP in FY2013 from 6.7% in FY2009. Maldives, Pakistan, and Sri Lanka have been implementing fiscal consolidation programs under IMF standby arrangements. In Pakistan, higher security-related expenditure, power subsidies, and transfers to provinces pushed out the deficit in FY2010; the budget plan for FY2011 is being adjusted in the face of challenges from devastating floods in August. In Maldives, a political stalemate may threaten to block further fiscal reform. Nepal's government, which approved a partial budget for the first 4 months of FY2011 following the prime minister's resignation, faces an uphill struggle to control fiscal spending due to the absence of clear policies to guide expenditures.

Generally across the subregion, fiscal consolidation needs to be accompanied by growth-oriented structural reforms, especially infrastructure development to remove bottlenecks to growth, particularly in the areas of energy and roads.

Reflecting upward revision in growth estimates for most countries, the South Asian GDP growth projection is revised to 7.8% in 2010 in this *Update* from 7.4% in *ADO 2010* (Figure 3.1.7). This in good part reflects improved growth prospects for India (which accounts for about four-fifths of GDP in South Asia), as India's growth projection was raised to 8.5% from 8.2%. South Asian GDP is forecast at 7.8% in 2011, slightly lower than the 8.0% projected in April, largely attributable to a slowdown in flood-ravaged Pakistan.

This *Update* revises up the inflation projection for South Asia to

3.1.7 GDP growth, South Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

7.9% in FY2010, 1.9 percentage points higher than previously forecast (Figure 3.1.8). This change essentially reflects the revised upward forecast for India, since changes for other countries from *ADO 2010*'s forecasts were marginal. Inflation pressures are, however, expected to ease to 6.5% in FY2011, moderately above the 6.0% projection made in April, as comfortable domestic food supply is assumed due to normal monsoons. Higher inflation in Pakistan largely accounts for the revision. Moderation in global oil and food prices continues to underpin a positive outlook for keeping inflation in check.

The current account deficit for the subregion in 2010 is projected to widen to 2.2% of GDP from 1.5% given in *ADO 2010* (Figure 3.1.9). A wider current account deficit in India was partly offset by improved external positions projected in Bangladesh and Pakistan, owing mainly to lower than expected trade deficits and stronger remittances. The current account deficit is projected at a slightly wider 2.5% of GDP in 2011, with the change coming mainly from Bangladesh, Pakistan, and Sri Lanka.

Country highlights

Afghanistan

Economic growth in FY2009 (which ended 20 March 2010) was impressive, with GDP up by 22.5%. This happy outturn stemmed from a strong recovery in agriculture (following a drought the previous year), while heavy external assistance continued to underpin expansion in industry and services. Yet despite the strong economic rebound, prices tumbled during the year, reflecting lower global prices and the recovery in domestic crop production (food has a 61% weighting in the index). Large external trade and services deficits continued to be funded through grants and other non-debt-creating flows.

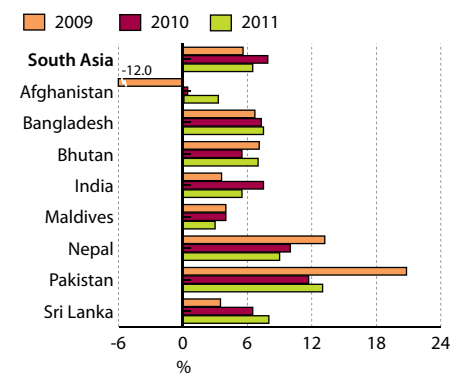
During the Kabul International Conference on Afghanistan on 20 July 2010, the IMF announced a staff-level agreement on a new 3-year economic program of \$125 million under the Extended Credit Facility. But since then, the IMF has decided to review the proposed program, with an indicative date for the new program as end-2010. The program aims to keep inflation low, strengthen banking supervision and regulation, increase fiscal revenues, promote transparency in mining, and improve efficiency in the budget process and public spending—all while protecting the poor.

Given the strong economic momentum shown the previous year, economic growth in FY2010 is forecast to be 8.9%—higher than the 7.6% projected in April—and then moderate to 6.8% in FY2011. These forecasts are based on key assumptions that include continuance of reform in the fiscal, financial, and public enterprise sectors; maintenance of large development-partner funding; normal weather; and a gradual improvement in security. Inflation in FY2010 is revised down to 0.4% and to 3.4% in FY2011. As projected in *ADO 2010*, the current account deficit (after grants) is expected to be stable at about 2% of GDP in FY2010 and FY2011.

Bangladesh

GDP growth in FY2010 (ended 30 June 2010) is estimated at 6.0%, higher than the 5.5% projected in *ADO 2010*. Given the sharp decline

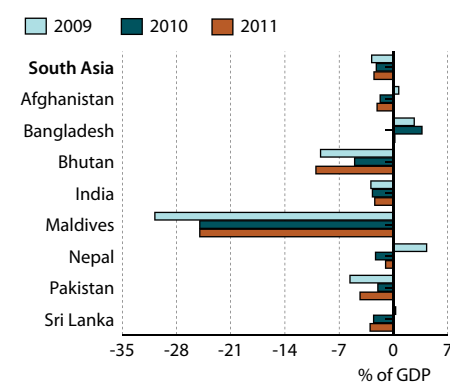
3.1.8 Inflation, South Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.1.9 Current account balance, South Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

in the growth in exports and remittances, the better than expected performance stemmed from a boost in domestic consumption, which was underpinned by the rapid growth in credit to the private sector and by a rise in public sector wages.

On the supply side, higher growth in agriculture and services accounted for the expansion. Growth in industrial production was slightly lower than a year earlier but held up well given continued power shortages and weak garment exports.

Annual average inflation rose to 7.3% from 6.7% in FY2009 as pressures on prices intensified because of robust consumption demand. As import payments rose slightly more than export earnings, the trade deficit expanded only marginally. Remittance growth fell by nearly half from the previous year, mainly because of the continued decline in the numbers of workers leaving for jobs abroad. Still, with a limited expansion in the trade deficit, increased workers' remittances boosted the current account surplus to \$3.7 billion, which, at 3.7% of GDP, was well above the *ADO 2010* projection of 1.8%

GDP growth in FY2011 is forecast at 6.3%, unchanged from that given in *ADO 2010*. Strong domestic demand supported by the ready availability of credit will again drive growth. Average inflation for FY2011 is projected at 7.5%, marginally lower than the 7.8% in *ADO 2010* because of the likely moderation in global oil and other commodity prices. Growth in imports and exports will rise, responding to some pickup in domestic and global demand. Expansion in workers' remittances will again slacken, and the current account surplus will fall to 0.2% of GDP.

Bhutan

Power production and export to India remain near capacity levels. Sales of industries (of which three-quarters is exported) such as cement, ferro-alloys, and chemicals, which had contracted earlier, surged in the last quarter of 2009. Credit to private sector is strong, expanding by about 20%. Moreover, revisions to the budget for FY2010 (ended June 2010) boosted capital expenditure substantially.

With these new developments, this *Update* revises estimated growth for FY2010 to 7.0% from 6.0% in April. With construction having started on a new hydropower project, growth momentum is expected to be sustained at 7.0% in FY2011.

The estimates for inflation have been marked up to 5.5% and 7.0% in FY2010 and FY2011, respectively, mainly owing to higher inflation in India, the dominant trade partner. Reflecting the expected stronger economic growth, the balance-of-payments current account is now projected to be in deficit by 5.0% of GDP in FY2010 and 10.0% of GDP in FY2011.

The government released its new Economic Development Policy in June 2010. The policy sets objectives for the country to become self-reliant and achieve full employment by 2020. It identifies areas of economic opportunities and proposes to promote these sectors with a package of incentives under the "Bhutan Brand." The initiative would reflect the values of Bhutanese society and history, as well as the philosophy of "Gross National Happiness."

India

The economy is on a path to impressive recovery. Growth data in the first quarter of FY2010 came in at 8.8%, the highest in more than 2 years. Macroeconomic management, however, has become more complex due to heightened inflation pressures and a strengthening in the real effective exchange rate. A gradual withdrawal from the expansionary monetary policy stance begun in early 2010 has been initiated and a series of upward revisions made to short-term policy rates.

This *Update* chalks up the forecast for average inflation in FY2010 from 5.0% to 7.5%. However, as nonfuel commodity prices slacken in FY2011 and domestic production and the stock of foodgrains remain comfortable, inflation is still expected to moderate to 5.5% in FY2011, as projected in *ADO 2010*.

With a somewhat stronger than expected recovery under way, projected growth for FY2010 is nudged up to 8.5% from 8.2%. Moreover, the key drivers of growth—consumer demand and private investment—are expected to remain buoyant in FY2011, pushing growth to 8.7% in FY2011 as forecast in *ADO 2010*, despite the slight moderation in growth in industrial economies envisaged in this *Update*.

Favorable developments on the export front are expected to help assuage some of the complexity of macroeconomic management. Trade flows in FY2010 will strengthen, primarily due to the pull factor originating from the buoyancy in world trade. Exports are projected to grow by 18.0% in FY2010 and 15.0% in FY2011. Sectors such as information technology (IT) and IT-enabled services, gems and jewelry, and agricultural and allied products are expected to post impressive export performance. Import growth will see strong performance of 20% in FY2010 due to robust domestic industrial production and investment before moderating to 18% in FY2011.

Taking account of developments to date, the current account deficit is revised from 1.5% to 2.7% of GDP in FY2010 and from 2.0% to 2.4% in FY2011.

Maldives

Affected by the global economic recession, GDP fell by 3.1% in 2009 as tourist arrivals dropped by 4.0%. Tourism, the mainstay of the economy, started to pick up from late 2009 and the country saw a 21% jump in tourist arrivals in January–July 2010 relative to a year earlier. The rebound was led by a surge in tourists from the PRC, though there was also a solid return of European tourists, who account for about two-thirds of all visitors.

Too-rapid fiscal expansion in recent years, combined with the drop in tourism earnings, has pushed the current account deficit to unsustainable levels and led to a marked fall in foreign exchange reserves. The government has, since December 2009, implemented an economic adjustment program supported by an IMF standby arrangement and its Exogenous Shocks Facility, and by an ADB Economic Recovery Program. A donor forum is also providing financial assistance that will underpin adjustment efforts and foreign exchange reserves.

As tourist arrivals are higher than expected in April, this *Update* revises the GDP growth projection for 2010 from 3.0% to 3.5%. Recent

political tensions between the ruling and the opposition parties, however, pose risks for the long-term growth perspective. Progress in some reform areas that need legislation, most notably expanding the tax base, has been slow. For example, a business profit tax has been discussed and debated in Parliament for more than a year, even though it is essential to fiscal adjustment and to long-term economic sustainability. Civil service restructuring may also be delayed.

Nepal

GDP growth decelerated to 3.5% in FY2010 (ended mid-July 2010) from 4.0% in FY2009, mainly due to the impact of inclement weather on agriculture. Industry saw a modest improvement, reflecting some easing of fuel and power shortages, although the difficult political transition continues to weigh on business confidence. Growth of services was supported by a sustained increase in tourist arrivals, which partly offset the impact of decelerating remittances. Average annual inflation remained in double digits, driven mainly by food shortages due to a poor harvest.

A lagged impact of the global economic crisis was seen in sharply decelerating remittances and a decline in exports. These factors resulted in an unprecedented current account deficit of 2.3% of GDP and a marked fall in reserves. Decelerating remittance inflows, coupled with aggressive lending by banks in real estate, triggered a liquidity crunch in the banking system, sharply driving up interest rates.

The economy is now expected to grow by 4.0% in FY2011, down from the 4.5% projected in *ADO 2010*. Assuming normal weather conditions, agricultural growth is expected to pick up in FY2011. With disruptive political strikes abating, industrial growth should maintain or improve its pace. The FY2011 monetary policy imposes restrictions on the entry of new banks, and this will crimp services expansion.

On the demand side, the major deceleration will be in consumption as remittance growth continues to slow. Although inflation is expected to fall in India, inflation in Nepal is unlikely to moderate to 8.0% as projected in *ADO 2010* and, in fact, will likely edge up to 9.0% given the lag in price transmission between the two countries and Nepal's expansive domestic policies.

Imports are gradually adjusting to the slower remittance inflows, but persistently weak exports will keep the current account in deficit, now estimated at 1% of GDP in FY2011, versus the 1% surplus projected in *ADO 2010*.

Political uncertainty associated with frequent changes of government and with a protracted constitution-drafting process remains a major risk to stronger growth in FY2011. For the third year running, a partial budget only was approved for FY2011 in the face of political disruptions. This risks curtailing the capital spending that is critical for a growth revival.

Pakistan

Pakistan enjoyed a modest rebound in FY2010, growing by 4.1% after negligible growth in FY2009. This upturn was supported by a continued buildup of foreign reserves and a steep drop in inflation. The current account deficit narrowed sharply, reflecting a modest rebound in exports

and lower imports, lower services and income deficits, and a strong expansion in workers' remittances. Inflation fell from the 20.8% average pace in FY2009, but remained high at 11.7%. Fiscal slippage in FY2010, however, was substantial as revenue fell short of target and current spending topped budget allocations due to higher security outlays and ballooning energy-related subsidies.

Prospects for FY2011 have been subsumed by the extensive damage from the devastating flooding in much of the country. The widespread damage to agriculture and key infrastructure has affected every sector of the economy and will pose significant challenges for growth in the short to medium term. As the supply and distribution of goods and services have been hit, the resulting shortages will exert significant upward pressure on prices.

Pressures on the current account deficit will also intensify, due to a higher than envisaged increase in food and material imports and lower than projected exports stemming from the losses in agriculture and manufacturing output.

Flood-related expenditure will alter the fiscal outlook relative to the pre-flood budgetary targets for FY2011. In this context, the urgency of reforms necessary to release fiscal space for reconstruction and development is greater than ever before.

Sri Lanka

The economy picked up strongly from the beginning of 2010. First-quarter growth was 7.1%, with all three major sectors of the economy (agriculture, industry, and services) registering significant growth. Inflation, which had climbed to 6.9% by February 2010, fell to 4.8% by June. Policy rates that had been slashed in February–November 2009 were cut yet again in July and August 2010. Credit to the private sector, which contracted during much of 2009 on weak demand and banks' cautious approach to lending, turned positive from March 2010 with the pickup in economic activity. The stock market is vibrant, reflecting strong confidence among both local and foreign investors.

The budget, which was postponed on account of two major elections held in early 2010, was presented to Parliament in June 2010. The fiscal deficit for the year is expected to be 8.0% (including grants), down significantly from 9.8% in 2009, narrowed mainly by expenditure rationalization. With satisfactory progress in the economic adjustment program, the IMF released funding under the country's standby arrangement and extended it for a year.

The current favorable momentum is expected to continue, and this *Update* upgrades the 2010 GDP growth forecast to 6.5%, from 6.0% in *ADO 2010*. Political stability, improved credit ratings, private sector revival, and government infrastructure investment underpin a strengthened economy. No change is made in projected inflation.

Imports have picked up, though the turnaround in exports is less significant. The withdrawal of GSP Plus by the European Union in August 2010 could affect export performance in the last quarter of the year. On these developments, the projected current account deficit is now expected to widen to 2.5% of GDP in 2010, from 2.0% given in *ADO 2010*. No change is made in the 2011 forecast (3.0% of GDP).

Southeast Asia

Subregional assessment and prospects

Aggregate GDP growth in the 10 Southeast Asian countries is now forecast to increase by 7.4% in 2010, faster than previously expected and a sharp rebound from growth of just 1.3% in 2009 (Figure 3.1.10). Better than expected performances in the first half of the year—driven by a strong recovery in global trade and a broad-based increase in domestic demand—are behind the upgrade.

The recovery in many Southeast Asia economies was initially driven by a pickup in both global and regional demand, particularly from the PRC. This caused a sharp recovery in exports of both manufactured goods and commodities. The resulting increase in manufacturing output, the firming up of labor markets, higher wages, and increased agricultural commodity prices led to higher urban and rural incomes and a rebound in private consumption.

Investment also surged as business sentiment improved on the back of stronger global and domestic demand. Economic stimulus programs introduced during the downturn in 2009 continued to exert a positive influence on domestic demand during the first-half of 2010 in a number of these economies.

Despite a sharp increase in subregional exports, the contribution of net exports to economic growth was generally modest, or negative in the case of Malaysia, as imports increased even faster due to the heavy dependence of most countries on imported inputs for manufactured exports.

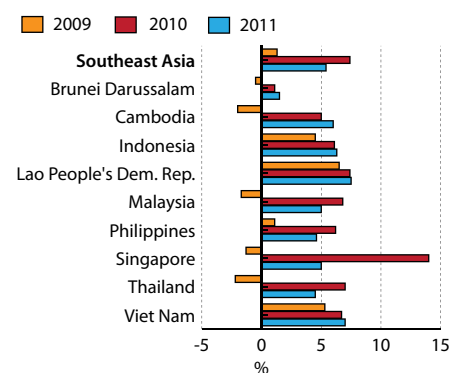
Growth forecasts for 2010 are revised up from April for all subregional countries, except Brunei Darussalam and Myanmar, with those most open to international trade—particularly Malaysia, Singapore, and Thailand—recovering the fastest. Singapore had the fastest year-on-year growth (17.9%) in the first half of 2010 as net exports contributed most to GDP growth, while investment and consumption powered GDP growth in Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.

In the more open economies of Malaysia and Thailand, the rebuilding of inventories, which were run down in 2009, contributed substantially to GDP growth, as did private consumption and fixed investment. Government consumption in these two economies remained at relatively robust levels owing to disbursements under stimulus programs. The main contribution to growth in Indonesia and the Philippines, which are less dependent on exports, was private consumption, followed by fixed investment.

Brunei Darussalam is still expected to experience a modest recovery in 2010, but will be held back a little by the government's decision to conserve the country's oil and gas reserves, and by limited progress in economic diversification. In Myanmar, foreign investment in the hydrocarbon sector, a modest recovery in agriculture, and an increase in election-related public expenditure will likely increase GDP, but not to the extent projected in April. Higher growth in Cambodia and the Lao People's Democratic Republic will be underpinned by rebounds in exports and tourism.

Growth in the subregion will likely slow in the second half of this year relative to the generally fast pace of the first 6 months, and the expansion is forecast to moderate in 2011. Various common factors will contribute to

3.1.10 GDP growth, Southeast Asia



Source: Asian Development Outlook database.
[Click here for figure data](#)

this slowdown. During the second half of 2010 and in 2011, the favorable base effect of a contraction in, or sharply slower, GDP growth in the first half of 2009 will play itself out. Moreover, with recovery now appearing to be firmly on track, fiscal and monetary authorities are likely to complete the unwinding of policy stimulus this year. Interest rates have been raised in Malaysia, Thailand, and Viet Nam, and other measures have been taken to contain emerging asset bubbles in some stock and property markets.

The world economy is experiencing considerable uncertainty, though, and there are signs that economic activity across Southeast Asia is starting to decelerate. Investment due to restocking is slowing in Indonesia, Malaysia, the Philippines, and Thailand, suggesting that the restocking cycles in both export and domestic markets are nearing completion. In several countries, net exports were beginning to exert a bigger drag on growth in the second quarter relative to the first, suggesting slowdown in demand for exports. GDP growth in Southeast Asia as a whole is now projected to moderate to 5.4% in 2011, bumped up a little from *ADO 2010*.

As economic recovery strengthened in January–June, inflation across the subregion edged up, but remained manageable. Aggregate inflation is projected to rise to 4.2% in 2010 (Figure 3.1.11), from 2.6% in 2009 when global food and fuel prices dropped in the wake of the global recession. In 2011, inflation for the subregion is also seen at 4.2%. Forecasts for both years are a shade lower than in *ADO 2010*. Inflation pressures have been kept subdued in several economies, including Malaysia, the Philippines, and Thailand, by the presence of output gaps, while a steady appreciation of the currencies of the bigger economies against the US dollar helped contain imported inflation. Inflation is expected to rise during the rest of 2010 as output gaps narrow.

In 2011, higher domestic demand, combined with a planned reduction in subsidies in some economies, will add to inflation pressures, offset to some extent by firming exchange rates and a forecast decrease in global food prices. Myanmar and Viet Nam will continue to post the highest rates of inflation during the forecast period (although forecasts for both are trimmed from April).

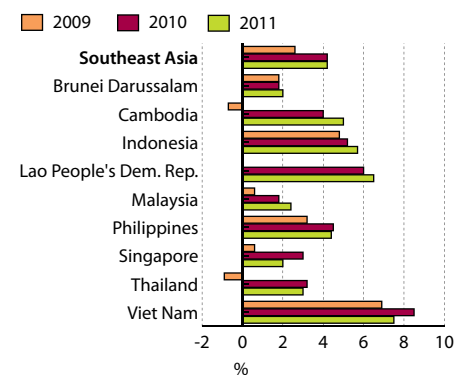
With some intercountry differences, the overall subregional current account surplus as a share of GDP is still forecast to decline to 5.7% in 2010, from 7.1% in 2009, and to remain at around 5.7% next year (Figure 3.1.12). Export growth is projected to moderate over the rest of this year and into 2011 owing to a less supportive external environment, the completion of inventory building in industrial economies, and lower prices for some commodities. Import growth is likely to remain robust, a result of buoyant domestic demand. Viet Nam's current account deficit is expected to narrow because of improvements in its trade account, remittances, and inbound tourism.

Country highlights

Indonesia

A welcome increase in fixed capital investment together with higher levels of private consumption drove 5.9% growth in GDP in the first half of 2010. Government consumption spending declined as the government

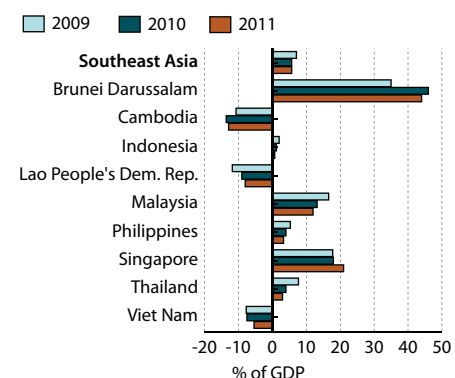
3.1.11 Inflation, Southeast Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.1.12 Current account balance, Southeast Asia



Source: Asian Development Outlook database.

[Click here for figure data](#)

unwound its fiscal stimulus and as budget disbursement lagged behind schedule. The monetary authorities left the policy interest rate at low levels to stimulate growth in credit and in the context of modest core inflation and an appreciating exchange rate. On the production side, services contributed most to GDP growth, while manufacturing and mining expanded at a moderate pace. Agricultural output was affected by bad weather.

Investment is expected to gather momentum through the second half of 2010 and private consumption to grow at a healthy rate. Export growth will moderate, though. On balance, the forecast for full-year growth is raised from April to 6.1%, and for 2011 to 6.3%, owing to projections of further growth in private consumption and in private and public investment.

Inflation accelerated to just over 6% in July and August, fueled by higher prices for food (a result of bad weather) and an increase in electricity tariffs. Some of the pressures on prices were one-time and seasonal factors (which were expected to subside). Forecasts for year-average inflation of 5.2% in 2010 and 5.7% in 2011 are trimmed from those made in April. However, inflation could exceed these forecasts given the quickening economic growth, accommodative monetary policy, and possibility that bad weather could revive upward pressure on food prices.

While merchandise exports rebounded by 39% in the first half of this year, imports rose by nearly 50%, owing to the need to import materials for the export industries together with the demand for imported consumption and fixed capital goods. Current account surpluses are now forecast at 1.2% of GDP in 2010 (slightly lower than expected in April) and 0.7% in 2011.

Malaysia

First-half GDP growth was stronger than expected at 9.5%. Recovery in global trade and a broad-based increase in domestic demand drove the recovery. While the pace of growth will ease in the second half, private consumption is seen remaining robust, reflecting a firming labor market and higher incomes. Private investment in fixed capital and inventories is supported by a recovery in export-oriented manufacturing industries. Efforts to reduce the fiscal deficit are likely to damp public consumption and investment during the rest of 2010. Monetary stimulus, too, is being unwound—the central bank raised its policy interest rate three times from March to end-August 2010.

The slowdown anticipated in the second half is mainly due to base effects (the economy picked up from a slump in the second half of 2009) and slower growth in several export markets. Nevertheless, the forecast for growth in 2010 is raised to 6.8% on the basis of the powerful first-half recovery. For 2011, GDP growth is forecast to moderate to 5.0%, owing to less favorable base effects, unwinding of policy stimulus, and tamer growth in global and regional export markets.

Upward pressure on prices has been milder than anticipated, so that the 2010 inflation forecast is lowered to 1.8%. The continuing output gap, exchange rate appreciation (the ringgit strengthened by 8.8% against the US dollar in the first 8 months), and maintenance of price controls on some basic goods will keep inflation at low levels. In 2011, higher domestic demand combined with planned reductions in subsidies will add to

inflation, while the firming exchange rate and subdued global commodity prices will counteract some of that influence. Taking these factors into account, inflation is now forecast to edge up to 2.4% in 2011.

On the trade front, export growth is projected to moderate over the rest of this year and into 2011, due to a less supportive external environment, the completion of inventory buildups in industrial economies, and lower prices for some export commodities. Import growth is expected to remain robust owing to buoyant domestic demand. A narrowing of the trade surplus is likely to be reinforced by deterioration in the income balance because of increased outflows of profits and dividend payments. This narrowing should be partly offset by an improvement in the services account as inbound tourism picks up. Forecasts for the current account surplus are edged down to the equivalent of 13.2% of GDP this year and about 12% in 2011.

Philippines

Economic growth of 7.9% in the first half of 2010 was stronger than expected. Private consumption accounted for about half the total growth, supported by a near 7% gain in the US dollar value of remittances sent home by workers abroad. Investment contributed significantly to growth for the first time since 2007, with a 21% increase in fixed capital investment. Government expenditure also climbed, ahead of presidential and legislative elections in May and as a result of additional spending on conditional cash transfers to poor families and reconstruction of typhoon-damaged infrastructure.

On the production side, industry contributed most of the GDP growth as export-oriented manufacturing (particularly electronics) as well as construction and mine production rose steeply. Services grew, but agriculture contracted in the first half because of dry weather.

Growth is expected to decelerate in the second half as the low-base effect fades and inventory rebuilding levels off. For the full year, GDP growth is forecast to be 6.2%, revised up from April because of stronger than foreseen rebounds in trade and investment. In 2011, growth is seen easing to 4.6% as a consequence of base effects, reduced policy stimulus at home and abroad, and slower growth in world trade. The new government aims to rein in the fiscal deficit, but also to promote public-private partnerships to build infrastructure.

Inflation pressures have been milder than anticipated. Upward pressures on rice prices caused by the dry weather were countered by an increase in rice imports, and a 2.8% appreciation of the peso against the US dollar in the first 8 months helped to shield the economy against imported inflation. Inflation forecasts are trimmed to 4.5% in 2010 and 4.4% in 2011.

The external position strengthened in the first half of 2010. Merchandise exports rebounded by 38.5%, propelled by a surge in shipments of electronic products, and imports increased by 29.7%. The current account surplus rose, a result of a narrower deficit in merchandise trade (but a smaller surplus in services trade) and the substantial remittances. The overall balance of payments increased, lifting gross reserves to nearly \$50 billion by August. Forecasts for the current account surplus are raised to 4.0% this year and 3.3% next year.

Singapore

Rebounding from last year's economic contraction, GDP surged by 17.9% in the first half of 2010. The export-led recovery spilled over into stronger private consumption and investment. Merchandise exports rose by 37.5% in US dollar terms in the first half, and imports by 34.6%.

Stronger external demand for goods such as chemicals, electronics, and pharmaceuticals drove a surge in manufacturing production. About 40% of Singapore's exports were destined for the PRC, and growth in that market helped to offset weakness in industrial countries.

Export-oriented services—finance, tourism, and trade-related—joined the recovery. Net exports of goods and services contributed more than half the total first-half increase in GDP.

Growth will decelerate in the second half, given base effects brought about by a pickup in the prior-year period, coupled with the impact of more moderate expansion in the PRC and several other export markets. The forecast for full-year growth is raised to 14.0% (and it could exceed that high rate) in light of the much stronger than expected outcome for January–June. For 2011, the growth forecast is maintained at 5.0%, in the context of subdued global growth. Large current-account surpluses are still projected for both years.

Inflation picked up from 0.2% year on year in January to 3.3% in August. The monetary authorities, starting to reverse an effective loosening of monetary policy implemented during the global financial crisis, in April this year raised the Singapore dollar's trading band and allowed the currency to appreciate. The forecast for average inflation in 2010 is raised to 3%, owing to higher than expected domestic demand. The government, concerned that a bubble might be inflating property prices, has taken steps to curb speculation in housing, and has said that it will increase the supply of public housing and land available for residential construction. Inflation is expected to slow to about 2% in 2011, in tandem with economic growth.

Thailand

Vigorous growth in the first half of 2010 pulled the economy out of the contraction experienced in 2009. Momentum was interrupted when political tensions broke out into violent demonstrations in Bangkok during April and May, though GDP still managed to grow by 10.6% in January–June.

Domestic demand contributed nearly all the GDP growth in the first half. Private consumption benefited from a firming labor market and higher farm incomes, as well as from fiscal stimulus measures initiated in 2009. Fixed capital investment rose significantly, with increases in investment in machinery and equipment as well as building. Delayed disbursement on government projects damped public investment, however. From the supply side, industry contributed nearly all the GDP growth. Services also expanded, but agricultural production fell slightly because of drought and pest infestations.

Growth in the second half of 2010 will decelerate markedly, as the base effect of the slump in the first half of 2009 fades and because of slowing growth in several major export markets. Monetary policy stimulus is being withdrawn—the Bank of Thailand started to raise its

policy interest rate in July. Nevertheless, the economy is now expected to expand by 7.0% in 2010, revised up from April because of the stronger than expected rebound in the first half. In 2011, growth will likely moderate to about 4.5%. A resurfacing of the domestic political tensions remains a risk to this outlook.

The baht appreciated by 5.3% against the US dollar in the first 8 months of 2010, which contributed to containing inflation (it averaged 3.4% year on year in that period). The full-year inflation forecast is trimmed to 3.2%. Price pressures are expected to ease slightly next year, along with economic activity.

Merchandise exports rose sharply from 2009's low levels, by 36.6% in the first half of 2010, and imports surged by 51.7%. Surpluses in the current and capital accounts pushed up international reserves to \$151.5 billion by July. The current account surplus is seen at 4.0% of GDP this year and 3.0% in 2011.

Viet Nam

First-half economic growth of 6.2% was stronger than expected, with solid gains in the industry and services sectors and modest growth in agriculture. The rebound in world trade spurred manufacturing production, and a recovery in global travel lifted inbound tourism. Construction slowed early in the year when domestic credit was squeezed, but it then turned up strongly. Robust growth was recorded in utilities, transport and communications, and financial services. On the downside, production of crude oil resumed its decline.

Fiscal and monetary stimulus initiated during the global crisis sparked a near 40% surge in credit growth as 2009 progressed, putting upward pressure on inflation and eroding foreign exchange reserves. With macroeconomic stability at risk, the authorities started to withdraw the stimulus from late in 2009. Macroeconomic conditions improved in the second and third quarters. The current account deficit narrowed sharply in the first half of 2010 from the second half of 2009, and foreign reserves started to increase from low levels. Policy tightening and a good rice harvest pulled back inflation to 8.2% in July–August 2010, from 9.5% in March, although it increased to 8.9% in September.

The authorities devalued the dong exchange rate three times between November 2009 and August 2010, by a total of about 11% against the US dollar. The sizable trade deficits and relatively high inflation, coupled with residents switching from local-currency assets into US dollars and gold, had put downward pressure on the dong.

