Asian Development Bank

ASIAN DEVELOPMENT

Outlook

2009 Update

Broadening openness for a resilient Asia

Asian Development Bank
The annual *Asian Development Outlook* provides a comprehensive economic analysis of 45 economies in developing Asia and the Pacific.

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Developing Asia as a whole is proving to be more resilient to the global economic slowdown than was expected when Asian Development Outlook 2009 (ADO 2009) was published in March this year. Consequently, this Update sees somewhat stronger growth for both this year and next than was earlier forecast. The region’s economic expansion for 2009 is projected to come in at 3.9%, up slightly from the March forecast of 3.4%, on the back of much stronger growth in East Asia and South Asia. The growth projection for 2010 is likewise upgraded to 6.4% from 6.0% in March.

The global economy is experiencing its worst peace-time slump in eight decades. World trade and industrial production are set to decline sharply this year, leading to a contraction of the world economy.

Unfavorable events originating in the major industrial economies have cascaded on to developing Asia. The region’s more open economies were hit the hardest, mainly from falling global demand for their exports. Double-digit declines in exports were common since the last quarter of 2008 through the first half of this year.

As in the major industrial economies, governments and central banks in the region were quick to remedy the growth slack, providing the necessary fiscal and monetary stimuli. Economic activity in the large developing Asian economies rebounded and output looks set for a V-shaped comeback.

But even with a nascent recovery, the region should not be complacent. Downside risks to the outlook remain. A prolonged global recession will reduce the speed at which developing Asia can return to its potential rate of growth. Hasty removal of fiscal and monetary stimuli can likewise degrade the ongoing recovery.

Policy measures to broaden openness need to be adopted to support economic resilience and sustained development. In the last 60 years, the multilateral trading system has underpinned global growth and prosperity. Globalization and openness must continue, but their scope and structure need to be reviewed if the region is to soften some of the economic jolts that hit it every few years.

Before both the 1997–98 Asian financial crisis and the current global downturn, developing Asia enjoyed years of rapid economic growth, reaping the benefits of its financial and trade openness. The onset of both periods of turmoil, however, brought to the fore the perils of excessive and unbalanced openness.

A major lesson from the 1997–98 crisis is that openness must be matched with well-entrenched institutions and regulatory systems that can effectively manage financial globalization. Developing Asia successfully reformed its financial systems in the wake of the 1997–98 crisis, boosting its resilience to financial shocks, which helped shield it from the adverse effects of the current global economic downturn.
Yet the recovery from the 1997–98 crisis carried the seeds of the next dangerous harvest, coming as it did from an overreliance on external demand from the major industrial economies. The ongoing global turmoil has therefore battered the region through plummeting export demand, evaporating capital inflows, and stalling remittance growth. To strengthen its resilience and reduce its vulnerability to external shocks, developing Asia needs to address the geographically unbalanced structure of its trade, capital flows, and movement of workers by promoting closer economic linkages within the region. Such moves, together with a more balanced economy in which domestic demand plays a bigger role, can help the region’s economies achieve rapid yet stable growth.

As developing Asia emerges from the global downturn, its footprint on the world economy is becoming more pronounced. So, although the longer-term future looks promising, the region’s greatest challenge in the medium term is to live up to the demands of this heightened responsibility.

HARUHIKO KURODA
President
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JONG-WHA LEE
Chief Economist
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Definitions

The economies discussed in *Asian Development Outlook 2009 (ADO 2009) Update* are classified by major analytic or geographic groupings. For purposes of *ADO 2009 Update*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to the 44 developing member countries of the Asian Development Bank and to Brunei Darussalam, an unclassified regional member.
- **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **East Asia** comprises People’s Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei, China.
- **South Asia** comprises Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- Unless otherwise specified, the symbol “$” and the word “dollar” refer to US dollars.

*ADO 2009 Update* is generally based on data available up to 31 August 2009.

Acronyms and abbreviations

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<td>consumer price index</td>
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Highlights—ADO 2009 Update

Despite a notable slowdown in its economic expansion relative to potential, developing Asia is leading the recovery from the global downturn. Its growth is underpinned by the relatively healthy state of its financial systems prior to the financial crisis; by the fiscal and monetary stimuli that have been quickly provided by governments and central banks across the region; and by the rapid turnaround in its larger, less export-dependent economies.

However, risks remain on the downside: hasty withdrawal of the fiscal and monetary measures supporting aggregate demand would stunt developing Asia’s nascent recovery, and any slippage in the major industrial economies’ recovery would delay the region’s return to its long-term growth path.

To develop more resilient economies, developing Asia should broaden the scope and structure of openness. Reducing its vulnerability to external shocks requires policy makers to tackle the geographically unbalanced structure of its trade, capital flows, and movement of workers. By promoting closer economic linkages within the region and a more balanced internal economic structure with a bigger role for domestic demand, policy makers in developing Asia will be able to achieve rapid yet stable growth for the region.
Key Messages

- The global economy may just be coming out of its worst peace-time downturn since the Great Depression of the 1930s. Part 1 of this *Update* to the *Asian Development Outlook 2009 (ADO 2009)* that was released in March, envisages a global economic contraction this year on account of steep declines in world trade and industrial production. While fiscal stimulus packages and easy monetary policies have averted a collapse of the global financial system and limited the depth of the recession, conditions for a sustainable world economic recovery are still uncertain.

- The main channel by which the global financial crisis and economic slump spread to developing Asia was the collapse of demand in major global markets, hitting the region’s exports. With a large proportion of regional trade in parts and components supporting supply chains, imports also buckled. The more open economies of East Asia and Southeast Asia—such as Hong Kong, China; Republic of Korea (henceforth Korea); Malaysia; Singapore; Taipei, China; and Thailand—were hardest hit, and their economies contracted significantly from the second half of 2008 until well into the first half of 2009.

- But many regional governments’ quick and decisive response to the weak global environment prevented a freefall in developing Asia’s economic growth. Tax cuts, greater public spending, targeted assistance, and easy monetary policies boosted consumption and investment. The regional economy is now poised to achieve a V-shaped rebound. The larger economies provided much of the impetus for the region’s transition to recovery. In addition, stronger financial systems in the region than elsewhere at the onset of the financial crisis underpinned the region’s resilience to the global downturn.

- Nevertheless, there is no room for complacency, and the region’s nascent recovery faces downside risks. Externally, a lengthier global downturn than currently forecast would retard the region’s full recovery, and without a revival of the global economy, the region’s long-term growth potential would remain unattainable. Internally, in its current economic structure, developing Asia cannot be the sole driver of its own growth. Likewise, mistimed exit strategies for fiscal and monetary stimuli would imperil the region’s rebound; and pulling away the carpet of fiscal and monetary support before the recovery has a firm foothold may lead to a double-dip decline instead of the expected V-shaped rebound.

- To strengthen its economic resilience and sustain its development, developing Asia must adopt policies to broaden the scope and structure of its openness to trade, capital flows, and movement of workers. Part 2 of this *Update* calls for promoting intraregional economic links while maintaining vital existing links with the rest of the world. Success in this twin-track approach will enable the region to exploit the potentially vast but largely neglected gains from closer relations with its neighbors. Combined with a stronger domestic economy, broader openness can help regional economies achieve rapid yet stable growth.
Outlook for 2009 and 2010

- Since the publication of ADO 2009 in March, global economic conditions have worsened, requiring an update of forecasts for the G3 economies of the United States, eurozone, and Japan. A deeper contraction of 3.7% in 2009 is now seen in the G3, followed by a modest recovery of 1.1% in 2010 as inflation remains quiescent. The volume of world trade is set to decline more sharply this year but rebound more quickly next year, both relative to ADO 2009.

- Oil prices have been rising steadily since March 2009, but have stayed well below July 2008’s peak. Global demand remains subdued and inventory levels high. In addition, production capacity of members of the Organization of the Petroleum Exporting Countries is projected to increase substantially. Together these factors should damp the scope for further price increases in the short term. Nonenergy prices have been less volatile, increasing only subtly since the beginning of this year. The nonenergy price trajectory in the next 2 years depends on a host of factors, including a recovery in demand, weather conditions, and supply setbacks.

- While some signs of worldwide economic stabilization are beginning to emerge, risks to the global outlook remain tilted to the downside. Governments around the world slashed interest rates and taxes and raised spending to boost sagging aggregate demand. Yet exiting these measures too early may lead to a protracted slowdown and derailment of the global recovery, and correct timing is key to avoiding a double-dip downturn. Increased resort to protectionist measures and the persistent stalemate in global trade negotiations is likewise threatening the fragile trade rebound. In addition, the continued weakness in housing markets could also cloud prospects for the world economy, while cost-push inflation may return with resurgence in global oil prices. Finally, the risk of a global emergency from H1N1 flu may have diminished, but the virus could still mutate into a more virulent strain, with far more serious public health consequences.

- Despite the notable slowdown in growth this year in most economies across developing Asia, the region has proved to be more resilient than earlier feared. Part 3 of this Update projects economic expansion of developing Asia to come in at 3.9%, revised up by 0.5 percentage points from the ADO 2009 forecast of 3.4%, on the back of much stronger growth in East Asia and South Asia. The growth projection for 2010 is likewise upgraded to 6.4% from 6.0% in March.

- This resumption of growth has taken place amid a low to mild inflation environment across the region. Coming off last year’s peak, inflation in developing Asia is forecast to come in at just 1.5% in 2009, down from the March projection of 2.4%. More robust growth is likely to push prices up faster in 2010, raising the forecast to 3.4%. Central bankers in the region will therefore want to put a tight watch on monetary policies so as not to encourage asset bubbles that would inflate prices to levels that are no longer justified by fundamentals.
Slower growth in industrial countries has resulted in a weak recovery in developing Asia’s exports. But imports were even more sluggish as demand for intermediate goods waned. Overall, the region’s current account is expected to register a surplus of 5.0% of GDP in 2009. With developing Asian economies increasingly relying on domestic demand to boost growth, their current account surplus is projected to fall further to 4.3% of GDP in 2010.

There are notable divergences in the outlook across subregions and economies. In particular, the Update upgrades projections for East Asia and South Asia, while downgrading those for other subregions. Likewise, it has raised forecasts for the larger regional economies, such as the People’s Republic of China (PRC), Korea, India, and Indonesia, while lowering those for the smaller, generally more open economies.

Economic expansion in East Asia is now projected to reach 4.4% in 2009, supported by stronger growth in the PRC and a shallower contraction in Korea, than foreseen in ADO 2009. The PRC’s massive fiscal stimulus package announced last year and the aggressive monetary easing in 2009 bolstered economic growth in that country. The Government’s 8.0% growth target set at the start of the year now looks within reach, with the Update projecting the economy to expand by 8.2%. Similarly, Korea’s fiscal stimulus has been effective, and the economy is forecast to shrink by just 2.0% this year, compared with March’s 3.0% forecast.

Subregional inflation is set to decline to 0.2% in 2009, largely because the PRC and Taipei, China will see deflation. In 2010, consumer prices are expected to rise to 2.6% on account of a gradually strengthening subregional recovery. Current account projections are slightly downgraded for the next 2 years, relative to March.

Prospects for growth this year in South Asia have improved to 5.6%, up from the ADO 2009 forecast of 4.8%, with the Update shifting up the outlook for five of the eight subregional economies. India’s economic expansion, in particular, has been upgraded by 1 percentage point to 6% due to the expected positive effects of a continued large fiscal stimulus announced in its July 2009 budget and the emerging signs of recovery in private business confidence. Subregional inflation has been contained following the drop in oil prices in the second half of last year, with some economies starting to record deflation in recent months. Consumer prices are thus forecast to increase at 4.7% in 2009, below the 5.6% expected in March.

In 2010, subregional growth is likewise upgraded to 6.4% from 6.1% in ADO 2009. Stronger growth is projected to lift prices, raising the inflation forecast to 4.9% from 4.4% in March. In current-account terms, the drop in global oil prices from last year’s peak provided much relief for South Asia’s economies, curtailing the projected subregional deficit to 1.7% and 2.2% of GDP in 2009 and 2010, respectively.

Aggregate growth in the 10 Southeast Asian economies is now expected to slow to 0.1% in 2009 compared with the March growth forecast of 0.7%. More positive prospects for Indonesia and Viet Nam failed to counterbalance the deterioration among the more open, as well as the smaller, economies in the subregion. Next year, overall growth is put at 4.3%, similar to the March forecast.
Considerably weaker domestic demand and lower oil and food prices are expected to lead to a sharper than earlier expected decline in inflation across the subregion. In 2009, the forecast is revised downward to 2.5% from 3.3% in ADO 2009. The inflation projection for 2010 is maintained at 4.1%. As a precipitous decline in exports is likely to be more than offset by a steeper decline in imports, the subregion’s current account surplus in 2009 is now expected to be 5.4% of GDP, against the 4.4% predicted in March. Next year, the surplus is forecast to come in at 4.6% of GDP owing to a mild recovery in demand for the subregion’s exports from industrial countries and a pickup in imports.

Across Central Asia, projections for economic growth are now much bleaker than in ADO 2009 due to lower commodity prices; a deeper downturn in the Russian Federation (the subregion’s main trade and financial partner); and weaker capital inflows, investments, and remittances. Subregional growth is forecast to slow to 0.5% in 2009 and 3.6% in 2010, compared with 3.9% and 4.8% projected in March. The largest Central Asian economy, Kazakhstan, is seen contracting by 1.0% in 2009, a reversal from the 2.0% growth earlier expected in ADO 2009, as it grapples with the fallout from a banking crisis and lower oil prices.

Inflation pressures in the subregion have been curbed by sharp drops in domestic demand and lower commodity prices. As a result, the Update revises downward the inflation forecasts for 2009 and 2010 to 7.6% and 7.3%. The overall current account position of the subregion is also very likely to deteriorate, as hydrocarbon exporters labor under lower oil prices and hydrocarbon importers suffer from greatly reduced remittance inflows.

Economic growth in the Pacific in 2009 is slightly downgraded to 2.8% from 3.0% expected in March, largely as a result of a less optimistic growth forecast for the Democratic Republic of Timor-Leste (the subregion’s third-largest economy). Only three of the 14 subregional economies are likely to expand by more than 1.0% this year. Weaker prospects stem from falling incomes from tourism and remittances brought by the global slowdown. The Update pencils in minor adjustments for subregional inflation and the current account.

Overall, developing Asia is set to emerge from the global slump ahead of the rest of the world. Progress in rehabilitation efforts after the Asian crisis in 1997–98 ensured that the region’s financial systems were relatively healthy when the global financial crisis erupted, and allowed the region to manage, in the main, a soft landing. Fiscal stimulus measures and easy monetary policies also proved to be highly effective in bolstering regional growth.
Broadening openness for a resilient Asia

- Openness to foreign trade and capital flows has underpinned world economic growth in the last 60 years, and will continue to do so in the future. Developing Asia’s economic success, including robust growth that raised per capita incomes and lowered poverty levels, likewise depended on its outward orientation. But the 1997–98 Asian financial crisis and the latest global slump have exposed the risks that the region faces from a narrow application of openness. Broadening the scope and structure of openness is needed to support developing Asia’s economic resilience and sustained development.

- During the Asian crisis, the massive reversal of foreign capital inflows underlined the risk of excessive financial openness. A key lesson learned from that crisis was the need for strong domestic institutional capacity—that is, sound and efficient financial systems—to effectively manage financial globalization. In the aftermath of the crisis, developing Asia reformed its financial systems, boosting its resilience to financial shocks, and to a large degree shielding itself from the effects of the recent tumult.

- However, the region’s recovery from the 1997–98 crisis came at the expense of overreliance on extraregional demand, a dependency that, in the last year or so, has battered the region’s exports, reduced capital inflows, and slashed remittance growth. A key lesson is that regional policy makers need to address the geographically unbalanced structure of the flows of its trade, capital, and workers.

- Mechanisms need to be put in place to safeguard domestic economies against excessive and unbalanced openness. Policies to build up domestic capacity and enhance regional cooperation are required to bolster the resilience of regional economies and reduce their vulnerability to external shocks.

- Strengthening intraregional trade (especially for final goods) can help reduce developing Asia’s overdependence on exports to industrial countries and can provide an additional engine of short-run recovery and long-run growth. Achieving this entails boosting domestic economies through a wide range of rebalancing policies as outlined in ADO 2009; removing barriers to intraregional trade, particularly behind-the-border obstacles to freer trade in goods and services; and promoting regional cooperation to institutionalize concrete and specific efforts toward facilitating intraregional trade.

- Effectively managing financial globalization can ensure that capital flows are less destabilizing to regional economies. This requires encouraging a shift in the composition of foreign capital to less volatile longer-term inflows by improving the investment climate; strengthening domestic financial markets with requisite oversight mechanisms, and keeping appropriate levels of foreign exchange reserves (especially those economies with managed exchange rate systems); and supporting the establishment of regional capital markets, to be able to successfully tap and mobilize the regional savings pool.
Migration is increasingly important in the global landscape, and Asian countries are well known labor exporters. Also, remittances are a more stable source of foreign currency than many other nontrade sources. Developing Asia’s governments should therefore maximize the benefits of labor flows by ensuring that the migration channel is kept open, enhancing the safety and security of formal systems for funds transfers, and providing an environment that encourages households to invest more of the funds that they receive. Regional cooperation to avoid protectionist policies would also enhance the interests of both home and host countries.
### Table 1 Growth rate of GDP (% per year)

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Notes: Developing Asia refers to 44 developing member countries 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.
Part 1

Coping with the global recession
Coping with the global recession

A year has passed since the collapse of Lehman Brothers in September 2008—a watershed event for the world economy. Global financial markets had been sputtering for more than a year up to that point—with exposure to low-quality mortgage-backed securities leading to several high-profile financial failures in the United States (US) and United Kingdom (UK). Although many major industrial economies had already slipped into recession by mid-2008, the month of September still stands out. The de facto nationalization of mortgage lenders Fannie Mae and Freddie Mac, followed in quick succession by the closure of Lehman Brothers and the bailout of insurer AIG, sent world financial markets reeling. With global finance seizing up—and risk premiums on new lending spiking—the weaknesses that were dragging down the US and UK financial sectors further undermined real economic activity, and spread globally.

This impact is clearly seen in the two figures at right. For the first time since the end of World War II and its aftermath, in 2009 global gross domestic product (GDP) will contract, by an estimated 1.4% (Figure 1.1.1). The collapse in world trade has been even more dramatic (Figure 1.1.2). Merchandise trade will decline by a magnitude that has not been matched in peace time since the Great Depression. No part of the world has been spared. Yet within the tumult, developing Asia’s growth has been surprisingly buoyant.

Authorities across the globe responded quickly and decisively to the threat of a potential replay of the Great Depression. They took extraordinary steps to shore up the tottering international financial system and restore confidence, opening wide the taps on money supply to combat the credit drought, while boosting public spending plans and slashing taxes to prop up economic activity. In some cases, they adopted unprecedented methods to stave off disaster.

Now, in September 2009, there are signs of an emerging global recovery, though it is still too early to say if the momentum has fully shifted for the major industrial economies. This raises a critical question for developing Asia: Will the region manage to keep its buoyancy until a sustained global recovery takes hold?

This chapter was written by Benno Ferrarini, William James, Juthathip Jongwanich, Donghyun Park, and Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila.
Long recession avoided?

The recession in many of the major industrial economies has already set several records. In the case of the US, this recession is the longest since the Great Depression. The continuing housing crisis, rising unemployment, and crippling of major industries as consumers retrench has made it very difficult to ascertain whether the trough has been reached.

Across the major industrial economies, there is reason for cautious optimism regarding recovery, as GDP growth in the second quarter of 2009, industrial production, and trade have distinctly improved relative to previous quarters (Figure 1.1.3), but it is still too early to declare an end to the recession. Even if one could, the outlook is for a weaker than usual recovery and there are even those who predict a double-dip recession as the impact of fiscal stimulus wears off and governments face the realities of managing huge increases in public debt and revenue losses. The financial sector remains fragile as many banks in the US, UK, and some eurozone countries retain loan portfolios tainted with nonperforming assets—including toxic residential and commercial mortgage-backed securities—and face increasing delinquency on credit card debt and automobile loans.

Coherent policies for recovery and growth rebalancing

Policy actions by central banks and governments to prevent a complete collapse of the financial system and to provide stimulus to demand were enacted in a timely fashion. Monetary policy adopted “quantitative easing” to provide banks with additional reserves and cash in addition to the slashing of policy rates to historic lows. Expansionary fiscal policy in the form of tax rebates and massive government expenditure programs, together with the normal operation of automatic stabilizers such as unemployment insurance and reduced income tax withholdings, added to the stimulus. These bold policies were successful in pulling the world economy back from the brink of a second great depression.

Discretionary fiscal stimulus and automatic stabilizers may have cushioned the rate of decline in economic activity and the loss of employment, and are likely pushing growth into positive territory in the second half of 2009, or at least stabilizing it.

The share of the US, Japan, and European Union (EU) in world imports as well as other important western economies has been declining since the turn of the century, and it is apparent that the share of developing Asia and other emerging economies has been rising, but from a low base (Figure 1.1.4). The industrial economies are losing their sway over global trade relative to developing economies. Thus it is imperative that both industrial and developing economies seek to boost growth in world trade together in order to spur recovery in global industrial production and
growth. If either or both instead resort to protectionist measures, this will make it more difficult to achieve a robust global recovery.

Households in the US and much of the eurozone and the UK are heavily indebted and much less wealthy than before the financial crisis, and so it is not going to be possible to return to the precrisis imbalances between income and expenditure, and investment and savings. In particular, households in deficit countries such as the US and UK will have to consume less out of their disposable income and save more.

With the US budget now in deficit by over 10% of GDP and with virtually all the eurozone economies having fiscal deficits well above the 3% stability and growth pact limit (Ireland, for example, has a deficit of 7% of GDP), other sources of demand—particularly private investment and net exports—will need to drive growth. This means that high-surplus economies such as People’s Republic of China (PRC), Germany, Japan, and the Gulf States will have to save less, and consume and import more. Signs are there that this process is beginning to take root—for example, the trade deficit of the US has narrowed while the trade surplus of the PRC has fallen.

Still, better international coordination of policies will be required to ensure that recovery does not relapse into stagnation or even double-dip recession, so as to reduce imbalances between spending and income; to minimize the opportunities for regulatory arbitrage, which may prompt adverse financial flows; and to undertake specific actions for strengthening global economic institutions and governance. The decision by G20 finance ministers at the September meeting in London to continue to enact fiscal stimulus measures until a robust recovery was evident is an important step in this direction.

In the current situation it is imperative that major industrial economies maintain coherent policies aimed at strengthening demand in order to avoid a prolonged recession and a weak and fragile recovery. One lesson to draw from previous deep global downturns, including the Great Depression, is that central banks must avoid tightening monetary policy prematurely and taking steps that undermine banking system stability. As Japan’s experience in 1997 demonstrated, governments must also avoid premature increases in taxation and maintain fiscal stimuli until sustained output growth is clear. Once private demand recovers, monetary and fiscal stimulus can be withdrawn, gradually.

The outlook for recovery from the economic slump has been greatly improved by the decisive policy actions in the major G3 economies (US, eurozone, Japan) to ease monetary conditions and to provide a strong fiscal stimulus. Moreover, the agreement of the G3 to work closely with developing countries in the G20 to maintain fiscal stimulus policies and to keep economies open to foreign investment bodes well for the global outlook. This combination of policies plus the avoidance of blatant beggar-thy-neighbor trade actions has kindled hopes for a V-shaped rebound in global output.

However, there are still major policy issues causing concern over the medium-term prospects for a robust return to sustained growth, especially as regards consolidating financial market recovery, preserving trade openness, timing exit strategies from unsustainable fiscal stimulus and money creation, and resolving global imbalances, as discussed below.
Financial market recovery in the cradle of the crisis
The outbreak and rapid spread of the financial market turmoil from the US and the UK to the rest of the world, as well as a general collapse of confidence in financial markets, nearly led to catastrophe. Early measures were effective in avoiding deeper problems (Box 1.1.1).

Normalization slowly began to return in early 2009, but concerns remained. Positive signs included reduced spreads between overnight lending rates of the commercial banks and Treasuries in both the US and UK (Figure 1.1.5). Lower risk premiums are indicative of the restoration of some measure of financial stability. In addition, equity market capitalization had also begun to recover by the second quarter of 2009 (Figure 1.1.6).

However, there are still indications that housing market problems in the US will continue to put a damper on bank balance sheets and to depress household expenditure as the number of foreclosures mounts (Figure 1.1.7). Similarly in the UK, banks’ write-offs of household dwellings have been on the rise (Figure 1.1.8).

The continuing problems in the US housing market and the difficult circumstances that many households are experiencing in a context of sharply rising unemployment are leading to increases in default rates on consumer loans, credit card debts, student loans, and automobile loans. The problem is manifested in an increased number of failures among the smaller commercial banks, as reported by the Federal Deposit Insurance Corporation. The number of banking failures in 2009 compared with 2008 has yet to level off (Figure 1.1.9), even though the size of the institutions failing is much smaller in terms of assets and liabilities.

In the UK, banks’ funding difficulties remain. The Bank of England has expressed concern about the marked fall in bank lending to nonfinancial corporations in the second quarter, which may pose difficulties for companies that need to refinance existing loans (Figure 1.1.10). Similarly, household lending remains subdued, and lending

1.1.1 Measures to stave off meltdown

Only massive injections of liquidity into financial markets and institutions in the affected economies and the extension of direct swap lines between central banks in the G3 and elsewhere, including developing Asia, prevented the collapse of the payments system and widespread failure of commercial banks and other financial institutions.

The reduction of policy rates to historic lows in the G3 in late 2008 was accompanied by a swathe of innovative programs and actions to put huge quantities of new money into the financial markets.

In the US, providing liquidity support through new central bank lending vehicles, paying interest on bank reserves, and extending the maturity of short-term loans through the discount window were helpful in providing commercial banks with fresh funds but were insufficient in themselves to restore financial stability.

Also needed to stem the panic were direct balance sheet support through outright purchases of assets and direct injections of new capital into ailing financial institutions and through the de facto nationalization of the large mortgage lenders Fannie Mae and Freddie Mac as well as other financial entities judged “too big to fail.”

In the UK, measures included a program to provide banks with a credit guarantee scheme and a liquidity program allowing institutions to swap their assets for Treasury bills.

As long as the potential for inflationary consequences is kept in check and long-term interest rates stay low, it is likely that the Federal Reserve and the Bank of England will maintain low (near zero) policy interest rates and provide other support to strengthen their still-fragile financial sectors.

As of the third quarter of 2009, some of the larger commercial banks in both countries seem to be recovering as profits begin to rise, enabling them to repay loans and build stronger capital bases.
rates continue to be high and largely inelastic to cuts in the official rate by the Bank of England. Partly as a result, UK housing market activity has improved only slightly from the very low levels seen around the turn of the year, and increases in housing prices have been tenuous so far.

Preserving trade openness

The first major policy issue causing concern is that of preserving and strengthening the world trading system. The severe contraction in world trade is fraying the consensus against protectionism. Governments are tempted to cave in, both to domestic lobbies seeking protection and to those opposing foreign companies and immigrants (particularly immigrants entering occupations traditionally filled by the domestic labor force). Government procurement bias in fiscal stimulus measures is also a bone of contention. Nearly every domestic sector that is suffering losses of profits and jobs from automobiles to farms is demanding help in the form of protection—and policies are often shaped to appease such important constituencies.

In North America, for example, trade relations among partners in the North American Free Trade Agreement (NAFTA) have deteriorated, with preferential trade suffering as a result. The US tightened border restrictions on intra-NAFTA overland transportation, and Mexico retaliated by placing penalty duties on 80 US export items. Mexico has seen its GDP contract sharply, as has Canada to a lesser degree. In the EU, there is mounting pressure from those less affected by the economic malaise objecting to bailouts of those who have been hit, and trade within the EU has been severely reduced as incomes and employment have fallen.

The temptation to raise legal trade barriers in the form of safeguards, antidumping measures, and export restrictions (Box 1.1.2) is also cause for concern. The World Trade Organization (WTO) reported that 24 of its members and the EU introduced 83 new trade-restricting measures in the first 3 months of 2009, more than twice the number of measures aimed at easing barriers to trade during the same period (WTO 2009). Nor do these new restrictive measures include “gray area” restrictions such as those on pork imports from suppliers in countries with human cases of swine flu (H1N1).

The multilateral trading system has underpinned global growth and prosperity for the past six decades. But whether the Doha round of global trade talks, currently in deadlock, can be jump-started will be a key test for governments around the globe. Failure to do this will have serious implications for developing countries, not least those in Asia.

Timing of exit strategy

A second major concern is the appropriate implementation of exit strategies. Getting their timing right will be crucial to avoid a double-dip recession and to move the G3 economies back toward trend growth by reducing the difference between actual and potential GDP—the output gap—without igniting inflation. The massive expansion of central bank balance sheets has enormously boosted commercial banks’ lending capacity. This has potential inflationary consequences, even though at present prices are ebbing with the collapse in consumer spending, in private investment, and in international trade. And, although deflation
1.1.2 A rise of nontariff barrier protectionism

Increased use of legal protectionist instruments might temporarily boost domestic production and consumption in certain sectors, but overall, they could have adverse effects, especially on resource allocation. Still, protectionist pressures globally have seen a marked increase, but those seen during the second half of 2008 through the first half of 2009 tended to differ from traditional approaches, which mostly focused on tariff barriers.

These nontariff approaches include use of antidumping investigations and measures, global safeguards, countervailing duties, and PRC-specific safeguards (as well as restrictions on government procurement). They are costly (in terms of scarce human resources in international trade negotiations and jurisprudence) and tend to undermine competition and reduce trade volume. Their effects could be prolonged since it takes time to file petitions and initiate investigations after which definitive measures then may be implemented. In addition, once in place, they are difficult to remove, potentially creating a host of future complications. They are also likely to provoke retaliation, thereby undermining the trading system and discouraging economic recovery.

Since late 2008, there has been a rise in newly initiated investigations of nontariff barriers (Box figure 1). Their number rose from fewer than 40 cases in the first quarter of 2007 to 80 cases in the last quarter of 2008, before declining to around 60 cases in the first quarter of 2009. Antidumping contributed primarily to a rise in nontariff barriers but leveled off after the initial escalation. In contrast, global safeguard measures increased noticeably, which is a new and striking feature of protectionist pressure. For the first half of 2009, initiated investigations of global safeguard measures rose to 15 cases from only seven in 2007, a figure that Bown (2009) projects could rise to 30 for the whole year.

Countries have taken recourse to antidumping investigations as the main form of legal protectionism, but global safeguard investigations have recently become more important. Antidumping covered several sectors, but iron and steel dominate (25% of total initiated investigations) mainly because of the global downturn’s severe effects on the automotive industry. Next come plastics and rubber (18%), chemicals (12%), machinery (12%), wood (12%), other metals (9%), and textiles (6%). In contrast, 80% of initiated investigations on global safeguard measures were concentrated in nonsteel products (Bown 2009).

Developing countries initiated most trade remedy measures during the downturn (Box figure 2). Antidumping from developing economies has, in fact, increased substantially since 2000, that is, since well before the global downturn [James 2008]). In the first half of 2009, they launched 78% of total investigations, with the PRC and India accounting for almost 50%. Among industrial economies, the US was the largest initiator while the European Union, having launched 20 investigations in 2008 launched only two in the first half of 2009. Japan has initiated no recent investigation.

is not yet a serious threat to macroeconomic stability in the US and the eurozone, it may well be more of a threat to Japan.

Unchecked deflation from a continuing fall in aggregate demand is also a threat, and is a threat precisely because it elevates the real value of debt, erodes profits of businesses, and induces consumers to delay purchases in expectation of future price cuts. It also tends to exacerbate unemployment when unions and workers resist cuts in nominal wages, because a decrease in the price level results in higher real wages. However, once the recovery begins in earnest, and unless monetary easing is reversed, inflation pressures and expectations may take hold and lead to a rebirth of “stagflation”—an uncomfortable combination of elevated unemployment and price increases.

The debate over the outlook for inflation has global consequences...
Developing countries, especially the PRC, were targeted by these trade remedy instruments. Developing countries accounted for around 85% of total targeted exporters, and almost half of these were directed at the PRC (more than 70 of the 181 newly initiated investigations in 2008) (Box figure 3). Initiated investigations of these trade remedies also rose in other East and Southeast Asian economies. In 2008, Indonesia; India; Malaysia; Taipei, China; and Thailand were named in 37 of the 181 investigations. For industrial countries, almost half of the instruments were targeted at the G3 economies, particularly the US.

All in all protectionist pressures, especially nontariff barriers, have shown a marked increase since late 2008. However, this creeping protectionism has not yet caused a further slowdown of global trade or created a protectionist spiral. Nevertheless, rampant protectionism still needs to be guarded against.

In addition to the nontariff approaches mentioned above, “buy domestic” provisions associated with fiscal stimulus packages may indirectly distort global trade and therefore increase concerns over protectionism. For example, in February this year, the “buy American” provision that featured in the $787 billion stimulus package requires public works such as infrastructure improvement to use iron, steel, and other goods made in the US, as long as the provision does not contravene commitments to trade agreements. The stimulus packages introduced by the PRC and Thai governments also contain “buy domestic” provisions.

In practical terms, a “stand-still” on new protectionist measures should be agreed upon to promote economic recovery. It would be preferable if countries refrained from use of antidumping as retaliation in a time of trade stress and instead rely on the WTO dispute resolution mechanism, as Japan does. In cases where temporary measures discriminating against foreign products have been imposed, the appropriate review mechanism should be conducted to ensure the orderly unwinding of such measures once the recovery is in train.

References


Resolving global imbalances

As pointed out in Asian Development Outlook 2009 (ADO 2009) in March this year (ADB 2009), the third concern relates to attaining a robust and
1.1.3 Central bank exit strategies

How and when will central banks reverse monetary easing? Even though it is still too early to start exiting now, because of the stimulus measures’ size and scope, exit strategies need to be carefully laid out.

Balancing inflation concerns (due to excess liquidity) and the risk that liquidity is prematurely withdrawn is not easy, as seen in the experience of two past exit strategies. The dangers of tightening too early are deflation and a return to recession, as clearly evidenced by the experiences of the US in 1937 and 1938 and Japan in 2001 and 2002 (Box figure 1). In both cases, the economies fell back into recession, with deflation as a result. Yet the dangers of tightening too late are hyperinflation—and a return to recession.