Assuming that macroeconomic stability is maintained in the forecast period, economic growth this year is projected at 6.7%, revised up from April in light of the stronger first-half performance and a quickening in growth anticipated in the second half of 2010. Growth is seen rising to 7.0% in 2011 as investor confidence improves, reflecting more subdued inflation and more robust external accounts.

Given that credit growth has moderated and macroeconomic conditions have generally improved, forecasts for inflation are shaved to 8.5% in 2010 and 7.5% next year. The current account deficit is seen narrowing to 7.5% of GDP and 5.4%, and foreign reserves are expected to increase modestly. However, a premature easing of policy, or a perception

of looser policy by financial markets and domestic investors, would risk derailing the stabilization efforts, putting inflation on an upward path and reserves on a downward one. That would likely require a more stringent policy tightening later, denting growth prospects in 2011.

Other economies

Brunei Darussalam

After contracting by an estimated 0.5% in 2009, this economy is forecast to stage a modest recovery and grow by 1.1% in 2010 and 1.5% in 2011. Growth will be underpinned by a small increase in oil and gas production as global demand and prices for hydrocarbons picks up with the recovering global economy. The start of production and exports of methanol in the first half of 2010 will provide a lift to growth.

Still, the hydrocarbon sector's contribution to growth will remain modest, given the government's decision to tap reserves sparingly to extend the life of energy production. Private consumption is likely to be tame this year a result of measures taken to prevent the buildup of a credit bubble through restrictions on lending and tighter regulations on credit card debt.

Inflation is set to edge up to 1.8% in 2010 and 2.0% in 2011, a touch higher than forecast in April. Its evolution depends largely on movements in prices of food, most of which is imported. Stability of the Brunei dollar against the US dollar and maintenance of an extensive array of government subsidies will hold inflation to low levels.

Forecasts for current account surpluses have been raised to 46% of GDP in 2010 and 44% in 2011. The surpluses are underpinned by higher oil and gas prices, a likely increase in tourist arrivals, and increased net income inflows with a recovery in prices of the country's assets abroad. Growth in imports, however, is projected to more than offset higher exports, reflecting increases in the machinery and equipment that are needed for oil exploration, together with growth in construction materials for government infrastructure projects.

Cambodia

Economic growth in 2010 is now forecast at 5.0%, upgraded from *ADO 2010* because of solid growth in garment exports and tourism arrivals. US Department of Commerce figures indicate that garment imports to the US from Cambodia in the first 7 months of this year increased by over 10% in US dollar terms, and by about 24% in volume terms, compared with the prior-year period.

Tourist arrivals rose by 12.4% in the first 6 months of 2010. However, growth in construction remains subdued and agricultural production is expected to be hurt by the late arrival of the rains this year.

Growth is projected at around 6% in 2011, reflecting forecast increases in garment exports and tourism receipts, an expansion of rice exports following a new rice production and export policy, and a pickup in nongarment manufacturing and some other services subsectors.

Inflation has been more muted than was expected in April, so that the full-year forecast for 2010 is trimmed to 4.0%. Next year, inflation is likely to edge higher to about 5%, in step with economic activity.

In the external accounts, preliminary data showed that merchandise exports grew by 6.1% in the first 6 months of 2010, a faster pace than for imports (4.8%). The recovery in tourist arrivals is expected to lift income from this source. The current account deficit, excluding official transfers, is anticipated to be narrower than forecast in April, at about 13.6% of GDP in 2010 and 12.9% in 2011. Gross foreign reserves edged up to nearly \$2.5 billion in the first 7 months of 2010 from end-2009, equivalent to about 4 months of projected imports.

Lao People's Democratic Republic

Prospects have improved for this economy, and the forecast for GDP growth in 2010 is lifted to 7.4%. The industry sector, particularly minerals and hydropower generation, has continued to expand, and export orders for garments rose by about 15% year on year in the second quarter of 2010. Tourism arrivals have increased modestly. However, drought delayed planting of rice, which could dent growth in agriculture this year. The GDP growth forecast for 2011 is maintained at 7.5%.

Inflation has been higher than expected, accelerating to 6.8% year on year in July. The main factors were higher food and fuel prices, with the drought hurting food production and prices. Inflation is now projected to average 6.0% in 2010, quickening to 6.5% in 2011.

This year's start of large power exports from the Nam Theun 2 hydropower project and rising global prices for exports of copper, gold, and silver have improved the current account position. Forecasts for the deficit on that account are narrowed to 9.0% of GDP in 2010 and 8.0% in 2011.

Exports of electricity and minerals are set to increase further next year with the commissioning of more hydropower projects and expansion of two mines scheduled for completion by end-2010. The overall balance of payments will remain positive over the forecast period, supported by inflows of foreign direct investment.

Myanmar

GDP growth is expected to rise to 5.0% in FY2010 (ending 31 March 2011) and to 5.3% in FY2011, both forecasts lowered slightly from *ADO 2010*. The economy this year is expected to get a lift from foreign investment in two new gas fields and construction of an oil and gas pipeline to the PRC.

Private consumption will be supported by an increase in public sector wages announced earlier in the year, and higher rural incomes coming from a modest increase in agricultural commodity prices and a gradual increase in agricultural production. Public consumption and investment are likely to rise due to expenditure that is related to national elections announced for November 2010. In FY2011, agricultural output is projected to increase further, assuming that efforts to modernize the sector gain traction after the elections.

Inflation is forecast to quicken to 7.5% in FY2010 as prices for imported food and fuel rise from last year's low levels, and then move up by about 1 percentage point next fiscal year. Exports during the forecast period will be offset by imports due to higher prices for imported petroleum products and increased imports of capital equipment, construction materials, and consumer goods. The current account deficit is forecast to widen from 1.8% of GDP in FY2010 to 2.3% in FY2011.

The Pacific

Subregional assessment and prospects

The aggregate growth projection for 2010 is raised to 4.3% (Figure 3.1.13), mainly owing to upgrades in the growth outlook for the Solomon Islands and Timor-Leste, two of the larger economies. The Solomon Islands' revision is based on a stronger than expected rise in prices for some commodities, which will lift exports. For Timor-Leste, higher growth than previously expected in April's *ADO 2010* is driven by increases in government expenditure, funded by revenue from offshore petroleum production.

Solid growth in Papua New Guinea, the biggest Pacific economy, is a major contributor to the subregional aggregate projection. The forecast for this producer of agricultural commodities, metals, and energy is maintained at 5.5%.

However, the good prospects for these resource-driven economies mask the fact that the majority of Pacific economies are barely growing, and that forecasts for several are revised down. Tonga is now expected to join the Fiji Islands in facing a contraction of economic output this year. Tonga's downgrade is the result of delays in infrastructure investment coupled with weaknesses in remittances, tourism, and domestic demand. Forecasts also are lowered for the Cook Islands, Kiribati, Nauru, and Vanuatu.

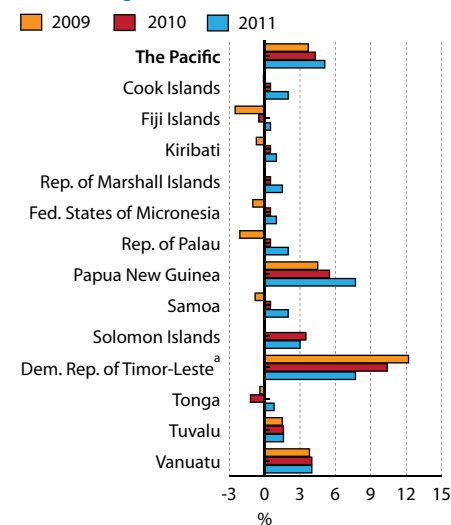
Growth in tourist arrivals in most destinations in the Pacific has slowed this year as the Fiji Islands regains some of the market share that it lost last year (partly on account of floods). But heavy discounting of tourism services in the Fiji Islands is expected to translate into minimal increases in tourism receipts.

Governments in the Cook Islands, the Republic of the Marshall Islands, Samoa, the Solomon Islands, and Tonga adopted programs of policy reform and public sector adjustment, assisted by development partners. These programs provide budget support to finance infrastructure upgrades and help to preserve priority expenditure on government services.

In 2011, subregional growth is expected to pick up to 5.1%, revised up slightly from the earlier forecast. The projection for Timor-Leste is raised to 7.7% because of higher levels of government spending, and Papua New Guinea is expected to grow at this rate, too, as investment accelerates in a large gas export project. The Fiji Islands and Nauru are likely to resume growth next year, supporting the increase in the subregional total. Growth forecasts are lowered a touch for Kiribati and Tonga, though. Excluding the two energy producers (Papua New Guinea and Timor-Leste), growth for the rest of Pacific subregion is forecast to remain low at 1.3%. Higher and sustained rates of growth there depend on further policy reforms.

Subregional inflation is projected to increase to 5.9% in 2010 (Figure 3.1.14), up from 2009 and faster than previously anticipated. Inflation has been driven by higher global prices for oil and commodities and by accelerating price pressures in some of the subregion's trading partners. Marked increases in inflation are now seen for the Fiji Islands and Timor-Leste. The projection for inflation in the Pacific in 2011 is maintained at 5.4%.

3.1.13 GDP growth, the Pacific

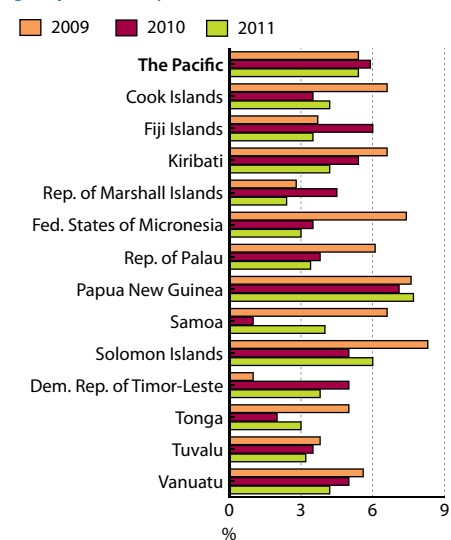


^a non-oil GDP.

Source: Asian Development Outlook database.

[Click here for figure data](#)

3.1.14 Inflation, The Pacific



Source: Asian Development Outlook database.

[Click here for figure data](#)

As in previous years, large current account deficits are projected for 2010 in most Pacific economies. Current account deficits are expected to widen from 2009 for economies including Papua New Guinea, Samoa, and the Solomon Islands as growth in imports of goods and services outpaces that for exports. Timor-Leste's strong external position, a consequence of income from oil and gas extraction, puts the subregional total into surplus (Figure 3.1.15).

Country highlights

Fiji Islands

The economy is forecast to contract by 0.5% in 2010, the fourth consecutive year of shrinking GDP. Sugar production is expected to fall from 2009 levels, due largely to dry weather, a declining area under sugarcane as farmers leave the industry, and poor mill performance. Tourist arrivals have picked up, but revenue has been dented by aggressive price discounting.

Fiscal constraints have damped government spending, although budget revisions at midyear allowed for a small net increase in spending to repair damage from cyclones in early 2010 and from widespread termite infestation this year. Consumer spending has been hurt by rising inflation and weakness in remittance inflows.

GDP growth is expected to resume in 2011, at the low rate of about 0.5%. The government that was installed after a military coup in December 2006 is taking action to overcome some of the difficulties (primarily concerning access to land) faced by the sugar industry. It is also discussing a standby arrangement with the IMF, which, if concluded, would likely improve business and investor confidence.

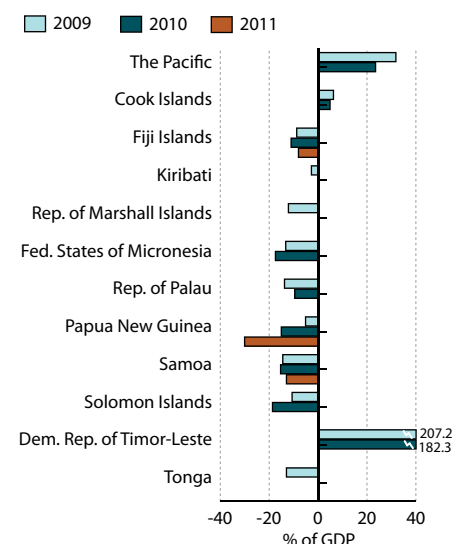
Inflation accelerated to 10.5% year on year in April 2010 due to the removal of some price controls, the impact of a devaluation of the Fiji dollar in April 2009, higher fuel prices, and increased liquidity in the banking system. Inflation is now expected to average 6% in 2010, revised up from April. By 2011, the impact of the devaluation and removal of price controls will have faded, so that inflation next year is forecast to decelerate to 3.5%.

The Reserve Bank of Fiji raised the reserve requirement for commercial banks in two stages during June and July 2010 to reduce excess liquidity in the banking system. However, growth in credit to the private sector has been below 1% in 2010, and credit fell in some months.

The external position is expected to remain fragile, with the current account deficit widening to 11.0% of GDP in 2010. Foreign exchange reserves at end-August 2010 were equivalent to 3.7 months of imports of goods and nonfactor services, but are inflated by restrictions on repatriation of bank profits and company dividends.

The Fiji Islands faces a large external financing gap in 2011 when a \$150 million sovereign bond matures. The government's response has been to limit expenditure, and prioritize export promotion and import substitution. However, across-the-board cuts in government operations and in staffing have diminished its capacity to provide services. Measures to bolster revenue may be necessary.

3.1.15 Current account balance, The Pacific



Source: Asian Development Outlook database.

[Click here for figure data](#)

Papua New Guinea

This resource-rich economy is benefiting from the recovery in global commodity prices, especially for copper, gold, and crude oil. However, as foreseen in April, some major resources projects have been delayed. Construction of a \$16 billion liquefied natural gas (LNG) project has been held up by land access and compensation issues, as well as by a shortage of skilled labor. Startup of production at a new Ramu nickel–cobalt mine, originally scheduled for midyear, has been delayed until the end of the year by a dispute with a landowner group over environmental issues.

Other industries are performing strongly. In agriculture, production levels are expected to rebound from depressed levels in 2009, and an outbreak of cocoa pod borer disease has been contained. Construction activity has been boosted by new resource projects and demand for new commercial and residential properties, which are in short supply. Competition and expansion in the mobile telephone industry continues to stimulate services growth.

On the back of higher commodity prices and better agricultural production, the value of exports increased by about 37% in the first half of 2010 from the prior-year period. Private sector credit grew by 18% in the 12 months to June 2010. Public expenditure in real terms increased by about 2% in the 12 months to March 2010, even though revenue fell by 18%, as the government drew down about \$700 million (equivalent to 9% of GDP) from trust funds established during times of very high commodity prices in the past.

Taking these factors into account, the GDP growth forecast for 2010 is maintained at 5.5%. Next year, growth is expected to accelerate to 7.7% as investment picks up in various projects, particularly the big LNG plant.

Inflation is seen remaining relatively high, averaging 7.1% in 2010 and 7.7% in 2011. Price pressure is being generated from high levels of private sector activity and public sector spending from trust funds.

The current account deficit is expected to widen sharply this year (to 15% of GDP) and next (to 30%), in large part a result of a surge in imported equipment required for the LNG plant and other projects. Foreign reserves totaled \$2.8 billion at end-June 2010, sufficient for about 15 months of nonmineral import cover.

Democratic Republic of Timor-Leste

Growth in the preferred measure of this economy—GDP excluding offshore petroleum production—was revised up for 2009 from a preliminary estimate of 5.0% in *ADO 2010* to 12.2%. The upgrade was driven by a fourth-quarter surge in own-funded government expenditure, particularly on capital items, and a better than expected agricultural performance.

Growth forecasts for this year and next, too, are raised from April, to 10.4% and 7.7%, respectively, mainly owing to higher levels of government expenditure funded by the country's earnings from offshore oil and gas production. The original 2010 budget allowed for a small increase in own-funded government expenditure, but a supplementary budget approved in June 2010 increased expenditure by nearly 40%. Much of this is allocated for cash transfers (such as to war veterans) and for small-scale capital works, which will keep aggregate demand high.

Private construction, transport and communications, wholesale and retail trade, and agriculture are all expanding this year.

Inflation, which accelerated to 6.6% year on year in June 2010 from 1.6% at end-2009, is now expected to average 5.0% this year, higher than the previous projection. The gain reflects higher imported inflation and buoyant domestic demand. For 2011, inflation is projected to slow to 3.8% as growth in the domestic economy eases and global oil prices moderate.

Assets in the nation's Petroleum Fund rose to \$5.9 billion in the first 4 months of 2010 and are projected to reach \$6.4 billion by year-end. The savings are accumulating faster than expected, despite government withdrawals that substantially exceed estimated sustainable income. (That income figure—now 3% of the net present value of petroleum revenue—is that level of withdrawal that can be sustained indefinitely.) While the 2010 budget originally kept expenditure below estimated sustainable income (\$502 million), the amount to be withdrawn is now budgeted to exceed it by \$309 million.

Key issues for budget management are whether the higher levels of expenditure are fiscally sustainable, and whether implementation capacity has advanced so that additional budget allocations can be spent effectively and in a transparent and accountable manner.

In July 2010, Timor-Leste became only the third nation to comply with the Extractive Industries Transparency Initiative, an international agreement that aims to strengthen governance by improving transparency and accountability in the mining and oil industries. Compliance provides international recognition that Timor-Leste is accurately and fully disclosing the government revenue it receives from petroleum.

Small Pacific countries

Samoa

After 5 consecutive quarters of contraction, GDP grew by 0.7% year on year in the October–December quarter of 2009; slight 0.5% growth is still forecast for 2010. Post-tsunami reconstruction has stimulated growth (a tsunami battered coastal areas in September 2009). Inflows of remittances from Samoans working abroad rose after the tsunami. However, that increase has faded, in part because of weak labor markets in some source economies. Tourism, too, is subdued: visitor arrivals for the first 4 months of 2010 fell by 4.7% year on year.

The government plans to maintain an expansionary fiscal policy in FY2011 (ended 30 June 2011) through increased spending on education, health, and agriculture, coupled with tsunami-related expenditure. The budget deficit is set to widen to 9.4% of GDP in FY2011 from 7.6% in FY2010.

Economic growth is expected to pick up to about 2% in 2011, generated by government spending, reconstruction activity, and higher inflows from remittances and tourism as economies strengthen in source countries.

Inflation has been low so far in 2010; indeed the consumer price index fell by 0.3% year on year in June. Prices are expected to edge up later in the year because of higher costs of fuel and goods imported from New Zealand. On the basis of lower than expected inflation in the first half of 2010, the full-year forecast is lowered to 1.0%. Inflation next year is seen

accelerating to 4.0% in tandem with the pickup in domestic demand and rising prices for imported goods.

The FY2011 budget strategy statement acknowledges that fiscal consolidation may not be achievable until after FY2013, because of tsunami-related costs. The macroeconomic framework in the budget shows public debt peaking at 52% of GDP in FY2013 (in net present value terms).

Solomon Islands

A stronger than expected recovery in production of cocoa, fish, logs, and palm oil has prompted an upward revision to the 2010 GDP growth forecast, to 3.5%. Higher prices for most of these commodities stimulated output. However, the pickup in the economy from 2009, when GDP was flat, has been uneven. A survey of business expectations showed that 61% of businesses in June 2010 reported unchanged or declining sales compared with the same period in 2009 (though 56% expected sales to improve over the next 3 months).

Government finances remain strained. Revenue collections fell short of budget targets in the first 5 months of 2010, and payroll costs exceeded budget by about 10%. Development expenditure was below target levels.

Policy reforms aimed at strengthening fiscal operations and reducing the economy's dependency on logging and foreign aid are being implemented with assistance from development partners. The IMF in June 2010 approved an 18-month \$18.3 million standby credit facility to support the reforms.

Economic growth is expected to moderate to 3.0% in 2011 as the decline in logging continues, a result of unsustainable harvesting of the native forest for over 20 years. Still, GDP growth could exceed this forecast if efforts to restart gold production at the Gold Ridge mine are successful. (The impact on government finances would be limited, though, due to generous tax breaks for mining.)

Inflation has been at modest levels so far in 2010, and the full-year forecast is lowered to 5.0%. Higher prices for imports, notably fuel and food, are expected to exert upward pressure later this year and in 2011 (when inflation is forecast at 6.0%).

The current account deficit is now expected to widen to nearly 19% of GDP in 2010, with imports of machinery and equipment (for mining and telecommunications) contributing to higher imports. Foreign reserves nevertheless rose to \$1.5 billion in June 2010, equivalent to 6.7 months of imports of goods and nonfactor services. The increase was attributable to inflows from donors and the first tranche of the IMF credit.

Tonga

GDP declined by an estimated 1.2% in FY2010 (ended 30 June 2010), a worse outcome than projected in April. The contraction was the result of weakness in remittances from overseas workers and in tourism receipts, poor export performance, and delays in spending on public infrastructure.

Remittances fell by 11.6% from FY2009. Recent monthly data indicate that the decline is slowing. Nonetheless, high unemployment in major source markets, notably the US, suggests that remittances will remain relatively weak. Earnings from tourism fell by 14.8% in FY2010.

Credit to the private sector has contracted since banks tightened lending conditions when bad loans increased 2 years ago. The contraction in credit to businesses has been sharper than that to households.

GDP is expected to increase in FY2011, but the growth forecast is lowered to 0.8% in view of subdued remittances and tourism, credit constraints on the private sector, a weak business outlook, and fiscal constraints (giving the government little room to stimulate growth).

Government revenue fell short of the budget target by 20% in FY2010, requiring expenditure restraint and increased reliance on grants. A further decline in revenue is expected in FY2011. The net present value of public debt stands at 55.8% of GDP; more than 90% is external. The government intends to run primary budget surpluses in FY2012 and FY2013.

Inflation averaged about 2% in FY2010, lower than forecast. Price pressures will be a little stronger in FY2011 as the economy resumes growth and because domestic food prices are rising. The FY2011 inflation forecast is kept at 3.0%.

Both exports and imports declined in the year to February 2010, the weakness in imports reflecting the soft domestic demand. Foreign reserves have remained high, at the equivalent of 6.5 months of import cover in March 2010. In FY2011, exports are expected to recover slightly and imports to grow, widening the current account deficit. Foreign reserves are likely to remain at a comfortable level through FY2011.

Vanuatu

Projected economic growth in 2010 is revised down to 4.0%, primarily because of a weaker than expected performance in tourism, which contributes about 20% of GDP. After growing by 10.8% in 2009, tourist arrivals fell by 6.0% in the first 5 months of 2010, the result of vigorous marketing and heavy discounting by the tourism industries in the Cook Islands and the Fiji Islands.

Soft domestic demand is evident in slowing growth in both imports and private sector credit. Imports from Australia fell by 5.9% in the first quarter of 2010. Receipts from the value-added tax declined in January and February 2010 from prior-year levels.

Inbound tourism, particularly from Australia and New Zealand, is expected to be stronger in 2011 than in 2010, given the outlook for robust economic growth in those countries. However, tourism capacity constraints are emerging in Vanuatu, which could cap prospects for the industry. The GDP growth forecast for 2011 is maintained at 4.0%.

Inflation was 2.8% year on year in the first quarter of 2010, but is projected to accelerate and average 5.0% in 2010 due to the imposition of excise taxes on tobacco and beverages in March 2010 and higher prices for imported goods. Next year, inflation is expected to moderate to 4.2% as the effects of the introduction of the excise taxes fade.

Vanuatu's growth over the past 8 years has been based largely on private sector investment underpinned by policy reforms that improved the business environment. Maintaining solid GDP growth in the medium term is likely to require that reforms focus on state-owned enterprises. They earn very low returns on capital employed, divert government resources from social investments, and, as they are often the sole service providers, drive up costs of doing business.

A recent audit of one of the larger state enterprises showed that its accumulated losses totaled \$20 million. Moreover, court rulings affirm that the government can be considered a guarantor of state enterprise debts. Of 14 state firms engaged in commercial activities, only four have reported commercially acceptable returns in the past 5 years.

Others

The Cook Islands' economy is expected to grow by 0.5% in 2010, downgraded from *ADO 2010*. Concerns over the level of public debt led to budget cuts, and some infrastructure projects have not proceeded as planned. Further, the tourism industry has performed poorly, despite heavy discounting. Cyclone Pat in February 2010 caused an estimated NZ\$15 million damage on the island of Aitutaki, the second most visited location in the country.

GDP is forecast to increase by 2.0% in 2011 owing to a pickup in construction and improved external demand. Inflation is projected at 3.5% this year, rising to 4.2% in 2011 on the back of higher oil prices and the impact of higher inflation in the Cook Islands' major trading partner, New Zealand.

Kiribati is now forecast to grow by 0.5% in 2010, also revised down from April. Remittances have continued to decline and demand for copra is lower than was expected. The expected improvement in growth next year is downgraded a touch, too. Inflation forecasts are trimmed in view of the weaker domestic demand.

Nauru was expected to record slight growth in FY2010 (ended 30 June 2010), but its GDP is now estimated as flat, largely because storm damage at the port together with weak demand restricted exports of phosphate. Aid from the Russian Federation, amounting to about A\$10 million, will be used mainly to repair mooring facilities. Together with a recovery in world phosphate demand, this should support a return to economic growth, of around 4%, in FY2011.

Growth projections for the Republic of the Marshall Islands, the Federated States of Micronesia (FSM), the Republic of Palau, and Tuvalu are unchanged from *ADO 2010*. The Marshall Islands and FSM are both seen growing by 0.5% in FY2010 (ended 30 September 2010), better results than in the previous fiscal year. For FSM, development partner-funded infrastructure activities will provide additional employment, support domestic demand, and increase government revenue.

Palau, too, is forecast to grow by 0.5% as fiscal tightening gets under way in an effort to stabilize government finances. In 2011, the growth performances of the Marshall Islands, FSM, and Palau are expected to improve along with continued global recovery.

For Tuvalu, economic growth of 1.6% is expected in 2010, supported by an increase in government expenditure. The outlook is similar for 2011, although there is a risk to the forecast if the number of Tuvaluan seafarers gaining employment continues to decline, given the significant contribution to the economy from their remittances.

Bangladesh

Growth in FY2010 was better than expected in April 2010, as a pickup in domestic demand neutralized the impact of weak expansion in exports. Inflation came in below the April projection, and the current account surplus was higher. For FY2011, this *Update* retains the outlook of a moderate uptick in growth, but with a slightly lower forecast for inflation and a larger fall in the current account surplus. To raise growth prospects, power and gas shortages need to be eliminated and reforms accelerated. More fundamentally, political stability will be critical to boosting growth.

Updated assessment

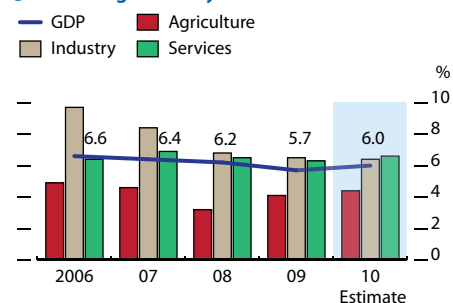
Ministry of Finance sources estimate GDP growth for FY2010 (ended June 2010) at 6.0% on a preliminary basis. This is higher than the projection of 5.5% in the *Asian Development Outlook 2010 (ADO 2010)* released in April as well as the previous year's 5.7% (Figure 3.2.1). Given the sharp decline in the growth of exports and remittances—the economy's two traditional drivers—the better than expected performance stemmed from a boost in domestic consumption, which was underpinned by a strong expansion in credit to the private sector and a rise in public sector wages. Investment was reported to be unchanged at 24.4% of GDP.

Growth in agriculture is estimated at 4.4% (4.1% projected in *ADO 2010*) as major crops performed better than forecast. The higher production was aided by continued government support (including subsidies on input prices), higher procurement prices, expanded credit, and better delivery of extension services. The services sector grew by 6.6% (as against 5.9% projected in *ADO 2010*), reflecting stronger than expected performances of wholesale and retail trade, and transport services.

Industrial growth of 6.4% came in slightly lower than a year earlier as power shortages continued. Still, it was higher than the *ADO 2010* projection of 5.6%, with domestically oriented manufacturing more than offsetting the effects of slower production for export. Robust growth of mining and quarrying and continued expansion of construction and the housing sector, especially in the second half of the fiscal year, also bolstered the sector's performance.

After decelerating in the previous year, inflation rose in FY2010, reaching a 9.1% year-on-year high in February 2010 from 2.3% in June 2009, then moderating through the end of the fiscal year (Figure 3.2.2). Annual average inflation edged up to 7.3% (marginally lower than the 7.5% projected in *ADO 2010*) from 6.7% in FY2009. With relatively benign global commodity prices, inflation pressures intensified, primarily because of demand pressures from the rapid private credit growth and a boost in public sector wages.

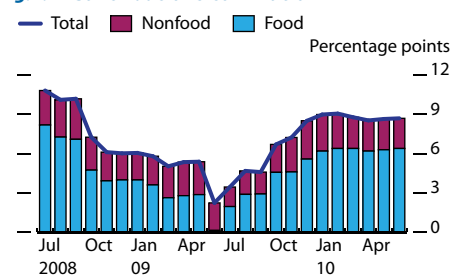
3.2.1 GDP growth by sector



Source: Ministry of Finance. *Bangladesh Economic Review 2010*.

[Click here for figure data](#)

3.2.2 Contributions to inflation



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. July. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

Money supply (M2) and private credit grew strongly year on year during FY2010 (Figure 3.2.3), exceeding their respective annual targets set in the monetary policy of Bangladesh Bank (the central bank). Net credit to the government, however, declined in this period, as strong revenue growth reduced the need for borrowing. Facing mounting inflation pressures, Bangladesh Bank raised commercial banks' cash-reserve requirement by 50 basis points to 5.5% in May 2010. In August 2010, the bank also raised the repo and reverse repo rates by 100 basis points.

The bank's Monetary Policy Statement (MPS), issued in July 2010, indicated that there may have been some diversion of private credit into consumer spending and into speculative investments in the stock market and real estate.

The lending rate declined slightly to 11.2% in June 2010 from the year-earlier level. But the contemporaneous decline in the deposit rate was greater, falling to 6.0%, and to a negative 1.3% in real terms.

To bolster growth, the government adopted an expansionary fiscal stance for FY2010. Expenditure expanded by 25.5% (raising its share in GDP to 16.0% from 14.3% in FY2009). Revenue collection during the year was buoyant: at an estimated 11.5% of GDP, it was up by 1.1 percentage points from FY2009 (Figure 3.2.4). The pickup in domestic economic activity, together with improvements in tax administration, contributed to the strong tax receipts.

Another year of underspending in the annual development program (4.1% of GDP, in place of the 4.4% originally planned) and the good revenue outturn contained the fiscal deficit to 4.5% of GDP (lower than the 5.0% budget target).

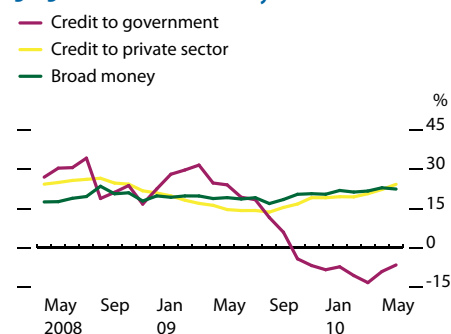
In FY2010, net losses of the 44 nonfinancial state-owned enterprises were estimated at \$18.7 million, a marked switch from the net profit of \$477.2 million in the previous year. A move back into loss of the Bangladesh Petroleum Corporation (BPC) (because no adjustment in the domestic administrative prices of petroleum products were made following the steep rise in global oil prices over the fiscal year), a much worse loss of the Bangladesh Power Development Board (BPDB), and weaker net income of the Bangladesh Telecommunication Regulatory Commission largely accounted for the sharp deterioration (Figure 3.2.5).