The Federal Reserve, acutely aware of these dangers, in March this year started a program to accelerate acquisitions of securities in order to keep long-term interest rates low. It has largely replaced the liquidity facilities with securities held outright, mainly mortgage-backed securities, while keeping its balance sheet at the expanded level of about $2 trillion (Box figure 2). Treasuries and agency debt continued to increase.

It is now in a process of exiting from the short-term credit operations. Credits that had been expanded through term auction credits, the Commercial Paper Funding Facility, and central bank liquidity swaps have been reduced significantly since January this year.

Yet concerns about the ability of markets to absorb the supply of new Treasuries appear evident in the rise in bond yields. While this shift indicates a sign of improved market sentiment—a condition necessary for a successful exit—overall financial conditions remain tight.

The Bank of Japan, in contrast, has not initiated an apparent exit out of the short-term operations that it introduced after the collapse of Lehman Brothers. This mainly reflects the continuing tight credit conditions of those hit hard by the collapse of exports, and partly the lessons learned from the experience of 2001 and 2002 (when policy was tightened too early).

In G3 economies generally, growth in bank credit to the private sector continues to slow; debt markets (particularly those with asset-backed securities and those not supported by the public sector) remain weak; and lower-quality borrowers have limited access to capital market funding, which suggests that any hasty exit out of short-term credit operations would be premature.

Another concern is that the recent improvements in the financial markets could lead to complacency. Although the risk of dipping into a deflationary spiral seems to have receded, price movements are still in negative territory. Confidence remains fragile, and risks could reemerge, especially since the improvement in the G3 financial markets stems from the massive public sector support.

In particular, ensuring adequate bank capitalization is crucial, and cleaning troubled assets will take a long time. Unless the G3 central banks tread warily, the economic recovery will be dragged down, as seen in the past episodes in the US and Japan.
sustainable global recovery, which will require major adjustments to the composition of GDP growth. These changes will have serious implications for developing Asia. The US trade deficit has already fallen by almost 52% in the first half of 2009 compared with the same period in 2008, but only because imports have fallen faster than exports. For GDP growth to recover sustainably, trade will have to return to growth and US net exports will have to become a major contributor, along with private fixed capital formation.

As the US cuts spending relative to income and consumes less out of current income (hence saving more), the rest of the world—in particular the high-surplus economies mentioned above—will also have to switch to new, chiefly domestic, growth engines and to import more. Longer term, the US will also have to curb its growing dependence on imported oil and energy through efficiency, conservation, and development of clean and competitive energy sources, thereby reducing its deficit with oil-exporting countries.

The US output gap is already approaching 5% (Figure 1.1.11). The Organisation for Economic Co-operation and Development (OECD) has forecast that it will reach 5.4% in 2010, while its estimates for Japan and the eurozone are around 6%—implying a 5.8% output gap for the major industrial economies. This has implications for exit strategies from the current massive fiscal stimulus and easy monetary policies in industrial countries. The financial crisis may exacerbate the falling growth trend as investment slumps, deficits grow, and debt burdens increase. However, there may be mitigating factors because households will have incentives to work longer hours so as to rebuild wealth and reduce their indebtedness.

Policies, too, will affect outcomes. Efforts to keep nonviable banks and inefficient industries alive would do much to scuttle growth, as seen in Japan’s “lost decade” of the 1990s. In the US case, efforts to reform health care, social security, and other entitlements as well as the fact that many enterprises have cut costs to the bone will work in the direction of restoring some growth potential during the recovery by freeing up resources for more efficient uses. Clearly, hard choices are ahead for policy makers worldwide.
Recovery at hand?

The assumptions regarding global economic conditions underlying the regional outlook, which this Update revises, have changed since ADO 2009 was published in March this year (Table 1.2.1). In particular, actual growth in 2008 in the G3 economies was much slower than forecast in ADO 2009. This Update also substantially reduces estimates of world trade growth. With inflation subdued, it assumes that central banks will maintain low interest rates for the foreseeable future and that this will encourage a mild recovery in 2010 in the G3 and a rebound in world trade.

### 1.2.1 Baseline assumptions for external conditions

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<tr>
<td>Brent crude spot prices&lt;br&gt;(average, $ per barrel)</td>
<td>72.6</td>
<td>97.3</td>
<td>43.0</td>
<td>63.2</td>
<td>50.0</td>
</tr>
<tr>
<td>Nonfuel commodity prices&lt;br&gt;(% increase)</td>
<td>17.0</td>
<td>21.0</td>
<td>-32.2</td>
<td>-23.8</td>
<td>6.5</td>
</tr>
<tr>
<td>CPI inflation&lt;sup&gt;a&lt;/sup&gt; (G3 average, %)</td>
<td>2.2</td>
<td>3.2</td>
<td>-0.3</td>
<td>-0.3</td>
<td>1.2</td>
</tr>
<tr>
<td>World trade volume&lt;sup&gt;b&lt;/sup&gt;&lt;br&gt;(% increase)</td>
<td>7.5</td>
<td>3.7</td>
<td>-3.5</td>
<td>-9.7</td>
<td>1.9</td>
</tr>
</tbody>
</table>

<sup>a</sup> Average growth rates are weighted by GNI, Atlas method.<br><sup>b</sup> Merchandise exports.


Financial indicators have begun to improve as authorities have managed to avert financial disaster through massive interventions that increased liquidity and helped reduce the cost of funds for major banks and insurance providers. Banks and other financial institutions that were in deep trouble in the wake of the collapse of Lehman Brothers in September 2008 are now liquid and most have been able to raise capital.

Fears of imminent breakdown of the payments system have clearly subsided. Spreads between interbank lending rates and Treasuries have consequently narrowed (Figure 1.1.5 above) and short-term rates are now below long-term Treasury yields due to aggressive easing of monetary policy. Yield curves have steepened, indicating that recovery may be in the offing.
Other indications of financial stabilization are seen in rallies in major stock indexes (the Dow Jones Industrial Average has risen above 9,000 and the S&P 500 above 1,000 in recent months). Although stock prices are still considerably below pre-September 2008 peaks, the recovery in equities may be a leading indicator that the worst of the downturn is now over.

Job losses have moderated in the US and the eurozone although not yet in Japan. Preliminary estimates of GDP growth for the second quarter of 2009 in the G3 and some other OECD economies are stronger than in the first quarter, indicating that the degree of contraction is moderating and that the trough of the recession may be at hand in the last 2 quarters of 2009. For example, in its July World Economic Outlook, IMF modified its 2009 forecast for G3 GDP contraction to be less severe (3.8%) than it initially forecast in April (4.2%). Other real indicators such as retail sales growth, housing starts, as well as indexes of consumer and business sentiment began to show signs of improvement, or at least of stabilization, toward the end of the second quarter.

United States

During the first quarter of 2009, GDP contracted at an annualized rate of 6.4%, as industrial production plummeted at rates not seen since the Great Depression. The preliminary estimate of GDP in the second quarter of 2009 was better than expected at just a 1.0% (annualized) contraction, due largely to government expenditure and partly to a modest boost in net export growth. Consumption and investment continued to pull back overall economic growth during the second quarter (Figure 1.2.1).

Job losses mounted persistently, with June’s losses of 463,000 up sharply from the May decline of 303,000. Since the recession officially started in December 2007, 6.7 million workers have lost their jobs and unemployment has spiraled to 9.7% in August 2009. Job losses moderated to 216,000 in August, providing a glimmer of hope that the worst is over. In addition, US households have borne a loss of wealth equivalent to more than a year’s GDP (around $14 trillion).

In the face of such massive losses of employment and wealth, highly leveraged US households are reducing spending faster than their disposable income is falling, marking a gain in the personal saving rate from near zero at the start of the downturn to 5% in the second quarter of 2009, the highest rate in over a decade (Figure 1.2.2). These moves are, however, being counterbalanced by a huge increase in the government budget deficit, which will likely hit 11–13% of GDP (Figure 1.2.3) for the full fiscal year ending 30 September. For the first 11 months of the fiscal year, the Congressional Budget Office reports that government expenditure was already up by 19% and revenue down by 16% relative to the same period of the previous year.

Overall, with households increasing their saving and the economic slowdown reducing investment, the US external imbalances have been tempered somewhat as less foreign borrowing has been required. The US current account deficit has fallen by half from peak levels in 2006 (6% of GDP) to 2.9% in the year to the second quarter (Figure 1.2.4). The unwinding of unsustainable current account imbalances, coupled with...
1.2.1 Dollar fluctuations

Initial depreciation
The value of the United States (US) dollar has fluctuated considerably over the last couple of years (Box figure 1). It fell sharply from January 2007 to July 2008, with both nominal and real effective exchange rates (NEER and REER) depreciating by almost 15%. The dollar fell against the euro and yen, and the currencies of some developing economies, including the People’s Republic of China (PRC), Philippines, and Thailand. The dollar’s depreciation was generally limited against the pound sterling and currencies of other developing Asian countries, such as Indonesia and the Republic of Korea.

Rebound and reversal
Although the underlying external imbalances remained, the dollar started appreciating in late 2008 as investors sought safety after the collapse of Lehman Brothers. The currency climbed against the euro, pound, and almost all developing economies’ currencies. As the economic malaise spread, many investors moved their cash into safe-haven assets. Inflows into US Treasuries, for example, jumped to a peak of $260 billion in the fourth quarter of 2008, from $95 billion in the second.

The direction in the value of the dollar switched again in the second quarter of 2009. The NEER and REER began to depreciate, both falling relative to the first quarter by around 8%. Even though economic recovery in the eurozone, United Kingdom, and Japan has lagged that in the US, limited room for the Federal Reserve to cut its benchmark rate led to a narrowing real interest rate differential between the US and other industrial countries, which made the dollar less attractive. Returning risk appetite and anxiety over growing US government deficits also helped undermine the dollar.

The low interest-rate policy and quantitative easing in the US have made it cheap for institutions to borrow and have helped make the dollar a funding currency for the carry trade. With rising equity and commodity prices and initial signs of a global recovery, investors moved from the safety of US Treasuries and the dollar into riskier assets. Box figure 2 shows that capital inflows into US Treasuries tumbled in early 2009, taking the surplus in the financial account down to only $58.3 billion, from $273.6 billion in the second half of 2008. But even a narrower deficit in the current account failed to offset this heavy fall in the financial account.

Future possibilities
The dollar may continue to weaken, since global economic recovery and better prospects for equity and commodity markets are prompting investors to move out of dollar-denominated assets. In addition, the slower path of monetary policy easing in the rest of the world relative to the US will likely make investment in the US less attractive. Moreover, continued efforts by both industrial and developing economies to rebalance their economies could weaken the dollar. However, a faster recovery in the US than in other industrial countries may provide some strength in the near term.

Concerns of non-US central banks about their dollar holdings and dollar-denominated assets may put pressure on the US Government to adopt policies to stabilize the currency.

1 That is, investors use the currency of a country with exceptionally low interest rates to buy higher-yielding assets.
investors shifting their portfolios to riskier assets, will be sources of weakness for the dollar in the near term (Box 1.2.1).

The impact of the recession on US international trade has been severe (and interestingly, greater on preferential than nonpreferential trade—Box 1.2.2). International trade was initially propping up US growth during 2008 as exports continued to rise in both nominal and real terms even as imports slowed. In real terms, imports in 2008 contracted by 3.5% even as exports grew by 5.4% year on year, thus boosting net exports. The growth of trade, however, began to slow sharply in the third quarter of 2008 and the contractions in the final quarter of 2008 and the first quarter of 2009 were very sharp indeed. Preliminary data for the second quarter of 2009 show that imports and exports probably bottomed in the first quarter of 2009 (Figure 1.2.5). However, year on year, both imports (down 20.7%) and exports (down 22.9%) continued to contract sharply.

1.2.2 Preferential free trade agreements

United States (US) imports under preferential free trade agreements (FTAs) started to contract earlier than imports as a whole when examined quarter on quarter; measured year on year, they contracted faster than world imports. Quarter-on-quarter imports under the North American Free Trade Agreement (NAFTA) began to slide in the third quarter of 2008 even as overall imports continued to rise. Imports from Canada and Mexico under NAFTA preferences started to contract in the third quarter of 2008 compared with the previous quarter, and the rate of decline then accelerated (Box figure).

NAFTA preferential imports of the US cumulatively collapsed by almost 40% in the first 6 months of 2009 compared with the same period in 2008—a more rapid rate of contraction than imports from all sources, which fell by about one third. US domestic exports to NAFTA partners (down 29%) also fell more sharply than exports to the rest of the world (down 25%) over the same period.

The reason for the relatively rapid contraction of preferential imports appears to be that trade is highly concentrated in automobiles and textiles with Canada and Mexico. Hence the collapse reflects the failure of large corporations such as General Motors and the sharp decline in consumer demand in those sectors.

A lesson to draw from this experience is that in sectors where applied most-favored-nation tariffs are high, such as automobiles and textiles, trade is likely to be diverted to preferential partners on a large scale, and production may become excessive within the FTA concerned (in this case, NAFTA). Thus when demand collapsed, such trade and production were particularly vulnerable. Time will tell if special programs such as “cash-for-clunkers” will help revive intra-NAFTA automotive trade.

Quarter-on-quarter imports from all US bilateral FTAs in force in the third quarter of 2008 show a similar pattern of accelerating contraction from 18.6% in the fourth quarter of 2008 relative to the third, and further declining to 25.8% in the first quarter of 2009 relative to the previous quarter. Cumulatively, imports from US FTA partners fell more sharply than imports from US non-FTA partners in the first 6 months of 2009.

US exports have also contracted more steeply with FTA partners than globally, whether measured in nominal or real terms. For all FTA partners, the collapses in US exports were 23% in the first quarter of 2009 (real prices), 19% for all destinations, and around 18% for nonpreferential destinations.

Bibliography

The improvement in the US trade balance (goods and services) resulted from a sharper fall in imports than exports but in May 2009, exports actually grew by 1.4% compared with April while imports continued to contract (by 0.7%) bringing the monthly deficit to just $26.4 billion—the lowest amount since November 1999. However, US imports rebounded in July over June, perhaps reflecting the fiscal stimulus and improved retail sales. US exports did not grow as rapidly as imports, slightly widening the monthly trade imbalance.

Signs that the trough in the downturn had been reached were becoming clearer at the beginning of the third quarter of 2009. First, the Conference Board’s Leading Economic Index had risen for three consecutive months (April–June 2009) with seven of the 10 components showing improvement—the first upturn in the index since July 2007 (Figure 1.2.6). Second, housing prices stopped falling in May 2009 and showed the first monthly rise in 36 months (Figure 1.2.7). Third, retail sales have begun to rebound with automobile sales jumping under the Government’s “cash-for-clunkers” program, although consumer sentiment remains unsettled (Figure 1.2.8). The biggest part of the $787 billion fiscal stimulus package is expected to be felt in the last 2 quarters of 2009 and may well propel GDP figures into the positive range by year-end.

Despite these signs of recovery, the forecast for US GDP growth is unchanged from ADO 2009: a contraction of 2.4% in 2009, with a weak recovery of 1.6% growth in 2010.

**Eurozone**

Economic activity in the eurozone decelerated further during the first quarter of 2009, with GDP contracting by 9.2% (q-o-q, annualized). However, the contraction slowed to 0.5% during the second quarter, fueling hopes that the nadir has passed and that the economy is pulling out of a recession. Eurozone GDP is currently expected to shrink by 4.3% in 2009, and to resume anemic growth of 0.5% in 2010.

The GDP contraction in the first quarter of 2009 was driven primarily by declines in gross fixed capital formation and in net exports (Figure 1.2.9). Second-quarter investment spending continued to retrench against a backdrop of excess capacity and low investor confidence; government consumption remained essentially unchanged. The eurozone’s trade balance turned positive in March 2009 and recorded a more robust increase in June. Together with a slight rebound in private consumption, this switch has lifted GDP growth from its severe contraction the previous quarter.

Industrial production during the first half of 2009 continued to decline, by more than 20% year on year, and reflected low industrial confidence, despite some timid signs of recovery in confidence from April 2009. Production remains weak across the eurozone as a whole, with those countries depending strongly on export demand generally faring the worst.

Germany is a case in point: the country started facing a sudden and dramatic plunge in export demand around the second half of 2008, pushing the economy into recession and causing companies to cut down investment plans drastically through the first quarter of 2009. Weak
exports, depressed consumption, and an investment slowdown in the face of substantial inventories have taken their toll. The prospects for recovery hinge mainly on a sustained improvement in export orders—and encouragingly, the first signs of a substantial rebound in orders and industrial production appeared in the country statistics of June 2009.

For the eurozone, data on industrial orders for June 2009 show a rebound in total manufacturing orders, with a hike in capital and nondurable consumer goods more than outweighing a continuing decline in durable consumer goods orders (Figure 1.2.10).

Unemployment continued climbing, averaging 9.5% in July 2009 (Figure 1.2.11), and is expected to exceed 11% by 2010. The labor market situation tends to be worse for countries recovering from burst domestic asset bubbles, where the collapse of the domestic construction sectors caused huge job losses. In Ireland and Spain, for example, unemployment reached 12.5% and 18.5%, respectively, in July.