The government released \$303.5 million (out of the \$370 million earmarked in the FY2010 budget) to enable BPC and BPDB to settle part of their past liabilities to banks and other creditors. The 6%–7% rise in the power tariff, effective March 2010, aimed to reduce BPDB losses, though expected new generation (from rental diesel units under construction) will raise costs.

Export growth slowed to 4.2% from 10.1% in FY2009 (Figure 3.2.6) as readymade garment exports (knitwear and woven cloth products) grew by only 1.2%, dropping their share in total exports (\$16.2 billion) from 79.3% in FY2009 to 77.1% in FY2010. Continued weak retail sales and low prices in the United States (US) and the European Union (EU), combined with domestic power outages and limited supplies of natural gas used in processing, contributed to the disappointing export performance.

In addition, frequent labor unrest for higher pay and better working conditions affected production. A new minimum wage of Tk3,000 a month (about \$43) was set in June, a raise from Tk1,662 a month

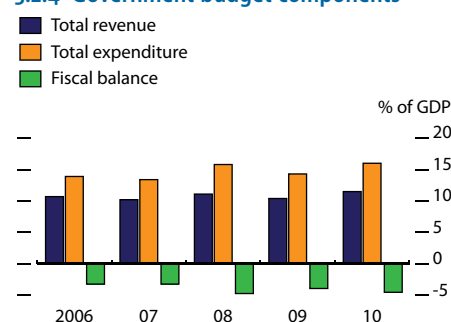
3.2.3 Growth of monetary indicators



Source: Bangladesh Bank, 2010. *Monthly Economic Trends*. June. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

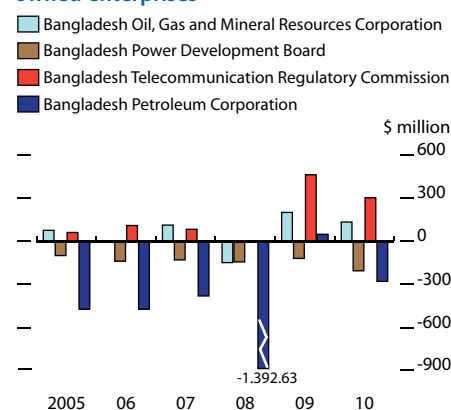
3.2.4 Government budget components



Source: Asian Development Outlook database.

[Click here for figure data](#)

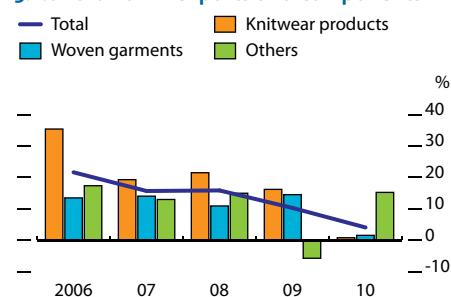
3.2.5 Profit and loss at selected state-owned enterprises



Source: Ministry of Finance. *Bangladesh Economic Review 2010*.

[Click here for figure data](#)

3.2.6 Growth in exports and components



Sources: Bangladesh Bank. *Annual Report 2008–2009*; 2010. *Major Economic Indicators: Monthly Update*. June. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

prevailing since 2006, however the new wage was less than the Tk5,000 a month that garment workers asked for.

Earnings from other products increased sharply by 15.2% but still accounted for less than one quarter of exports. Takings from jute and jute goods rose sharply, responding to the rising demand for these environment-friendly products. However, revenue from frozen foods, tea, and chemicals declined because of weak demand.

Imports rose by only 5.4% in FY2010 (Figure 3.2.7). Rice imports fell, following the good domestic production. The import of consumer and intermediate goods declined, and that of capital goods decelerated.

Remittance growth fell by nearly half to 13.4% from the 22.4% in the previous year, mainly because of the continued decline in the numbers of workers leaving for jobs abroad (Figure 3.2.8). Nevertheless, with a limited expansion in the trade deficit, increased workers' remittances boosted the current account surplus to \$3.7 billion from \$2.4 billion in FY2009 (at 3.7% of GDP, the surplus was well above the *ADO 2010* projection of 1.8%).

The deficit in the combined capital and financial account narrowed to \$313 million in FY2010 from \$374 million a year earlier, despite a marked decline in net foreign direct investment, reflecting larger capital transfers and lower net outflows of portfolio and other investment. Gross foreign exchange reserves of the central bank reached \$10.7 billion at end-June 2010, up by about \$3.3 billion from the previous year (Figure 3.2.9).

The exchange rate against the US dollar remained essentially stable at about Tk69/\$1 in FY2010, as the central bank made large foreign exchange purchases in the interbank market to prevent nominal appreciation. Still, due to higher relative domestic inflation, the real effective exchange rate appreciated by about 5% during the fiscal year.

The Dhaka Stock Exchange general index rose steeply (Figure 3.2.10), as significant new involvement of institutional participants and retail investors helped the index to gain 105.8% in the year to end-June 2010. Low returns on bank deposits and ready availability of credit appeared to play a major role. Market capitalization also doubled during the year, reaching \$38.6 billion (about 38.7% of GDP), primarily reflecting the stock price rise, though there were new listings.

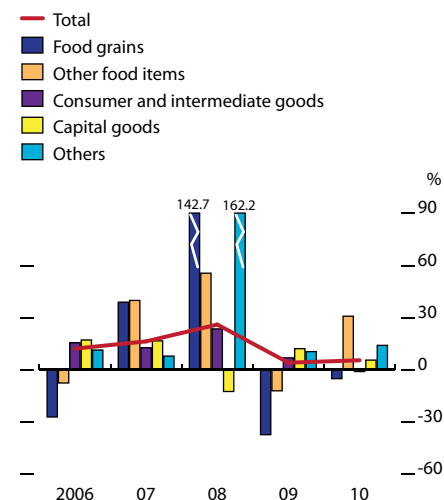
To limit exposure of banks and financial institutions to the stock market, the central bank restricted banks' exposure to no more than 10% of their liabilities. It allowed financial institutions to invest up to 25% of their paid-up capital and reserves.

Prospects

The forecast for FY2011 assumes that government policy will balance growth with containing inflation; that political stability will prevail; that progress is made on structural reforms; that planned additional rental power generation will reduce shortfalls; and that normal weather conditions will prevail.

GDP growth in FY2011 is forecast at 6.3% (Figure 3.2.11), unchanged from *ADO 2010*. The slow global recovery will prevent export and remittance growth from returning to their respective precrisis levels. Stronger domestic demand, supported by the ready availability of credit

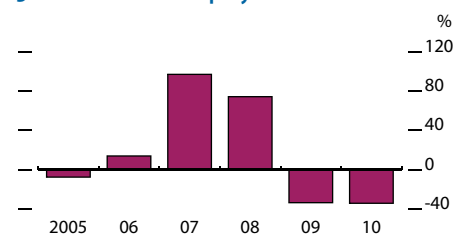
3.2.7 Growth in imports and components



Sources: Bangladesh Bank. *Annual Report 2008–2009*; 2010. *Major Economic Indicators: Monthly Update*. June. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

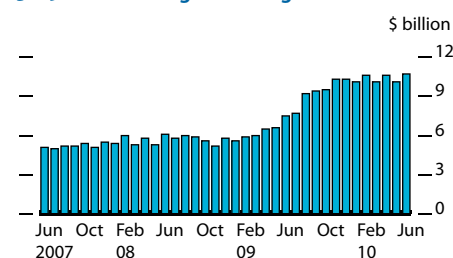
3.2.8 Growth in employment abroad



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. July. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

3.2.9 Gross foreign exchange reserves



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. June. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

for productive purposes and continued fiscal stimulus, will buttress the modest expansion.

As posited in *ADO 2010*, more robust industry performance of 7.5% growth is the main factor seen supporting overall GDP growth in FY2011. Some pickup in production for export, on the back of strong domestic demand and higher production by small and medium-sized enterprises and by agro-based industries, underlie the projection. The government's purchase of rental power and better demand management is expected to alleviate power shortages that have been a major constraint on industrial production.

Agriculture growth is expected to be 4.1%, slightly slower than in FY2010 but close to its historical average. Higher industry growth, alongside some revival of trade, is expected to push up expansion in services slightly to 6.7%.

The FY2011 budget continues an expansionary stance: public expenditure is projected to rise by 19.6% from the previous year. The budget included a \$288 million-equivalent stimulus package for exporters to help them cope with the continued impact of weak global demand. Budget policy seeks to support a higher medium-term growth trajectory by boosting spending on infrastructure, especially additional energy sources. It also takes aim at social equity by strengthening safety net programs and making higher investment in health and education.

The budget deficit is projected to widen to 5.0% of GDP in FY2011, from 4.5%. Three-fifths of the deficit will be financed by domestic borrowing (a higher share than in FY2010) and two-fifths by external sources (Figure 3.2.12). Given the government's estimate of available nonbank financing sources, the bulk of the domestic financing increase will need to come from the banking system, potentially limiting private sector access to credit.

The FY2011 budget targets a 16.8% increase in revenue (about a 0.5% increase in the tax-to-GDP ratio), aided by widening the tax base, simplifying tax payment, and strengthening tax enforcement. About half a million new income tax payers are expected to be added to tax rolls during the year.

The budget provided several tax incentives for stimulating economic activity. It lowered duties on equipment for power and energy, industrial machinery, and selected industrial raw materials; cut domestic taxes applicable for small and medium-sized businesses and agro-based industries; and eliminated value-added tax on local production for selected items while keeping it unchanged on identical imported goods.

The government is giving priority to eliminating the growing power shortages through heavy investment in the sector. For the short term, it is putting in place a program of small (100 megawatt) rental generation units. Since over four-fifths of current power generation is gas fired, it seems open to addressing gas shortages by inviting international bidding for gas exploration. It is also seeking ways to diversify fuel sources through importing liquefied natural gas and coal for power generation.

Separately, a landmark agreement that was signed with India in August provides for a power transmission line to be built between the two countries. Power imports from India should be available by end-2012.

To boost infrastructure investment, the government issued new

3.2.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	5.5	6.0	6.3	6.3
Inflation	7.5	7.3	7.8	7.5
Current acct. bal. (share of GDP)	1.8	3.7	0.5	0.2

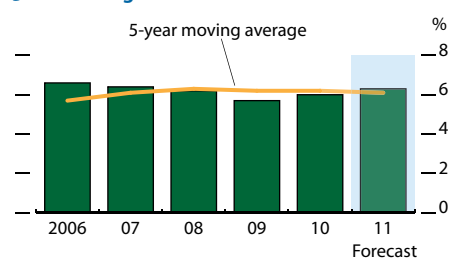
Source: ADB estimates.

3.2.10 Dhaka Stock Exchange indicators



Source: Bangladesh Bank. 2010. *Major Economic Indicators: Monthly Update*. June. <http://www.bangladesh-bank.org>
[Click here for figure data](#)

3.2.11 GDP growth



Sources: Bangladesh Bureau of Statistics. 2009. *National Accounts Statistics*. May; Ministry of Finance. *Bangladesh Economic Review 2010*.

[Click here for figure data](#)

public–private partnership (PPP) guidelines and took steps to set up a Bangladesh Infrastructure Finance Fund to facilitate PPP in infrastructure. The government earmarked \$430 million in the FY2011 budget to fund the new entity, adding to a reallocation of \$230 million of unused resources for PPP projects included in the FY2010 budget. Bond issues are another likely source of funding.

This *Update* shaves the average inflation projection for FY2011 to 7.5% from the 7.8% in *ADO 2010* (Figure 3.2.13), in view of the likely moderation in global oil and other commodity prices. Still, expected adjustments in domestic power and gas tariffs, demand-side pressures from higher public expenditure, and the lagged effects of strong money-supply growth will sustain inflation at close to the FY2010 rate.

Compared with projections in this *Update*, the MPS aims at higher growth (6.7%) and lower inflation (6.5%) for FY2011. However, with the central bank alert to unproductive and speculative use of credit, the MPS projects that the year-on-year growth in money supply will slow from 18.8% in FY2010 to 15.2% in FY2011, while private credit growth will decline from 21.1% to 16.0% over the same period.

Imports are forecast to grow by 11.0% in FY2011, reflecting a rise in domestic demand for imported raw materials and capital equipment. Exports—continuing the rising trend seen in the fourth quarter of FY2010—are expected to grow by 8.0%, largely in response to the moderate expansion in global demand (and reflecting the previous year’s low base).

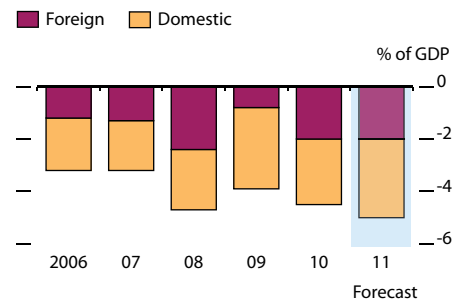
The country’s market share for readymade garments in the US rose marginally to 4.3% in FY2010, although it declined slightly in the EU to 8.5% in the third quarter of FY2010.

Bangladesh stands to gain if the People’s Republic of China sheds some part of the readymade garment market because of its rising labor costs. In addition, if the government’s plans for improving power and gas supply and transportation facilities come to fruition—and so take off some of the costs that the industry currently has to shoulder—the competitive edge of Bangladesh vis-à-vis other developing-country producers in this market segment will be honed.

Slower growth of 8.0% in workers’ remittances is foreseen because of the continued decline in the outflow of migrant workers. Nevertheless, remittance receipts will offset the modestly larger trade deficit. The current account surplus is estimated to fall sharply to 0.2% of GDP (Figure 3.2.14).

Several downside risks could prevent these projections from being realized. A waning recovery in the US and EU would likely result in weaker retail sales and lower demand for Bangladesh’s exports. Inability to reduce power and gas supply shortages as planned would constrain growth. Finally, political instability or natural disasters would also undermine the forecast expansion.

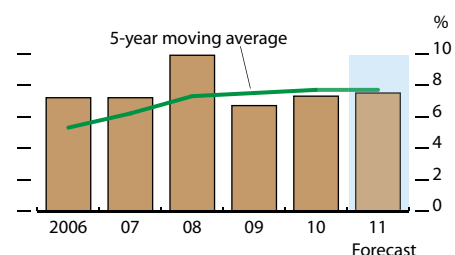
3.2.12 Deficit financing



Source: Asian Development Outlook database.

[Click here for figure data](#)

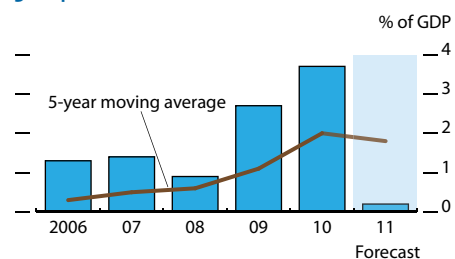
3.2.13 Inflation



Source: Bangladesh Bank, 2010. *Monthly Economic Trends*. June. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

3.2.14 Current account balance



Source: Bangladesh Bank, *Annual Report 2008–2009*. <http://www.bangladesh-bank.org>

[Click here for figure data](#)

People's Republic of China

Fiscal and monetary stimulus, coupled with recovery in world trade, drove double-digit growth in the first half of 2010. As the stimulus phases down, GDP growth is seen easing in the second half. The full-year forecast is kept at the 9.6% given in April. GDP growth is anticipated to step down by a half percentage point in 2011 from 2010, assuming the absence of stimulus programs and subdued industrial-country growth. Lower than expected inflation this year has prompted a slight downward revision to the 2010 forecast. Looking further forward, rebalancing the sources of economic growth remains imperative.

Updated assessment

GDP growth moderated to 10.3% in the second quarter of 2010 from 11.9% in the first (Figure 3.3.1), putting the expansion in January–June at 11.1%. While investment and consumption continued to drive growth from the demand perspective, the contribution of net exports turned positive in the second quarter for the first time since the onset of the global recession.

With the impact of the government's aggressive fiscal and monetary stimulus programs starting to recede, growth in nominal fixed-asset investment pulled back to 24.8% in the first 8 months of 2010 from the very high rate of 33.0% in the prior-year period. Growth of industrial output eased to 16.0% in the second quarter from 19.6% in the first, reflected in a marked slowing of growth in power generation and the production of automobiles, cement, and steel (Figure 3.3.2). The purchasing managers' index for manufacturing output declined from 55.8 in January to 51.7 in August (Figure 3.3.3).

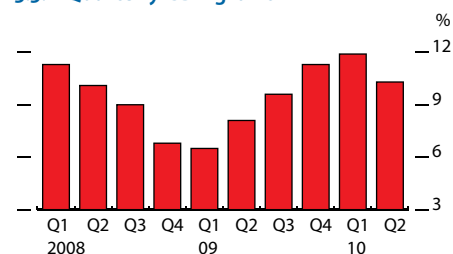
Retail sales, a proxy for consumption, held up well, increasing by 18.2% in nominal terms in the first 8 months from 15.1% a year earlier. Private consumption was supported by higher than expected employment generation and increased salaries and pensions, which lifted real incomes in urban and rural areas by 7.5% and 9.5%, respectively, from January to June. Sales of household appliances also benefited from government subsidies on these items.

By sector, industry grew by 13.2% and services by nearly 10% in the first half, both benefiting from the stimulus programs. However, drought in the south and northeast regions led to a decline in the summer harvest, so that agricultural output rose by a modest 3.6%.

Consumer prices, after falling for most of 2009, have edged higher this year (Figure 3.3.4), bumped up by low-base effects from the prior year, higher food prices caused by the bad weather, and excessive liquidity from the monetary stimulus. However, upward pressures were modest, and for the first 8 months of 2010 inflation averaged 2.8% year on year.

The government moved to curb sharp rises in prices of residential

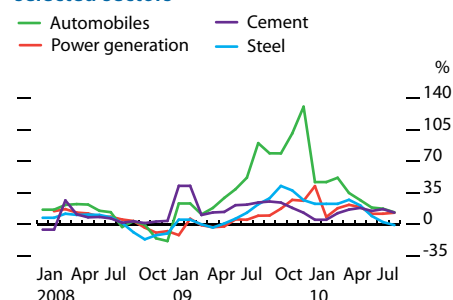
3.3.1 Quarterly GDP growth



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

3.3.2 Growth in industrial production, selected sectors



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

property spurred by investment demand and the expansionary monetary stance. Price increases for new housing in 70 major cities accelerated to 15% year on year in April. From May, though, policies to cool the market started to have an impact (Figure 3.3.5). Government actions included increasing downpayments on second homes (from 40% to 50%) and raising mortgage interest rates to at least 1.1 times the benchmark rate set by the central bank. In the main coastal cities, banks were encouraged to temporarily refuse loans for third homes.

At the same time, the government increased the availability of land for residential purposes and the supply of low-income housing. Further, the authorities directed 78 enterprises that are owned by the central government and whose core business is not property focused to stop participating in the property market. Their privileged access to bank loans under the stimulus package apparently was adding to land and housing price pressures.

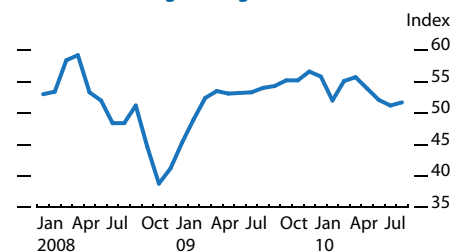
Merchandise trade has staged a vigorous recovery (Figure 3.3.6), after diving at the start of the global recession. Exports in nominal terms rose by 35.4% in the first 8 months of 2010, and imports by 45.8%. Imports decelerated in April–July, reflecting a slowdown in the fiscal stimulus and fewer infrastructure project startups. The trade surplus of \$104.5 billion for the first 8 months was considerably less than for the same period in 2009. Net exports made a slight contribution to GDP growth in the second quarter.

Foreign direct investment (FDI) in the first 7 months increased by about 20% to \$58.4 billion, illustrating the continued appeal of the burgeoning economy to international companies. Reflecting official efforts to combat pollution, new guidelines to encourage investment in what the government considers to be environmentally sound projects (such as high-tech industries, certain services, and energy-efficient technologies) have been written. A ban was imposed on foreign investment in polluting and energy-intensive projects, and in sectors suffering from overcapacity. Outbound investment, primarily directed at manufacturing and mining, increased by about 24% to \$5.65 billion.

After 2 years of a de facto peg of the yuan to the US dollar, the central bank (the People's Bank of China) in June 2010 said that it would gradually allow greater flexibility in the exchange rate against a basket of currencies for the PRC's main trading partners. By mid-September, the yuan had appreciated by 1.5% against the US dollar from the start of 2010 (Figure 3.3.7). The real effective exchange rate appreciated by 2.4% in the first 7 months of the year. Foreign reserves rose to \$2.45 trillion at end-June, the pace of reserves accumulation slowing mainly as a consequence of the smaller trade surplus.

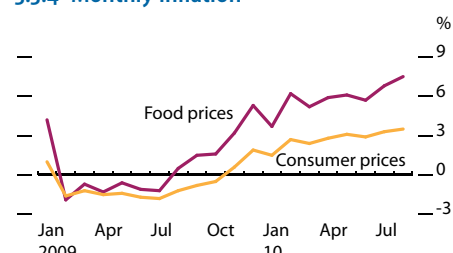
Monetary officials started to rein in the very expansionary monetary stance adopted during the global recession, in view of the strong economic growth, sharp rise in property prices, and risks that funds would be diverted into unproductive purposes. The target for new lending in 2010 was pared back to CNY7.5 trillion (actual lending in 2009 totaled an exceptional CNY9.6 trillion), and the authorities set monthly credit quotas for banks. New bank lending decelerated to CNY5.7 trillion in the first 8 months of this year (still well above levels in 2007 and 2008—Figure 3.3.8) from CNY8.2 trillion in the prior-year period.

3.3.3 Purchasing Managers' Index



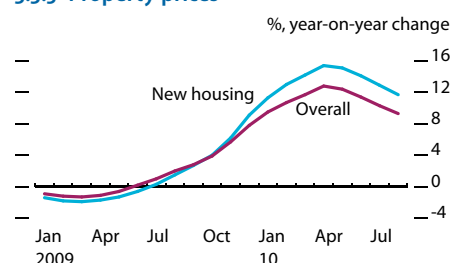
Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

3.3.4 Monthly inflation



Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

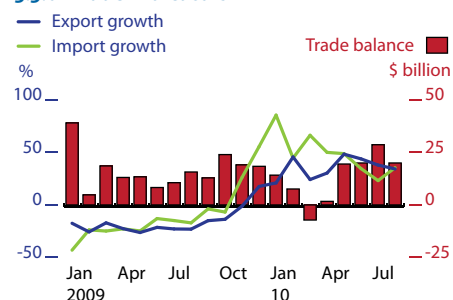
3.3.5 Property prices



Note: Overall property prices cover both residential and nonresidential buildings.

Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

3.3.6 Trade indicators



Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

Tightening measures also included 3 half-percentage point increases in the banks' reserve requirement ratio (to 17% for large banks) and open-market operations by the central bank to absorb liquidity. M2 money supply growth moderated to 19.2% in August from 27.7% at end-2009 (Figure 3.3.9).

Share prices have declined, partly because of the clampdown on the property market and concerns over possible further tightening measures. The Shanghai Composite Index fell by nearly 20% in the 8 months through August. However, the market's decline did not stop Agricultural Bank of China from raising almost \$22 billion in August through an initial public offering in Hong Kong, China and in Shanghai, the largest in the world to date.

Fiscal stimulus, too, is phasing down. Total government spending in 2010 is budgeted to increase by 11%, about half the pace seen in 2009. An 8% budgeted increase in revenue looks conservative, and the fiscal deficit for this year will likely be narrower than 2.8% of GDP, the official target.

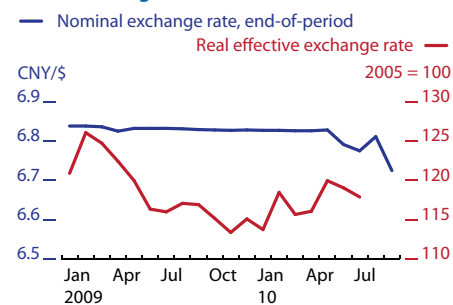
Local governments have used their off-budget investment arms to tap into the flood of bank lending unleashed during the stimulus programs, and have channeled those funds into local infrastructure projects, not all based on solid commercial foundations. An investigation of this practice by bank regulators found that, of CNY7.7 trillion disbursed by banks to local government investment arms, perhaps one-fifth is at risk of becoming bad loans. The regulators, while tightening guidelines for such lending, maintained that the banking sector is secure because the ratio of nonperforming loans was just 1.3% at midyear and the average provisioning ratio was 186%.

Another outcome of the massive stimulus programs that have been conducted mainly through state-controlled banks and enterprises has been to increase state ownership and control of the economy. The government has issued guidelines that, it has said, are aimed at redressing this development, opening to private investment some previously closed industries, including public utilities, rural financial services, telecommunications, low-income housing, and science and technology ventures.

Rapid economic growth generated 6.4 million new jobs in urban areas in the first half, and more than 3 million laid-off workers were rehired. The national jobs-to-applicants ratio exceeds 1, signaling more vacancies than job-seekers. The stimulus programs fostered employment in central and western regions, attracting back a large number of migrant workers from coastal cities. The tightness of the labor market prompted higher wages and, in some cases, better working conditions (as well as a few strikes), contributing to the increase in consumer spending.

Senior government officials have highlighted the benefits of urbanization as a means to strengthen domestic demand, enhance services delivery, and reduce income inequality. In this connection, a new residence permit system has been adopted in 10 cities to reform the household registration (*hukou*) system and foster urbanization. The new permit grants to migrant workers the same social benefits as to those registered in the cities. Permit holders can later apply for the urban *hukou* if they meet certain conditions. The system is expected to result in migrant workers progressively becoming permanent urban residents,

3.3.7 Exchange rates

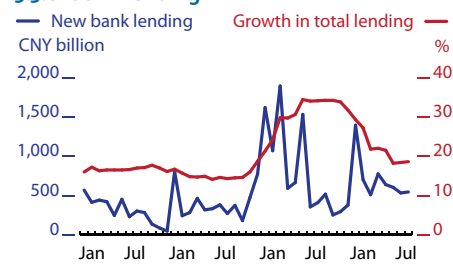


Note: Latest data for nominal exchange rate are as of 15 September and for real effective exchange rate as of end-July.

Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

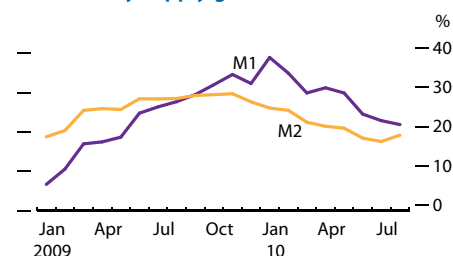
3.3.8 Bank lending



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

3.3.9 Money supply growth



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

enhancing mobility of labor and raising migrant workers' disposable incomes.

Addressing the issue of environmental damage inflicted by decades of heavy investment in industry and the economy's low-energy efficiency, the government plans to include low-carbon targets in the Twelfth Five-Year Plan (2011–2015). It is drawing up fiscal incentives and supportive policies to promote the use of renewable energy (wind, solar, biomass, and geothermal), and to increase the use of nuclear power. New anti-pollution taxes, too, have been proposed and, if approved, will likely be tried in one or two provinces later this year.

Prospects

The forecasts assume that the planned fiscal stimulus programs will be fully disbursed through the second half of 2010, and that no new stimulus measures will be introduced. As noted above, the fiscal deficit in 2010 is likely to be narrower than the budgeted deficit of 2.8% of GDP, mainly because of stronger than projected growth in revenue. In 2011, fiscal policy is assumed to be less stimulatory than 2010 and the deficit will narrow further from this year's level in relation to GDP.

On monetary policy, the outlook assumes that tightening measures taken this year to stem the flood of bank lending will rein in money supply and credit growth toward government targets.

Growth in fixed-asset investment has pulled back steadily this year (Figure 3.3.10) and is expected to moderate further as the impact of the fiscal and monetary stimulus wanes. This deceleration will temper demand for industrial products, such as cement, during the forecast period. A government plan to cut excess production capacity in the steel industry, by as much as 300 million tons, or about half 2009's steel output, will also cool growth in the industry sector. Furthermore, determined efforts to reduce carbon emissions and other environmental damage will likely crimp growth in some industries. The PRC has become the world's largest energy consumer, which adds some urgency to efforts to raise energy efficiency and reduce polluting emissions.

Private consumption is projected to remain brisk, underpinned by growth in employment and incomes, which in turn is helped by a trend to relocate labor-intensive industries to central and western areas and by policies to improve conditions for migrant workers. Government incentives to buy automobiles and household electrical appliances also favor consumption growth. Consumer confidence has continued to recover from low levels in the first half of 2009 (Figure 3.3.11).

Growth in merchandise exports is expected to decelerate in the second half of 2010, owing to the base effect as exports moved higher in the prior-year period, more subdued demand from some export markets, and the expiration of PRC tax rebates. Import growth, too, will soften, given the high import component of PRC exports (about 50%) and more restrained industrial production. The central bank's June adjustment to exchange rate policy is unlikely to have much of an impact on trade flows in the near term.

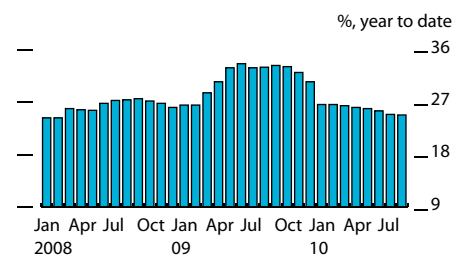
GDP growth is forecast to step down to about 9% in the third quarter of 2010 and to 8% in the fourth, so that full-year growth is 9.6%

3.3.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	9.6	9.6	9.1	9.1
Inflation	3.6	3.2	3.2	3.2
Current acct. bal. (share of GDP)	5.7	5.6	5.3	5.2

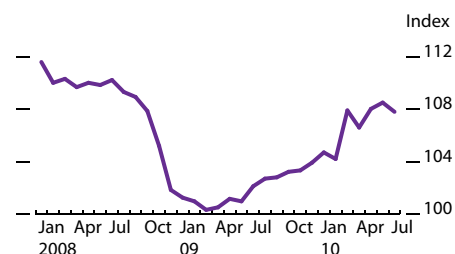
Source: ADB estimates.

3.3.10 Growth in fixed asset investment



Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

3.3.11 Consumer confidence



Source: CEIC Data Company (accessed 16 September 2010).
[Click here for figure data](#)

(unchanged from the *Asian Development Outlook 2010* forecast in April). Taking into account the phasing out of stimulus policies in 2010 and expected subdued growth in industrial economies next year, the GDP growth forecast for the PRC in 2011 is maintained at 9.1% (Figure 3.3.12). Sizable current account surpluses are still projected—5.6% of GDP for this year and 5.2% for 2011.

Flooding in the summer raised prices of food and some other items, though this effect is expected to be temporary. Price increases that were anticipated this year for water, natural gas, and electricity have been postponed until next year. Average inflation for 2010 is forecast at 3.2%, trimmed from April, in light of lower than expected price pressures in the first half. Inflation in 2011 is forecast to be the same as this year's average (Figure 3.3.13).

Downside risks to the outlook mainly relate to the fragility of external demand, exacerbated by European fiscal and debt concerns this year. A weakening of the euro could exert appreciation pressures on the yuan's real effective exchange rate, hurting exports to the European Union, the PRC's largest trading partner. There is a risk of a worse than expected deterioration in PRC bank asset quality, a consequence of the flood of bank lending that in some cases has been diverted into unproductive purposes. That risk would be heightened if measures to cool the property market have a more severe impact than currently anticipated.