Growing unemployment and underutilized capacity are exerting downward pressure on nominal wage growth within the currency bloc, nurturing fears of consumer price deflation. Consumer prices fell by an annual rate of 0.2% in August 2009, from a 0.7% decline in the previous month. This is in stark contrast to the 3.8% inflation rate a year earlier. Although deflation is likely to persist over the coming months, the European Central Bank (ECB) expects inflation to reappear by end-2009, particularly once the full effects of its expansionary policy stance have passed through, and the base effect from the steep fall in global energy prices has moved out of the comparison period. Moreover, wage growth is expected to remain positive.

To support its ailing banking sector and stimulate lending to the nonfinancial sector, ECB further lowered its policy rate, the last time in May 2009 by 25 basis points, to 1.0%. This brings the reduction in the ECB key interest rate to a total of 325 basis points since October last year. Moreover, ECB surprised financial markets in June 2009 with a massive allotment of €442 billion to banks over 12 months at a 1.0% fixed interest rate, in an effort to counter the sharp deceleration in monetary aggregates and bank lending in the eurozone since early 2008. The move had the immediate effect of driving down overnight and longer-term market interest rates, as well as temporarily weakening the euro. However, it is too early to assess its full effectiveness in restoring credit channels and lending to the nonfinancial sector, and in jump-starting the process of recovery.

Public finances across the eurozone have deteriorated markedly, with the aggregate budget deficit expected to exceed 5% of GDP in 2010, more than twice its rate in 2008. Out of 27 EU member states, at end-2008 21 had a worsening government balance while 12 were in breach of the 3% stability and growth pact deficit limit. The deterioration of government deficits and public debt is likely to continue all this year, largely driven by the impact of automatic stabilizers and the boost in fiscal stimulus packages through the European Economic Recovery Plan, launched in December 2008. The plan aims to boost demand and stimulate confidence through budgetary outlays of €200 billion, equivalent to about 1.5% of the EU’s GDP.

The first signs of a turnaround came into view in August 2009, as the eurozone’s two largest economies, France and Germany, reported

![Figure 1.2.10 Growth in industrial orders, eurozone](http://epp.eurostat.ec.europa.eu)

![Figure 1.2.11 Harmonized unemployment rate, eurozone](http://epp.eurostat.ec.europa.eu)
surprisingly strong annualized preliminary second-quarter growth rates of 1.4% and 1.3%, respectively. The latest data show Germany’s exports to have rebounded by 11.9% in June and 3.9% in July from their previous levels a month earlier.

Improving private sector confidence across the eurozone provides a further indication that the bottom might have been reached: for over five consecutive months, the monthly Eurostat surveys of confidence in the industry, services, consumer, retail, and construction sectors have moved upward, reversing the long and profound decline in confidence that lasted from June 2007 to March 2009 (Figure 1.2.12).

Individual countries’ quarter-on-quarter growth performances vary substantially, however (Figure 1.2.13). Apart from France and Germany, only Greece managed to return to positive second-quarter output growth, while Italy and Spain continued contracting, at 1.9% and 4.2%, respectively. Outside the eurozone, the UK recorded a 2.6% shrinkage of its GDP, substantially worse than the EU27 average of 0.9% contraction.

Differences among eurozone economies’ growth rates are somewhat less pronounced when measured in the year to the second quarter. Among the larger economies, only France recorded a milder decline in its year-on-year growth performance, mainly because of its stronger insulation from the financial channel of crisis contagion. However, the contraction in all the core European economies, including France and Germany, points to the importance both of a rebound in exports for their GDP growth to recover, and their governments’ capacity to maintain or even expand fiscal stimulus.

To the extent that eurozone economies vary substantially with regard both to their export dependence and to their fiscal constraints, divergences or even reversals in quarter-on-quarter growth performances are likely to persist throughout the rest of 2009.

Japan

The profile of economic performance in Japan in the first 6 months of 2009 was similar to that in many other industrial countries, with a severe first-quarter contraction in GDP followed by a recovery in the second. Public investment (aside from the statistical discrepancy) was the only positive contributor in the first quarter, but the rebound reflected a significant strengthening in exports and private consumption, which together brought the economy back to growth of 2.3% in the second quarter (Figure 1.2.14). Private investment, however, continued to decline during the first 2 quarters.

Exports began to grow again in February, but remained well below levels of the same period a year earlier (Figure 1.2.15). Shipments to all major trading partners—US, EU, and developing Asia—rebounded, especially the pickup in intermediate goods to the rest of Asia. However, the sustainability of developing Asia’s import demand is uncertain as rising demand reflects temporary fiscal stimuli. For Japan, import growth remained sluggish due to weak domestic and external demand. The trade and current balances turned to surplus in February after recording deficits in January, but for the first half of 2009, the current account balance was 46% below that in the year-earlier period.
A softening of import prices driven largely by the decline in the oil price improved Japan’s terms of trade. In July 2009, import prices were 30.4% lower than prior-year levels, while export prices were 12.8% down. Weakness in consumption and external demand is worrisome because it is pinching corporate profits, which fell by 53% year on year in the second quarter with expectations that they will remain weak. Consequently, capital spending in the next few quarters will likely be in the doldrums. Moreover, while uncertainty about the economic recovery persists, firms remain reluctant to hire: the unemployment rate climbed to 5.7% in July, exceeding the previous worst rate of 5.5% (seasonally adjusted) in April 2003. In addition, salary income has contracted for 13 consecutive months, and at a worsening rate. General pessimism over short-run business conditions and employment persists.

Machinery orders registered a sharp contraction of 42.6% in the first half of 2009 relative to the same period in 2008, and capacity utilization stayed low. Manufacturing production, however, began to recover in March, albeit sluggishly. In addition, the Tankan survey (of both large manufacturers and nonmanufacturing industries) for the second quarter showed little improvement in its negative sentiment (Figure 1.2.16). Wholesale prices were off 8.5% year on year in August, the sharpest fall on record, due to weak domestic demand and the steep fall in oil prices.

Against this gloomy backdrop, supplementary budget funding of about ¥14 trillion ($147 billion) was passed in May this year as a stimulus that is set to help consumers and firms cope with a fading labor market and weak external demand. Since mid-May, this package has centered on giving incentives in the form of “eco-points” to purchase eco-friendly home electronic appliances, and on subsidizing consumers trading in their old cars for more fuel-efficient ones. Positive impacts are appearing, with the measures boosting consumption demand and helping firms’ inventory adjustments.

Household real consumption expenditure leveled off in May after falling for 14 consecutive months, but then fell by 2% year on year in July. Consumption expenditure is likely to be weak in the coming months because of deteriorating income—wages slumped by 9.7% year on year in June, the sharpest drop on record. These falls are largely related to cuts in bonuses and overtime pay, which, in turn, are hurting retail sales.

The consumer price index (excluding fresh food) saw a record decline of 2.2% year on year in July, in part due to lower fuel prices than in 2008. Falling equity prices have been taking a toll on firms and consumers. Nonetheless, from its end-year 2008 close, the Nikkei average showed a gain of 14.5% by end-July (Figure 1.2.17) amid expectations of some improvement in corporate profitability (Figure 1.2.16 above). This gain may help firms attract new funding, yet it will take time to be felt in consumers’ pockets or to affect domestic spending.

The Democratic Party of Japan, which came to power at end-August, hopes to boost the domestic economy by encouraging consumer spending directly through households via, for example, subsidies to families with children.

Japan’s growth outlook remains fragile on concerns about the sustained impact of the current fiscal package and rising oil prices. The new Government plans to reprioritize the measures in the package,
and suspend implementation of the unused portion of supplementary budgets, particularly of infrastructure projects, which might put the economy on hold until the impact of a second supplementary budget to be passed later this year is felt. Trade growth is expected to pick up, but sluggishly.

Downside risks to growth are set to persist through 2009 and are likely to overshadow deflation concerns. The economy in 2009 is expected to contract by 5.8% with a weak recovery to 1.1% growth in 2010. Consequently, no monetary tightening by the Bank of Japan is expected either this year or next.

Commodity prices

Global commodity prices—energy and nonenergy—saw extraordinary volatility in 2008. In the first 7 months and led by crude oil, they scaled near-record highs. They then collapsed (Figure 1.2.18) as the financial crisis and slump hit. During the first quarter of 2009, they stabilized and in the second began to rise moderately, primed by brightening global economic prospects.

Energy

The index of energy commodity prices (oil, coal, and natural gas) closely mirrors global oil prices (Figure 1.2.19). The recent surge in crude oil prices appears to be influenced by the beginnings of a modest recovery that may increase transport demand as world trade begins to pick up. Production cuts by the Organization of the Petroleum Exporting Countries (OPEC), oil-inventory adjustments, a weakening of the US dollar, and expectations of further economic recovery are also seen as playing a role. Oil prices have rebounded strongly over the first 8 months of 2009 as global oil demand has begun to firm, but they are not expected to rise much further as long as global demand growth remains subdued (Box 1.2.3).

The factors affecting oil have also impacted on other energy commodity prices, coal in particular. Coal prices, which fell precipitously from the peak reached in mid-2008, have begun to turn up. Their pickup also reflects strong PRC import demand in the first half of the year. However, since the PRC has built up large inventories, it is expected that coal prices will remain stable in the rest of 2009.

Nonenergy

Nonenergy commodity prices, including metals and minerals and agricultural commodities, have been less volatile than those for energy. After falling about one third from peaks reached in mid-2008, they gained 13% in the first 2 quarters of 2009. Metals and minerals recovered, largely as a result of restocking and high import demand in the PRC; with recovery in global prices, mining activity may pick up and limit any further rise in prices.

Agricultural commodity prices have been sensitive to economic conditions but also to the weather. The balance of forces of supply and demand has kept agricultural prices relatively stable this year (Figure 1.2.20), though some supply setbacks may be caused by drought
and other adverse conditions in major producing countries. However, recent bumper harvests have led to large stocks and these will cushion any shortfall in 2009's harvests.

The reduced volatility in food prices reflects the absence of speculative and hoarding behavior that drove prices sharply higher from 2007 to mid-2008. Some food commodities may be vulnerable to price increases, particularly those in demand as biofuels. Sugar prices are also expected to rise as the largest producer, India, faces adverse weather and a sharp reduction in supply. Raw materials prices are expected to remain flat this year but may rebound next year as the global recovery gathers momentum.

Hence, nonenergy commodity prices seem likely to enter a period of greater stability and more moderate prices, compared with the exceptional volatility and high prices seen from 2007 to mid-2008.

**Risks to the global economic outlook**

Some of the risks that confronted the world economy just a few months ago have attenuated as the global outlook has improved. For example, the threat of deflation, which was brought on by collapsing aggregate demand, has faded as demand has begun to rebound. Still, the signs of an improving outlook should not be mistaken for a full-fledged recovery, and risks remain. Foremost among these are a misjudged exit from stimulus packages; a continued weak housing market in the US; resurgent global oil prices; and greater virulence of the flu pandemic.

**Misjudged exit from stimulus**

Above all, policy makers around the world are faced with the delicate issue of a correctly timed and appropriate exit strategy, or when and how to withdraw the huge fiscal and monetary stimuli administered to revive free-falling economies at the depth of the global slump. How effectively they manage this and other risks will determine how soon, and how securely, the world economy regains its footing. For, although the huge expansionary macroeconomic policies had their desired effect in helping turn around global prospects, retaining such expansionary stances for too long can undermine future macroeconomic stability.

In the short term, the expansion of liquidity arising from excessively loose monetary policy can fuel inflation, especially when aggregate demand is picking up and reducing the economy’s spare capacity. Although it is probably too early to worry about inflation, keeping interest rates too low for too long will eventually lead to inflationary consequences or a return of asset bubbles. The risk is not negligible since the effect of monetary policy is felt only after a long lag, which means that the earlier interest rate cuts may further stoke aggregate demand.

In the long term, higher spending and lower taxes will store up fiscal problems for the future as public debt-to-GDP ratios rise to unhealthy levels. It may take years for governments to repay the debts incurred in a few months. This not only implies higher taxes in the future but it also limits the capacity of governments to pursue countercyclical fiscal policy when the next downturn threatens.

No less important than the issue of when to exit is how. For
1.2.3 Recent oil price trends and implications for the world economy

Risk from rising oil prices to global recovery

Global oil prices are reflecting the global business cycle. Having tumbled as the global economic downturn intensified during the fourth quarter of 2008 and the first quarter of 2009, they have since begun a fitful recovery. The incipient recovery of the world economy is lifting them, and as developing Asia is a significant net importer of oil, it stands to suffer terms-of-trade losses. More worryingly, a rebound in oil prices may contribute to inflation pressures that are likely to reassert themselves as the region’s recovery takes hold. For this reason, rising oil prices are one of the biggest downside risks to developing Asia’s recovery.

Tandem recovery of oil price and global economy

The trajectory of global oil prices has closely tracked the state of the world economy since the second half of 2008 (Box figure 1). After a breathtaking climb from $50 per barrel in January 2007 to $146 in July 2008, they fell sharply to $42 by end-2008, reflecting the slump in the world economy and global trade. The global slowdown of late 2008 and early 2009 had a sizable adverse effect on global oil demand, which fell by a staggering 4.0 million barrels per day (bpd) in the first quarter of 2008 relative to a year earlier.

In contrast, oil demand has continued to contract in the United States (US), Japan, and European Union (EU), albeit at a slower pace. The net result is that for 2009 as a whole oil demand will most probably fall, by around 2 million bpd (Box figure 3). Still, recovering global oil demand fueled largely by recovering Asian demand is tightening the gap between supply and demand, and contributing to rising global oil prices. Global oil prices are also benefiting from the current mood of optimism engulfing global equity and commodity markets.

Support from resurgent Asian demand

Developing Asia seems to be recovering faster and stronger than other regions. Even before the global financial crisis, growing demand from the People’s Republic of China (PRC) and India was a key driver of rising global oil prices. In 2009, the revival of demand from the region is helping prop up global oil prices. There has been significant growth of oil demand in PRC, India, and Republic of Korea in recent months, reflecting the resilience of those economies (Box figure 2).

Short term: Still-high inventory stocks

Global oil prices have paralleled the global business cycle since July 2008, and demand has been the dominant driver. However, high levels of inventories are one supply-side fundamental that will damp upward price pressures in the short run. A key measure of inventory levels—total OECD company stocks on land—is expected to remain above its 2008 level through December this year, and comfortably

The recovery of oil prices in the first 8 months of 2009 has been much gentler than the decline during the second half of 2008. To some extent, this is because the global recovery, unlike the global slowdown, has so far been uneven.

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1.2.3 Recent oil price trends and implications for the world economy (continued)

above the “unofficial” target of the Organization of the Petroleum Exporting Countries (OPEC) of 52–53 days (Box figure 4). The buildup of OECD stocks averaged around 400,000 bpd in 2008 as a whole and is expected to be smaller, but still positive, this year.

On the demand side, it would take an improbably robust global recovery to make a significant dent in inventories. On the supply side, if OPEC leaves output unchanged, inventories will reach even higher levels. Even if OPEC manages to agree on significant production cuts, say of up to 1 million bpd, inventory stocks should remain high enough to limit the scope for price increases.

Medium term: Spare OPEC capacity

OPEC’s production capacity is projected to increase substantially, by about 2 million bpd, during 2008–2010. This increase translates into higher spare capacity that will damp the scope for price increases, even in the face of rising demand from the PRC and India, until around the middle of next decade.

Further reinforcing the moderation of price pressures in the medium term is an increase in non-OPEC production capacity in the short term. Although non-OPEC production fell by about 400,000 bpd in 2008, it is expected to rise by about the same amount this year (Box figure 5). New fields coming online in the Gulf of Mexico and Brazil will raise non-OPEC production capacity until 2012.

Long term: Reemergence of price pressures

As argued in Asian Development Outlook 2009 (ADB 2009), the global financial crisis and subsequent slump have done nothing to alter the long-term fundamentals of the oil market. Against the backdrop of a structural increase in demand from the PRC and India, both OPEC and non-OPEC production capacity are expected to peak by the middle of next decade. The combination of demand growth and supply constraints will become the primary driver of prices. In particular, the reduction of OPEC’s spare capacity means that a rerun of the price surge of 2003–2008 cannot be ruled out. However, precisely when prices will begin to climb again on a sustained basis remains highly uncertain.

Remote risk of short-run oil price surge

In principle, the incipient world economic recovery entails a substantial risk of an oil price surge. A pronounced surge may even derail or at least seriously impede the recovery. In practice, there are two fundamental factors that suggest that any increase in global oil prices will be moderate in the short run.

First, global recovery itself is uncertain and fragile, especially in the G3. Second, high inventory levels, which are likely to persist in the short run, will limit the scope for price increases. However, the prospect of relatively moderate oil price rises should not lull policy makers into complacency. Even moderate increases in oil prices can help trigger inflation, especially since the region has recently pursued expansionary monetary policy. Governments should also continue to phase out costly fuel subsidies and, more generally, encourage more efficient use of oil before the next big surge of oil prices arrives.

Bibliography

example, sharp reversals of the fiscal stance or hikes in interest rates may undermine business and consumer confidence. Policy makers should withdraw the monetary and fiscal stimulus in a way that does not jeopardize the nascent recovery. Yet, too much caution in reversing the expansionary policies may be ineffective in preventing overheating and inflation pressures.

The optimal speed and strength of stimulus withdrawal is inevitably a tricky decision that requires a great deal of sound judgment on the part of policy makers. Further complicating their calculations is the risk that recovery is neither sustainable nor robust enough to withstand a huge stimulus cut. That is, if the recovery has been driven by expansionary macroeconomic policies, reversal of policies may slow or even derail it.

**Continued weak US housing market**

The global financial crisis and economic slump are rooted in the bursting of the US housing bubble. Many key indicators, in particular GDP growth trends, suggest that the US economy has bottomed and is beginning to pick up. However, one enduring source of concern is the US housing market (Figure 1.1.7 above). More specifically, foreclosures are continuing to rise as workers lose their jobs and wages remain flat. Since pickup in employment tends to lag an economic recovery, the labor market is unlikely to pick up soon and support the housing market.

The value of US mortgages often exceeds the value of homes, which implies negative net worth or equity in homes. In fact, more than 15.2 million mortgages, or 32.2% of all mortgaged properties, were in negative equity as of 30 June 2009. Furthermore, the aggregate property value for mortgages with negative net worth was $3.4 trillion, which represents the total property value at risk of default. (The baseline scenario used in Table 1.2.1 implicitly assumes that this risk will not be realized on a widespread scale.)

One solution is to restructure these mortgages, but restructuring is not in the financial self-interest of the mortgage servicers who administer the mortgages. So far the Government has failed to take any action to effectively alter the incentives of the mortgage servicers. Just as rising home values spurred US private consumption prior to the crisis, foreclosures and negative equity in homes will constrain private consumption, in turn delaying the onset of a full-fledged recovery. Similarly, weak housing markets will also curtail the recovery of the EU economies that experienced housing bubbles of their own.

**Resurgent global oil prices**

The one bright spot of the financial crisis and economic downturn was that together they stopped the astonishing escalation of global oil prices, which reached record levels in July 2008. By helping hold down overall prices, cheaper oil enabled monetary authorities to pursue expansionary policies without their having to worry about inflation. Although global oil prices plunged as the turmoil intensified in the fourth quarter of 2008, they have made a fitful recovery this year. They may gain further momentum when the global recovery gains traction.

Supply and demand fundamentals, in particular large inventories, suggest that a sharp runup in prices, such as that seen before the financial
crisis, is unlikely (Box 1.2.3, above). Nevertheless, if global consumption grows more rapidly than currently forecast because of a faster than expected global recovery and if geopolitical events create major supply disruptions, a much steeper price ascent cannot be ruled out. In this case, the specter of cost-push inflation, which had dissipated along with the collapse of oil prices, may rematerialize to cast its gloom over global recovery.

Even if, as is more likely, oil prices remain flat or rise only slowly, they may combine with strengthening aggregate demand and loose monetary conditions to lay the foundation for another bout of inflation. That is, higher oil prices can contribute to inflation pressures in an overall environment that is conducive for a revival of inflation.

**Flu pandemic**

The initial global scare over H1N1 flu (swine flu) seems to have subsided, although H1N1 can still mutate and become more dangerous in the northern hemisphere's winter. Yet in light of the pandemic's ease of transmission, lowering the guard in any part of the world will have spillover effects elsewhere. Indeed, with H5N1 (avian flu) entrenched in several Asian countries (PRC, Indonesia, Viet Nam, and probably some parts of northern India and Bangladesh), developing Asia needs to strengthen surveillance. As East Asia's experience with the SARS epidemic showed, a pandemic can have dire economic repercussions.
ADO 2009 emphasized that the economies of developing Asia had very limited direct exposure to the toxic assets that originated in western banks, mortgage lenders, hedge funds, and other financial companies. This analysis still holds good. Various financial indicators and banking sector data support the contention that Asia's financial systems were well prepared for the crisis: nonperforming loans were quite low as a share of total loans; banks were well capitalized; and, aside from banks in the Republic of Korea (hereafter Korea), reliance on credit lines to western banks was minimal (Figures 1.3.1–1.3.3). Nonetheless, stock prices in Asia were closely linked to global markets and suffered badly in 2008.

The main channels by which the financial crisis and subsequent global slump spread to Asia were in the real economy—chiefly the collapse of demand for Asian exports in major global markets—but also through reduced demand for Asian services in the form of reduced tourism and slower demand for immigrant labor services from developing Asia. Still, financial-channel shocks strongly reverberated around the world in late 2008, and Asian equity and bond markets could not escape the asset-price implosion and the dislocation in trade credit. Finally, loss of confidence threatened to cause bank runs as frightened depositors were tempted to withdraw funds on any rumor that a particular bank was exposed to losses—particularly following the failure of Lehman Brothers.

The more export-oriented Asian economies, especially the newly industrialized economies, suffered most from the collapse of international trade and had the most severe contractions in industrial production as firms drew down inventories and shuttered production (Figures 1.3.4 and 1.3.5). The rate of decline in imports quickly matched that of exports as supply chains reacted to the evaporation of demand in major industrial economies. For their part, the region’s resource-rich economies suffered from export declines due to sharp corrections in previously elevated commodity markets.

Beyond the trade channel, private external capital flows into the region slowed sharply. Foreign direct investment inflows and other forms of financial flows from the major industrial economies tumbled in the midst of the financial panic that gripped the world after September–October 2008. The credit squeeze was also reflected in elevated spreads of Asian bonds. The impact on investment was severe.

There are already indications that output and activity are set to recover in Asia—data for second-quarter 2009 industrial production and exports in the newly industrialized economies, for example, show the beginning of what might be a V-shaped recovery. Other indicators of the real economy in developing Asia provide a mixed picture, however.

For example, in East Asia retail sales growth began to recover in recent months in Korea and in Taipei, China but not in Hong Kong, China (Figure 1.3.6). In Southeast Asia, retail sales are still...
contracting in Singapore and Thailand and are rebounding in Malaysia and Viet Nam. Sales of durables such as motor vehicles remain depressed in much of the region, but have begun to rebound somewhat in some countries. Tourism throughout the region continues to suffer the effects of the global recession, although Malaysia and Taipei,China are showing some growth.

Unemployment in much of the region has risen, particularly in the more export-dependent economies of Hong Kong, China; Singapore; and Taipei,China (Figure 1.3.7). However, the prospects for labor market improvement seem favorable as industrial production continues to accelerate.

Despite the relatively strong dependence on exports and investment in the region, in the second quarter of this year most Asian developing economies were seeing both a rapid rebound in economic growth, driven by recovery in industrial production, and rallies in equities and other assets (see below). Developing Asia last faced a debilitating financial crisis and regional recession in 1997–98, which originated within the region. But it emerged rapidly as a result of favorable global economic conditions.

This time around, quite different circumstances prevail. First, the financial crisis originated in the western industrial economies and spread to Asia largely through a collapse in world trade. Second, while Asian financial systems are robust, the collapse in external demand has hit the region hard as industrial production contracted sharply with a fall in exports. Third, extreme volatility in global commodity markets has created additional uncertainty. The question is: Will developing Asia be able to escape the slump rapidly and by what means? Clearly, it will have to generate new demand through sources other than exports to the G3 economies.

Fiscal and monetary actions

Almost every large economy in developing Asia has implemented measures to stimulate aggregate demand through fiscal and monetary expansion. In turn, households were relatively quick to spend fiscal windfalls that came in the form of tax cuts and income support, giving a fillip to consumption that began to boost GDP by the second quarter of 2009.

Fiscal stimuli in 11 Asian developing economies averaged 7.1% of nominal 2008 GDP. The emphasis of governments’ efforts to boost demand through discretionary fiscal measures differed, but the boost from the stimulus was strong enough to arrest the decline in GDP growth, even though automatic stabilizers are fairly weak across most countries in the region. For example, almost all the PRC’s CNY4 trillion package was invested in infrastructure projects or other types of construction activities. In contrast, the authorities in Hong Kong, China emphasized tax cuts, public-housing rent reductions, and other forms of household income support. Korea opted for a mix of tax cuts and expenditure measures.

Monetary authorities have reduced interest rates (Figure 1.3.8) to provide liquidity so as to boost investment and expenditure on durable

![Graphs and charts]

1.3.4 Industrial production growth, newly industrialized economies

1.3.5 Export growth, newly industrialized economies

1.3.6 Change in retail sales in selected Asian economies, Q3 2008 vs latest

1.3.7 Change in unemployment rates in selected Asian economies, Q3 2008 vs latest
goods that are sensitive to interest rates. For example, the Bank of Korea reduced its policy rate by 325 basis points from October 2008 to February 2009, and kept the rate at 2% through August. Bank Indonesia also brought down its policy rate by 300 basis points from December 2008 to August 2009 to a record low of 6.5%. Likewise, the Reserve Bank of India cut its policy rate substantially (by 425 basis points) and injected liquidity into banks. It also raised deposit rates available to nonresident Indian savers.

Monetary policy easing was facilitated by a general softening of inflation pressures and lower prices of commodities and energy. However, there is still a danger that Asia may face asset price inflation rather than general price level increases, for reasons discussed in the next section, and this may pose a threat to the soundness of the region’s financial systems.

Asset prices in Asia: Cause for concern?

One consequence of expansionary monetary policies, especially if their duration and strength exceed optimal levels, is that they may push asset prices to excessive levels. Asian equity markets, along with those around the world, have rallied in anticipation of global economic recovery (Figure 1.3.9).

Part of the Asian asset markets’ stronger performance is because the region is recovering faster than other parts of the world. However, the region’s asset price rally is also being fueled by excess liquidity from the expansionary monetary policies. This overhang is finding its way into equity and property markets.

It is always difficult to assess the extent to which a stock market rally reflects improved fundamentals, or possibly a bubble, even though one widely watched indicator—the price–earnings ratio—has risen significantly in some countries. Nevertheless, failure to tighten monetary policy at some point will create conditions that are conducive to the formation of bubbles in the future. A downward correction in asset prices invariably has painful consequences for the financial system and the economy, as most recently illustrated by the bursting of the US housing bubble.

Among Asian countries, concerns about overheating asset markets are most pronounced in the PRC, which has witnessed a surge of bank lending this year (Figure 1.3.10). Encouragingly, however, this surge moderated in July. Partly as a result, the Shanghai Composite Index cooled off notably in August, and this may help head off a bubble. Although it may be difficult for Asian central bankers to focus policies on asset markets in the face of a fragile and uncertain recovery, they need to monitor the situation closely so as to preempt a future bubble.
Developing Asia’s prospects

Developing Asia is leading the global economic recovery with a strong rebound in GDP growth that began in the second quarter of this year. Underpinning the resurgence was the impetus to demand from expansionary fiscal and monetary actions (Figure 1.4.1) taken by governments throughout the region, especially the PRC and India. Indonesia and Viet Nam also saw solid economic growth.

The Update raises the forecasts for GDP growth for developing Asia as a whole from those given in ADO 2009. The region is now projected to grow by 3.9% in 2009 and 6.4% in 2010 (Figure 1.4.2), up from 3.4% and 6.0%. Of course, individual performance in 2009 is likely to vary, with some subregions deteriorating relative to the earlier forecasts (Central Asia, Southeast Asia, Pacific) and others gaining (East Asia and South Asia).

Similarly for 2010, the Update upgrades forecasts for East Asia and South Asia as a result of faster than expected growth in the two largest economies. Pacific growth is also expected to be better than earlier forecast, and Southeast Asia is virtually unchanged. For Central Asia, the forecast is lowered from ADO 2009. But in short, the 2010 outlook is for growth in all subregions to come back strongly relative to 2009, giving a V-shaped trajectory to developing Asia’s recovery from the world recession (Figure 1.4.3).

One reason that developing Asia has recovered faster than the rest of the world is the relative robustness of its financial sector. This provided a buffer against the global financial turmoil. The strong fiscal position of most large economies in developing Asia also enabled them to pursue expansionary fiscal policies. Existing high saving rates and low levels of household debt made consumers in developing Asia more amenable to spending the additions to income from the fiscal stimulus. In contrast, the outlook for the industrial countries is for a more modest recovery, with growth in 2010 still much slower than in 2007 and only slightly faster than in 2008.

With external demand from the main industrial countries still relatively weak, it will be difficult for developing Asia to return to the high growth rates achieved in 2006–2007. Growth in 2010 will only return to about 6–7% rather than the 9–10% rates that were recorded prior to the crisis.

The resumption of growth has taken place against a backdrop of low inflation or even mild deflation (Figure 1.4.4). The region as a whole has benefited from the steep slide in oil prices and from improved supply of food and raw materials. Despite the sharp reduction in short-term interest rates engineered by central banks and the pumping of liquidity into financial markets, the threat of inflation remains muted.

Tight global credit conditions during the depth of the financial crisis led to a substantially slower net inflow of foreign investment into emerging markets, including developing Asia. More recently, there has been apparent recovery of portfolio capital flowing into the region as equities markets have rallied (Figure 1.3.9, above). Less foreign direct...
investment is flowing into the region but there are early signs that multinational enterprises have sharply reduced unwanted inventories and are now in a position to ramp up production. In addition, industrial output is now on the rise in PRC, Korea, and Singapore after the deep plunges in the fourth quarter of 2008 and the first quarter of this year.

Banking systems have not buckled under the strain of the crisis of confidence and there are signs that lending is reviving. Much of the lending is going into domestic demand–driven sectors such as consumer credit for purchases of durable goods, but much of it may also be going into stock and real estate markets. Authorities will therefore have to monitor the situation carefully when making credit available for large-ticket items, so as to avoid new asset surges in those markets. Fortunately, commodity prices have been moderate and show few signs of the volatility seen in the past year.

Once the impetus from fiscal stimulus packages wears off, it will be essential that domestic consumption and private investment take over as the drivers of growth. Rebalancing Asian growth through increasing investment and consumption expenditures relative to income (and thereby saving less out of income) will help keep momentum behind the global recovery. In some instances, structural reforms need to be stepped up to rekindle growth. Fortunately though, most developing Asian economies have relatively low debt-to-GDP ratios and are on a sound fiscal footing, such that prolonged stimulus will not undermine future growth.

This is not the time for an exit from expansionary policies—the recovery remains fragile and subject to serious downside risks. Global trade is a case in point—even though the trough in world trade volume may have been reached in the first quarter of 2009, both imports and exports are still well below levels attained a year earlier. Hence, continuing the expansionary stance is warranted until global markets and demand are on a firm recovery path.

To ensure a robust revival of world trade in coming years, large Asian economies could take up the mantle of the Doha Round. An example is India’s hosting of the meeting of trade ministers in New Delhi in September, aiding the G20’s goal of reaching agreement on the Doha Round by end-2010. Efforts to head off protectionist tendencies are still important as governments continue to implement stimulus packages that involve procurement of tradable goods and services. The G20 consultations provide an excellent opportunity for developing Asia to push the trade talks forward. There are opportunities for successful agricultural negotiations as the G3 economies have proposed to step up assistance for agricultural development.

The outlook for developing Asia’s recovery is encouraging, but it is likely that growth will remain well below attainments of recent years. Developing Asia will only be able to regain a high-growth trajectory if the global economy is growing closer to its potential. A major challenge in this context is whether Asia can adjust to changing global conditions by striking an appropriate balance between openness and increased reliance on domestic demand–driven growth.
A new approach to openness for developing Asia?

Developing Asia's rising prosperity is closely associated with its openness to foreign trade. Indeed, many developing countries outside the region have attempted to emulate the successful export-led structural transformation that was earlier made by the newly industrialized economies of Hong Kong, China; Korea; Singapore; and Taipei, China. From the late 1960s to 2008, per capita incomes in those four economies had risen on average by a factor of nine (Figure 1.5.1), nearly eliminating poverty for their residents. The region’s economies on the next rung of the development ladder—the rapidly growing economies in Southeast Asia as well as the PRC—have also had a measure of success in applying the open-economy approach.

Although trade openness became the hallmark of the Asian model, openness to cross-border flows of capital and labor also played an important part in the region’s success. Yet openness is not without risks for the region, as is especially evident during episodes of crisis.

The 1997–98 Asian financial crisis had its roots in the sudden reversal of capital inflows. It exposed weaknesses in the region’s financial institutions, which were overexposed to foreign borrowing—a strategy that hinged on maintenance of stable exchange rate pegs. Because the major industrial economies remained strong, the region was able to export its way out of the downturn. However, the export-led mode of recovery became the weak point for developing Asia during the recent crisis.

More specifically, the region’s heightened reliance on external demand for growth hindered consumption and catalyzed reserves accumulation, which was widely viewed as insurance against a repeat of the 1997–98 devastation. This heavy reliance left the region vulnerable to the synchronized collapse of the major industrial economies. Trade within Asia, which largely reflects cross-border production networks manufacturing goods for sale outside the region, collapsed in turn. As a result, the most open, trade-dependent economies were hit the hardest by the global downturn.

For merchandise trade, a broader customer base for final goods is needed. Strengthening intraregional trade can help reduce developing Asia’s overdependence on the major industrial economies and support the shift away from unsustainable current account imbalances. Financial globalization needs to be effectively managed so that capital flows do not become a source of instability. This requires policy changes and domestic financial market development to create an environment that both fosters Asian intermediation for its savings and that attracts long-term foreign investment. Labor mobility has provided foreign exchange flows that have proven to be reliable even in times of crisis. Policies and institutional changes to ease the transfer of remittances can enhance the benefits of tapping into the international labor market.

For policy makers, the decision to open the economy further to international exchanges of goods and services, capital, and labor...
must be seen as a means to enhance economic resilience through diversification of markets.