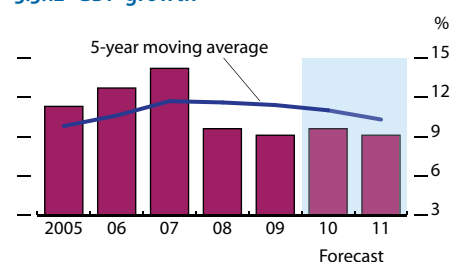
GDP growth would be more rapid than forecast if the domestic slowdown prompts the authorities to implement new fiscal or monetary stimulus. A stronger economic recovery in Europe that caused the euro to appreciate would likely spur PRC exports and GDP growth.

Longer term, failure to decisively implement the agenda to rebalance the PRC economy risks jeopardizing the sustainability of growth. A greater emphasis on private consumption demand, as against the current investment-driven economic growth model, would promote longer-term growth and raise living standards. Growth in consumption has been limited by the declining share of household income in total income, while the shares of enterprises and the government have increased.

From the production perspective, services have huge potential to contribute toward sustainable growth, since they account for only a relatively small proportion of GDP.

Finally, fiscal policy can play an important role in promoting a more consumption-driven and services-oriented economic model, particularly if it is complemented by other mutually supportive and consistent policies (Box 3.3.1).

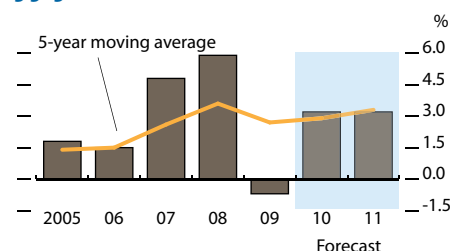
3.3.12 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

[Click here for figure data](#)

3.3.13 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

[Click here for figure data](#)

3.3.1 Fiscal policy's role in rebalancing the economy

The following fiscal goals could be pursued, within a broader overall policy environment, to support rebalancing and income redistribution.

Shift the emphasis of public spending from investment to public services and redistribute more corporate profits to social spending. Public expenditure on education, health, and social security combined amounts to only 6% of GDP, compared with an average of 28% in industrial economies. Allocating more fiscal resources to public services would raise the disposable income of households and thus reduce precautionary savings and encourage consumption. Further, strengthening the social safety net to protect the poor and the vulnerable promotes consumption (as well as equity), since those groups tend to spend more and save less. Rising profits earned by state-owned enterprises are generally not redistributed to the community because these enterprises seldom pay dividends to the state. A dividend stream from state enterprises to the government could fund additional social spending without straining public finances.

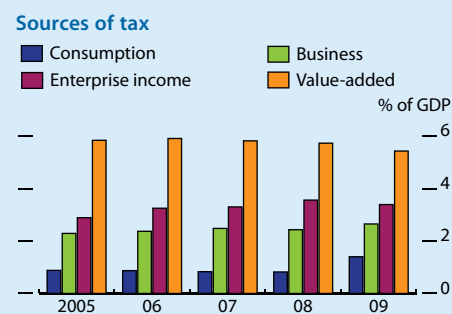
Strengthen automatic stabilizers. These mechanisms are taxes and transfers that adjust automatically to temper business cycles. For example, the amount paid out on unemployment benefits automatically increases in a recession when the labor market weakens, and such transfers contract as the economy turns up. Further, developing automatic stabilizers in the PRC would mitigate the risk and uncertainty households face in economic downturns, and thus encourage private consumption.

Increase the supply of low-income housing. Expanding such housing would increase the disposable income of poorer households. The government could establish municipal housing authorities to construct low-income housing and introduce fiscal incentives to attract private sector developers into this less profitable segment of the market. On the demand side, consumers could benefit from tax exemptions, cash subsidies or housing allowances, and capital grants on low-income housing. Further, provision of state guarantees or public mortgages, or both, would mitigate credit rationing that makes it difficult for poorer households to obtain housing finance.

Introduce property taxes. The government plans to pilot-test a property tax targeted at luxury residences in four cities, as part of its aim to curb property speculation. The expansion of the tax to all houses in urban areas, based on their value, could provide a substantial and steady source of revenue to fund public goods and services. This would in turn reduce precautionary saving and enhance consumption, contributing to rebalancing.

Subject services to value-added tax (VAT). VAT is the single largest source of tax revenue in the PRC, amounting

to just over 5% of GDP in 2009 (Box figure). The central government gets 75% of the revenue and provincial governments 25%. VAT is levied only on manufacturing, while services are subject to a business tax that raises a much smaller amount. Given local governments' heavy dependence on VAT revenue, they have a strong incentive to promote manufacturing rather than services. Rebalancing the economy could thus be advanced by including services in the VAT base, a measure that likely would also raise the revenue of local governments, increasing their capacity to provide public services.



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

Strengthen fiscal transfers to provinces. In both magnitude and timing, the flow of fiscal transfers from the central government to the provinces is unpredictable, constraining the capacity of local governments to provide public services. One approach would be to transfer a larger share of tax revenue, such as VAT, to provinces. Alternatively, the central government, while maintaining its decentralized arrangement for provision of social services, could increase its share in their financing. This could be achieved through redistributive and equalizing mechanisms to support poorer provinces. Otherwise, interprovincial disparities in social spending per person will remain, constraining consumption in the central and western provinces.

In this regard, a 5% resources tax on oil and gas has been introduced in Xinjiang Uygur Autonomous Region as part of a pilot project. It is expected to increase the region's revenue by the equivalent of 25% of its total 2009 revenue. This approach is intended to promote the efficient use of natural resources, as well as to bolster finances in less developed provinces, so reducing regional disparities.

Source

Donghyun Park and Yolanda Fernandez Lommen. 2010. The Role of Fiscal Policy in Rebalancing the People's Republic of China. *ADB Briefs*. Asian Development Bank, Manila.

India

The economy is making a strong recovery from the slowdown in FY2008. Still, to return to the high-growth plateau of precrisis years, successful resolution of several macroeconomic management and reform challenges is needed. These include maintaining export competitiveness by ensuring the right balance between the exchange rate and inflation, continuing the fiscal consolidation, improving agricultural productivity, addressing infrastructure bottlenecks, and sustaining investor confidence. For the current fiscal year, this *Update* slightly lifts the forecast for GDP growth, but raises the estimate for inflation and widens the forecast for the current account deficit. In FY2011 these variables are expected to improve relative to FY2010.

Updated assessment

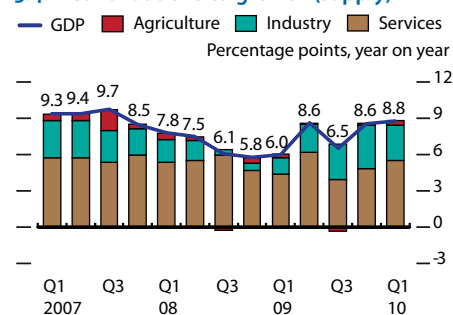
The complexity of macroeconomic and monetary management has become knottier since the publication of *Asian Development Outlook 2010* (ADO 2010) in April this year. Strong, well-timed macroeconomic policies cushioned the impact of the global downdraft and must now be wound down without their endangering the robust recovery that took hold this year. However, high headline inflation (triggered by high food prices due to structural supply constraints) and a strengthening rupee in real terms (mainly driven by relative prices), posed problems for monetary management.

Moreover, the rapid pace of the recovery has driven imports up and the trade deficit out. But capital inflows have been buoyant, and therefore policy needs to take into account their possible volatility, stemming from a sudden rise in risk aversion in global markets as well as any sustained erosion in India's export competitiveness.

GDP growth of 8.8% in the first quarter of FY2010 (ending March 2011) and 8.6% in the last quarter of FY2009 signaled a strong and (so far) durable recovery, primarily led by a healthy expansion in industry and buoyancy in services (Figure 3.4.1). Moreover, the performance of agriculture was reasonable in the first quarter, after a negligible expansion in FY2009 due to a poor summer monsoon. The subsectors that registered impressive growth included mining and quarrying; manufacturing; electricity, gas, and water supply; construction; and trade, hotels, transport, and communications.

From the demand perspective, investment took over as the major driver of growth in the second half of FY2009, from government consumption expenditure in the first. Indeed, investment contributed nearly one-half of GDP growth for the second half of the fiscal year. This revival was primarily due to an improved overall business outlook and the desire for greater production capacity following slow investment the previous year. Rapid growth in investment likely continued in the

3.4.1 Contributions to growth (supply)



Note: Fiscal quarters.

Source: Ministry of Statistics and Program Implementation. <http://www.mospi.nic.in> (accessed 31 August 2010).

[Click here for figure data](#)

first quarter of FY2010 (though preliminary GDP expenditure data are indeterminate because of a very large unclassified item).

Monthly manufacturing output data supplement the first-quarter GDP data to reveal the pattern of current expenditures (Figure 3.4.2). The bulk of improvement in manufacturing growth came from the capital goods and consumer durables goods sectors in FY2009, and this trend continued in early FY2010. Robust pickup in capital goods (apart from a revival in private sector investment) was in part attributable to higher spending on infrastructure. Automobiles, consumer electronics, home appliances, and other household products led the impressive performance of consumer durables.

Persistent high inflation somewhat mars the economic landscape. The year-on-year rate picked up to 11.0% in April 2010, and subsequently moderated to 8.5% in August (Figure 3.4.3). While initially bumped up by a surge in food prices reflecting a poor harvest, high food inflation appeared to be seeping through to wages and then to prices for manufactured goods, where inflation climbed to 6.4% in April, but subsequently slowed to 4.8% in August as monetary tightening gained traction.

Food price inflation stayed high at 14.6% in August 2010—despite record levels of government food stocks and a good spring harvest—adding further to popular discontent over continued high prices. (A June revision in domestic prices of petrol, diesel, cooking gas, and kerosene, while a welcome step in reducing high subsidies, has also nudged up overall inflation.)

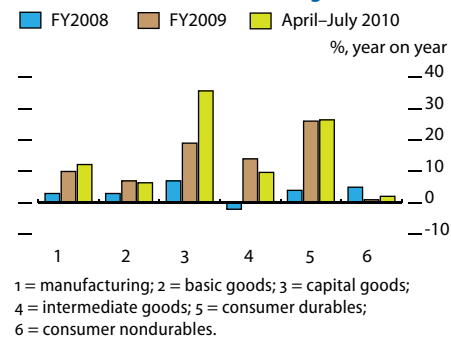
Still, the government expects inflation to moderate in the second quarter of FY2010 and beyond because this year's summer monsoon rainfall has been above average and a bumper agricultural outturn is expected to bring down food prices. The Reserve Bank of India (RBI), the central bank, expects that overall inflation will moderate to 6% year on year by end-March 2011.

In the context of the strong domestic recovery and inflation pressures, the RBI began a gradual withdrawal from its earlier expansionary monetary policy stance. It raised both the repo and the reverse repo rates by 125 and 175 basis points, respectively, from January to mid-September this year (Figure 3.4.4). It lifted the cash-reserve ratio by 100 basis points in the same period. In announcing the September decision to adjust rates (the first mid-quarterly policy review undertaken to better guide market participants), the central bank noted that India's recovery was rapidly converging to its trend rate of growth.

Strong momentum in industrial production, buoyant services sector indications, a favorable outlook for agriculture, and fiscal consolidation on its targeted path underpinned this assessment. Inflation remained the dominant concern and the upward rate adjustment would contain it and anchor inflationary expectations without disrupting growth.

On the external front, the central bank noted that the continued sluggishness of the global economy was constraining export growth, while the strong domestic recovery was pushing imports and the trade deficit higher. However, improved global investor sentiment was resulting in increased capital inflows and, if it continued, it would abate concerns even if exports remained sluggish.

3.4.2 Growth in manufacturing (use based)

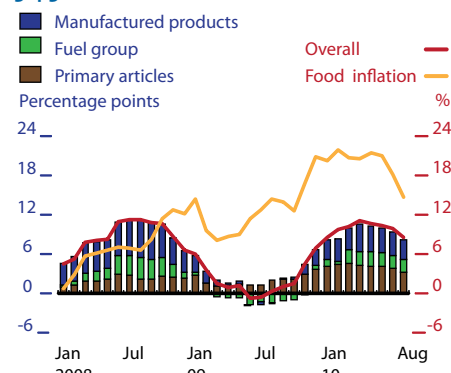


Note: Revised series adopted 14 September 2010, with base year = 2004–2005.

Source: CEIC Data Company (accessed 13 September 2010).

[Click here for figure data](#)

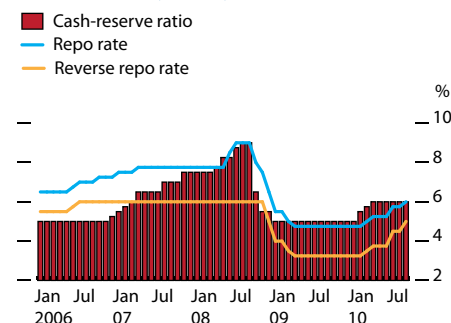
3.4.3 Contributions to inflation



Source: Ministry of Industry and Commerce. <http://eaindustry.nic.in> (accessed 17 September 2010).

[Click here for figure data](#)

3.4.4 Monetary policy indicators



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

In its statement, the RBI also indicated that policy adjustments over the year had brought back the high expansionary stance of policy to a more neutral position. With normalization largely complete, adaptations in central bank policies would now essentially be oriented to changing current and expected macroeconomic conditions.

The monetary measures have had a discernible effect on credit conditions. The call money market rate increased from a high of around 3.4% in December 2009 to 6.1%–9.0% by end-July 2010. Despite firming interest rates, the recovery in growth in bank credit to the commercial sector that began in November continued to be strong through August 2010 (Figure 3.4.5).

The key features of India's balance of payments during FY2009 were a slightly lower trade deficit (though it expanded over the year as the return to rapid growth sucked in imports); a weakening in the invisibles account surplus (because of slower growth in business processing services); and a marked widening in the current account deficit to \$38.4 billion (to 2.9% of GDP) (Figure 3.4.6).

An encouraging development was the burgeoning of net capital inflows during the year, as risk appetite returned with the upswing in growth in major industrial economies. The capital surplus more than covered the current account deficit and helped to rebuild foreign exchange reserves following the large loss in FY2008. India's external debt, as of 31 March 2010, was at \$261.4 billion (18.9% of GDP).

Balance-of-payments data for the first quarter of FY2010 are not yet available. Exports accelerated their post-October 2009 revival, surging by 34.4% in the first quarter of FY2010 (Figure 3.4.7), though this steep gain was partly due to the previous year's low base. The first quarter's stars were petroleum products (up 80%), gems and jewelry (36%), textiles (30%), and engineering goods (16%). Imports also leaped, registering growth of 35% in the first quarter. Data through August, however, indicate a marked slowing in exports versus an accelerating import pickup, widening the trade deficit.

Foreign exchange reserves fell slightly in the first fiscal quarter but subsequently advanced to show roughly a \$4 billion gain over the first 5 months of FY2010, to total about \$258 billion at end-August (Figure 3.4.8). This increase in reserves (though less than the \$20 billion in the period a year earlier), suggests that, in the face of a growing trade deficit, net capital inflows stayed strong. Indeed, portfolio investment by foreign institutional investors amounted to \$12.2 billion in the first 5 months of FY2010, some 20% above the prior-year level.

Despite some moderation in capital inflows in the first quarter of FY2010 (especially in May), and consequent nominal depreciation of the rupee against the dollar, the pressure on the rupee to appreciate has reemerged due to strong capital inflows in the second quarter. Indeed, the Indian currency appreciated by more than 11% in real terms between August 2009 and August 2010 (Figure 3.4.9). This was mainly attributable to high inflation (relative to trading partners). The authorities are keen to push growth to 9%–10% over time, and so may want to resist any appreciation in the exchange rate and to this end the expected reduction in inflation over the coming months will be beneficial.

Given the volatile nature of capital inflows in reaction to external

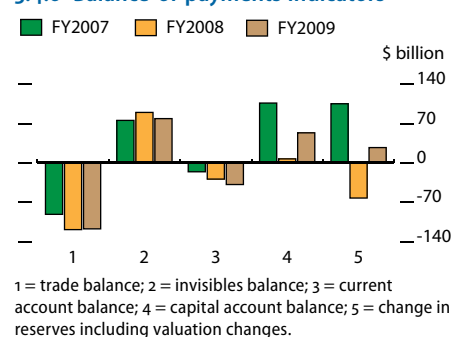
3.4.5 Credit growth to private sector



Source: Reserve Bank of India. <http://www.rbi.org> (accessed 13 September 2010).

[Click here for figure data](#)

3.4.6 Balance-of-payments indicators

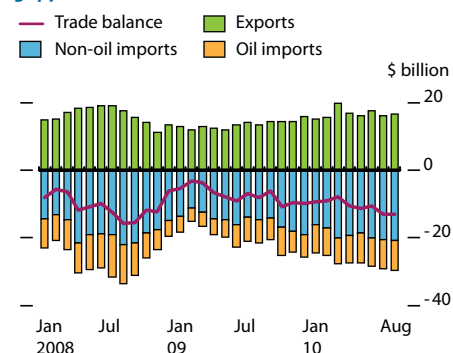


1 = trade balance; 2 = invisibles balance; 3 = current account balance; 4 = capital account balance; 5 = change in reserves including valuation changes.

Source: Reserve Bank of India. <http://www.rbi.org> (accessed 11 September 2010).

[Click here for figure data](#)

3.4.7 Trade indicators

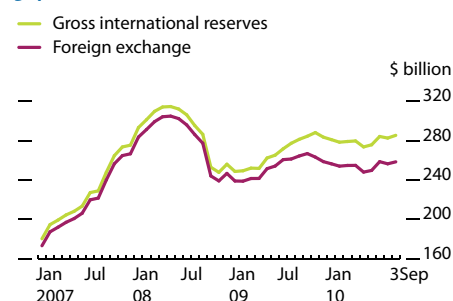


Note: Total exports and imports based on customs data.

Source: Ministry of Commerce. <http://commerce.nic.in/index.asp> (accessed 16 September 2010).

[Click here for figure data](#)

3.4.8 International reserves



Note: Gross international reserves includes gold and SDRs.

Source: CEIC Data Company (accessed 15 September 2010).

[Click here for figure data](#)

events, striking the right balance among growth, inflation, and competitiveness objectives will be a delicate maneuver. A continued stable recovery in the industrial world should sustain positive global investor sentiment, and hence capital inflows to India.

Amid uncertainties about global recovery, the central government's FY2010 budget deficit was set to decline to 5.5% of GDP, about a 1.2 percentage point reduction as part of a multiyear plan for winding down the large fiscal stimulus provided earlier (Figure 3.4.10). Receipts from the sale of bandwidth for mobile telephony and wireless broadband in auctions turned out to be almost three times the budgeted amount; however, the additional funds were largely offset by a Rs.546 billion supplement to the budget that raised total expenditure by about 5%. Data through August show buoyant revenue collection, such that the deficit target should be readily met.

The June 2010 the government's decision to decontrol gasoline (petrol) prices—allowing them to adjust to global prices—as well as raising administered prices for diesel, cooking gas, and kerosene was a step in the right direction. While further actions are needed, the changes were an important start to reducing excessive subsidies and rationalizing incentives for energy use and production.

The introduction of a comprehensive, integrated (federal and state) goods and services tax (GST) to replace a myriad of indirect taxes is also a crucial reform both for achieving fiscal consolidation as well as minimizing distortions in the economy. It was expected to take effect from April 2011; however, it has been delayed as procedural requirements were not completed in time. Moreover, the revised version of the direct tax codes, approved by the Cabinet recently, appears to be a missed opportunity for fundamental reforms in the direct tax system. That version, too, will not take effect in April 2011 as originally planned.

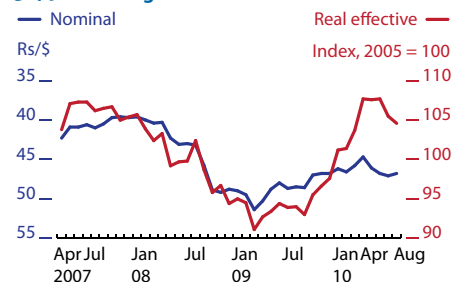
Despite renewed buoyancy in revenue stemming from higher growth, greater rationalization in expenditure will be needed to achieve the fiscal consolidation roadmap proposed by the 13th Finance Commission. That document envisaged the central budget deficit shrinking to 3.0% by FY2013 and the general government debt to 68% of GDP (from 80% at end-FY2009).

The Sensex, the main index of the Bombay Stock Exchange, saw a remarkable runup from March 2009 that has continued through August 2010 (Figure 3.4.11). The upturn was part of a general worldwide rally in stock prices. The Sensex has substantially outperformed a general index of emerging Asian stock markets—the Morgan Stanley Capital International All Country Asia Pacific (excluding Japan)—whereas they had often moved in virtual lockstep before.

Prospects

ADO 2010 forecasts for FY2010 and FY2011 were based on six key assumptions: monetary and fiscal stimuli would be withdrawn gradually over the next 2 years; the domestic food supply position would be comfortable because of normal monsoons; international oil prices would average about \$80 per barrel in 2010 and \$85 in 2011; domestic fuel prices would be revised upward; industrial economies would show modest

3.4.9 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. <http://www.bis.org> (both accessed 13 September 2010).

[Click here for figure data](#)

3.4.10 Central government budget indicators

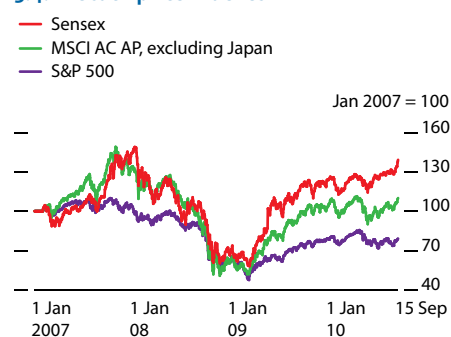


Note: FY2010 is an estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. <http://indiabudget.nic.in> (accessed 16 September 2010).

[Click here for figure data](#)

3.4.11 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

3.4.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	8.2	8.5	8.7	8.7
Inflation	5.0	7.5	5.5	5.5
Current acct. bal. (share of GDP)	-1.5	-2.7	-2.0	-2.4

Source: ADB estimates.

recovery in 2010 followed by further acceleration in 2011; and world trade would grow by 7%–8%. The main differences in assumptions between this *Update* and *ADO 2010* are moderation in growth in industrial economies in 2011; and faster growth in world trade in 2010 (9.5%) followed by a deceleration in 2011 (to 8.1%).

The positive response to monetary policy accommodation and fiscal stimulus are still boosting growth prospects in FY2010. The improved business optimism is reflected in several business confidence surveys (Figure 3.4.12, for example). Similarly, despite some moderation in the 50th round of the Industrial Outlook Survey of RBI for the assessment quarter (April–June 2010) as well as expectations for the July–September 2010 quarter, growth impulses remained very strong. Moreover, the HSBC Markit Purchasing Managers' Index for manufacturing has since January 2010 been sustained at a relatively high level (Figure 3.4.13).

Sustained business optimism and rebounded corporate earnings in the second half of FY2009 are likely to support new investment, despite a hardening of interest rates in recent months. Profit after tax of nongovernment, nonfinancial, listed companies increased by 44% in the last quarter of FY2009 as against a decline by 20% in the same period of FY2008. Strong private investment demand is corroborated by the commissioning of new projects. Industries like construction, road infrastructure, shipping, automobiles, cement, paper, and fertilizer are expected to see substantial project commissioning in the current fiscal year. This will generate demand for capital goods.

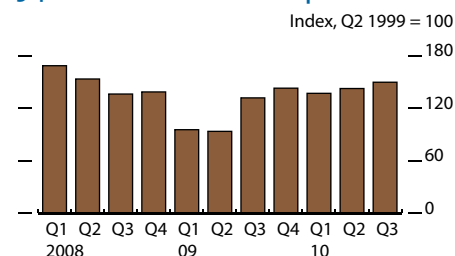
As argued in a recent RBI report, a buoyant stock market can also be conducive for domestic investment and growth. For example, rising asset prices (originating from rising stock price) would lead to improvement in the balance sheets of firms and banks, and hence easier access to funding at lower cost. The wealth effect could also exert a positive influence on private consumption.

Revival in private consumption is critical to maintaining the appetite for private investment demand. Higher disposable incomes (after an announcement of increased personal income tax limits in the last budget) will boost private consumption and the demand for consumer durable goods. Buoyancy in corporate wages will also boost urban consumption, while normal agricultural growth, expansion of the National Rural Employment Guarantee Scheme, and a higher minimum support price for pulses will strengthen rural demand for consumer durable goods and automobiles.

Despite a pickup in exports, the positive contribution of net exports that resulted from the sharper import decline in FY2009 will revert to the normal negative pattern in FY2010 as domestic demand and imports strengthen. The overall growth outlook, thus, will essentially be shaped by the renewed buoyancy in domestic absorption in FY2010. The overall GDP growth rate is expected to be 8.5% during FY2010, a touch stronger than the 8.2% projected in *ADO 2010*. The growth momentum is expected to carry on in FY2011 despite slight moderation in growth in industrial economies and world trade. In view of these developments, the growth forecast for FY2011 remains unchanged at 8.7% in FY2011 (Figure 3.4.14).

In contrast, the inflation forecast for FY2010 is raised substantially. Running against expectations in *ADO 2010*, inflation pressures did not

3.4.12 Dunn and Bradstreet optimism index

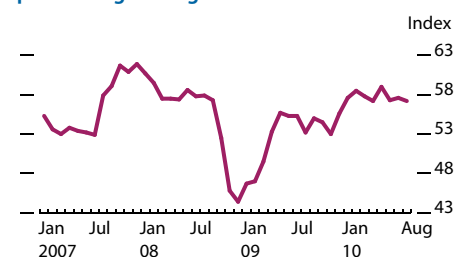


Note: The index is calculated as the ratio of the positive responses for six selected parameters (or "subindexes") for the period under review to the positive responses in the base period (Q2 1999).

Source: Dunn and Bradstreet India. <http://www.dnb.co.in> (accessed 31 August 2010).

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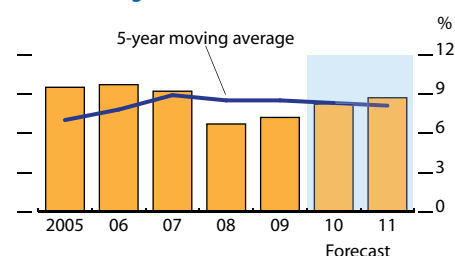
3.4.13 HSBC India manufacturing purchasing managers' index



Source: Bloomberg (accessed 10 September 2010).

[Click here for figure data](#)

3.4.14 GDP growth



Source: Asian Development Outlook database.

[Click here for figure data](#)

ease after the winter crop (harvested in April–June 2010), and the second-order impact of higher food and fuel prices remains an issue. However, overall year-on-year inflation is expected to decline by March 2011 due to a recovery in summer sown crops in 2010 (harvested in September–October), and the favorable impact of a high base in the second half of FY2009.

Nevertheless, projected average inflation will remain elevated at 7.5% in FY2010 despite sequential falls in the year-on-year rate. As nonfuel commodity prices slacken in 2011 and domestic production and stock of foodgrains remain comfortable, overall inflation is expected to moderate to 5.5% in FY2011 (Figure 3.4.15).

As forecast in *ADO 2010*, trade flows in FY2010 and FY2011 will strengthen, though less quickly than before the global slowdown, primarily due to the pull factor originating from the buoyancy in world trade and domestic growth. Exports are projected to grow by 18.0% in FY2010 and 15.0% in FY2011. Imports will maintain a relatively stronger growth (20%) in FY2010 due to buoyancy in investment and domestic industrial production before moderating to 18% in FY2011.

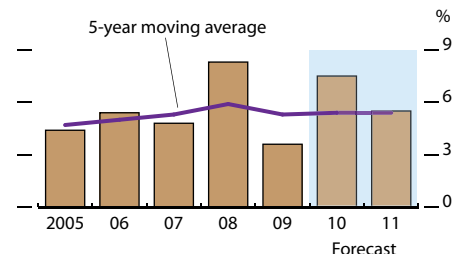
Sectors such as information technology (IT) and IT-enabled services, gems and jewelry, and agricultural and allied products are expected to post impressive export performance in the forecast period. Overall, the current account deficit as a share of GDP will remain relatively high at around 2.7% in FY2010 and 2.4% in FY2011 (Figure 3.4.16).

The possibility of surging capital inflows and, consequently, an excessive surplus in the capital account cannot be ruled out. This would pose a challenge for macroeconomic management in the coming months. Prolonged low interest rates in the major industrial economies could exacerbate the flow of short-term capital to India, leading to a complex balancing act between inflation and the nominal exchange rate. If Indian inflation does not abate as expected, the RBI would find it difficult to intervene in the foreign exchange market to damp rupee appreciation, due to limited options for sterilization.

A well-grounded, robust recovery will depend on the ability of the various levels of policy makers to coordinate effectively among themselves and achieve macroeconomic stability. There are two interrelated threats to stability: continued appreciation of the rupee as well as high actual inflation and inflation expectations. The former could jeopardize recoveries in many labor-intensive export-oriented industries, and the latter could force the central bank to take a sharply tighter credit policy, stunting growth.

The other downside risk to the growth forecasts is that the recovery in industrial economies will stall or an event that may shock global credit markets. Clearly, any renewed weakness in the external environment would deflate current positive trends.

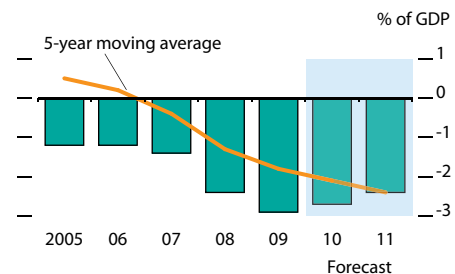
3.4.15 Annual inflation



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.4.16 Current account balance



Source: Asian Development Outlook database.

[Click here for figure data](#)

Indonesia

Stronger than anticipated economic recovery in the first half of 2010 was driven by growth in private consumption and private investment, gains that more than offset reduced government spending. GDP forecasts for this year and next are revised up from those made in *Asian Development Outlook 2010* in April. Inflation has been more subdued than expected, but there is a risk of price pressures building. The current account is projected to remain in surplus through the forecast period.

Updated assessment

GDP growth accelerated to 6.2% year on year in the second quarter of 2010 from 5.7% in the first (Figure 3.5.1.), putting the first-half expansion at 5.9%. The main drivers of growth on the demand side were private consumption and a welcome boost in investment.

Private consumption, supported by a firmer labor market, rising wages, and relatively high prices for agricultural commodities, grew by 4.5% in the first 6 months from the prior-year period and contributed nearly half the total GDP growth. By contrast, government consumption spending, which had expanded at double-digit rates from late 2008 through late 2009, fell by 8.9% in the first half of 2010 as the government unwound its fiscal stimulus and as budget disbursement lagged behind schedule.

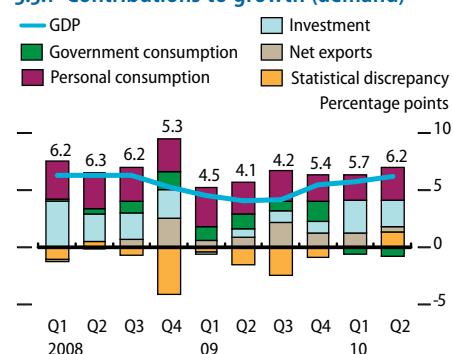
A 7.9% increase in fixed capital investment (Figure 3.5.2) was a particularly beneficial development, contributing to the economy's productive capacity and adding 1.8 percentage points to first-half GDP growth. Investment in machinery and transportation equipment rebounded (it had contracted in the year-earlier period), while investment in buildings (including infrastructure) was maintained at a solid pace.