The human toll from economic crises cannot be exaggerated, yet the efficiency-augmenting, growth-enhancing aspects of openness lie at the very heart of developing Asia’s economic achievements. No alternative development model has rivaled the success of the open, Asian approach. At the same time, developing Asia’s experience in the recent crisis underscores the risk of a narrow openness. Part 2 of the Update takes a closer look at the role of openness in developing Asia, outlining a broader, more resilient approach that would deliver rapid, yet stable, growth for the region.

References
Part 2

Broadening openness for a resilient Asia
Broadening openness for a resilient Asia

The global financial crisis and the economic slump have together highlighted issues surrounding “openness” in three areas—international trade, financial globalization, and remittances. Although the impact on developing Asia has been felt primarily through the trade channel, this part of Asian Development Outlook 2009 (ADO 2009) Update takes stock of the region’s level and structure of openness in all three interconnected areas, as future external shocks could affect the region through financial or other channels rather than trade, including remittances.

Now is an opportune time to revisit the issue of openness in developing Asia. The recent turmoil exposed the substantial risks of openness to a region long accustomed to effectively leveraging it to achieve economic success. In contrast to the Asian financial crisis of 1997–98, which was precipitated by reversal of foreign capital inflows, the slowdown of economic activity in 2008 and 2009 was caused by the collapse of exports to the industrial economies, in particular the United States (US). Despite the financial origins of the downturn, developing Asia’s financial systems did not suffer severe disruptions. It was only when the financial crisis spread to the real economies of the industrial world, crimping their appetite for imports, that the region’s real economies were battered. From developing Asia’s perspective, the global tumult manifested itself as a trade crisis rather than a financial crisis.

Although the Asian crisis, unlike recently, was financial in nature, it nevertheless helps explain why developing Asia’s economies were hit so hard by the recent global turmoil. Prior to 1997, developing Asia as a whole ran current account deficits, but since then it has run large and persistent surpluses. This reversal was motivated partly by regional policy makers’ desire to build up an ample war chest of foreign exchange reserves. The reversal implied a higher level of dependence on exports to the US and other industrial economies as a source of demand and growth. The region’s desire to protect itself from one type of risk from openness and globalization—financial instability due to volatile capital

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flows— inadvertently magnified its exposure to another type of risk—excessive dependence on exports. The deceleration of exports and growth in 2008 and 2009 was largely a realization of this risk.

From the viewpoint of developing Asia, the global maelstrom originated outside the region while the Asian crisis was partly homegrown. In contrast to the former period, the fundamentals of developing Asian economies have recently been in relatively good shape, as reflected in generally healthy current account and fiscal positions, adequate foreign exchange reserves, rapid growth, macroeconomic stability, and sound macroeconomic policies. Still, the region has suffered for its openness recently, despite strong fundamentals.

The most open, most export-dependent economies have been hit the hardest (Figures 2.1.1 and 2.1.2). Since those same economies have outperformed their less open neighbors, regional policy makers face a trade-off between the returns of openness (faster output growth) versus the risk of openness (greater volatility in output growth). The recent shock has brought this trade-off into sharp relief and added a new sense of urgency to improving its terms.

With respect to trade, evidence suggests that developing Asia’s level of openness may be less than optimal, in the broad sense that demand is geared excessively toward external demand (ADB 2009). More specifically, the region may be consuming too little and saving too much, and consequently relying disproportionately on foreign markets to purchase its output. Rebalancing domestic economies will move the region toward a level of openness where exports continue to make significant contributions to growth but a more vibrant domestic economy provides a measure of resilience against external shocks.

The financial crisis and slump have underscored some important features for policy makers. For example, the costs of openness are likely to be high for an economy that has no internal dynamism and that falls apart whenever the global business cycle turns down. In addition, the appropriate level of openness and the capacity to reduce the costs of openness through rebalancing will differ from country to country. Finally, developing Asia suffers from a skewed trade structure that depends disproportionately on demand from the US and other industrial economies. This is especially true for final goods, which is why the region has been hit so hard, despite the healthy growth of intra-Asian trade in recent years.

Although the financial impact of the crisis was weaker than the trade impact, some signs of financial stress were clearly evident. For example, in many countries borrowers with weaker credit ratings faced more difficult access to credit, while pullbacks of capital flows and sharp currency depreciations in some countries further highlighted the risks of financial globalization (Figure 2.1.3). Coordinated policy responses, such as US dollar swap lines, were introduced.

Nonetheless, these economies seem to have withstood the effects of instability, and this success points to the importance of their solid macroeconomic fundamentals and sound financial systems. In particular, sound and efficient financial markets and institutions are indispensable.

In addition to trade and financial linkages, migration and remittances are a third area hit by the financial crisis and economic downturn. These
events have forced employers to lay off workers, including foreigners, threatening remittance flows to some countries that send workers abroad. These migrant-sending countries are also facing increasing protectionist policies from migrant-receiving countries. Since the economic downturn, increasing unemployment has pitted the interests of receiving-country nationals against foreigners, as host-country governments tighten immigration policies to protect jobs for their nationals.

In the past remittances have proven to be a relatively stable source of foreign currency inflows to developing countries (Figure 2.1.4). Although remittances entail economic and social costs, they can contribute substantially to growth and poverty reduction, and they provide credit-constrained households means to smooth consumption. The key question for policy makers is how to capitalize on migration and remittances for growth, poverty reduction, and consumption smoothing while successfully managing potential costs.

Returning to the core issue of trade, the lopsided role of extraregional trade in the region’s growth creates a serious risk that the gains from greater trade with neighbors will not be fully exploited. Given the region’s rapid growth in recent years and the consequent emergence of a large middle class with growing purchasing power, the gains from greater intra-Asian trade in final goods is potentially large. The People’s Republic of China (PRC) and India are reaching income levels where millions of consumers are buying their first car or making their first trip abroad.

There are also large potential gains from greater flows of capital and remittances among developing Asian economies. Closer integration of regional financial markets will create more opportunities for investing developing Asia’s ample pool of savings within the region. In addition, measures to facilitate migration and remittances will benefit both young labor-abundant countries and aging labor-scarce countries.

However, addressing the geographically unbalanced structure of trade, capital flows, and remittances through the promotion of closer intraregional economic links need not—indeed, should not—come at the expense of vital longstanding links with industrial economies. The choice facing developing Asia is not between intra- and extra-Asian trade. The challenge is to strengthen intraregional trade up to a level that is commensurate with the rising prosperity of the region.

Intuitively, in light of its fast-growing income and purchasing power, the excessive dependence of developing Asia on extraregional demand is somewhat puzzling. The dependence is both structural and strategic, and the consequence of a decades-old growth strategy based on exports to industrial economies. As the region continues to grow and become even richer, more robust intraregional trade will naturally evolve alongside stronger domestic demand. Strategic policy measures to rebalance the economy will accelerate the emergence of self-sustaining domestic economies (ADB 2009). As experience of the European Union (EU) and North American Free Trade Agreement shows, vibrant intraregional and interregional trade can coexist.

Developing Asia’s governments should not just sit back and wait for strong domestic economies to emerge, but should instead make real efforts to create a more conducive environment for intraregional integration. The resultant policies would speed up developing Asia’s move
toward a broader openness, which would enable it to reap the gains from more intra-Asian trade, capital, and remittances.

Developing Asia has benefited enormously from its interaction with the rest of the world and will continue to do so in the future. However, its rapid growth and rising living standards imply large and growing potential gains from greater intraregional integration. But if the region fails to fully exploit these gains, it will be depriving itself of a valuable tool, both to protect itself from external shocks in the short run and to build up an additional source of economic dynamism in the long run.

Unlike growth and stability, the level and structure of openness do not constitute a policy objective in their own right. Instead, openness is the outcome of a set of policies and conditions that support growth and stability. Nevertheless, over time, various distortions may have contributed to overdependence on exports, to unbalanced trade patterns that favor trade with countries outside the region, to high dependence on extraregional financial markets and institutions, and to obstacles to migration and remittance flows within the region. Those distortions not only affect the level and structure of openness but can also adversely affect the trade-off between growth and stability, and so removing them may have a positive impact on this critical trade-off.

The implication is that a stronger domestic economy and more linkages within the region can help countries achieve rapid, yet stable, growth. The combination of rebalancing and intraregional integration will give to developing Asia greater resilience in the face of extraregional shocks.
Enhancing intraregional trade

The role of intraregional trade in developing Asia

The global financial crisis and economic slump together have hit hard developing Asia's exports and growth. Although the slump was financial in its origins, trade has been the dominant channel through which the financial crisis has been transmitted from the US to developing Asia. Given that the root cause of developing Asia's slowdown is the contraction of aggregate demand due to the contraction of external demand, the logical solution to short-run recovery and long-term growth is to find alternative sources of demand.

In the short run, the only realistic policy option is for governments to cut taxes and increase spending, serving as consumer of last resort, as they in fact did throughout the region. In the long run, as discussed in ADO 2009 (ADB 2009), one strategy is to strengthen domestic demand so that countries in the region consume more of what they produce. However, building up a more vibrant domestic economy is a long-term structural process that involves removing deep-seated structural impediments, such as weak financial and inadequate social protection systems.

This section explores another long-run potential source of demand and growth for developing Asia, namely intraregional trade, which is intimately related to domestic demand. More robust domestic demand within the countries of the region will enable them to buy more of each other's goods, as is the case among EU countries. Stylized facts suggest that while trade among developing Asian economies has grown impressively in recent years, much of the trade reflects trade in parts and components as opposed to trade in final goods. In particular, the PRC’s role as the workshop of the world means that economies around the region ship parts and components to the PRC, which assembles them into final goods and exports them to the US and other industrial economies.

Consequently, the growth of intra-Asian trade remains heavily influenced by growth of demand in the rest of the world. This is especially so for trade among East Asian and Southeast Asian economies, which trade extensively with each other. Upon closer analysis, lack of more substantive intraregional trade based on final goods, along the lines of the EU, is a direct result of weak domestic demand in regional economies. By the same token, the strengthening of domestic economies will stimulate more substantive intraregional trade.

The central objective of this section is, therefore, to empirically investigate whether intraregional trade can serve as an engine of recovery and growth for developing Asia. More specifically, it examines the issue of whether the PRC can serve as that engine.

The next subsection will make it clear why the PRC has a unique potential to drive regional growth through trade. The empirical analysis concentrates on manufactured goods rather than commodities since
manufactured goods account for a majority of intraregional trade. More significantly, the analysis is largely limited to the economies of the two subregions of East Asia and Southeast Asia, which have reached a fairly high degree of trade integration with each other.

While the analysis looks primarily at East and Southeast Asia, the results have implications for other parts of developing Asia as well. For example, although intra-South Asian trade is still relatively low, Bangladesh, Pakistan, Sri Lanka and other subregional economies are likely to reap increased benefits as trade integration among South Asian countries progresses further in the future.

In particular, just as East and Southeast Asia stand to benefit from the PRC’s rapid growth, South Asia stands to benefit from India’s fast growth. More generally, any evidence that trade integration in East Asia and Southeast Asia is contributing to the two subregions’ recovery and growth will provide some grounds for optimism about the prospects of intraregional trade to do the same for other parts of developing Asia.

**Growth of intra-Asian trade and the rise of the People’s Republic of China**

This section is motivated by the hopes and optimism surrounding a new potential source of demand and growth that may compensate for the weakening of an existing source of demand and growth. Those hopes and optimism are predicated on two stylized facts—the rapid growth of intra-Asian trade and the rise of the PRC as an economic force of global significance.

In purely quantitative terms, intra-Asian trade, especially among East and Southeast Asian economies, has increased notably in recent years. Although much of this trade is currently in parts and components rather than in final goods, the very fact that Asian economies are trading increasingly with each other provides some grounds for optimism about the future emergence of more substantive intraregional trade in which final goods play a bigger role. In other words, the quantitative growth of intra-Asian trade holds the promise that it may someday become a source of demand and growth in the region, as it is in the EU.

The stunning rise of the PRC as a global economic heavyweight potentially means the rise of a large and growing market for Asian exports. Although the PRC tends to be stereotyped as the workshop of the world, the country’s sheer size and growth mean that it is also an importer of global influence. For example, the PRC’s voracious appetite for raw materials has had a perceptible effect on global commodity markets.

More generally, the PRC is not only growing at a very rapid and sustained pace, but it is also a huge country that is home to more than a quarter of humanity. Therefore, in contrast to, say Malaysia, Singapore, or even Korea, the PRC is seen as a continental economy where both domestic demand and the economy are vibrant. This vigor is apparent in the fact that the PRC’s growth rate slowed to “only” 9.0% in 2008 and a projected 8.2% in 2009 while the rest of East and Southeast Asia is barely managing to grow at all. In fact, Hong Kong, China; Korea;
Malaysia; Singapore; Taipei, China; and Thailand are all projected to contract in 2009.

The combination of the two stylized facts has breathed life into the “PRC-as-an-engine-of-recovery-and-growth” hypothesis (in short, the “PRC-as-engine” hypothesis). This is a special variant of the intra-Asian “trade-as-an-engine-of-recovery-and-growth” hypothesis, which recognizes the special role of the PRC as the dynamic center of the growing trade-based integration of the region’s real economies. The remarkable resilience of the PRC in the face of the financial crisis and economic slump has given further impetus to the notion that the PRC can supplement the US as a new growth center for developing Asia.

To be sure, the rise of the PRC not only presents opportunities but also challenges. Above all, the PRC’s rise as a global manufacturing center poses a serious competitive threat to the third-country exports of regional countries. However, there is a growing tendency to view the PRC as a large and growing market rather than a competitor in other markets. The rethinking among the PRC’s neighbors is born of urgent necessity—to find a new source of growth; and rooted in cold hard reality—the remarkable transformation of the PRC.

Growth of intraregional trade in East and Southeast Asia

Despite the multidimensional origins of developing Asia’s economic success, the one common theme that stands out is its trade dependence. East and Southeast Asian economies in particular have successfully integrated themselves into the global real economy by trading extensively with the outside world. Between 1990 and 2008, their exports grew from $424.6 billion to $3.6 trillion in nominal terms and from $559.6 billion to $2.8 trillion in real terms, and imports grew from $429.0 billion to $3.3 trillion in nominal terms and from $565.4 billion to $2.6 trillion in real terms (Figure 2.2.1).

Furthermore, the share of those economies’ exports in global exports rose from 12.3% in 1990 to 21.9% in 2008, and the share of their imports in global imports rose from 12.0% to 19.4% during the same period (Figure 2.2.2). Mirroring the rise in East and Southeast Asia’s share of global trade, the region’s share of global GDP increased from 5.5% in 1990 to 12.3% in 2008.

In short, developing Asia is a highly trade-dependent region that has exported and traded its way out of all-too-typical developing-country poverty to become one of the centers of gravity in the world economy.

In recent years, the region’s countries have been trading increasingly with each other rather than with countries outside the region. Superficially, this suggests that intraregional trade has already become a major source of demand and growth. Superficial or not, aggregate bilateral trade data unambiguously point to a rise in the relative share of intra-Asian trade. Again, this trend is particularly evident for East and Southeast Asian economies. For this group of countries as a whole, the share of intraregional trade has risen from 31.7% in 1990 to 42.0% in 2008 (Figure 2.2.3). For each member of this group, the unmistakably clear overall pattern is one of an increase in the relative importance of intraregional trade at the expense of extraregional trade (Figure 2.2.4).

This pattern is also evident for all subgroups of countries within...
the region—the PRC, the newly industrialized economies (NIEs), as well as the major ASEAN economies. The implication is that in purely quantitative terms, East and Southeast Asian economies are trading more with each other and less with the rest of the world. Therefore, not only is trade important for the region; in addition, the geographic profile of the region’s trade is shifting toward trade with neighbors.

This quantitative shift has been used as the primary supportive evidence of the decoupling hypothesis, according to which the dependence of Asian growth on the US business cycle has fallen markedly. The underlying idea was that increasingly rich Asian countries were now selling more of their goods to each other rather than the US, so that a US recession would have a smaller impact on their economic performance than before. The story was plausible but it suffered from a critical flaw—it failed to look at the structure of growing intra-Asian trade.

In fact, according to the overall balance of evidence, a large part of intra-Asian trade reflects intra-Asian production fragmentation, in which different stages of the production process are carried out in different Asian economies. More specifically, the PRC has emerged as the preferred location for assembling parts and components produced in other East and Southeast Asian economies. International production fragmentation is, in effect, international vertical specialization in which each country specializes in a different stage of the production process. As such, East and Southeast Asian economies are likely to enjoy gains from the intraregional specialization and division of labor. Nevertheless, the production fragmentation-oriented nature of intra-Asian trade casts serious doubts on the validity of the regional trade-as-an-engine-of-recovery-and-growth-hypothesis.

**Surge of the People’s Republic of China and implications for developing Asia**

One of the most significant developments in the global economic landscape over the last 30 years has been the integration of the PRC into the world economy and its stunning growth. What makes the PRC’s rise so special is the sheer size of the country and hence its global and regional clout. The transformation of the PRC, which began 30 years ago, has accelerated in recent years. Between 1990 and 2008 for example, the share of the PRC GDP in world GDP rose sharply from 1.7% to 7.3% (Figure 2.2.5). Given the central role of trade and openness in the relentless expansion of the country’s economy, its trade has also experienced similarly rapid growth. The share of PRC exports in total world exports rose from 1.8% in 1990 to 9.1% in 2008, and its share of world imports rose from 1.5% to 7.0% during the same period. The PRC’s emergence as a global economic power thus closely parallels its emergence as a global trading power.