Investment was supported by a 4% appreciation of the rupiah against the US dollar in the first 8 months of 2010 and by a pickup in credit to the private sector. Net foreign direct investment inflows rose by about 45% to \$4.9 billion in the first half, suggesting consolidating international confidence in the economy.

The contribution of net exports to GDP growth was just under 1 percentage point in January–June, similar to the same period of the previous year.

Among production sectors, services grew by 8.3% (Figure 3.5.3). Double-digit expansion was recorded in telecommunications services as well as wholesale and retail trading. Services contributed more than half of total GDP growth (3.7 percentage points) on the supply side. Industry expanded by 4.4%, with a moderate recovery in manufacturing (output up by 4.0%), in part reflecting the recovery in export demand. The

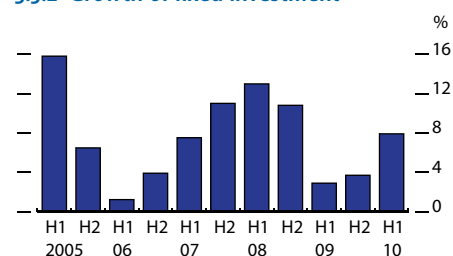
3.5.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

[Click here for figure data](#)

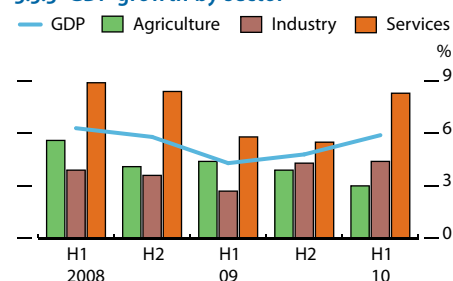
3.5.2 Growth of fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

[Click here for figure data](#)

3.5.3 GDP growth by sector



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

[Click here for figure data](#)

manufacturing production index edged higher during the first 6 months (Figure 3.5.4). Growth in mining was slightly ahead of the year-earlier period, at 3.4%. Industry as a whole contributed 1.8 percentage points to GDP growth.

Agriculture, however, recorded its weakest performance for 3 years due to bad weather. Production in this sector rose by 3.0%, and made only a small contribution to GDP growth.

The rebound in world trade propelled merchandise exports by 39% in nominal US dollar terms during the first half, with notably strong gains in exports of oil and gas as well as rubber. Imports surged even faster than exports (Figure 3.5.5), at nearly 50%, in large part reflecting the need for imported inputs for manufactured exports and increases in capital equipment imports. The half-year trade surplus rose by just over 14% to \$17.4 billion. After taking into account deficits in services trade and the income account, the outcome for the current account was a surplus of \$3.9 billion (equivalent to 1.2% of GDP).

At \$12 billion, the surplus in the overall balance of payments was more than double that of a year earlier (Figure 3.5.6), driven by increasing foreign investment in Indonesian bonds and short-term debt securities, coupled with the increase in foreign direct investment. Significant volumes of capital flowed out of the country in May, triggered by a rise in global risk aversion during the Greek sovereign debt crisis, though inflows resumed in June. International reserves in the first 8 months of 2010 rose to \$81.3 billion, equivalent to 6.1 months of imports and government foreign debt payments. This strong external position contributed to the rupiah's appreciation against the dollar.

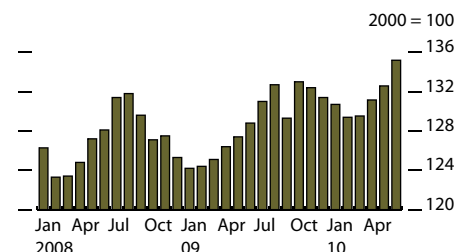
Higher levels of short-term capital inflows over the past 18 months have increased the country's exposure to the risk of a sudden reversal in these sometimes volatile capital movements. To temper that risk, the authorities have built additional foreign reserves and adjusted policies to check short-term flows. For example, Bank Indonesia has imposed a minimum 30-day holding period for central bank certificates, has issued longer-dated certificates, and has introduced a new term-deposit facility for commercial banks.

Robust economic growth helped to trim the rate of unemployment, to 7.4% in February 2010 from 8.1% in February 2009. About 2.9 million jobs were generated in that 12-month period, mainly in industry, domestic trade, and construction. Poverty incidence, as measured by the national poverty line, was 13.3% in March, down about 2 percentage points over 2 years.

Inflation, subdued at below 4% year on year since mid-2009, accelerated to just over 6% in July and August 2010 (Figure 3.5.7). That increase was fueled by a surge in the price of rice and some other food, in part a result of the bad weather, and higher electricity tariffs. For the first 8 months of this year, inflation averaged 4.6%. (Bank Indonesia's inflation target is 4%–6% for 2010–2011.)

The central bank left its policy interest rate unchanged at 6.5% through September 2010 to stimulate growth in credit and in the context of modest core inflation (4.2% in August) and an appreciating exchange rate. (The monetary authorities had cut the policy rate by 300 basis points to 6.5% between October 2008 and August 2009 to support growth during

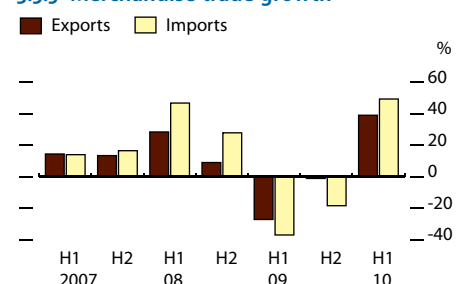
3.5.4 Manufacturing production index



Source: CEIC Data Company (accessed 15 September 2010).

[Click here for figure data](#)

3.5.5 Merchandise trade growth

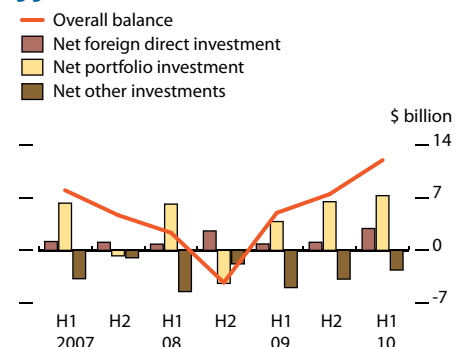


Note: Based on balance-of-payments data.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 September 2010).

[Click here for figure data](#)

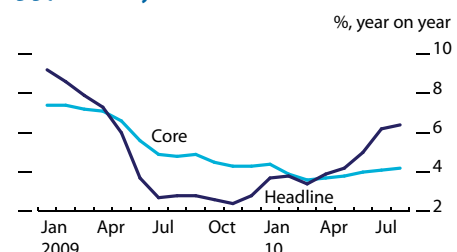
3.5.6 External balance indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

[Click here for figure data](#)

3.5.7 Monthly inflation



Sources: CEIC Data Company (accessed 3 September 2010); Asian Development Outlook database.

[Click here for figure data](#)

the global recession.) Bank Indonesia, did, however, opt to raise the primary reserve requirement ratio for banks, effective 1 November 2010, to drain some of the considerable excess liquidity in the banking system. The central bank also took steps to encourage banks to spur sluggish lending, with the result that credit to the private sector started to pick up in the second quarter and was running at about 19% in July.

Domestic financial markets were generally buoyant. The Jakarta Composite Index of share prices climbed by nearly 22% in the first 8 months of 2010 (Figure 3.5.8). Yields on 5-year government local-currency bonds fell by 132 basis points to 7.7% during that period.

Revisions to the 2010 budget approved by Parliament in May widened the budget deficit target to 2.1% of GDP. These changes take into account higher international oil prices than originally expected, so that the amount allocated for energy subsidies in 2010 was increased to the equivalent of \$15.7 billion. The revised budget includes a provision to raise retail fuel prices if international prices exceed the projected price in the budget (\$80 per barrel) by 10%. Electricity tariffs were raised by an average of 10% from July.

The revised budget also allocated additional spending for physical infrastructure, poverty reduction, education, and reconstruction of earthquake damage. However, the budget outturn in the January–June period showed a surplus of Rp46 trillion, or 0.7% of GDP, instead of the budgeted deficit. Only about 35% of the 2010 budget spending was disbursed in the first half, mainly owing to delays in executing budget projects, a perennial problem (the equivalent spending figure a year earlier was 37%).

On the receipts side, higher domestic oil prices and production, an improved performance by state-owned enterprises, and the higher levels of business activity underpinned growth in government revenue.

Indonesia's debt-to-GDP ratio fell to 26% in August 2010 (preliminary data for national government debt), maintaining a decline that has seen the ratio fall by more than half over the past 6 years.

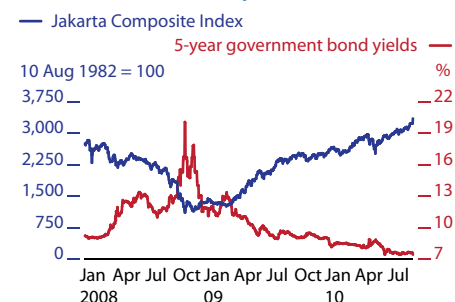
Prospects

The basis for the projections assumes that the government will implement the major policies formulated in the National Medium-Term Development Plan, which targets raising average annual GDP growth to 6.3%–6.8% in 2010–2014, and lowering the poverty incidence to 8%–10%.

Fiscal deficits are projected through the forecast period. Government spending will accelerate in the second half of this year, following the slow start to budget disbursement, although the targeted budget deficit of 2.1% of GDP for this year seems unlikely to be achieved (a deficit of about 1.5% seems in prospect, close to the 2009 deficit). Next year, the government is projecting a fiscal deficit of 1.7% of GDP. Deficit spending, together with some improvement in budget execution and increasing allocations for infrastructure, will support economic growth.

Monetary policy is assumed to be generally accommodative. The monetary authorities have indicated that they are inclined to adjust bank reserve requirements before they start to return the policy interest rate to more normal levels.

3.5.8 Financial market performance



Source: Bloomberg (accessed 15 September 2010).

[Click here for figure data](#)

3.5.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	5.5	6.1	6.0	6.3
Inflation	5.6	5.2	6.2	5.7
Current acct. bal. (share of GDP)	1.4	1.2	0.6	0.7

Source: ADB estimates.

Investment is forecast to gain momentum through the second half of 2010 and in 2011, underpinned by prospects for growth in exports, improved credit availability, and efforts by the government to accelerate disbursement on capital works. A survey by Bank Indonesia in the second quarter of this year showed that 81% of respondents believe 2010 to be a good time to invest. International investor sentiment toward Indonesia, too, is improving. Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's revised its rating outlook in June from Baa2 stable to Baa2 positive.

Private consumption is expected to be robust, backed by rising real incomes, a public wage increase, and growth in employment. The index of consumer confidence dipped in July and August when inflation accelerated (Figure 3.5.9), but it still suggested growth in consumption.

The pace of growth in exports will likely moderate in the second half of 2010, given the base effects from an upturn in exports late last year.

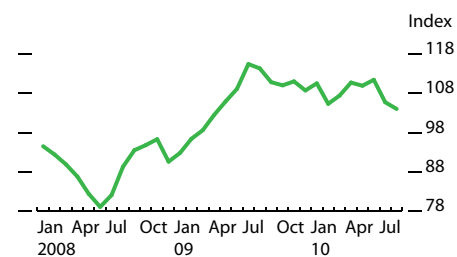
Taking these factors into consideration, GDP growth in the second half is projected to remain around the 6.2% rate recorded in the April–June quarter. The full-year 2010 forecast is revised up to 6.1% (Figure 3.5.10), in light of the upgrading of the projection for growth in world trade, and the stronger than expected, broad-based expansion of the Indonesian economy in the first half. GDP growth next year is seen at 6.3%, slightly higher than in 2010 owing to projections of continued growth in private consumption and in both private and public investment.

The surge in imports spurred by the stronger than expected domestic demand will trim the current account surplus from the level anticipated in April. Current account surpluses now are forecast at the equivalent of 1.2% of GDP this year and 0.7% in 2011.

Some of the upward pressures on prices in July–August were one-time and seasonal factors that are expected to subside. For the full year, inflation is forecast to average 5.2%, accelerating to 5.7% in 2011 (Figure 3.5.11) as domestic demand continues to strengthen. These forecasts are trimmed from April's on the basis of lower than expected inflation in the first half of 2010 and the pickup in investment, which will help to ease capacity constraints.

Still, there is a risk that inflation could exceed the forecasts, given the outlook for quickening economic growth and still low interest rates. Further bouts of bad weather would be reflected in higher prices for rice and vegetables, and global wheat prices have been under upward pressure. A return to high levels of inflation would dent private consumption and reduce room for accommodative monetary policy, hurting investment.

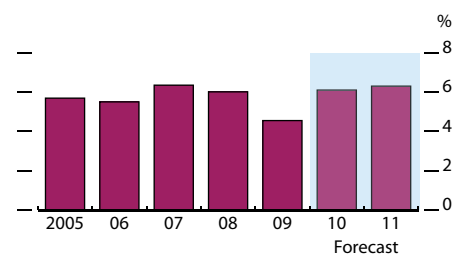
3.5.9 Consumer confidence index



Source: CEIC Data Company (accessed 15 September 2010).

[Click here for figure data](#)

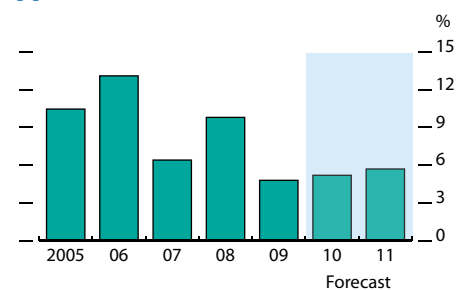
3.5.10 GDP growth



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.5.11 Inflation



Note: 2005–2007 base year = 2002; 2008 onwards base year = 2005.

Source: Asian Development Outlook database.

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Malaysia

Rebounding from contraction in 2009, GDP rose at a faster rate than anticipated in the first half of 2010. Exports recovered strongly, sparking a broad-based increase in domestic demand that powered the growth in GDP. The pace will slow in the second half, but the 2010 full-year forecast is raised from that presented in April. In 2011, the economy is expected to return to growth at a touch above trend level. Inflation has been milder than expected, and is forecast to remain low. Substantial current account surpluses will likely continue to underpin a firming ringgit.

Updated assessment

Recovery in global trade and a broad-based increase in domestic demand drove a stronger than expected economic rebound in the first half of 2010. GDP rose by 10.1% year on year in January–March (Figure 3.6.1), easing a shade to 8.9% in April–June. That put the expansion for the first 6 months at 9.5%, a turnaround from the year-earlier period when the economy contracted by 5.1%.

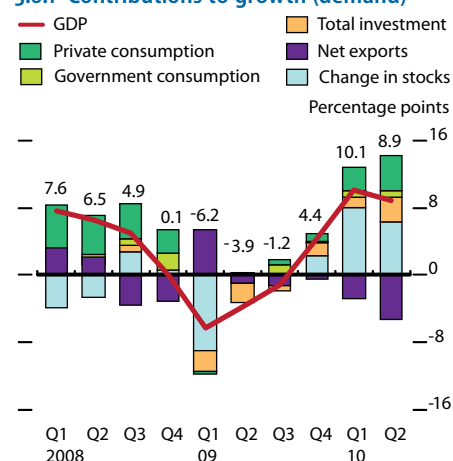
On the demand side, growth was underpinned by a robust 6.5% increase in private consumption in the first 6 months, reflecting renewed consumer confidence and rising incomes, which resulted from a lift in manufacturing output and wages coupled with higher agricultural commodity prices. Private consumption contributed 3.5 percentage points of total GDP growth in the first half. Government consumption spending increased by 6.6%, as disbursements of fiscal stimulus measures implemented in 2009 quickened.

Fixed capital investment rebounded by 9.4% owing to the recovery in world trade, while inventories posted their first increase in over 3 years. Total investment accounted for 2.0 percentage points of GDP growth. The large contribution of domestic demand to GDP growth was partially offset by net exports (in volume terms), which contracted from year-earlier levels as robust growth in exports of goods and services was offset by an even faster rise in imports, due to Malaysia's dependence on imported inputs for its manufactured exports.

In terms of supply, growth was spearheaded by a buoyant performance in manufacturing and services (Figure 3.6.2). Manufacturing, which accounts for around 25% of GDP, expanded by 16.4% in the first half, on account of the rebound in world trade. Production of electronic and electrical goods, which account for around one-third of total manufacturing, shot up by 32.8% owing to greater industrial-country demand to replenish depleted inventories.

Construction picked up by 6.3%, reflecting the impact of the fiscal stimulus on nonresidential and civil engineering activity. The services sector, which accounts for close to 60% of GDP, expanded by 7.9% in

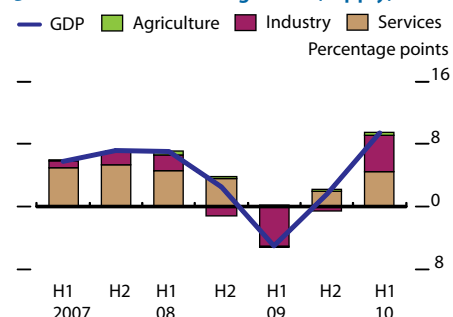
3.6.1 Contributions to growth (demand)



Source: Department of Statistics, Malaysia. <http://www.statistics.gov.my> (accessed 8 September 2010).

[Click here for figure data](#)

3.6.2 Contributions to growth (supply)



Source: Department of Statistics, Malaysia. <http://www.statistics.gov.my> (accessed 8 September 2010).

[Click here for figure data](#)

the first half, underpinned by growth in wholesale and retail trade and financial services.

Agricultural output also gained in the first half, by 4.5%. Production of natural rubber climbed steeply early in the year, then moderated owing to seasonal factors and bad weather. The weather problems, and replanting, meant that palm oil production rose only slightly.

Mirroring the economic recovery, the number of job vacancies in the first 6 months went up from prior-year levels, with the highest increases in manufacturing and services, and the number of layoffs fell. The unemployment rate was little changed at 3.7% of the labor force at end-June compared with the start of 2010.

Year-on-year inflation edged up to 1.9% in July 2010 from 1.1% in December 2009 (Figure 3.6.3), in tandem with rising global commodity and food prices. Prices of food and beverages rose by 2.9%, reflecting the stronger domestic demand and supply constraints due to the bad weather.

The current account surplus for the first half declined to a still substantial \$14.1 billion (12.6% of GDP), from \$16.5 billion a year earlier. Wider deficits in the income and transfer accounts, and a reversal in services from a surplus to a deficit, more than offset a trade surplus. The rebound in global trade pushed up merchandise exports (Figure 3.6.4), by 38.1% in US dollar terms in the January–June period.

Electronic and electrical products (about 40% of total exports) led the recovery as industrial countries restocked after running down inventories for much of 2009. Exports of palm oil and liquefied natural gas also rose strongly, owing to gains in both volume and prices. Strong demand from the People's Republic of China (PRC), now Malaysia's biggest trading partner, supported the export rebound. Higher exports were accompanied by a 44% leap in imports, mainly intermediate goods used in the manufacture of electronic and electrical goods for export. However, given the considerably higher export base, the surplus in the trade balance increased.

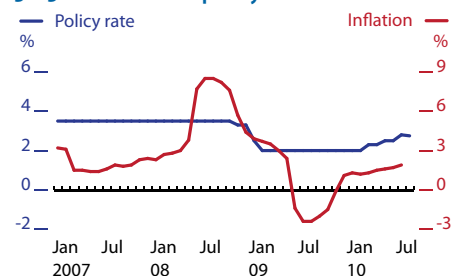
Deterioration in the services account stemmed mainly from higher payments on transportation as the volume of external trade picked up, and on other services such as insurance and finance, reflecting the bounce in economic activity. The wider deficit on the income account reflected higher outflows of dividends and interest from foreign companies operating in Malaysia than the equivalent inflows from Malaysian firms' investments abroad. The transfer account moved further into deficit due to higher remittances by foreign workers in Malaysia.

The lower current account surplus was accompanied by a significantly reduced deficit in the financial account due mainly to a reversal in portfolio flows from an outflow to an inflow. In part, that switch illustrated increased risk appetite for emerging market debt securities. Net foreign direct investment (FDI) recorded an inflow in the first half, compared with an outflow in the last 3 quarters of 2009.

Other investments, however, continued to register a large outflow. International reserves at mid-August 2010 amounted to \$95.1 billion, sufficient to cover 7.8 months of retained imports and 4.3 times short-term external debt (Figure 3.6.5).

Having run a budget deficit of 7.0% of GDP in 2009 (widened by spending on two fiscal stimulus packages), the government aims to rein

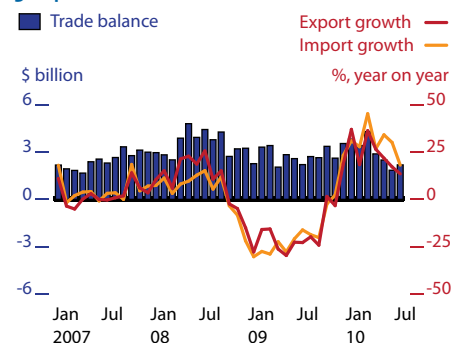
3.6.3 Inflation and policy interest rate



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. <http://www.bnm.gov.my>; CEIC Data Company (both accessed 8 September 2010).

[Click here for figure data](#)

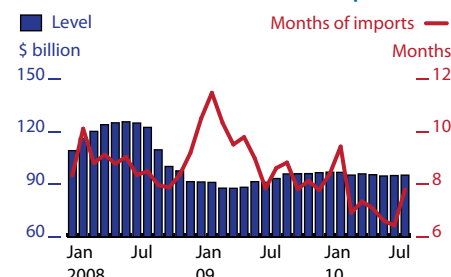
3.6.4 Trade indicators



Source: CEIC Data Company (accessed 8 September 2010).

[Click here for figure data](#)

3.6.5 International reserves and import cover



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. <http://www.bnm.gov.my>; CEIC Data Company (both accessed 10 September 2010).

[Click here for figure data](#)

in the deficit to 5.4% of GDP in 2010, mainly from the expenditure side. During the first half of 2010, revenue collection came in at 43.7% of budgeted receipts, while operational and development expenditures were 46.7% and 36.2%, respectively, of budgeted amounts. The fiscal outturn in the second quarter showed increases in indirect taxes, export duties, and nontax revenue owing to higher levels of economic activity and higher prices for petroleum, which is produced domestically. Development spending also picked up in the second quarter. At midyear, the 2010 fiscal deficit target appeared to be within reach (Figure 3.6.6).

Federal government debt at end-July 2010 was the equivalent of 53.2% of GDP, up from 41.4% at end-2008. Although this increase is of some concern, it is manageable in the context of a government commitment to fiscal consolidation over the medium term. Moreover, most public sector debt is domestic and the share of short-term debt is low.

Monetary stimulus, too, is being unwound this year. Bank Negara Malaysia, the central bank, increased its policy interest rate three times between March and end-August 2010, by a cumulative 75 basis points to 2.75% (Figure 3.6.3, above). (The policy rate had been cut to record lows during the recession.) The reserve ratio for banks was left at just 1.0%.

In response to the increase in the policy rate, the average overnight interbank rate has firmed, while the average lending rate of commercial banks edged up to 5.05% in the 2 months to end-June 2010, from 4.93%. Reflecting the rebound in economic activity, growth in bank lending picked up over the same period to 12.5% from 10.0%. Bank soundness indicators remain healthy: At mid-2010 the risk-weighted capital-adequacy ratio was 14.8% and net nonperforming loans were 2.2% of totals loans.

Yields on 10-year sovereign bonds had declined to 3.7% at end-August from 4.3% at the beginning of 2010, reflecting the upbeat outlook for the economy, a strengthening of the ringgit (it appreciated by 8.8% against the US dollar in the first 8 months of 2010—Figure 3.6.7), and moderate inflation. The Kuala Lumpur Composite Index of share prices rose by 12.5% in the same period on the back of the domestic and regional economic recoveries.

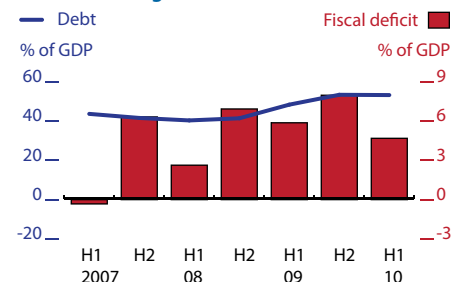
Prospects

With recovery now appearing to be firmly on track, the authorities are likely to complete the gradual unwinding of policy stimulus during the forecast period, though the economy will continue to benefit from fiscal stimulus this year. As of mid-August, 38% of the second stimulus package, which is to be fully disbursed by end-2010, had yet to be spent.

The government has signaled its intention to rein in the fiscal deficit over the medium term through subsidy reforms, streamlining the social safety net system, reviewing tax incentives to foreign and domestic companies, and rolling out a long-delayed goods and services tax. The fiscal deficit for 2011 is projected by the government's Economic Planning Unit at 3.8% of GDP, and according to the 10th Malaysia Plan (2011–2015) unveiled at midyear, the deficit is to be further narrowed to 2.8% by 2015.

Monetary policy is also likely to be tightened further. The central bank has flexibility as regards the timing and extent of interest rate rises,

3.6.6 Federal government fiscal indicators

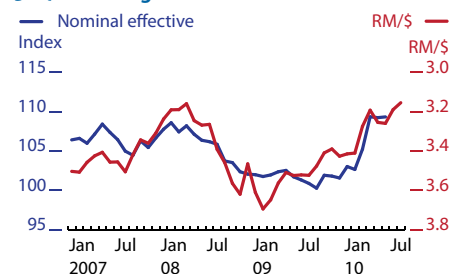


Note: Federal government debt is based on rolling annual GDP.

Source: Bank Negara Malaysia. <http://www.bnm.gov.my> (accessed 16 September 2010).

[Click here for figure data](#)

3.6.7 Exchange rates



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. <http://www.bnm.gov.my>; CEIC Data Company (both accessed 8 September 2010).

[Click here for figure data](#)

3.6.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	5.3	6.8	5.0	5.0
Inflation	2.4	1.8	3.0	2.4
Current acct. bal. (share of GDP)	14.0	13.2	13.8	12.0

Source: ADB estimates.

given a relatively large output gap and the strength of the ringgit, which is largely based on balance-of-payments surpluses. It can also raise its reserve ratio for banks as a way to tighten policy.

Even with the strong recovery this year, Malaysia's economic growth has slowed notably in the decade since the Asian financial crisis, with private investment declining to 9.5% of GDP in 2009 from an average of about 30% in the mid-1990s, and outward direct investment currently exceeding inward FDI. The economy lags behind some others in Southeast Asia in terms of growth, productivity, and investment rates.

The global competitive landscape, too, has become much more challenging with the country facing greater competition for FDI and exports in the context of likely slower growth in demand from industrial economies. It is widely accepted that the country can no longer rely on past strategies that drove growth, but needs a revamp to put greater emphasis on innovation, creativity, and high-valued-added industries.

The 10th Malaysia Plan suggests a new approach to structural reforms. It lays out the structural transformation needed if the country is to become a high-income nation by 2020 and focuses on, among other goals, improving the environment for private sector-led growth; moving toward inclusive socioeconomic development; developing and retaining a skills base as key to promoting productivity and innovation-led growth; and transforming the role of the government to become an effective facilitator in the transformation of the economy and to provide quality services.

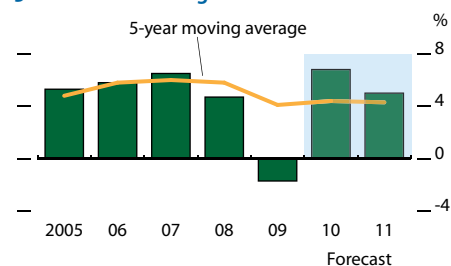
The new approach can be best illustrated by a comparison with some elements of the old: Growth through productivity (rather than growth through capital accumulation); private sector-led growth (dominant state participation in the economy); localized decision making (centralized strategic planning); cluster- and corridor-based economic development (balanced regional growth); favoring technologically capable industries and firms (specific industries and firms); a greater focus on Asian and Middle Eastern markets (an emphasis on being part of production chains to supply consumer goods and components to industrial markets); and policies to attract and retain foreign skilled professionals (restrictions on foreign skilled workers).

After consultation with the private sector, the government in September 2010 unveiled an Economic Transformation Program that further refines its plan to propel Malaysia toward developed-country status by 2020. The program is aimed at expanding higher-valued-added industries, such as energy, financial services, and public transportation to generate a greater number of well-paid jobs. It identifies 133 projects that would require investment totaling \$444 billion over 10 years, mostly from the private sector (60%) and government-linked companies (32%), with the government to provide 8% of the funding.

The challenge is daunting and is likely to require difficult trade-offs, particularly in the context of tighter fiscal resources. Consensus will need to be forged, which suggests a measured pace of implementation over the 10th Plan period, with little impact this year or next on GDP growth.

In the light of the stronger than expected GDP rebound in the first half of this year, the full-year growth forecast is raised to 6.8% (Figure 3.6.8). Higher growth will narrow, but not close, the output gap. Private consumption is expected to remain robust due a firming labor

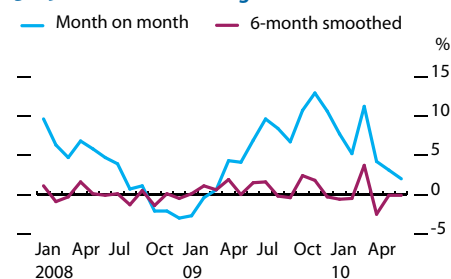
3.6.8 Annual GDP growth



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.6.9 Growth of leading index

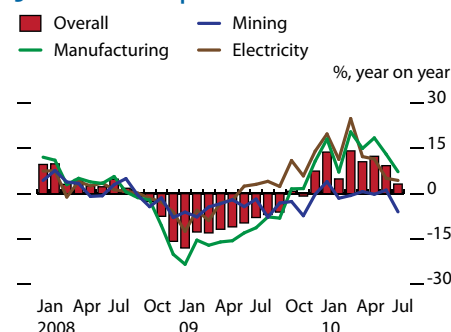


Note: The 6-month smoothed growth rate is computed as the ratio of the current month's index to the average index of the preceding 12 months.

Source: Department of Statistics, Malaysia. <http://www.statistics.gov.my> (accessed 10 September 2010).

[Click here for figure data](#)

3.6.10 Industrial production index



Sources: CEIC Data Company; Department of Statistics, Malaysia. <http://www.statistics.gov.my> (both accessed 8 September 2010).

[Click here for figure data](#)

market and higher incomes coupled with a pickup in business earnings and asset prices. Private investment in fixed capital and inventories will continue to get support from the recovery in export-oriented manufacturing industries, though investment growth still is moderated by excess capacity in some parts of the economy. Efforts to reduce the fiscal deficit are likely to damp public consumption and investment during the rest of 2010.

GDP growth is expected to moderate to a shade over 4% in the second half of this year, mainly owing to a base effect (the economy picked up in the second half of 2009). The government's index of leading indicators has contracted month on month since March 2010, while the 6-month smoothed growth rate of the index decelerated from 11.2% in March to 2.0% in June 2010 (Figure 3.6.9), indicating a slowing pace of economic growth for the rest of this year. Growth in the industrial production index slowed in June and July (Figure 3.6.10).

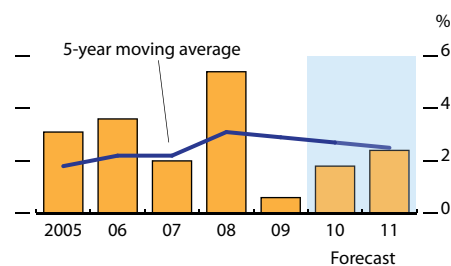
For 2011, GDP growth is forecast at about 5.0%, moderating from this year owing to less favorable base effects, unwinding of policy stimulus, and more subdued growth in several major export markets. Private consumption and fixed investment are projected to remain robust next year, as the labor market strengthens further and the output gap is closed. Public consumption, though, will probably be subdued because of the move to fiscal consolidation.

Upward pressure on prices has been milder than anticipated, so that the 2010 inflation forecast is lowered to 1.8%. The continuing output gap, exchange rate appreciation, and maintenance of price controls on basic goods will keep inflation at low levels. In 2011, higher domestic demand, combined with planned reductions in subsidies, will add to inflation, while the firming exchange rate and subdued global commodity prices will counteract some of that influence. Taking these factors into account, inflation now is forecast at 2.4% in 2011 (Figure 3.6.11).

On the trade front, export growth is projected to moderate over the rest of 2010 and into next year, due to a less supportive external environment, the completion of inventory buildups in industrial economies, and lower prices for some commodities. Import growth is expected to remain robust owing to buoyant domestic demand. A narrowing of the trade surplus is likely to be reinforced by a further deterioration in the income balance because of increased outflows of profits and dividend payments.

This narrowing should be partly offset by an improvement in the services account as inbound tourism picks up. Forecasts for the current account surplus are edged down to the equivalent of 13.2% of GDP this year and about 12.0% in 2011, putting the balances a little below those of recent years (Figure 3.6.12).

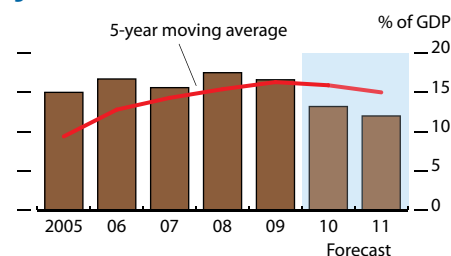
3.6.11 Inflation



Source: Asian Development Outlook database.

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3.6.12 Current account balance



Source: Asian Development Outlook database.

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Pakistan

The economy achieved a modest recovery in FY2010, as foreign reserves strengthened and inflation moderated. However, continued pressure from subsidies as well as weak tax receipts overwhelmed the targeted budget deficit. Assessing the medium-term outlook is problematic due to the devastating floods that began in early August and that clearly hit short-term growth. Coping with the human toll and the massive damage will be daunting. The urgency of fiscal reforms to create space for reconstruction and development funding is now more pressing than ever.

Updated assessment

Continued power shortages and security conditions held growth to a modest 4.1% in FY2010 (ended 30 June 2010), up from 1.2% in FY2009 (Figure 3.7.1). The severe energy shortfall is estimated to have reduced GDP growth by 2.0%–2.5%. Growth for the 3 years from FY2008 averaged 3.0%, substantially below the 6.2% pace recorded in the previous 6 years.

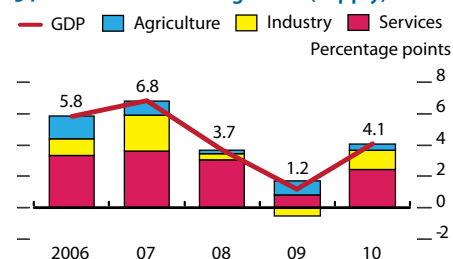
From the demand side, higher private and public consumption expenditure accounted for most of the expansion (Figure 3.7.2). Private consumption grew by 3.9% (accounting for two-thirds of GDP growth), fueled by gains in rural income buoyed, in turn, by better procurement prices and improved availability of consumer credit during the second half of FY2010. The resulting increase in demand for intermediate goods benefited from improved access to credit, bolstering corporate liquidity. Public sector consumption expanded by 13.4% (contributing about one-quarter of the rise in GDP), boosted by higher spending on public safety and internal security.

Unsurprisingly, investment remained weak in the context of subdued economic recovery and continued energy shortages. Total fixed capital formation contracted by 2.0% for the year: private investment dropped by 5.1%, more than offsetting a 6.5% increase on the public side. The decline in large-scale investment in manufacturing (15.4%) is a worrisome sign for the urgently needed strengthening and modernization of the structure of production, as are the very large contractions in investment for electricity and gas (11.0%) and transport and communications (14.1%), where additional capacities are needed to support sustained growth.

Net exports contributed moderately to growth, though this was mainly due to a fall in imports as exports expanded only modestly.

From the production side, a 4.6% expansion in services accounted for 59% of the rebound, led by stronger wholesale and retail trade and by an increase in public administration and defense. Gains in the sector were not uniform, however, and the finance and insurance subsectors continued to contract.

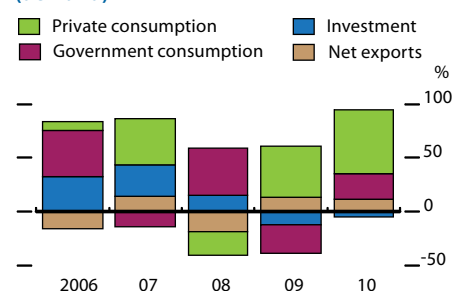
3.7.1 Contributions to growth (supply)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. <http://www.finance.gov.pk>

[Click here for figure data](#)

3.7.2 Share contributions to GDP growth (demand)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. <http://www.finance.gov.pk>

[Click here for figure data](#)

Large-scale manufacturing expanded by 4.8%, reversing the FY2009 contraction, with growth concentrated in areas associated with discretionary consumer spending, as well as pharmaceuticals (Figure 3.7.3). Production in the textile industry contracted as higher world prices for cotton yarn led to increased yarn exports, crimping supplies available to domestic value-added industries. Industry contributed 30% of overall growth, and the trend of a steady declining contribution by this sector to growth was reversed. The return of less favorable weather conditions kept agricultural growth to 2.0%, accounting for about 11% of the economic expansion.

Fiscal performance fell short of FY2010 budget targets. Planned policy reforms lost momentum as pressures on foreign reserves eased and calls for higher spending increased. The fiscal deficit at 6.3% of GDP was substantially higher than the 5.3% of GDP outcome in FY2009 and the deficit target of 5.1% of GDP (Figure 3.7.4). Even though the Public Sector Development Program was slashed by a fifth to 3.5% of GDP, this cut was insufficient to offset increased outlays for security, subsidies, and transfers to provincial governments.

Actual development spending rose by 7.8% but was significantly below its planned level. Reductions in development spending, which fell 14.5% short of its planned level, cut heavily into infrastructure outlays. This compression of development spending to rein in the deficit is both undesirable and counterproductive, as substantial infrastructure improvements are needed to support investment in the delivery of basic public services.

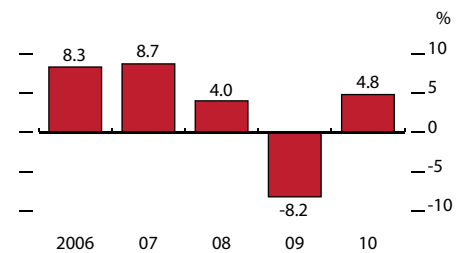
Overruns on current expenditure by the federal government for FY2010 amounted to 0.6% of GDP, with increases in security spending and other transfers, and a surge in energy-related subsidies. Despite a 37% rise in customer tariffs, power-related subsidies ballooned from the budgeted 0.5% of GDP to 1.0%, as tariff increases were insufficient for cost recovery. Total subsidies (including fertilizer and food) climbed to 1.6% of GDP.

The ratio of federal tax revenue to GDP fell to its lowest level in more than 30 years, as tax collection declined from 9.1% of GDP in FY2009 to 9.0% (Figure 3.7.5), well below the 9.4% target. A major factor was the sustained contraction of the telecommunications and finance sectors, both of which are heavy taxpayers.

The fiscal position is even more precarious than implied by the budget deficit alone. Net tax revenue available to the federal government (9.0% of GDP) was well short of current outlays (12.0% of GDP) in FY2010. Notably, the combined total of subsidy outlays (1.6% of GDP), defense spending (2.6% of GDP), interest costs (4.4% of GDP), and pensions (0.5% of GDP) amounted to 9.1% of GDP. General operating expenses of the federal government (2.9% of GDP) are thus left to be financed by borrowings (Figure 3.7.6). Additional pressure on domestic credit markets came from escalating losses of state-owned enterprises in recent years, which amounted to an estimated PRs245 billion or 1.7% of GDP in FY2010.

After declining to a low of 8.9% year on year in October 2009, inflation climbed back into double digits in the second half of FY2010, and was 12.7% in June 2010 (Figure 3.7.7). Second-half pressures came

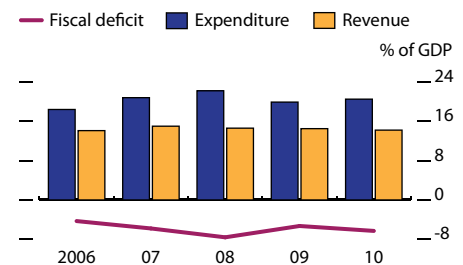
3.7.3 Production growth of large-scale manufacturing



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. <http://www.finance.gov.pk>; State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

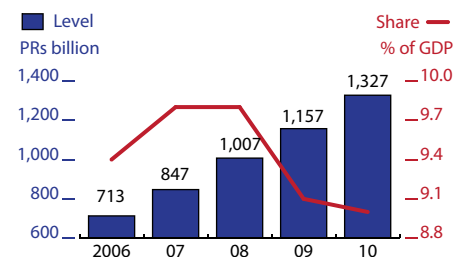
3.7.4 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and *Fiscal Operations July to June 2009–10*. <http://www.finance.gov.pk> (accessed 8 September 2010).

[Click here for figure data](#)

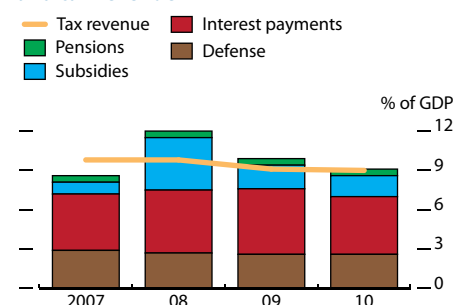
3.7.5 Federal Board of Revenue tax collection



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. <http://www.finance.gov.pk>; State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

3.7.6 Federal nonoperating expenditure and tax revenue



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. <http://www.finance.gov.pk>; State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

from higher global prices for food and energy and upward adjustments in electricity tariffs and administered domestic fuel prices. Inflation in FY2010 averaged 11.7%, well below the 20.8% of FY2009.

In a context of moderating inflation, the State Bank of Pakistan (SBP), the central bank, cut the discount rate by 150 basis points during the first 5 months of FY2010 to 12.5% in an effort to bolster economic activity. Broad money aggregates accelerated during the second half of the fiscal year as government recourse to bank financing surpassed FY2009's borrowing.

Overall, broad money expanded by 12.5% in FY2010, up from 9.6% in FY2009. For the year as a whole, federal government borrowing from the banking sector rose to PR\$309.5 billion (2.1% of GDP), damping private sector credit availability. Banks exhibited a preference for buying government securities during the year, regarding lending to the private sector as involving too-difficult credit-risk assessment. As a result, private sector credit, despite showing improvement from the previous year, remained significantly lower than FY2008's level (Figure 3.7.8).

Concerned with the resurgence of inflation pressures in the second half of FY2010 and the expansionary effects of fiscal overruns, the SBP took a cautious stance in setting policies for FY2011, increasing its policy rate by 50 basis points in early August 2010.

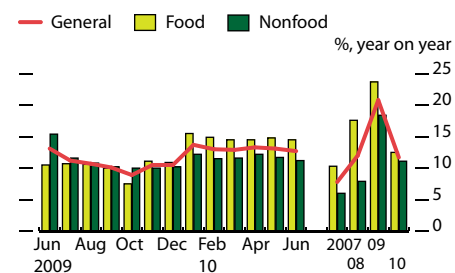
The current account deficit narrowed to \$3.5 billion (2.0% of GDP) from \$9.3 billion for FY2009, reflecting a contraction in the trade deficit and improvement in the invisibles accounts (Figure 3.7.9). On the trade front, imports declined by about 2.3% as financial weakness in two key industries (steel and oil refining) as well as a fall in investment crimped import demand. Moreover, exports recovered from a slump the previous year to expand by about 2.7%, with higher sales of rice, textiles, and pharmaceuticals.

About three-quarters of the improvement in the current account, however, came from a combination of a lower services account deficit (mainly owing to receipts of logistical support supporting the war against terror), lower interest payments, and continued strong growth (14%) in workers' remittances (Figure 3.7.10).

Although the current account deficit improved, financing became more difficult. The capital and financial account surplus fell by 14.8% to \$5.2 billion in FY2010, though this was less steep than the 26.2% fall of FY2009. Foreign direct investment inflows fell by two-fifths to \$2.2 billion, but a strengthening in other financing flows offset most of that. Unfortunately, much of the drop in such investment came in the communications, power, and transport sectors, where expansion in operating capacity is essential for faster economic growth.

Gross foreign exchange reserves, including commercial bank holdings, increased strongly in FY2010 to \$16.8 billion (Figure 3.7.11). The gain came from the overall balance-of-payments surplus and net additions from International Monetary Fund funding under a standby arrangement. The exchange rate was relatively stable against the dollar, depreciating by 4.8% during FY2010. However, high inflation relative to trading partners' led the real effective exchange rate to appreciate by 8.3%, hurting export competitiveness (Figure 3.7.12).

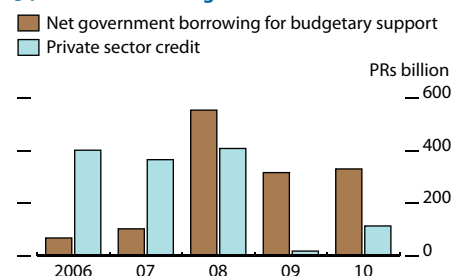
3.7.7 Inflation



Source: State Bank of Pakistan. *Annual Report 2009–10*. <http://www.sbp.org.pk>

[Click here for figure data](#)

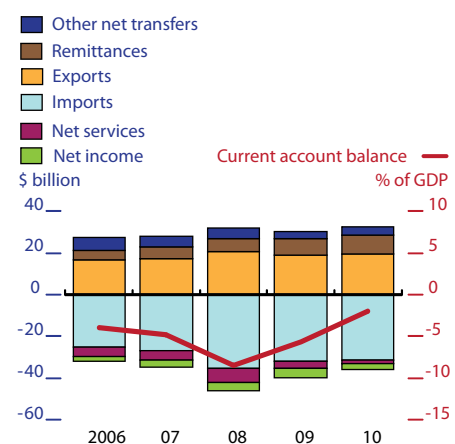
3.7.8 Bank financing of the deficit



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. <http://www.finance.gov.pk>; State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

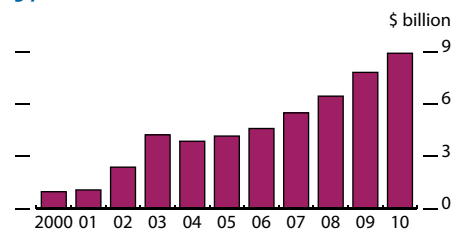
3.7.9 Components of the current account balance



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

3.7.10 Workers' remittances



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

Prospects

The impact on economic prospects of the massive flooding that began in early August 2010 is difficult to quantify. A comprehensive damage and needs assessment will be completed only after publication of this *Asian Development Outlook (ADO) Update*. The picture should also be a little clearer when an international donors' conference is held in late November.

It seems evident, however, that the economic impact will be heavily negative in the short run, due to extensive damage and reallocation of resources to cater for urgent needs. As losses in crops and livestock, damage to infrastructure, and limited economic activity in a large part of the country will damp growth prospects in virtually every sector, such that tepid GDP growth of 2.5% is expected in FY2011. Nevertheless, reconstruction and rehabilitation activities will subsequently have a positive impact on GDP.

As the major transportation arteries of the country have been severely damaged, shortages of goods and services—even with rapidly ramped-up imports—are expected to put substantial upward pressure on prices. Moreover, the likelihood of delayed sowing of crops in the upcoming season and, potentially, in the following season will create shortages of food and other commodities while undermining farmers' incomes.

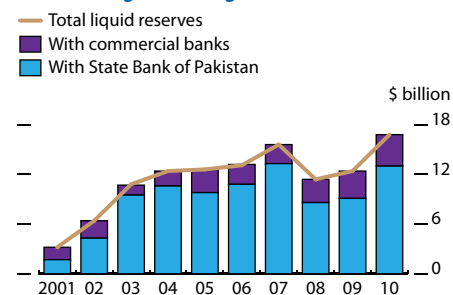
Inflation, for the most part induced by supply-side constraints, is expected to be higher than the 8.0% forecast in April's *ADO 2010*. This *Update* projects average inflation in FY2011 at 13.0%. The SBP in its Monetary Policy Statement for FY2011 projected inflation at 11%–12% (higher than the federal government target of 9.5%). The price hike emanating largely from the supply constraints will pose challenges for effective monetary management of the SBP. Also, while the central bank will find it difficult to fully implement its earlier monetary stance in the present circumstances, it will need to make substantial efforts to keep demand for credit from exacerbating inflation pressures.

Pressures on the current account will also intensify in FY2011. These will stem both from a steeper than earlier forecast rise in imports (reflecting the launch of reconstruction activity) and from domestic supply shortages pushing food, raw cotton, and other essential imports upward. Limits on existing infrastructure capacity and flood damage are expected to hold down export growth—already, flood-related damage has curtailed cotton and rice exports.

Still, workers' remittances, which increased by 13.2% in July–August 2010 over the same period the previous year, are expected to remain strong. If substantial grant aid is provided for relief, the deterioration in the current account deficit may be limited to 4.3% of GDP.

Flood-related expenditure will also alter the fiscal outcome, relative to the budget posted for FY2011, widening the fiscal deficit from the targeted 4.0% (Box 3.7.1). In this context, it will be even more important to address trends that were troublesome for the FY2010 outturn. Revenue measures are more urgent in view of the massive reconstruction requirements, as are improvements in revenue administration and collection.

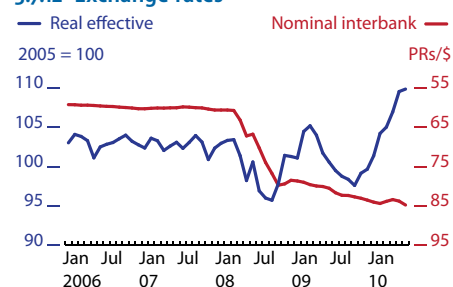
3.7.11 Foreign exchange reserves



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 8 September 2010).

[Click here for figure data](#)

3.7.12 Exchange rates



Source: International Monetary Fund. International Financial Statistics online database (accessed 9 September 2010).

[Click here for figure data](#)

3.7.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth ^a	-	4.1	-	2.5
Inflation	12.0	11.7	8.0	13.0
Current acct. bal. (share of GDP)	-3.6	-2.0	-4.2	-4.3

^a In light of the government's revisions to the GDP series in June 2010, April's *ADO* GDP growth forecasts are not comparable with current forecasts and have been omitted.

Note: The projections for FY2011 are preliminary and subject to revision.

Source: ADB estimates.

3.7.1 Fiscal alignment

The massive flood-related devastation underscores the need for reprioritization on the fiscal front so as to expand fiscal space for reconstruction. The federal government in the budget for FY2011 has already emphasized its commitment to fiscal consolidation and to policies needed to support a robust expansion of the economy.

A 50% hike in government salaries reflected the recommendations of the Pay and Pension Commission, in an effort to offset the erosion of their real incomes in the past 3 years. To offset the expansionary impact of these provisions, the federal budget included a freeze on all nonsalary recurrent outlays at FY2010 levels and a rationalization of the Public Sector Development Program as well as a reduction in the salaries of ministers.

The budget for FY2011 also called for an aggressive 45% reduction in total subsidies, including a 67% reduction in allocations to cover electricity tariff differentials. These lower subsidies would require efficiency measures that produce saving equivalent to the 30%–40% increase in tariffs that would otherwise be required to meet cost recovery. Flood-related damage and social safety net requirements will necessarily impact the expected deficit for FY2011.

Policies for FY2011 recognize the inconsistency between current losses by state-owned enterprises (SOEs) and fiscal sustainability. Bank credit outstanding to SOEs reached 2.6% of GDP, and financing of commodity operations stood at 2.8% of GDP. Since it has not drawn up immediate plans to privatize key SOEs, the federal government has established a committee to develop an overall approach to improve their management and operation.

Total outstanding guarantees for SOEs at end-April 2010 amounted to 4.2% of GDP, underscoring the budget's vulnerability to SOEs, both in terms of their performance and their contingent liabilities. Privatization for some large SOEs is on hold for the moment, but measures to improve management and reduce their increasingly burdensome losses are urgent.

Specific tax measures in the FY2011 budget, which could lift tax revenue by 20%, include: a 1% increase in the goods and services tax to 17%; reforms to that tax from 1 October 2010 to improve revenue and limit cascading; a capital gains tax on stocks and shares; higher excise

duties on cigarettes and household appliances; higher withholding taxes on commercial importers and air tickets; and improvements to revenue administration. Additional revenue measures are being formulated to generate revenue for relief and reconstruction.

The FY2011 budget targets a rise in federal government public sector development spending of about one-third relative to the FY2010 outturn, taking outlays up from 3.5% of GDP to 4.4% in FY2011. Moreover, investment spending was reprioritized to secure more timely completion of key ongoing projects in the areas of transportation, hydropower, and water.

Expectations regarding pledges made by the Friends of Democratic Pakistan in Tokyo in April 2009 have been revised downward in face of the slower than expected pace of disbursements in FY2010. External support in response to flood-related damage will contribute to higher increases in development spending with the magnitude of the increase for FY2011, among other factors, to be determined also by the absorptive capacity of the economy.

An alignment between expenditure and the policy priorities that provide the fiscal space to support critical investments in infrastructure is needed both to broaden the economic base and to achieve sustainable improvements to the current account. Lower imports, lower development spending, and an explosion of unproductive recurrent spending for subsidies simply increase the apparent risk to investment, reducing the inflows needed to put the economy on a sustainable path.

The drain of subsidy requirements for the energy sector also needs attention: while the federal government has increased consumer tariffs, a substantial gap remains, requiring a combination of efficiency gains and further tariff increases. The energy sector as a whole will need to be placed on a financially viable footing if the necessary investment in productive capacity is to be realized.

Both the magnitude and the composition of federal spending in recent years have undermined macroeconomic stability and sustainability, and these trends must change. The compression of development spending to accommodate runaway recurrent costs is not consistent with fiscal sustainability, and neither is an improvement in the external account built on restrained imports needed for investment and capital development.

Philippines

Higher than expected economic growth in the first half of 2010 was driven by strong domestic investment and industrial output, helped by external demand. Consumption (both private and government) continued to expand. Economic growth will likely ease in the second half, but given the strong January–June outcome, the forecast for the full year is raised from April's *Asian Development Outlook 2010 (ADO 2010)*. Growth next year will still decelerate from this year's pace, as anticipated in *ADO 2010*. Inflation has been moderate and is expected to remain so. The current account is forecast to record solid surpluses.

Updated assessment

Recovery in the first half of 2010 was stronger than expected, with GDP increasing by 7.9%, compared with growth of just 0.9% in the first half of 2009. The pace of growth quickened marginally from the first quarter to the second (Figure 3.8.1). Consumption, investment, and net exports all contributed to growth in the January–June period.

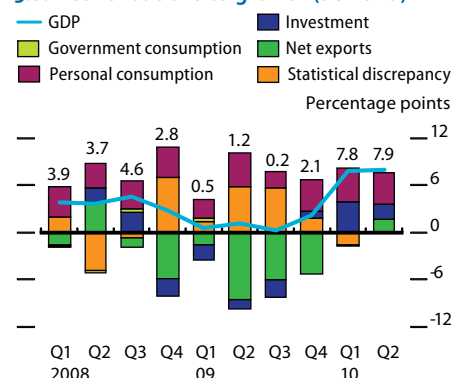
Private consumption grew by 5.1%, largely on account of increases in spending on food and drinks, utilities, and transportation. Remittances from overseas workers remained a key support of consumption, growing by nearly 7% to \$9.1 billion (the increase in peso terms was 2.2%). About half the total GDP growth in the first 6 months came from the lift in private consumption.

Investment made a significant contribution to GDP growth for the first time since 2007. Outlays on fixed capital investment surged by just over 21% year on year, with equipment investment rising by 30% from low prior-year levels. Strong growth was recorded in spending on commercial vehicles, industrial machinery, and telecommunications equipment. Fixed investment as a ratio to GDP rose to 17.2%, the highest level in 7 years (Figure 3.8.2).

Government expenditure also climbed in the first half, in part a consequence of presidential and legislative elections in May 2010. The government raised spending on social protection programs that include conditional cash transfers to poor families who commit to keep children in school, and on infrastructure, notably reconstruction of typhoon-damaged facilities. Net exports of goods and services made just a small contribution to GDP growth, reflecting a strong rise in imports that accompanied the recovery in exports.

From the production side, GDP growth was driven by a rebound in industry, notably manufacturing (representing 66% of the sector), where output rose by 16.2% from depressed prior-year levels. Export-oriented electronics manufacturers did particularly well as export demand rallied. In other industry categories, construction (17% of the sector) expanded by 15.7% and mine production (8%) rose by a rapid 23%, supported by

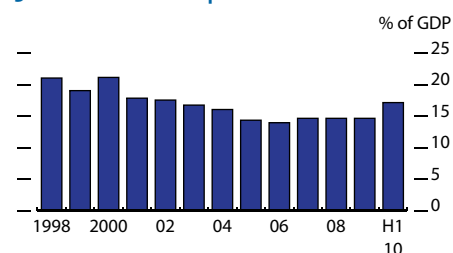
3.8.1 Contributions to growth (demand)



Sources: *Asian Development Outlook* database; National Statistical Coordination Board. <http://www.nscb.gov.ph> (accessed 27 August 2010).

[Click here for figure data](#)

3.8.2 Gross fixed capital formation



Sources: *Asian Development Outlook* database; National Statistical Coordination Board. <http://www.nscb.gov.ph> (accessed 27 August 2010).

[Click here for figure data](#)

the recovery in global demand and higher metals prices. Industry as a whole contributed 5.0 percentage points of the total 7.9% GDP growth (Figure 3.8.3).

Services, the biggest sector of the economy, grew by 6.7% in January–June 2010. However, agriculture contracted by 2.9%, mainly owing to dry weather caused by an El Niño weather pattern. The dry spell was so severe that it cut agricultural employment by 802,000, offsetting much of the employment generated by industry and services. Consequently, the unemployment rate rose to 8.0% in April 2010 from 7.5% in April 2009. Underemployment accounted for another 17.8% of the workforce. As a mark of the broad-based scarcity of jobs, about 20% of the unemployed have college degrees.

Inflation edged higher (Figure 3.8.4) to average 4.2% in the first 8 months of 2010, although price pressures were generally milder than anticipated in April at the launch of *ADO 2010*. A 2.8% appreciation of the peso against the US dollar over this period helped to shield the economy from imported inflation. Bangko Sentral ng Pilipinas, the central bank, withdrew several liquidity-enhancing measures it had implemented during the global financial crisis. It did, though, maintain the low policy interest rates it had brought in during the crisis—4.0% for the overnight borrowing rate and 6.0% for the overnight lending rate.

Merchandise exports on a US dollar basis rose steeply each month, from low prior-year levels, to be 38.5% higher in the first half (Figure 3.8.5). Exports were propelled by a near 50% jump in shipments of electronic products. Imports increased by 29.7% in the first half, reflecting the stronger demand for capital equipment and consumer goods, and the need to supply imported inputs for export-oriented manufacturing industries.

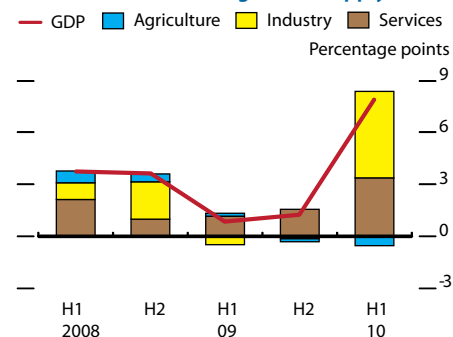
The deficit in merchandise trade narrowed slightly in the first half of 2010 to \$4.8 billion, owing to the steeper rebound in exports than imports. However, the surplus in services trade fell to \$1.0 billion as higher net outflows on services such as transportation more than offset rising income from business process outsourcing. After taking into account remittances, the current account surplus rose to \$4.4 billion, equivalent to 5.0% of GDP.

Portfolio investment recorded net outflows of \$1.2 billion, in large part reflecting investors' global risk aversion as a result of the European sovereign debt crisis. Net foreign direct investment fell to just \$445 million. Still, the capital and financial account posted lower net outflows of \$192 million in January–June 2010 (net outflows were \$2.6 billion a year earlier), owing to improvements in trade credits and other flows. The overall balance of payments recorded a larger surplus (\$3.3 billion).

External surpluses buoyed the peso and lifted gross international reserves to \$49.6 billion in August, representing 9.2 months of import cover and 9.5 times short-term external debt based on original maturity. The buildup in reserves also reflected government borrowing abroad to fund its spending.

Government expenditure rose by 13.3% in the first 7 months of 2010 (excluding interest paid on the national debt), outpacing a 10.3% increase in tax revenue. The fiscal deficit for the first half widened to the equivalent of 4.9% of GDP (Figure 3.8.6).

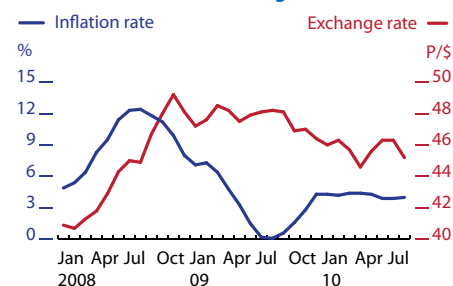
3.8.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board. <http://www.nscb.gov.ph> (accessed 27 August 2010).

[Click here for figure data](#)

3.8.4 Inflation and exchange rate



Sources: National Statistics Office. <http://www.census.gov.ph>; Bangko Sentral ng Pilipinas. <http://www.bsp.gov.ph> (both accessed 3 September 2010).

[Click here for figure data](#)

3.8.5 Merchandise trade growth



Note: Based on balance-of-payments data.

Source: CEIC Data Company (accessed 27 August 2010).

[Click here for figure data](#)

The new government, taking office on 30 June, said it aims to limit the full-year fiscal gap to 3.9% of GDP, the same level as 2009, by tightening expenditure in some areas and more determined tax administration. Certainly, the stronger than expected GDP growth will support the revenue-raising effort, and there are signs of expenditure restraint (noninterest outlays fell by 1.3% year on year in July).

The 2010 gross borrowing program has been expanded to about 9% of GDP, from 7.5% in 2009. Approximately one-third (\$5.5 billion) is to be sourced from abroad, with about \$4 billion on commercial terms and the rest in official assistance. Notwithstanding the expected higher borrowing, yields on government securities in the first 8 months edged lower than in the prior-year period. Also, the yield spread between the US and Philippines Treasuries narrowed from the peaks of 2008 and 2009. Ample liquidity in the domestic market and a robust external position helped counter concerns over fiscal weakness.

Bank lending to both consumers and businesses has expanded during 2010, with growth in credit for production activities picking up to 12% year on year in July (the highest rate of growth since June 2009). Bank capital-adequacy ratios are well above 10%, while nonperforming loan ratios remain in the low single digits.