In the context of East and Southeast Asia, the rise of the PRC signals the arrival of a neighborhood heavyweight with far-reaching ramifications. The PRC’s share of developing Asia’s GDP rose from 23.4% in 1990 to 47.6% in 2008. During the same period, its share of East and Southeast Asian GDP rose from 31.0% to 58.9% (Figure 2.2.6). Similarly, the PRC’s exports are accounting for a larger share of East and Southeast Asian exports, and the same holds true for its imports (Figure 2.2.7).
In principle, the PRC’s growing weight in developing Asia’s GDP and trade is a welcome development that offers the promise of a large, fast-growing, and geographically close market. At the same time, there are elements of competition, as well as complementarity, between the PRC and its neighbors. In particular, competition from PRC products may displace its neighbors’ exports in third-country markets. Potential competition is most pronounced in trade but not limited to it. For example, ASEAN countries have expressed concerns about the PRC’s competitive threat to foreign direct investment (FDI) inflows.

However, regional economic growth is not a zero-sum game in which the PRC’s growth has to come at the expense of others. A richer PRC may well pull up its neighbors by providing a huge market for goods, a source of millions of tourists, profitable investment opportunities, demand for financial and other services, and countless other mutually beneficial activities. The PRC’s spectacular growth can indeed be a positive-sum game that imbues the entire region with a new sense of economic dynamism.

Yet the prospects for such optimism depend on the extent to which the PRC’s own growth is fueled by domestic demand rather than exports. A promising stylized fact is that in sharp contrast to much of Asia, the PRC has maintained a surprisingly robust growth rate in the face of the recent global shock. Such resilience has reinvigorated the popular view that the PRC can become a new engine of recovery and growth for the region (and, less plausibly, the entire world). In fact, since the outbreak of the crisis, there has been a growing tendency within developing Asia to highlight potential complementarities rather than potential competition.

Partly wishful thinking maybe, but also firmly rooted in the hard reality of a fast-rising regional heavyweight.

**Trade with the People’s Republic of China as an engine of regional growth**

The confluence of the two above-mentioned stylized facts—rapid growth of intra-Asian trade and the spectacular rise of the PRC as a global economic power—points to a natural candidate for reviving the region’s short-run growth and long-run dynamism, namely exports to and trade with the PRC.

In fact, the PRC has already emerged as the center of intra-Asian trade, and much of the rapid growth of intra-Asian trade reflects the growth of trade between the PRC and other countries in the region. For example, exports to the PRC as a share of total exports have grown rapidly in each of the major economies in East and Southeast Asia between 1990 and 2008 (Figure 2.2.8); and the pattern has been similar for imports (Figure 2.2.9). Conversely, the share of the PRC’s exports to East and Southeast Asia has fallen, as has the share of its imports from that region (Figure 2.2.10).

But the fact that Asian countries export more to and trade more with the PRC does not, in and of itself, indicate that the PRC has become an engine of growth. As noted earlier, the growth of the PRC’s trade with its neighbors largely reflects the growth of intra-Asian production fragmentation, or vertical specialization. So, while the PRC has increasingly become the central hub of intra-Asian trade, it has become...
the center of a regional production network rather than an independent source of demand for the region.

The sheer size and dynamism of the PRC means that even aside from its central role in intra-Asian production fragmentation, it has a unique role to play. Even though, say, Singapore (or Hong Kong, China) may trade extensively with other Asian countries and is highly integrated into the regional economy, it is a small, open economy with no perceptible impact on regional trade and growth. The same can be said for even larger regional economies, such as Korea.

In illustrating the presence or absence of a robust domestic economy, the exact share of domestic demand in total GDP matters much less than resilience in the face of a severe external shock. In a sense, the recent crisis is a stress test of the highest order for the domestic economy. The PRC’s growth performance in 2008 and so far in 2009, despite decelerating from 2003–2007, means that the PRC has passed the stress test with flying colors. The perception of the PRC as a continental economy with a sustainable, resilient domestic economy has thus found a great deal of support. The big question is this: How likely is it that the promise of the PRC-as-engine hypothesis will become reality? The next two sections attempt to answer it.

Impact of demand from the People’s Republic of China for imports on developing Asian GDP

The PRC-as-engine hypothesis is a theory about the PRC’s GDP exerting an independent and positive effect on the GDP of other countries in East and Southeast Asia. The reason for largely limiting the analysis to those two subregions is that the general level of regional economic integration, and in particular integration with the PRC, is more advanced there than in other parts of developing Asia. A key tangible result should be a positive relationship between the PRC’s imports from, and output levels in, the rest of the region.

The main interests are the relative magnitude of the impact of the PRC’s imports on the GDP of its neighbors and the evolution of this magnitude over time. In particular, an impact that is not visibly smaller than the impact of US imports would support the emergence of a second engine of growth in the region. Furthermore, an impact that is growing over time, especially relative to the US impact, would also support a twin-engine growth paradigm.

A vector autoregression (VAR) was used to identify the US and PRC import demand shocks, which are export demand shocks from the viewpoint of East and Southeast Asia. The VAR model is based on that of Haltmaier et al. (2007), who analyze macroeconomic data from the third quarter of 1993 to the fourth quarter of 2006, to assess the impact of PRC and US demand on GDP growth in Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. Their two major findings are that external shocks have played a major role in the domestic output fluctuations of their sample of developing Asian economies, and that PRC demand shocks have been as important as US demand shocks in explaining the domestic growth fluctuations of many regional economies.
These major findings remain largely valid even when the authors account for the possibility that PRC demand for Asian exports is a derived demand based on US demand for final goods.

Through the VAR model, it was attempted to assess the relative contributions of shocks to US import demand and shocks to PRC import demand to GDP in nine regional economies from the first quarter of 1990 to the fourth quarter of 2008. The sample of economies consists of the four NIEs (Korea; Hong Kong, China; Singapore; and Taipei, China); the ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand); plus India. India is included in the sample in light of its large and growing economic weight. A high PRC contribution would support the PRC-as-engine hypothesis, and a growing contribution would suggest that the PRC is becoming more of an engine over time.

A three-variable structural VAR was estimated for each country in the sample. Using Malaysia as an example, the VAR model includes the three following variables: domestic real GDP, US real imports from Malaysia (that is, Malaysia's real exports to the US), and the PRC's real imports from Malaysia (that is, Malaysia's real exports to the PRC). For full technical details of the VAR analysis, including impulse response functions and variance decomposition results, refer to Park and Shin (2009a).

The most significant result is that PRC demand has become a more important source of GDP fluctuations in five out of the nine sample economies—Hong Kong, China; Indonesia; Philippines; Taipei, China; and Thailand. In and of itself, this would lend support to the PRC-as-engine hypothesis. Another somewhat predictable finding is that the role of PRC demand as a source of GDP fluctuations differs a lot across the sample economies. For example, the PRC does not matter at all for India but matters hugely for Singapore. Overall, the three-variable VAR results indicate that the PRC's import demand already has a big impact on the output of economies in the region, not noticeably smaller than the impact of US import demand. Furthermore, its role has strengthened appreciably since the Asian crisis.

While such results bode well for the PRC-as-engine hypothesis, there is a serious risk that they overestimate the extent to which the PRC serves as an independent source of demand and growth for the region. This pertains to the basic structure of intra-Asian trade alluded to earlier. More specifically, that structure suggests that the PRC's demand for imports from its neighbors is a derived demand that is based on final demand in the US and elsewhere. What is driving the PRC's demand for imports from, say, Malaysia is not the PRC's own demand but US demand for final goods from Asia. To control for this possibility, the three-variable VAR model was expanded to four variables. The additional variable is US real imports from the PRC, which contains large inputs of intermediate goods (parts and components) from the rest of the region.

The clear overall pattern that emerges is that the PRC's exports to the US emerge as a new significant source of GDP fluctuations. Critically, once one controls for the possibility that the PRC's demand for Asian exports is largely demand derived from US demand, exports to the PRC are no longer a significant determinant of GDP in Asian countries. The results are most pronounced for the four NIEs. The only three countries
where exports to the PRC remain significant even after controlling for derived demand are Korea, Philippines, and Thailand.

In short, the evidence from the regressions casts doubt on the validity of the PRC-as-engine-of-growth hypothesis. The results of the three-variable model indicate that exports to the PRC have a positive and significant effect on the GDP of East and Southeast Asian economies. However, the results of the four-variable model suggest that the PRC’s apparently positive impact reflects US demand for Asian goods, rather than independent demand from the PRC.

Still, the evidence from the regressions provides only indirect evidence for the hypothesis that PRC demand for Asian goods is primarily derived rather than direct demand. It is therefore necessary to turn to an analysis of trade data to obtain direct information about the structure of intra-Asian trade.

**Relative importance of parts and components versus final goods**

One must analyze the trade data for two main reasons. First, the derived demand hypothesis is fundamentally a hypothesis about the structure of intra-Asian trade. Second, the PRC-as-engine hypothesis is also ultimately a trade-based story that relates how growing demand for imports from a fast-rising PRC lifts the rest of the region to a plateau of reduced vulnerability to extraregional shocks and a higher sustainable growth rate.

At a conceptual level, the key issue is whether the share of parts and components in the PRC’s imports from the rest of the region is rising, falling, or stable. A rising share would support the notion that the PRC’s role in intra-Asian trade is primarily that of an assembler of parts and components, and thus lend support to the derived demand hypothesis. A falling share would indicate that the PRC’s role as an assembler for the region is weakening, which can be interpreted as indirect evidence of the emergence of a more substantive trade between the PRC and the rest of Asia based on demand for final goods from the PRC.

A vast literature based on standard trade data analysis unambiguously points to a secular increase in intraregional trade among East Asian economies since the early 1980s. Examples of this literature include Kwan (2001), Drysdale and Garnaut (1997), and Frankel and Wei (1997). The standard trade data analysis used in this literature implicitly assumes trade based on horizontal specialization, that is, exchange of goods which are produced from start to finish in one country. International production fragmentation—carrying out different production activities in different countries—has become an increasingly significant structural characteristic of economic globalization in recent decades. In particular, trade based on fragmentation or vertical specialization is playing a key role in trade among East and Southeast Asian economies.

Various studies have examined the structure of the PRC’s trade with its Asian neighbors to gauge the extent to which such trade is driven by demand from the US and other economies outside the region. Decomposing trade into basic products, parts and components, and final
goods, Haltmaier et al. (2007) find a large role for parts and components in intra-Asian trade, in particular between the PRC and the rest of Asia. They conclude that this evidence supports the conventional wisdom that the PRC is the endpoint of a giant Asian assembly line for exports to the US and elsewhere—meaning that the PRC serves as a conduit rather than engine of growth for the region.

Similarly, Athukorala and Yamashita (2009) find that the PRC is the final assembly center in global production networks based in East and Southeast Asia. Athukorala and Yamashita (2008), Ng and Yeats (2001), Athukorala (2005), and Pula and Peltonen (2008) all reconfirm the central role of vertical specialization in intra-Asian trade and conclude that extraregional trade is likely to remain the region’s engine of growth in the foreseeable future.

Description of disaggregated trade data
The data for the analysis are of monthly frequency and derived from official PRC customs agencies’ merchandise trade export and import statistics. These are the official international trade statistics released by the PRC Government. The data from January 1996 to December 2005 are held by TradeData International. The data cover trade in goods or merchandise, and exclude trade in services. Merchandise trade statistics only record goods that add to or subtract from the stock of material resources of a country by entering (imports) or leaving (exports) its territory.5

Following Haltmaier et al. (2007), a comprehensive decomposition of trade into four categories is adopted: basic goods, construction materials, parts and components, and final goods. The critical distinction is between parts and components on the one hand and final goods on the other. Parts and components are manufactured intermediate goods that are combined with other inputs to produce final goods. With few exceptions, parts and components cannot be used as final goods. In contrast, final goods are goods that can be directly consumed with little or no processing.

The two other categories of goods are basic goods (food and beverages, natural resources, and raw materials) and construction materials (cement). As Haltmaier et al. (2007) point out, classifying the goods into parts and components against final goods necessarily involves some room for subjective discretion and judgment. It is also impossible to know how a good was used as a part or component or a final good once it has been imported.

Haltmaier et al. (2007), as well as most of the other studies that examined the structure of intra-Asian trade, classified goods according to Standard International Trade Classification Revision 3. However, the data for this analysis is collected on the basis of the International Harmonized Customs Classifications.6

Shares of parts and components versus final goods: Key findings
The PRC-as-engine hypothesis is predicated on the assumption of a dynamic domestic economy rooted in robust domestic demand. The underlying idea is that of a large and fast-growing PRC absorbing more imports from its neighbors, and thus speeding up their recovery in the
short run and enabling more rapid growth in the long run. The validity of this hypothesis depends crucially on whether the PRC directly consumes the imports or processes the imports for export to other countries. Other things equal, final goods are more likely to end up being consumed domestically while parts and components are more likely to end up being consumed abroad. Of course, it is entirely possible that parts and components are used as inputs in producing final goods that are consumed domestically while final goods such as capital goods are used to produce goods that are exported to other countries. Therefore, the relative share of parts and components versus final goods is an imperfect measure of the relative importance of derived demand versus direct demand in a country’s demand for imports.

Nevertheless, because trade data cannot state the final use of imports, the decomposition of imports into parts and components versus final goods is probably the best measure available for making inferences about final use. A smaller share of parts and components in the PRC’s imports would indicate a lower relative importance of derived demand, which would weaken the derived demand hypothesis and thus indirectly support the PRC-as-engine hypothesis. Furthermore, a falling share of parts and components over time would suggest that the PRC’s role as an assembler is diminishing, with a corresponding increase in its role as a consumer. This is true with respect to the world as a whole but especially with respect to East and Southeast Asia, given the extensive intraregional production fragmentation discussed earlier.

Before a review of the share of parts and components, the PRC’s importance in world trade, as well as East and Southeast Asia’s importance in the PRC’s trade, is examined. The PRC’s share in global trade has been continuously increasing (Figure 2.2.5 above). Its share of global exports has shot up from a little less than 1.9% to 9.3% and its share of global imports has risen from 1.5% to 7.1%. Although the PRC tends to be stereotyped as an export machine, the growth of its imports has been almost as impressive. However, a notable gap between the export and import shares opens up around 2003, in line with the large current account surplus experienced by the PRC in recent years. East and Southeast Asia’s relative importance as a trading partner seems to have decreased somewhat during 1996–2008 (Figures 2.2.11 and 2.2.12). However, the decline is much more pronounced for East Asia’s share of PRC exports, from 35.5% to 27.2%, than it is for PRC imports, from 34.2% to 32.9%. To a large extent, the falling share of East Asia in the PRC’s trade reflects the PRC’s successful integration into the world economy, in particular its growing success in exporting to more distant markets.

Between 1996 and 2008, as shown in Figures 2.2.13 and 2.2.14, the share of parts and components in the PRC’s total imports is much higher (averaging 32.8%) than in its total exports (averaging 17.9%). The share of final goods in the PRC’s imports (averaging 45.2%) is correspondingly much lower than the share of final goods in its exports (averaging 70.0%). This can be viewed as evidence of the PRC’s global role as a net importer of intermediate goods for assembly and reexport to the rest of the world. However, the share of parts and components in imports has been falling while that in exports has been rising. The share of final goods in exports has been falling throughout the sample period. The pattern for the share
of final goods in imports is more mixed. Although the share was rising until about 2003, it has fallen sharply since then.

The most interesting and significant part of the analysis of the PRC’s trade structure pertains to the structure of its trade with East and Southeast Asia. As was the case for the world as a whole, as shown in Figures 2.2.15 and 2.2.16 for East and Southeast Asia the share of parts and components in the PRC’s imports (averaging 38.8%) is substantially higher than in the PRC’s exports (averaging 21.2%).

Similarly, for the most part, for East and Southeast Asia the share of final goods in the PRC’s exports (averaging 62.0%) exceeded the share in its imports (averaging 51.0%). This suggests that part of the final goods assembled in the PRC is exported to the rest of developing Asia, which is consistent with the plethora of “made-in-China” manufactured goods found in markets throughout developing Asia. More important, the shares of parts and components and of final goods in the PRC’s imports from East and Southeast Asia average 38.8% and 51.0% for the whole sample period, respectively.

Therefore, while trade in parts and components is indeed a key element of intra-Asian trade, so too is trade in final goods. Both derived demand and direct demand may be important drivers of the PRC’s demand for Asian imports, and there is no reason why a flourishing trade based on production fragmentation cannot coexist alongside a flourishing trade based on PRC domestic demand. Crucially, the share of parts and components in the PRC’s imports from East and Southeast Asia decreased substantially from 43.6% to 33.8% from 1996 to 2008, and the share of final goods increased appreciably from 43.6% to 54.7% during the same period.

These changes can be viewed as a weakening of the PRC’s regional role as an assembler and a corresponding strengthening of its role as a consumer. Equivalently, the declining import share of parts and components suggests that direct demand may be playing an increasing role in PRC demand for imports from its neighbors, and therefore the PRC’s prospects to act as an engine of recovery and growth seem to have improved in recent years. Overall, the recent pattern of trade between the PRC and East and Southeast Asia indicates that the PRC may be becoming more of a consumer and less of an assembler in the region.