Prospects

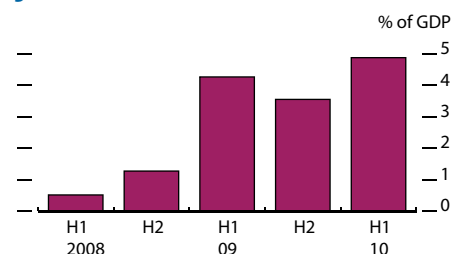
The incoming government has signaled the following broad economic policies. First, it targets reining in the fiscal deficit from 3.9% of GDP in 2010 to 2.0% by 2013 and then to keep it at that rate through 2016. Stronger efforts at tax collection, prudent expenditure and liability management, and sales of public assets are intended to help achieve this goal. The government will also push for a fiscal responsibility law that would require legislators who support new appropriations or revenue-eroding bills to identify sources of funding or offsetting cuts in expenditure.

Next, it aims to trim government debt from about 57% of GDP in 2010 to 52% in 2016. The debt-management strategy also includes strengthening oversight of government-controlled firms with large liabilities, lengthening the loan maturity profile, and increasing reliance on domestic capital sources and peso debt. (In September 2010, the government raised \$1 billion from its first sale of peso-denominated global bonds. The issue, whose bonds mature in 2021, was heavily oversubscribed and priced to yield 5.0%).

The new administration intends to promote public-private partnerships to build infrastructure and to revamp the institutional and governance framework to encourage these arrangements; to enhance social safety nets and basic social services, and to streamline business-registration procedures.

More immediately, it proposes to pull back the fiscal deficit to 3.2% of GDP in 2011. While slowing the growth of public spending overall next year, the new government plans to put greater emphasis on social services, raising outlays on social services by about 14% to just over one-third of its total spending. The budget for education will increase by 18% (the largest rise in over a decade). The conditional cash transfer program will be

3.8.6 Fiscal deficit



Source: CEIC Data Company (accessed 9 September 2010).

[Click here for figure data](#)

3.8.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	3.8	6.2	4.6	4.6
Inflation	4.7	4.5	4.5	4.4
Current acct. bal. (share of GDP)	3.3	4.0	3.2	3.3

Source: ADB estimates.

expanded to include more poor households, and government-paid health insurance coverage will be broadened to cover more poor families and workers in the informal sector.

National government spending on infrastructure will be reduced by about 10% in 2011 in expectation of increased private sector participation. The government is planning to implement a number of projects in transport and utilities under public–private partnerships next year.

On the basis of inflation remaining within the central bank’s target range (3%–5% for 2011), the outlook assumes that monetary policy will remain accommodative for some time, as policy interest rates only gradually edge up to more normal levels.

Signs are positive for continued growth in private consumption and investment. Surveys on consumer and business expectations conducted in the third quarter of 2010 showed gains in indexes of confidence (Figure 3.8.7). Business confidence was bolstered by the stronger domestic and external demand, the smooth political transition after the May elections, and optimism over the new administration. An increasing number of firms indicated that they would expand production and employment.

Consumption will continue to draw support from remittances; indeed, the central bank now expects remittances to increase by 8% to \$18.7 billion this year (Figure 3.8.8), raising its forecast from 6% previously. Investment is underpinned by strong business and consumer confidence, rising capacity utilization, and low interest rates. This is reflected in the rising stock market (the share price index rose by 31.2% from end-2009 to mid-September, when it reached a record high), and growth in bank lending. Investment approvals by the Philippine Economic Zone Authority and the Board of Investments, which cover most investment pledges, nearly trebled to about \$5 billion in the first half of 2010 from the weak prior-year period.

From the production perspective, manufacturing is expected to maintain solid growth, although it will likely slow from double-digit rates recorded in the first half of 2010 (Figure 3.8.9), when the low-base effect boosted growth. Private construction will continue to benefit from remittance inflows. The rebound in external trade, robust consumption spending, and pickup in investment will be reflected in growth in services. Agriculture could perform better than the first 6 months of this year, although a forecast La Niña weather pattern could produce excessive rainfall and so damage crops later this year.

Economic recovery will decelerate in the second half of 2010, mainly because the low-base effect will fade and inventory rebuilding will level off. The overall global economic environment is expected to weaken as evidenced by the slowdown in the growth of US and Japan in the second quarter of 2010. Seeming to corroborate this, the growth in the value of merchandise imports pulled back sharply to just 1.4% in June from over 31% in May, while the growth in factory output has broadly decelerated.

Taking these factors into account, GDP is projected to expand by 6.2% in 2010, revised up from *ADO 2010* because of the stronger than expected rebound in trade and investment. In 2011, growth is forecast to ease to 4.6% (Figure 3.8.10) as a consequence of base effects and reduced policy stimulus at home and abroad.

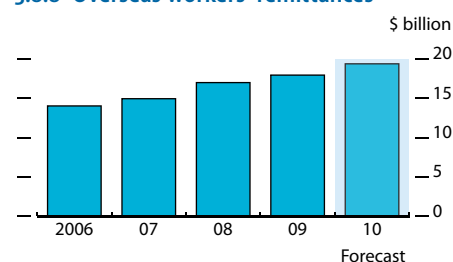
3.8.7 Confidence indexes



Source: Bangko Sentral ng Pilipinas. <http://www.bsp.gov.ph> (accessed 16 September 2010).

[Click here for figure data](#)

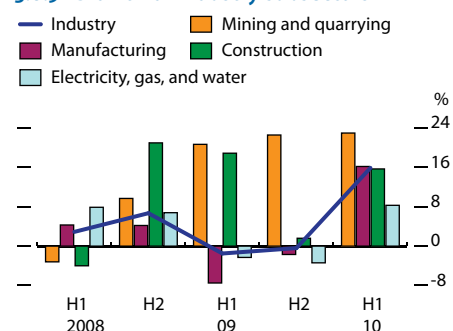
3.8.8 Overseas workers' remittances



Sources: Bangko Sentral ng Pilipinas. *The Philippines: Creating Opportunities through Effective Governance*. <http://www.bsp.gov.ph>; CEIC Data Company (accessed 10 September 2010).

[Click here for figure data](#)

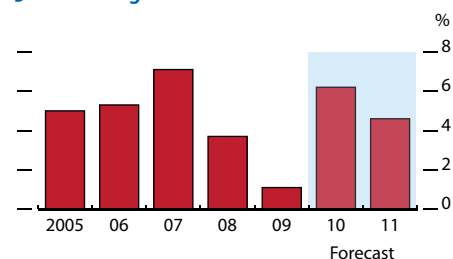
3.8.9 Growth of industry subsectors



Sources: *Asian Development Outlook* database; National Statistical Coordination Board. <http://www.nscb.gov.ph> (accessed 27 August 2010).

[Click here for figure data](#)

3.8.10 GDP growth



Source: *Asian Development Outlook* database.

[Click here for figure data](#)

Inflation will continue to pick up through this year as the economy's output gap closes, and utility and transport prices rise. It is expected to average 4.5% for 2010. This is lower than the forecast made in April mainly due to moderate increases in food prices. Upward pressure on rice prices caused by the dry weather in the first half has been countered by an increase in rice imports (Figure 3.8.11). Contracted rice imports for this year are up by 43% from 2009, and by early August 2.1 million tons, or 94% of the total volume contracted for 2010, had arrived.

The firm peso will also exert downward pressure on prices. In 2011, expected moderate increases in global energy and commodity prices, coupled with slower domestic economic growth and reduced policy stimulus, will likely put inflation at about 4.4% (Figure 3.8.12), slightly lower than forecast in April.

Remittances and earnings from business process outsourcing will contribute to current account surpluses of about 4% of GDP in 2010 (revised up from the April forecast due to stronger than expected merchandise exports), and 3.3% in 2011.

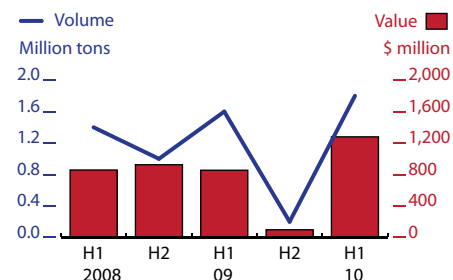
One key challenge for the government is to improve revenue collection so as to support social and development spending, which have lagged for many years. The new administration has said it will avoid increasing taxes or introducing new taxes, so that raising revenue depends heavily on strengthening tax administration.

On the expenditure side, public service wages and benefits (29% of total expenditure in January–July) have risen, mainly due to newly legislated salary increases for the public service, while interest on the public debt accounts for one-fifth of all expenditure, crowding out development spending. National government outstanding debt remains elevated, equivalent to about 57% of GDP (Figure 3.8.13).

A second challenge is to upgrade the investment climate. This enhancement is needed to encourage the creation of new businesses and employment, which is currently inadequate to absorb the growing labor force. The relatively low level of private investment in recent years is attributed to infrastructure deficiencies as well as to weaknesses in governance and in the policy climate.

Risks to the 2010–2011 forecasts come from uncertainty over the strength and pace of the global economic recovery and a stronger than anticipated La Niña weather disturbance that could hurt agriculture. Despite balance-of-payments surpluses and substantial foreign reserves, financial markets could become unsettled if fiscal slippage continues, raising the country's risk premium.

3.8.11 Rice imports

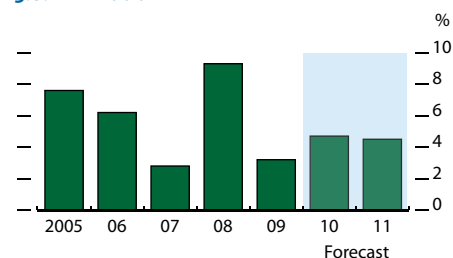


Note: First half 2010 volume figures for January–May 2010 only.

Source: CEIC Data Company (accessed 8 September 2010).

[Click here for figure data](#)

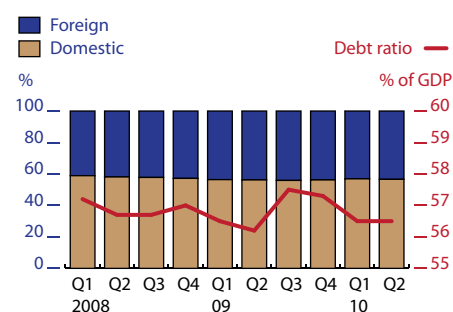
3.8.12 Inflation



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.8.13 National government outstanding debt



Source: CEIC Data Company (accessed 9 September 2010).

[Click here for figure data](#)

Thailand

A vigorous economic recovery in the first half of 2010 was driven by a rebound in exports that kick-started industrial production and stimulated investment. Private consumption also recorded solid growth. Second-half growth will show a more subdued pace given base effects, but the full-year 2010 GDP forecast is raised sharply from that projected in April's *Asian Development Outlook 2010 (ADO 2010)*. The more moderate pace of growth in the second half of 2010 is forecast to continue in 2011. An appreciating exchange rate for the baht and rising interest rates will help to curb inflation.

Updated assessment

Recovery from the 2009 economic slump was stronger than expected, especially in the first quarter of 2010 when GDP rose by 12.0% year on year. The momentum continued into the second quarter. It was interrupted when political tensions that had been simmering over recent years boiled over into violent demonstrations over 7 weeks in central Bangkok during April and May. But as the violence was confined mainly to a section of the capital, the economic impact was limited: GDP grew by 9.1% in the second quarter (Figure 3.9.1), and by 10.6% in the January–June half.

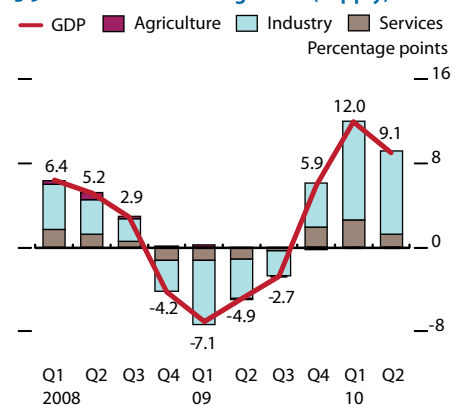
A rebound in exports kick-started the recovery, but domestic demand contributed virtually all the gain in first-half GDP (Figure 3.9.2). Private consumption increased by 5.3%, after contracting by 2.3% in the prior-year period. Supporting factors included the much-improved economic and labor-market outlook, higher farm incomes due to rising prices of crops, and fiscal stimulus measures put in place during the recession. Sales of durable goods, such as electrical appliances and passenger cars, surged in the first half (the latter by nearly 60%).

Government consumption expenditure rose by 6.8%, partly owing to disbursements of fiscal stimulus programs initiated in 2009. The government also paid compensation (in the form of grants, soft loans, and tax breaks) to businesses damaged during the violence.

Fixed capital investment increased steeply by 12.5% in the first half, mainly a result of stronger private investment, which rebounded by 17%. Substantial increases were recorded in machinery and equipment investment as businesses expanded production capacity in response to the stronger export and domestic demand for manufactured products. Private construction rose by 9%. That reflected a pickup in both residential and commercial building, stimulated by temporary tax incentives. Fixed capital investment contributed 2.6 percentage points to GDP growth.

Public investment fell slightly in that half relative to a year earlier, owing to slow disbursement of investment by state enterprises, including those in the Map Ta Phut industrial estate. Seventy-six projects were suspended there when a Thai court ruled in September 2009 that

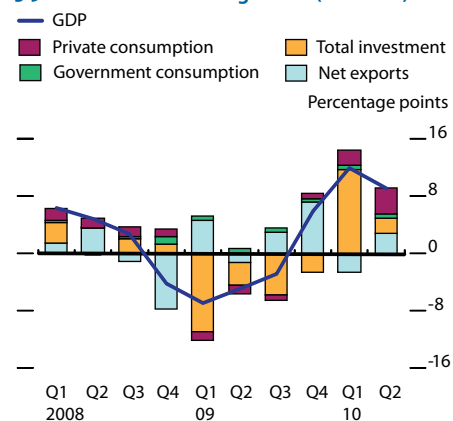
3.9.1 Contributions to growth (supply)



Source: National Economic and Social Development Board. <http://www.nesdb.go.th> (accessed 2 September 2010).

[Click here for figure data](#)

3.9.2 Contributions to growth (demand)



Source: National Economic and Social Development Board. <http://www.nesdb.go.th> (accessed 2 September 2010).

[Click here for figure data](#)

operating licenses had been issued without completion of the necessary environmental impact assessments. Since then, the government has clarified which industries must undertake these assessments and, in September 2010, the court decided that all but two of the projects could proceed. (The two that remained suspended can resubmit applications for licenses after completing their assessments.)

Disbursement of funds under the Thai Khem Kaeng (Strong Thailand) infrastructure program that started in October 2009 was also behind schedule (69% of the allocated amount was disbursed in the 10 months through July 2010).

On the supply side, industry rebounded by 18.7% in the first half of 2010, after it contracted in the prior-year period, and it contributed nearly all the GDP growth. Spurred by the bounce in export demand, manufacturing production soared by about 23% in January–March (Figure 3.9.3), and by 18% in April–June. Shipments abroad of passenger cars nearly doubled in value in the first 6 months, and those of electrical appliances jumped by two-fifths.

Services started the year on a strong note, but its growth slowed when the political strife and violence eroded consumer confidence and reduced inbound tourism for a time. Still, tourism arrivals rose by 12.1% in the first half (Figure 3.9.4). (Some visitors bypassed the capital and went to other Thai cities.) Agricultural production fell slightly in the first half because of drought and pest infestations in rice and cassava crops.

Growth in manufacturing and services absorbed most of those who lost jobs in 2009, so that by midyear there were signs of labor shortages in some industries.

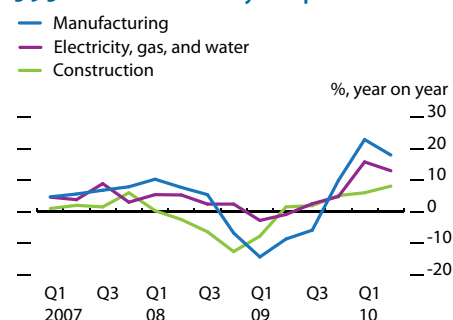
Consumer prices had declined for much of 2009, turning up late last year as domestic demand lifted and global oil prices rallied. The consumer price index continued to edge higher in the first 8 months of 2010, easing a little in April, when the demonstrations in Bangkok dented consumer sentiment (Figure 3.9.5). Inflation averaged 3.4% year on year in January–August. An appreciation of the baht against the US dollar (by 5.3% over the same 8 months) helped to mitigate the impact of higher import prices.

During the global crisis, the Bank of Thailand lowered its policy interest rate by 250 basis points to 1.25%. It maintained that low rate through the first half of 2010. After the domestic political situation settled somewhat, and in the context of the revival of the economy and inflation, the central bank started to normalize the policy rate, with increases in July and August of a cumulative 50 basis points (Figure 3.9.6).

As world trade recovered from the 2009 slump, Thailand's merchandise exports rebounded by 36.6% in US dollar terms in the first half of 2010 from the prior-year period. Exports also benefited from tariff reductions effective January 2010 under the ASEAN Free Trade Area (AFTA) agreement. Shipments to Southeast Asian markets jumped by 55.2% in value in the first half. Furthermore, exports to rapidly growing India and the People's Republic of China soared by about 54% and 48%, respectively (against an increase of 27% in exports to major industrial economies—Figure 3.9.7).

Imports soared by 51.7% in January–June 2010, from low levels in the first half of 2009. The sharpest rise was in imports of semifinished goods and raw materials (up by 63%), much of this destined for export-oriented

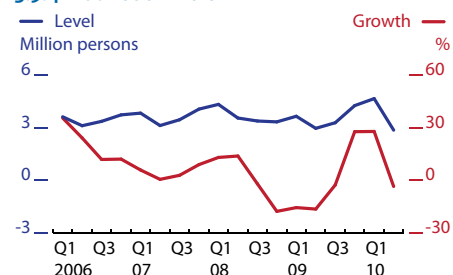
3.9.3 Growth in industry components



Sources: National Economic and Social Development Board. <http://www.nesdb.go.th> (accessed 2 September 2010).

[Click here for figure data](#)

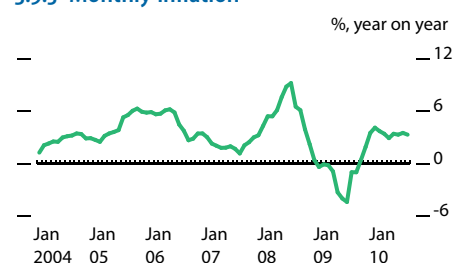
3.9.4 Tourist arrivals



Source: National Economic and Social Development Board. <http://www.nesdb.go.th> (accessed 2 September 2010).

[Click here for figure data](#)

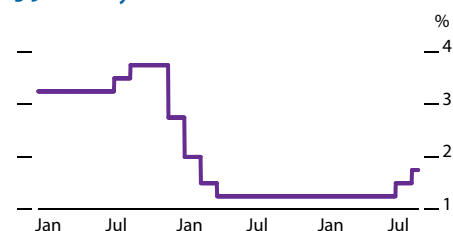
3.9.5 Monthly inflation



Sources: CEIC Data Company; Bureau of Trade and Economic Indices. <http://www.price.moc.go.th> (both accessed 2 September 2010).

[Click here for figure data](#)

3.9.6 Policy rate



Source: Bloomberg (accessed 5 September 2010).

[Click here for figure data](#)

manufacturing. Imports of capital equipment rose by 32%, reflecting the boost in fixed investment, and imports of consumer goods climbed by 36%. Higher global oil prices contributed to the rise in the import bill.

The current account registered a surplus of \$6.5 billion in the first half of 2010 (4.2% of GDP), mainly a result of a substantial \$6.7 billion surplus in merchandise trade. The capital and financial account recorded a net inflow of \$5.8 billion in the form of portfolio, direct, and other investment such as loans. However, foreign direct investment inflows have been weakening for several years (Figure 3.9.8).

International reserves rose by 22% to a sizable \$151.5 billion in the 12 months to July 2010, equal to 9.6 months of import cover and 4.7 times the short-term external debt.

Domestic financial markets have been buoyant. The SET index of share prices rose by almost 30% in the first 8 months of 2010, recovering from a dip in April–May during the worst of the strife. Demand for government bonds pushed down the yield on 10-year securities by about 1 percentage point to 3.3% over the first 6 months.

The government budgeted to rein in the fiscal deficit to the equivalent of 3.8% of GDP in FY2010 (ended 30 September 2010), from 4.3% of GDP in FY2009. Revenue grew much faster than expected, so the actual FY2010 gap is likely to be just 0.5% of GDP, or less. Most of the financing for the infrastructure program is off-budget.

Public debt as a ratio to GDP declined a touch to 43.2% by June 2010, from 43.9% at end-2009. Nevertheless, the debt is still above the 38.1% level seen in 2008, the result of government borrowing, mainly in domestic markets, to fund fiscal stimulus programs during the economic slump. Strong revenue inflows in the first half of 2010 reduced the need for the government to issue bonds for financing the fiscal deficit in this period.

Prospects

The projections assume that the political situation will be relatively calm during the forecast period, and that national elections scheduled to be held in 2011 will go smoothly.

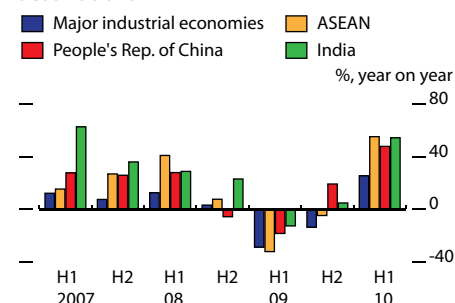
Fiscal policy will likely be aimed at supporting economic growth during the forecast period and ahead of the elections, reinforced by off-budget expenditure under the Thai Khem Kaeng infrastructure program, which runs through 2012. The government is targeting a FY2011 fiscal deficit equivalent to 4.1% of GDP, significantly wider than the expected FY2010 deficit.

As for monetary policy, the Bank of Thailand is expected to edge its policy rate higher in the context of a continuing economic recovery, moderate inflation pressures, and currently negative real interest rates.

The outlook for exports is for further growth, but not at the rapid recovery pace seen in the first half of 2010. For full-year 2010, merchandise exports are projected to increase in value by 25%, stronger than anticipated in April. The forecast for imports is also raised, to 35% for this year. Growth in tourism has resumed after the decline in April–May, and prospects are good for the tourism industry next year.

Private consumption is expected to grow in the second half of 2010, given a recovery in consumer confidence after the April–May

3.9.7 Export growth, selected other destinations

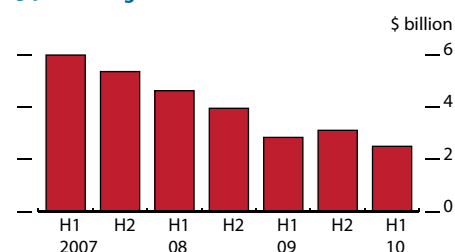


ASEAN = Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam).

Source: Bank of Thailand. <http://www.bot.or.th> (accessed 2 September 2010).

[Click here for figure data](#)

3.9.8 Foreign direct investment



Source: Bank of Thailand. <http://www.bot.or.th> (accessed 2 September 2010).

[Click here for figure data](#)

3.9.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	4.0	7.0	4.5	4.5
Inflation	3.5	3.2	3.0	3.0
Current acct. bal. (share of GDP)	4.0	4.0	2.0	3.0

Source: ADB estimates.

demonstrations (Figure 3.9.9) and higher farm incomes. The private consumption index was growing at relatively high rates at midyear (Figure 3.9.10).

Several government decisions this year will bolster private consumption. Concessions for low-income households—free electricity, water, and public bus and train services—have again been extended, this time through end-2010. The government will provide low-interest loans to low-income households so that they can repay higher-interest debt owed to loan sharks. It will also promote microfinance to improve such households' access to finance. Further, the authorities maintained a freeze on the price of gas used for cooking and for fueling motor vehicles until February 2011.

A 5% wage rise for most government employees from April 2011 will contribute support to consumption spending next year.

Private investment is likely to be underpinned by expectations of further gains in world trade through the forecast period and by growth in bank lending. The government's clarifications of environmental regulations, plus the September 2010 court ruling on the Map Ta Phut projects, should assist the effort to attract investment into industry. The index of business sentiment is higher in 2010 than other recent years, despite a dip during the demonstrations (Figure 3.9.9, above).

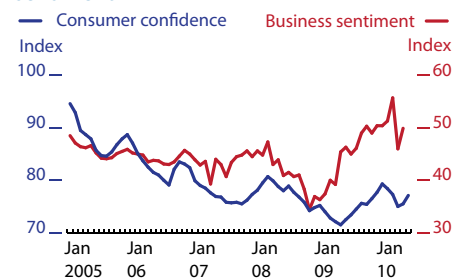
Taking into account the vigorous recovery in the first half of 2010 and the outlook discussed above, the 2010 GDP growth forecast is raised to 7.0% (Figure 3.9.11). Growth in the second half will decelerate markedly, owing to a base effect and expected slower pace of expansion in several external markets such as the PRC. These influences will continue in 2011, when Thailand's GDP growth is seen at 4.5%. The current account is forecast to remain in surplus (equivalent to about 4% of GDP this year and 3% in 2011—Figure 3.9.12).

Inflation for 2010 is forecast to average 3.2%, kept in check by the gradual rise in interest rates and the appreciating baht. Next year, inflation is forecast to be slightly lower, about 3.0%, owing to the deceleration in domestic economic activity coupled with likely modest increases in global oil and commodity prices. Capital inflows and current account surpluses will likely maintain pressure on the baht to appreciate, although the Bank of Thailand might well move to moderate the currency's rise if it sees the pace as excessive.

Risks to the outlook include the frail recoveries in industrial economies and a possible resurfacing of domestic political tensions. Addressing divisions in Thai society illustrated by several years of political turmoil and the violent demonstrations earlier in 2010, the government has drawn up a so-called reconciliation framework that includes a goal of narrowing social and economic gaps. So far, the focus is on broad social protection policies rather than policies to improve economic opportunities in less developed regions of the country.

The government has approved, in principle, the establishment of a national saving fund to provide pensions for people in the informal sector. It has also agreed to the idea of a farmers' welfare fund that would provide pensions and other benefits to farmers and their families, and that would offer financial support for rice production. While there is a need to strengthen the social safety net, it will be important to ensure that the policies are fiscally sustainable in the longer term.

3.9.9 Consumer confidence and business sentiment

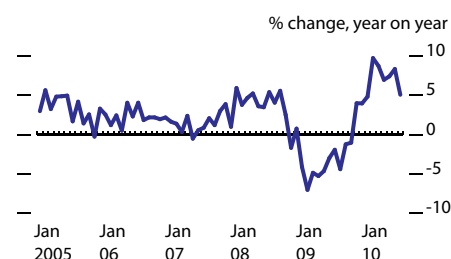


Note: A reading of less than 100 for consumer confidence and less than 50 for business sentiment denotes a deterioration.

Sources: Center for Economic and Business Forecasting; Bank of Thailand. <http://www.bot.or.th> (both accessed 10 September 2010).

[Click here for figure data](#)

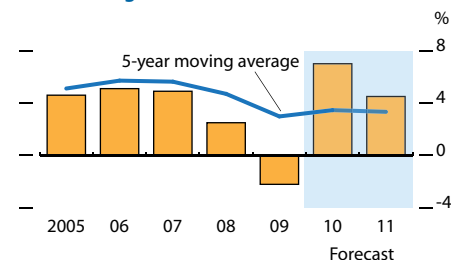
3.9.10 Composite private consumption index



Source: Bank of Thailand. <http://www.bot.or.th> (accessed 10 September 2010).

[Click here for figure data](#)

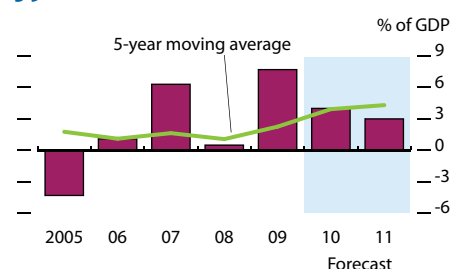
3.9.11 GDP growth



Source: Asian Development Outlook database.

[Click here for figure data](#)

3.9.12 Current account balance



Source: Asian Development Outlook database.

[Click here for figure data](#)

Viet Nam

Steps taken by the government to stabilize the economy have contributed to an improvement in the external and foreign reserves positions. Economic growth quickened in the second quarter of this year relative to the first and is now forecast to be slightly higher in both 2010 and 2011 than anticipated in April. Projections for inflation are lowered a touch. This outlook assumes that policies during the forecast period focus on macroeconomic stability and that the policy stance is communicated effectively, while also addressing structural reforms.

Updated assessment

Viet Nam started to withdraw policy stimulus late in 2009, and GDP growth slowed from 6.9% year on year in the fourth quarter of 2009 to 5.8% in the first quarter of 2010 (Figure 3.10.1), before picking up in the second quarter. The government tightened policy late last year after credit growth accelerated to nearly 40%, resulting in a sharp deterioration of the balance of payments and a decline in foreign exchange reserves.

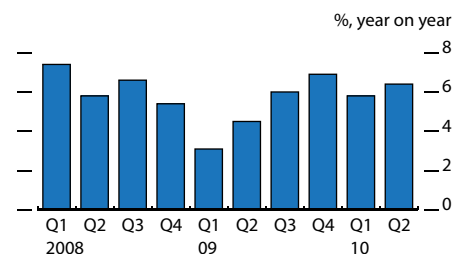
The shift from strong fiscal and monetary stimulus implemented during the global recession to a more balanced policy stance helped to stabilize financial and economic conditions and, together with the global economic recovery, paved the way for solid economic growth this year. GDP increased by 6.2% in the first half of 2010, compared with 3.9% in the same period a year earlier.

Industry expanded by 6.5% in the first half of 2010, with double-digit growth in production of electricity, gas, and water, and a rebound in manufacturing to nearly 8% growth (from just 2% a year earlier) as world trade in manufactured goods recovered. Construction slowed in the first quarter, after credit was squeezed, but it picked up to record 10% growth for the first 6 months. Production of crude oil, however, resumed a declining trend as oil fields matured, falling by 14.6% to 9.8 million metric tons in the first 8 months of 2010 (Figure 3.10.2). Industry as a whole contributed 2.6 percentage points of total GDP growth in the first half.

Reflecting higher levels of private consumption, business activity, and tourism, services grew by 7.1% in the first half, contributing 2.9 percentage points of the GDP growth. Visitor arrivals rose by about 35% to 3.4 million in January–August from a year earlier. The hotels and restaurants subsector recovered from a first-half contraction in 2009 to grow by 8.0% in the first 6 months of 2010. Robust growth was also recorded in transport and communications, as well as financial services.

Output of agriculture improved by 3.3% from 2009 levels. Favorable weather led to a better rice harvest, and fisheries production rose in the first half of 2010. Agriculture made a small contribution to GDP growth.

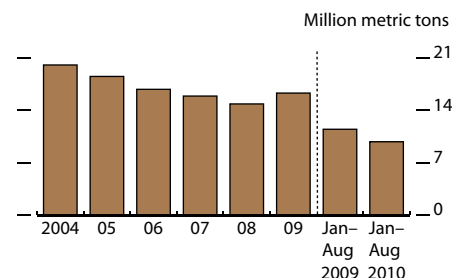
3.10.1 Quarterly GDP growth



Source: General Statistics Office of Viet Nam.

[Click here for figure data](#)

3.10.2 Crude oil output



Source: General Statistics Office of Viet Nam.

[Click here for figure data](#)

Solid domestic demand was reflected in retail sales growth of about 27% in nominal terms in the first 8 months of 2010, with growth accelerating in more recent months. Growth in government-funded investment moderated to about 11% in nominal year-on-year terms in the first 8 months from 48% in the same period of 2009, owing to the withdrawal of policy stimulus in early 2010.

Inflation quickened from 2.0% year on year in August 2009 (as economic and credit growth accelerated) until reaching an apogee of 9.5% in March 2010. Policy tightening and the good rice harvest contributed to pulling back inflation to 8.2% in July and August 2010 (Figure 3.10.3), although it increased to 8.9% in September.

The better global trade environment underpinned a 20.6% rebound in merchandise exports in customs-based US dollar terms in the January–August period. (Exports in 2009 fell by about 10% as global trade contracted.) Demand recovered for Viet Nam’s textiles and footwear (about a quarter of all exports), and shipments of electronics and machinery tools jumped by about 40%. Merchandise imports increased by 25.7%, spurred by the recovery in manufactured exports, which rely on imported materials, and higher demand for both consumption and investment goods.

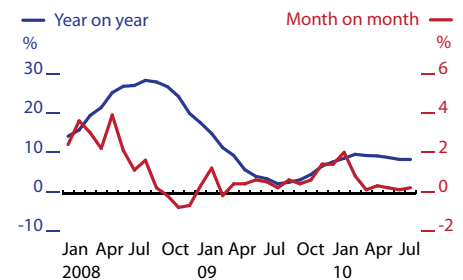
The trade deficit narrowed in the first half of this year from levels in the second half of 2009 (Figure 3.10.4). Preliminary data put the first half merchandise trade deficit at \$3.8 billion on a balance-of-payments basis, a considerable improvement on the \$8.1 billion gap in July–December 2009 (but wider than a \$249 million deficit in January–June that year). Taking into account recoveries in remittances and tourism earnings, the current account deficit narrowed to an estimated \$2.7 billion in the first half (5.6% of GDP) from \$8.0 billion in July–December 2009. (A surplus of \$0.6 billion was recorded in the first half of 2009.)

With an improvement in the capital account, the overall balance of payments likely turned to a small surplus in the second quarter of 2010, after recording deficits since the start of last year. Gross official reserves were estimated at \$13.5 billion at end-June 2010 (representing 9.6 weeks of imports of goods and services), a modest rebuilding from \$11.8 billion in March 2010, although still down from \$14.1 billion at end-2009 (Figure 3.10.5).

Sizable trade deficits and relatively high inflation, coupled with residents switching from local-currency assets into US dollars and gold, continued to put downward pressure on the dong exchange rate. The spread between the black market rate and the reference rate of the central bank (the State Bank of Viet Nam, or SBV) widened to 6.8% in mid-February. That prompted the SBV to devalue the currency by 3.4% in February against the US dollar, followed by a further 2.1% devaluation in August (Figure 3.10.6). The trading band for the dong was maintained at $\pm 3\%$. Subsequently, the gap between the black market and reference rates narrowed to about 3% in September. From November 2009 to August 2010, the dong was devalued three times, by a total of about 11% against the US dollar.

Monetary tightening steps taken by the SBV included an increase in the base interest rate and removal of interest rate caps and subsidies.

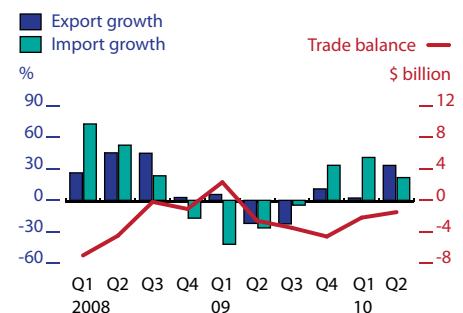
3.10.3 Monthly inflation



Sources: General Statistics Office of Viet Nam; ADB estimates.

[Click here for figure data](#)

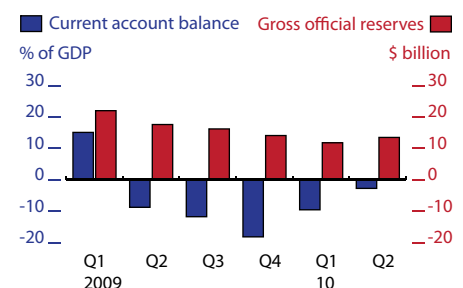
3.10.4 Trade indicators



Sources: State Bank of Viet Nam; ADB estimates.

[Click here for figure data](#)

3.10.5 Current account and reserves

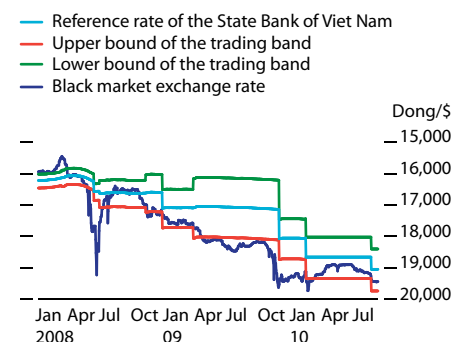


Note: Gross official reserves exclude the government’s foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Source: State Bank of Viet Nam; ADB estimates.

[Click here for figure data](#)

3.10.6 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

[Click here for figure data](#)

During the global financial crisis, the central bank had cut by half the base rate to 7% (from October 2008 to February 2009), in order to support economic growth. The SBV started to unwind that stimulus in December 2009, when it raised the base rate by 1 percentage point to 8.0% and ended interest rates subsidies on short-term loans. The central bank removed interest rate caps on medium- and long-term loans in February 2010 and on all dong-denominated loans in April.

Consequently, monetary conditions tightened in the first quarter of 2010, although they eased somewhat in the second. Total liquidity (M2) at midyear was up by 12.7% from end-2009 and by 23.7% from June 2009. Commercial banks pushed lending rates above 15% when interest rate caps were removed. However, the authorities responded by urging the banks to moderate the increases, so that lending rates were trimmed to 13%–14% in the third quarter. The VN index of stock prices declined by 8.0% in the first 8 months of 2010.

Credit in the first quarter grew by just 3.6% from end-2009, but by midyear credit growth had picked up to 11.7% from end-2009. That put the year-on-year growth in credit at 28.9%, slowing from the near 40% rate in the second half of 2009 (Figure 3.10.7) toward the official 2010 target of 25% credit growth.

Most of the fiscal stimulus measures implemented during the global financial crisis expired at end-2009. Reflecting a somewhat more restrained fiscal stance, the government is targeting a 2010 budget deficit equivalent to 6.2% of GDP, narrower than the actual deficit in 2009 of 7.0%.

Prospects

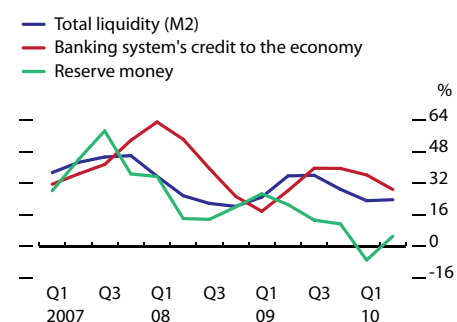
The outlook assumes that the government will maintain macroeconomic stability during the forecast period, so that the balance of payments gradually improves and the fiscal deficit narrows. It is assumed that the authorities target growth in credit at 25% and maintain efforts to safeguard and enhance banking system soundness.

On these assumptions, government investment could be restrained by fiscal consolidation, but recoveries in world trade and financial conditions will underpin growth in private investment. Illustrating improvements in the investment environment, Viet Nam's ranking in the Global Competitiveness Index compiled by the World Economic Forum was upgraded to 59 of 139 countries in 2010 (from 75 in 2009), and its ranking in the Forum's Enabling Trade Index rose to 71 of 125 economies (from 89 in 2009). Progress being achieved in a government drive called Project 30, to simplify bureaucratic procedures, is reducing red tape for businesses.

Private consumption growth is projected to get support during the forecast period from rising incomes and recovering remittance inflows.

Viet Nam is benefiting substantially from the rebound in world trade, which is projected to continue through 2011 at nearly the same pace as this year. Growth in the country's merchandise exports was running at about 30% in July–August, supporting growth in industry and, to a lesser degree, in agriculture. In particular, trade with the People's Republic of China (including Hong Kong, China) has stepped

3.10.7 Growth of money and banking indicators



Note: Banking system data changed since 2007.

Sources: State Bank of Viet Nam. International Financial Statistics online database; ADB estimates.

[Click here for figure data](#)

3.10.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	6.5	6.7	6.8	7.0
Inflation	10.0	8.5	8.0	7.5
Current acct. bal. (share of GDP)	-7.6	-7.5	-5.5	-5.4

Source: ADB estimates.

up owing to a rebound in those economies reinforced by a free trade agreement that came into effect in January 2010 between the PRC and the Association of Southeast Asian Nations.

The impact on the trade deficit from the real devaluation of the dong (due to a larger nominal devaluation than inflation differentials) is expected to be limited, largely because exports of manufactured goods usually require substantial imported materials and equipment.

GDP growth for 2010 is, on this basis, seen at 6.7% (Figure 3.10.8). The forecast is raised slightly from April's Asian Development Outlook 2010 (ADO 2010) in light of the pace of growth in the first half coupled with expectations of a quickening in the second half, as well as the upward revision in the ADO baseline assumptions for the recovery in world trade in 2010. The economic expansion rate is expected to pick up slightly in 2011, to about 7%, as investor confidence improves in tandem with more subdued inflation and a more robust external position.

The current account deficit, as a ratio to GDP, is forecast to narrow in the forecast period (Figure 3.10.9) due to an improving trade account, inflows of remittances, and the recovery in tourism. Deficit forecasts (7.5% of GDP in 2010 and 5.4% in 2011) are little changed from ADO 2010. The overall balance of payments is expected to continue improving, supported by foreign direct investment attracted by the expanding economy as well as by capital inflows. Foreign reserves are seen increasing modestly to more comfortable levels.

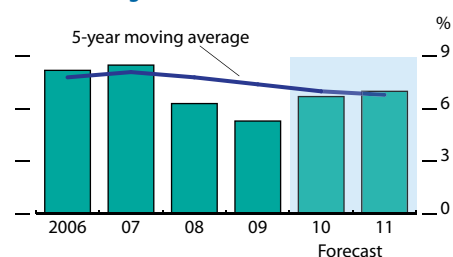
Inflation is projected to average 8.5% in 2010, easing to 7.5% next year (Figure 3.10.10) on the assumption that domestic macroeconomic stability is maintained and that global oil and commodity prices are relatively steady in 2011. These forecasts are lowered slightly from April owing to the improvement in macroeconomic conditions and moderate growth in credit. However, large swings in inflation (from 28% year on year in August 2008 to 2% in August 2009, then up to over 8% this year), together with expectations of dong devaluation, suggest that inflation expectations, too, are not firmly anchored.

The government is putting in place regulations that would enable it to impose price controls on a range of goods sold by private companies. Such controls, if implemented, could limit price increases to some extent in the short term, but would also risk eroding business sentiment.

In a significant step to strengthen the authority of the SBV in implementing monetary policy and safeguarding the financial system, the National Assembly in June 2010 approved a new SBV Law and a new Credit Institutions Law (Box 3.10.1).

Separately, the SBV has taken steps to address the issue of banking system stability with new prudential policies that take effect on 1 October 2010. Under these changes, the capital-adequacy ratio for banks is raised from 8.0% to 9.0% and restrictions are introduced on banks expanding into higher-risk businesses, such as securities and real estate trading. Banks must meet a minimum capital requirement of VND 3 trillion (\$158 million) by end-2010. The SBV indicated that it is ready to assist banks to meet the capital requirement, including by facilitating mergers and acquisitions. There have been concerns about

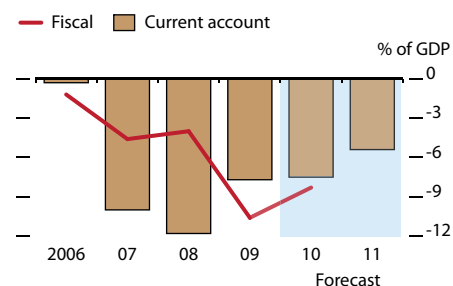
3.10.8 GDP growth



Sources: General Statistics Office of Viet Nam; Asian Development Outlook database.

[Click here for figure data](#)

3.10.9 Fiscal and current account deficits

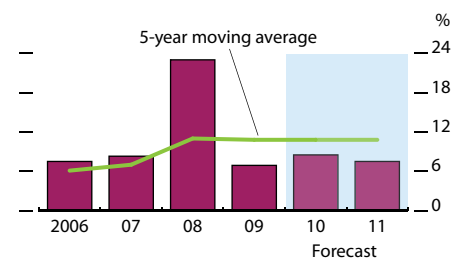


Note: This is overall fiscal balance, including off-budget expenditure and on-lending, not the fiscal balance based on government's definition.

Source: Asian Development Outlook database.

[Click here for figure data](#)

3.10.10 Inflation



Sources: General Statistics Office of Viet Nam; Asian Development Outlook database.

[Click here for figure data](#)

some banks' capital adequacy, risk-management capacity, and the quality of their loan portfolios.

Domestic risks to the economic outlook in the forecast period center on any premature easing of monetary or fiscal policies (or both), or a perception of looser policy by financial markets and domestic investors. An early easing, or the perception of a relaxation, could derail the macroeconomic stabilization efforts, putting inflation on an upward trajectory and pressure on external accounts.

Such developments would erode consumer and business confidence and deplete already low foreign reserves. The resulting macroeconomic instability would likely require more stringent policy tightening, which would undermine the growth prospects for next year. It will be crucial that the authorities maintain a firm and consistent policy stance, and communicate such a position effectively to the market, until inflation is clearly on a downward track and foreign reserves increase.

The other major challenge is to raise the efficiency of the economy and reduce supply-side constraints through structural reforms. Much has been achieved in lifting Viet Nam to "lower-middle-income" status (a World Bank classification for economies that graduate from the "low income" group when per capita annual gross national income reaches \$996). The government is now preparing a new socioeconomic development strategy for the next 10 years, scheduled to start in 2011. This provides an opportunity to address infrastructure bottlenecks, deficiencies in the legal and regulatory framework for the private sector, inefficiencies and corporate governance problems at state-owned enterprises, and shortages of labor skills.

Structural policies that promote productivity growth and support development of higher valued-added activities hold the key to sustaining growth and extending its benefits to more people.

3.10.1 Strengthening the financial framework

Two laws approved by the National Assembly in June 2010—a new State Bank of Viet Nam Law and a Credit Institutions Law—together with various legal documents issued by the central bank and other agencies, mark important progress in strengthening the framework for conducting monetary policy and safeguarding banking system stability. The laws go into effect on 1 January 2011.

The new SBV Law will enhance the central bank's autonomy and accountability in formulating and implementing monetary policy. It explicitly stipulates that the key objectives of monetary policy are to stabilize the value of the currency and to control inflation, putting more emphasis on these objectives than the current law.

Furthermore, the SBV's authority for surveillance and supervision of credit institutions is enhanced by the legislation.

The new Credit Institutions Law will allow credit institutions greater autonomy and flexibility in doing business, for example in setting fees and interest rates and in providing a wider range of financial services.

This law also simplifies administrative procedures for banking and sets out that institutions are to gradually adopt best international practices. It applies both to banks and nonbank financial institutions.

The image features a background with a blue-to-white gradient at the top, transitioning into a solid dark blue horizontal band. Below this band is a textured blue area. The text 'Statistical appendix' is centered in the dark blue band, with a thin white vertical line to its left.

Statistical appendix

Statistical notes and tables

The statistical appendix presents selected economic indicators for 44 developing member economies of the Asian Development Bank (ADB) and for Brunei Darussalam, an unclassified regional member, in three tables: gross domestic product (GDP) growth, inflation, and current account balance as a percentage of GDP. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. The tables contain historical data for 2007 to 2009 and forecasts for 2010 and 2011.

The data were standardized to the degree possible in order to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the balance-of-payments data are based on International Monetary Fund (IMF) accounting standards. Historical data were obtained from official sources, statistical publications, and databases, and documents of ADB, IMF, and World Bank. Projections for 2010 and 2011 are generally staff estimates made on the basis of available quarterly or monthly data, although some projections are from governments.

Most countries report on a calendar-year basis, while South Asian countries (except for Maldives and Sri Lanka) report all variables on a fiscal year basis.

Regional and subregional averages are provided for the three tables. The averages are computed using weights derived from levels of gross national income (GNI) in current United States dollars (US\$) following the World Bank Atlas method. The GNI data for 2007–2008 were obtained from the World Bank's *World Development Indicators Online*. Weights for 2008 were carried over through 2011. The GNI data for Cook Islands and Tuvalu were estimated using the Atlas conversion factor. Myanmar and Nauru have no GNI data, and data for these two countries are excluded from the computation of all subregional averages and totals. The following paragraphs discuss the three tables in greater detail.

Table A1: Growth rate of GDP (% per year). The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes

less subsidies on imports plus all nondeductible value-added or similar taxes. Constant factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most countries use constant market price valuation. Fiji Islands, India, Pakistan, and Sri Lanka use constant factor costs, while Maldives and Nepal use basic prices. The series for Timor-Leste has been changed and is now based on non-oil GDP only. In light of Pakistan's revisions to the GDP series in June 2010, the *Asian Development Outlook 2010* GDP forecasts are not comparable with current estimates and have been omitted.

Table A2: Inflation (% per year). Data on inflation rates represent period averages. Except for India, which reports the wholesale price index, inflation rates presented are based on consumer price indexes. The consumer price indexes of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul, Cambodia is for Phnom Penh, Marshall Islands is for Majuro, Solomon Islands is for Honiara, Timor-Leste is for Dili region, and Nepal is for urban consumers. The series for India has been revised due to a change in base year.

Table A3: Current account balance (% of GDP). The values of the current account balance, which is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers, are divided by GDP at current prices in US\$. In the case of Cambodia, and Lao People's Democratic Republic, official transfers are excluded from the current account balance. Federated States of Micronesia, Marshall Islands, Nauru, Republic of Palau, and Tonga report balance-of-payments data on a fiscal year basis.

Table A1 Growth rate of GDP (% per year)

Subregion/Economy	2007	2008	2009	2010		2011	
				ADO 2010	Update	ADO 2010	Update
Central Asia	12.0	6.1	2.7	4.7	5.1	5.9	5.7
Armenia	13.7	6.9	-14.2	1.5	6.4	3.0	4.0
Azerbaijan	25.1	10.8	9.3	9.5	3.8	9.7	3.5
Georgia	12.3	2.3	-3.9	2.0	4.5	4.0	4.5
Kazakhstan	8.9	3.3	1.2	2.5	4.8	3.5	5.2
Kyrgyz Republic	8.5	8.4	2.3	5.5	-3.5	6.0	7.0
Tajikistan	7.8	7.9	3.4	4.0	4.5	5.0	5.5
Turkmenistan	11.6	10.5	6.1	6.5	6.5	11.0	11.0
Uzbekistan	9.5	9.0	8.1	8.5	8.5	9.0	9.0
East Asia	11.2	7.3	6.1	8.3	8.6	7.7	7.7
China, People's Rep. of	14.2	9.6	9.1	9.6	9.6	9.1	9.1
Hong Kong, China	6.4	2.2	-2.8	5.2	5.8	4.3	4.3
Korea, Rep. of	5.1	2.3	0.2	5.2	6.0	4.6	4.6
Mongolia	10.2	8.9	-1.6	7.0	7.0	6.5	6.5
Taipei, China	6.0	0.7	-1.9	4.9	7.7	4.0	4.0
South Asia	8.7	6.3	6.7	7.4	7.8	8.0	7.8
Afghanistan	12.1	3.4	22.5	7.6	8.9	6.8	6.8
Bangladesh	6.4	6.2	5.7	5.5	6.0	6.3	6.3
Bhutan	13.5	11.8	6.0	6.0	7.0	6.5	7.0
India	9.2	6.7	7.4	8.2	8.5	8.7	8.7
Maldives	7.2	6.2	-3.1	3.0	3.5	3.5	3.5
Nepal	2.8	5.8	4.0	3.5	3.5	4.5	4.0
Pakistan	6.8	3.7	1.2	-	4.1	-	2.5
Sri Lanka	6.8	6.0	3.5	6.0	6.5	7.0	7.0
Southeast Asia	6.6	4.4	1.3	5.1	7.4	5.3	5.4
Brunei Darussalam	0.2	-1.9	-0.5	1.1	1.1	1.5	1.5
Cambodia	10.2	6.7	-2.0	4.5	5.0	6.0	6.0
Indonesia	6.3	6.0	4.5	5.5	6.1	6.0	6.3
Lao People's Dem. Rep.	7.8	7.2	6.5	7.0	7.4	7.5	7.5
Malaysia	6.5	4.7	-1.7	5.3	6.8	5.0	5.0
Myanmar	5.5	3.6	4.4	5.2	5.0	5.5	5.3
Philippines	7.1	3.7	1.1	3.8	6.2	4.6	4.6
Singapore	8.5	1.8	-1.3	6.3	14.0	5.0	5.0
Thailand	4.9	2.5	-2.2	4.0	7.0	4.5	4.5
Viet Nam	8.5	6.3	5.3	6.5	6.7	6.8	7.0
The Pacific	5.0	5.3	3.7	3.7	4.3	5.0	5.1
Cook Islands	9.5	-1.2	-0.1	1.0	0.5	2.0	2.0
Fiji Islands	-0.5	-0.1	-2.5	-0.5	-0.5	0.5	0.5
Kiribati	0.4	-1.1	-0.7	0.8	0.5	1.2	1.0
Marshall Islands, Rep. of	3.3	-2.0	0.0	0.5	0.5	1.5	1.5
Micronesia, Fed. States of	-0.1	-2.9	-1.0	0.5	0.5	1.0	1.0
Nauru	-27.3	1.0	0.0	2.0	0.0	4.0	4.0
Palau, Rep. of	-0.5	-4.9	-2.1	0.5	0.5	2.0	2.0
Papua New Guinea	7.2	6.7	4.5	5.5	5.5	7.7	7.7
Samoa	6.8	-3.0	-0.8	0.5	0.5	2.0	2.0
Solomon Islands	8.7	6.9	0.0	2.0	3.5	3.0	3.0
Timor-Leste, Dem. Rep. of	8.4	12.8	12.2	7.0	10.4	7.0	7.7
Tonga	-1.4	2.0	-0.4	0.4	-1.2	1.2	0.8
Tuvalu	4.9	1.3	1.5	1.6	1.6	1.6	1.6
Vanuatu	6.8	6.3	3.8	4.6	4.0	4.0	4.0
Average	10.1	6.6	5.4	7.5	8.2	7.3	7.3

- = data not available.

Table A2 Inflation (% per year)

Subregion/Economy	2007	2008	2009	2010		2011	
				ADO 2010	Update	ADO 2010	Update
Central Asia	11.2	16.3	6.1	6.7	6.6	6.6	6.4
Armenia	4.4	9.0	3.4	4.5	6.5	5.0	5.5
Azerbaijan	16.7	20.8	1.5	5.8	5.0	6.0	4.0
Georgia	9.2	10.0	1.7	6.0	6.0	6.0	6.0
Kazakhstan	10.8	17.0	7.3	6.8	6.8	6.5	6.5
Kyrgyz Republic	10.2	24.5	6.9	8.5	7.5	9.0	9.0
Tajikistan	13.2	20.4	6.5	10.8	8.0	9.5	9.5
Turkmenistan	6.3	14.5	0.1	3.5	3.5	5.0	5.0
Uzbekistan	12.3	12.7	14.1	9.3	9.3	9.0	9.5
East Asia	3.9	5.4	0.0	3.3	3.0	3.0	3.0
China, People's Rep. of	4.8	5.9	-0.7	3.6	3.2	3.2	3.2
Hong Kong, China	2.0	4.3	0.5	2.2	2.6	2.8	2.8
Korea, Rep. of	2.5	4.7	2.8	3.0	3.0	3.0	3.0
Mongolia	7.5	26.1	6.3	7.9	7.9	6.0	6.0
Taipei, China	1.8	3.5	-0.9	1.5	1.5	1.6	1.6
South Asia	5.7	9.5	5.6	6.0	7.9	6.0	6.5
Afghanistan	13.0	26.8	-12.0	8.4	0.4	4.5	3.4
Bangladesh	7.2	9.9	6.7	7.5	7.3	7.8	7.5
Bhutan	5.2	6.4	7.1	5.0	5.5	5.0	7.0
India	5.0	8.7	3.6	5.0	7.5	5.5	5.5
Maldives	7.4	12.3	4.0	4.0	4.0	3.0	3.0
Nepal	6.4	7.7	13.2	10.0	10.0	8.0	9.0
Pakistan	7.8	12.0	20.8	12.0	11.7	8.0	13.0
Sri Lanka	15.8	22.6	3.5	6.5	6.5	8.0	8.0
Southeast Asia	4.1	8.8	2.6	4.5	4.2	4.5	4.2
Brunei Darussalam	0.3	2.7	1.8	1.7	1.8	1.5	2.0
Cambodia	7.7	25.0	-0.7	5.0	4.0	5.0	5.0
Indonesia	6.4	9.8	4.8	5.6	5.2	6.2	5.7
Lao People's Dem. Rep.	4.5	7.6	0.0	5.6	6.0	6.0	6.5
Malaysia	2.0	5.4	0.6	2.4	1.8	3.0	2.4
Myanmar	32.9	22.5	2.2	8.5	7.5	9.0	8.5
Philippines	2.8	9.3	3.2	4.7	4.5	4.5	4.4
Singapore	2.1	6.6	0.6	2.3	3.0	2.0	2.0
Thailand	2.2	5.4	-0.9	3.5	3.2	3.0	3.0
Viet Nam	8.3	23.0	6.9	10.0	8.5	8.0	7.5
The Pacific	3.7	9.5	5.4	5.1	5.9	5.4	5.4
Cook Islands	2.5	7.8	6.6	3.5	3.5	4.2	4.2
Fiji Islands	4.8	7.7	3.7	3.4	6.0	3.1	3.5
Kiribati	4.2	11.0	6.6	5.9	5.4	4.9	4.2
Marshall Islands, Rep. of	2.7	14.8	2.8	3.8	4.5	4.4	2.4
Micronesia, Fed. States of	3.6	6.8	7.4	3.5	3.5	3.0	3.0
Nauru	2.3	4.5	2.2	2.3	2.3	2.4	2.4
Palau, Rep. of	3.0	10.0	6.1	3.8	3.8	3.4	3.4
Papua New Guinea	0.9	10.6	7.6	7.1	7.1	7.7	7.7
Samoa	5.5	11.5	6.6	2.5	1.0	4.0	4.0
Solomon Islands	7.6	17.3	8.3	7.3	5.0	6.0	6.0
Timor-Leste, Dem. Rep. of	8.9	7.6	1.0	3.2	5.0	3.8	3.8
Tonga	5.1	9.8	5.0	3.0	2.0	3.0	3.0
Tuvalu	2.2	5.3	3.8	3.5	3.5	3.2	3.2
Vanuatu	4.0	4.8	5.6	5.0	5.0	4.2	4.2
Average	4.4	6.9	1.5	4.0	4.1	3.9	3.9

- = data not available.

Table A3 Current account balance (% of GDP)

Subregion/Economy	2007	2008	2009	2010		2011	
				ADO 2010	Update	ADO 2010	Update
Central Asia	1.9	9.1	3.8	7.0	8.4	7.5	8.3
Armenia	-6.4	-11.8	-16.0	-12.0	-14.7	-10.5	-13.5
Azerbaijan	27.3	33.7	23.6	23.0	29.0	21.7	27.0
Georgia	-19.7	-22.8	-11.9	-14.0	-13.0	-14.0	-13.0
Kazakhstan	-7.9	4.7	-3.0	2.3	3.0	3.3	3.3
Kyrgyz Republic	-6.0	-13.6	4.0	-12.0	-6.5	-12.0	-9.0
Tajikistan	-8.6	-7.7	-7.3	-8.3	-7.8	-7.1	-8.5
Turkmenistan	15.5	18.7	17.8	30.0	30.0	30.0	30.0
Uzbekistan	19.1	16.7	12.0	13.0	13.0	14.0	14.0
East Asia	8.4	7.5	6.3	5.1	5.3	4.7	4.8
China, People's Rep. of	10.6	9.4	6.0	5.7	5.6	5.3	5.2
Hong Kong, China	12.3	13.6	8.7	7.6	7.6	7.2	7.2
Korea, Rep. of	0.6	-0.6	5.1	1.5	2.4	1.0	2.0
Mongolia	4.4	-13.7	-14.8	-16.1	-16.1	-21.2	-21.2
Taipei, China	8.9	6.8	11.3	8.2	8.8	6.7	7.3
South Asia	-1.7	-3.0	-2.8	-1.5	-2.2	-2.1	-2.5
Afghanistan	0.9	-1.6	0.7	-1.8	-1.7	-2.1	-2.1
Bangladesh	1.4	0.9	2.7	1.8	3.7	0.5	0.2
Bhutan	14.0	-2.0	-9.4	0.0	-5.0	0.0	-10.0
India	-1.4	-2.4	-2.9	-1.5	-2.7	-2.0	-2.4
Maldives	-41.5	-51.4	-30.8	-25.0	-25.0	-25.0	-25.0
Nepal	-0.1	2.9	4.3	-0.5	-2.3	1.0	-1.0
Pakistan	-4.8	-8.5	-5.6	-3.6	-2.0	-4.2	-4.3
Sri Lanka	-4.5	-7.1	0.3	-2.0	-2.5	-3.0	-3.0
Southeast Asia	8.2	5.0	7.1	5.7	5.7	5.6	5.7
Brunei Darussalam	39.6	50.4	35.0	33.0	46.0	31.0	44.0
Cambodia	-8.2	-12.2	-10.7	-16.3	-13.6	-17.0	-12.9
Indonesia	2.4	0.0	2.0	1.4	1.2	0.6	0.7
Lao People's Dem. Rep.	-17.2	-15.4	-11.8	-10.0	-9.0	-11.0	-8.0
Malaysia	15.6	17.5	16.6	14.0	13.2	13.8	12.0
Myanmar	0.6	-2.5	-1.0	-1.8	-1.8	-2.1	-2.3
Philippines	4.9	2.2	5.3	3.3	4.0	3.2	3.3
Singapore	26.7	18.5	17.8	18.0	18.0	21.0	21.0
Thailand	6.3	0.5	7.7	4.0	4.0	2.0	3.0
Viet Nam	-10.0	-11.8	-7.7	-7.6	-7.5	-5.5	-5.4
The Pacific	34.1	72.7	31.8	39.5	23.5	-	-
Cook Islands	6.5	4.7	6.3	4.3	4.9	4.3	-
Fiji Islands	-14.0	-17.7	-8.7	-11.0	-11.0	-8.0	-8.0
Kiribati	-1.1	-0.9	-2.7	-	-	-	-
Marshall Islands, Rep. of	-5.5	-5.3	-12.1	-	-	-	-
Micronesia, Fed. States of	4.2	0.7	-13.2	-17.4	-17.4	-	-
Nauru	-10.3	-	-	-	-	-	-
Palau, Rep. of	-6.4	-17.9	-13.7	-	-9.5	-	-
Papua New Guinea	2.9	9.9	-5.1	-15.0	-15.0	-30.0	-30.0
Samoa	-4.1	-7.7	-14.4	-15.3	-15.3	-12.9	-12.9
Solomon Islands	-15.3	-19.1	-10.6	-18.0	-18.6	-	-
Timor-Leste, Dem. Rep. of	295.0	421.7	207.2	271.7	182.3	-	-
Tonga	-9.1	-10.6	-12.9	-	-	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-7.4	-6.5	-	-4.1	-	-4.3	-
Average	6.5	5.4	4.8	4.1	4.1	3.6	3.7

- = data not available.