An important caveat in the declining share of parts and components in the PRC’s imports is the possibility that the PRC is moving up the technological and skills ladder to domestically produce more previously imported sophisticated parts and components. To the extent that this is happening, the falling share of parts and components reflects not so much the diminishing role of the PRC as the end point of the intraregional Asian production network as the intensification of PRC competitive pressures for the rest of Asia.

Furthermore, as said, the share of final goods in the PRC’s imports is at best an imperfect measure of the share of imported goods that are consumed in the PRC rather than reexported. Ditto parts and components. Therefore, while the declining share of parts and components in imports is significant and interesting, one must exercise a great deal of caution in interpreting this trend as evidence of a decline in the importance of derived demand relative to direct demand.

Within East and Southeast Asia, the decline in the share of parts...
and components in the PRC’s imports is most pronounced for the four high-income East and Southeast Asian economies (Figure 2.2.17). The share fell sharply from 50.2% in 1996 to 34.5% in 2008 for that group. This is significant because intra-Asian trade based on derived demand is most relevant for those countries. These countries as a group are technologically more advanced than the PRC and hence capable of producing high-tech parts and components that the PRC is not yet capable of producing. At the same time, their high labor costs render relocating the assembly stage of the production process most profitable. This explains why the share of parts and components is visibly higher in the PRC’s imports from the four high-income economies than it is for imports from other East and Southeast Asian economies.

Therefore, the fact that the decline in the share of parts and components is most visible for East Asian economies that are most likely to engage in vertical specialization with the PRC can be viewed as further evidence of a weakening of the PRC’s regional role as an assembler. But again, one must exercise caution in making such an interpretation to the extent that the decline in parts and components may be driven by the PRC’s closing of the technological gap with its more developed neighbors and producing more sophisticated parts and components. The share of parts and components in the PRC’s imports from other East and Southeast Asia has also declined (Figure 2.2.18) from 23.1% to 19.5% during 1996–2008, although not as sharply as for imports from high-income East and Southeast Asia.

Finally, despite East and Southeast Asia’s dominant role in developing Asia’s production fragmentation, the share of parts and components in the PRC’s imports from regional economies outside those two subregions is also quite high—averaging 33.2%. However, the share of final goods is far lower—averaging 16.6%—and the share of basic products is far higher—averaging 54.3% (Figure 2.2.19).

Trade balance between the People’s Republic of China and the rest of developing Asia

Another key trade indicator that can give information on the impact of trade with the PRC on the growth of other Asian countries is the trade balance. In an accounting sense, it is net exports rather than exports that capture the positive impact of trade on a country’s aggregate demand. Although trade is in and of itself beneficial, unbalanced trade—where one side exports disproportionately more to and imports disproportionately less from the other side—raises questions about the distribution of benefits. There are widespread concerns that the PRC’s massive trade surplus represents a large stimulus to the PRC’s own aggregate demand and hence growth but an equally large leakage of demand from the rest of the world. In fact, such concerns underlie the calls for protectionism against the PRC in the US and elsewhere. In short, trade balance with the PRC matters much to the rest of Asia in terms of the magnitude of the stimulus to demand and growth provided by trade with the PRC.

Table 2.2.1 shows that the PRC runs a trade surplus with East Asia. However, this surplus is mainly due to the surplus from its trade with Hong Kong, China, reflecting the special administrative region’s role as a major transshipment center for the Pearl River delta, which is the...
2.2.1 Trade balance with developing Asian economies, People’s Republic of China, $ billion, 1996 and 2007

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<thead>
<tr>
<th></th>
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<th>Basic products</th>
<th>Construction materials</th>
<th>Parts and components</th>
<th>Final goods</th>
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<td>-0.60</td>
<td>-11.74</td>
<td>0.15</td>
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</table>

Source: Staff estimates based on data from TradeData International Pty. Ltd.

hub of the PRC’s export-oriented manufacturing. If one excludes Hong Kong, China, the PRC runs a trade deficit with East and Southeast Asia. This deficit is primarily due to trade deficits with more developed East Asian economies such as Korea and Taipei, China. The PRC’s trade deficit with more developed East Asian economies, in particular Korea and Taipei, China, has been steadily increasing. However, whereas in 1996 most of the PRC’s trade deficit with Korea and Taipei, China occurred in the parts and components trade, by 2007, the final goods trade accounted for more of the deficit.

This change closely mirrors and is consistent with the declining share of parts and components in the PRC’s imports from the four high-income economies. The PRC has continued to run trade deficits with these economies in 2008 and 2009, but the projected deficits for 2009 are lower than for 2008 (Table 2.2.2). The PRC also runs a trade deficit with other East and Southeast Asian economies, but this is primarily due to trade in basic goods, especially in 2008 and 2009. The PRC runs a trade surplus in parts and components with other East and Southeast Asia and non-East and Southeast Asia, which supports the earlier argument that the PRC’s role as a regional assembler pertains primarily to high-income East and Southeast Asia. The PRC runs a trade surplus in final goods vis-à-vis these four economies. (Once again, however, this is mainly due to its trade surplus with Hong Kong, China. Excluding that economy, the PRC runs a large trade deficit in final goods with them.) The PRC’s final goods trade with other East and Southeast Asia is more or less balanced, and posts a surplus in final goods trade with non-East and Southeast Asia.

The overall pattern that emerges from the trade balance data is that, in striking contrast to its trade with the rest of the world, in particular with the US and EU, the PRC does not run a large and persistent trade surplus with developing Asia. In fact, once the PRC’s large trade surplus with Hong Kong, China is excluded (which reflects that economy’s role
as a transshipment hub), developing Asia runs a trade surplus with the PRC. This point lends further support to the argument that trade with the PRC provides a positive stimulus to demand and growth for the rest of developing Asia. The fact that final goods are accounting for a growing share of the PRC’s trade deficit with the rest of the region gives additional hope that the PRC is becoming less of an assembler and more of a consumer. At a minimum, the absence of a large imbalance in favor of the PRC should help to put to rest concerns that the benefits of intraregional trade accrue disproportionately to the PRC.

**The People’s Republic of China as an engine of recovery from the slump**

The trade data up to June 2009 were analyzed to see if there are any tangible signs that the PRC’s relatively healthy economy is helping the region recover from the global financial crisis and economic downturn.

Although the impact of the global crisis on the PRC’s own growth has been far from insignificant, the PRC continues to grow rapidly, with GDP growth for 2009 projected to be a robust 8.2%. This is in sharp contrast to the rest of the region, and indeed the world. The primary channel through which the PRC can help the region recover is the trade channel. Unlike the small open economies of developing Asia, the PRC has a sufficiently large domestic economy that can cushion the collapse of external demand and, it is hoped, provide a much-needed source of demand for its smaller neighbors as well.

Figure 2.2.20 shows the evolution of monthly global imports by major economies between January 2006 and June 2008. What is striking from the figure is that although the PRC’s imports collapsed along with those of other major economies until December 2008, they have rebounded sharply since January 2009. While the EU is also showing some faint signs of a recovery in imports, the signs are much clearer for the PRC.
fact, the PRC’s imports surged by 85% from $51.3 billion to $94.8 billion from January to July this year. Developing Asia and the rest of the world stand to benefit from the PRC’s reinvigorated appetite for imports.

More direct evidence about the PRC’s role as a regional engine of recovery from the global crisis can be found in data on trade between the PRC and East and Southeast Asia. The PRC’s imports from that group fell from $49.9 billion in July 2008 to $19.9 billion in January 2009 in line with the intensification of the crisis before rebounding to $37.4 billion by June 2009. PRC exports to East and Southeast Asia have also followed a similar pattern of decline and recovery but, significantly, the magnitude of the recovery in the first half of 2009 was much more limited, rising from $29.1 billion to $35.0 billion.

In this way, the PRC has been a significant source of additional net demand for the region in 2009. The pattern of import revival is similar in every grouping in Asia—high-income East and Southeast Asia, other East and Southeast Asia, and non-East and Southeast Asia. The biggest beneficiary of the PRC’s renewed appetite for imports between January and June 2009 was high-income East and Southeast Asia, which saw exports rise from $9.9 billion to $17.9 billion. Other East and Southeast Asia and non-East and Southeast Asia experienced more modest gains in their exports to the PRC—$3.5 billion and $0.4 billion, respectively—during the same period. Overall, Asian countries seem to have benefited substantially from the revival of PRC imports in the first half of 2009, which can be viewed as evidence that the PRC is leading the region out of the global crisis.

Overall, the analysis of the PRC’s trade patterns lends some support to the PRC-as-engine hypothesis. In particular, the share of final goods in the PRC’s imports from East and Southeast Asia has grown recently, and the share of parts and components has correspondingly declined. This suggests that the PRC’s direct demand for imports is growing relative to its demand derived from final demand in the industrial economies.

**Toward a broader trade openness**

The empirical evidence suggests that the PRC is not yet an independent source of demand and growth for East and Southeast Asia, but that it is beginning to become one. The VAR analysis indicates that, in the past, the superficially positive impact of the PRC’s imports on its neighbors’ output largely reflected the role of the PRC as an assembler of Asian parts and components for exports to the US. While such intraregional trade benefits the region by allowing for specialization and division of labor, it casts doubt on the PRC’s capacity to serve as an independent regional engine of recovery in the short run and of growth in the long run.

The analysis of more recent trade patterns between the PRC and its neighbors, however—in particular a secular shift in the composition of the PRC’s imports from parts and components toward final goods—suggests that the PRC is becoming more of a consumer and less of an assembler. This gives some hope that demand from the PRC can help offset the impact of extraregional shocks (such as the recent crisis) and provide its neighbors with an additional independent source of growth.

The rest of developing Asia could also benefit from greater
intraregional trade. This is especially true for South Asia where a large and fast-growing Indian economy has the potential to lift the entire subregion to a higher plateau through more intraregional trade.

The impact of the global economic slump on developing Asia’s growth is partly a result of two structural imbalances: in regional trade (overdependence on a few extraregional markets, especially the US); and in aggregate demand (excessive dependence on external rather than domestic demand). The resolution of one imbalance is bound up with the other. The emergence of a stronger and dynamic self-sustaining domestic economy will facilitate the growth of a more substantive intraregional trade based on final goods.

Regional policy makers can speed up intraregional trade in final goods by removing barriers to trade and taking other measures such as improving the transportation infrastructure. The Greater Mekong Subregion and Central Asia Regional Economic Cooperation are two examples of regional cooperation programs that are creating a conducive environment for intraregional trade. An even better strategy would be to liberalize trade with both intraregional and extraregional partners.

Whether the region continues to rely on an unreformed export-led growth strategy that is predicated on ever-rising extraregional demand for the region’s exports, or whether it moves toward a broader openness that relies more on domestic demand and intraregional trade, matters enormously for the welfare of the region.

Following the old strategy implies doing nothing and waiting for the US economy to fully regain its vitality, and points to a continued vulnerability to the US business cycle. It also implies a decline in the region’s long-term growth if the US appetite for imports shows a secular decline.

Adjusting toward a broader openness implies the self-enlightened pursuit of a more balanced growth strategy that enables domestic demand and intraregional trade to become more significant sources of demand and growth. This requires the removal of a wide range of deep-seated structural distortions on domestic demand and intraregional trade. Whether the region succeeds in its quest for a broader and more resilient trade openness will have a big influence on the success of its more fundamental quest for rapid yet stable growth.

Developing Asia is vulnerable to external shocks transmitted through the financial channel, as well as through international trade. On this front, too, there are ways to shield economies from such external blows.
Managing financial globalization

The recent pullbacks of capital inflows to developing Asia and sharp currency fluctuations in some of the region’s more financially integrated economies have brought renewed attention to the role and benefits of financial globalization. Although the adverse effects through the financial channel have been slight in developing Asia compared with those seen through the trade channel, financial stress was clear. Its spillover effects to domestic financial markets, however, have been limited and, for the most part, successfully managed.

In order to draw out critical elements of financial openness, the analysis here categorizes all developing economies into subgroups defined along two dimensions (Box 2.3.1). The first dimension has a financial globalization focus: How well is the economy integrated into international financial markets in terms of actual capital flows? The second dimension has a geographic focus: Is the economy in Asia?

The main group of interest is developing Asia’s highly integrated economies (Box 2.3.2). These 12 developing Asian economies have been the major recipients of capital flows to the region. Over the past two decades, nearly 90% of total regional capital inflows have been directed to them. In particular, they have been the dominant players in receiving FDI inflows, accounting for nearly 95% of the total. In addition, these 12 economies account for the vast majority of developing Asia’s GDP and foreign trade.

Drivers of capital flows

The highly integrated developing Asian economies have successfully attracted considerable foreign capital, both short-term funds and longer-term direct investment. However, year-to-year flows have fluctuated considerably—particularly in response to financial crises. Understanding the drivers of capital flows will help governments manage them better.

Capital flows during crises

Inflows and outflows. In developing Asia, capital inflows into the highly integrated economies were interrupted in 2008 as the global financial crisis deepened, resulting in a net capital outflow from the region (Figure 2.1.3 above). Portfolio and other investment flows, including bank loans, accounted for the decline, which was particularly notable in Hong Kong, China; India; Korea; and Taipei, China (Figure 2.3.1).

Nevertheless, total FDI inflows into developing Asia’s highly integrated economies increased in 2008, mainly because of the continued high rates of foreign investment in the PRC, but at a declining pace.
(Figure 2.3.2). The slowdown of inward FDI continued in the first quarter of 2009—especially in Korea; Philippines; Singapore; and Taipei, China, where electronics manufacturing and exports in general were hit hard. Direct investment abroad—outflows—in 2008 rose sharply from the group as a whole, dominated by investments made by the PRC. However, for those economies where contagion effects from the global slowdown were more pronounced, investment abroad eased. This continued into the first quarter of 2009. A similar pattern was also seen in cross-border mergers and acquisitions.

Comparing the crises. When one compares the global financial crisis and the Asian crisis, one key similarity that emerges is that FDI (both inflows and outflows) is more resilient to shocks than other forms of capital flows. Portfolio investment and bank loans saw sharper declines than FDI during the two crises, as well as higher volatility. Such resilience is shown by the coefficient of variation (the standard deviation divided by the mean). The coefficient of variation associated with FDI was by far lower than that for other forms of capital flows, especially during the two crisis periods (Figure 2.3.3).

Yet several clear differences between the two crises stand out. First, the breadth of the effect across economies in the region has been much wider in the recent global turmoil than in the 1997–98 crisis, though countries that have been hit hardest by the global economic downturn were also the most affected by financial tightening. The deteriorating external financing environment has halted much foreign investment, and is also affecting cross-border mergers and acquisitions.

Second, the response of FDI flows is quite divergent. In the earlier crisis, investors from outside developing Asia swooped in to buy assets for which prices had imploded, to the extent that FDI inflows to the region as a whole continued to increase. In contrast, in the latter crisis, developing Asia’s investors seized the opportunity to acquire cheap assets outside the region. This increased outward investment can be seen for PRC, India, and Thailand.

Third, even though the collapse of capital flows from the global turmoil has been more widespread than during the Asian crisis, strong financial institutions have served to shield the region from much of the damage. With solid indicators for nonperforming loans, risk-weighted capital adequacy, and ratio of loans to domestic deposits (Figures 1.3.1–1.3.3 in Part I), financial institutions have remained resilient to the recent stress. Moreover, the region’s huge holdings of foreign reserves have helped protect its exchange rates from speculative attacks.

Finally, quick policy responses during the turmoil helped minimize the adverse impact on the region’s economies. Many central banks expanded local currency liquidity support, guaranteed financial institutions’ liabilities, and injected capital into some banks. Current account surpluses, high sovereign ratings, and expanded deposit insurance also acted as buffers by supporting repatriation of capital and by allowing domestic lending to substitute for external lending. Moreover, central banks established dollar swap arrangements bilaterally with the Federal Reserve as well as cooperative swap arrangements within the region, which helped bolster confidence in local currencies.
Some conclusions. The trends mentioned above seem to underscore the importance of the following conditions in a country’s resilience to volatile capital flows in a financially globalized world: solid domestic institutions, especially in the financial sector; swift policy responses; and a sound macroeconomic environment with adequate reserves.

External versus internal factors
To what extent are capital flows determined by global events and to what extent do domestic policies matter? Both factors play a role, but if external events—the global factors—dominate, policy makers can do little to influence the flows of foreign capital. However, if internal conditions—the country-specific factors—drive capital flows, putting sound macroeconomic policies in place has heightened importance. The recent collapse of capital inflows to developing Asia raises the question of the relative importance of external and internal factors for the region.

In the analysis, external factors are proxied by growth prospects in the G3 economies as well as investment returns there. The internal factors include growth prospects; labor costs; level of human capital development; the business environment (including trade and financial openness); and adequacy of infrastructure in the highly integrated developing Asian economies.

Foreign direct investment. An estimation was carried out for FDI using bilateral data from the UNCTAD/Transnational Corporations database for 1994–2007. The sample comprises eight highly integrated developing Asian economies and 61 other countries, both industrial and developing.

In terms of attracting FDI inflows, the estimation results show that internal factors dominate. Yet external factors are still relevant. In the estimation period, a 1% increase in real income of G3 economies led to a 1.5% rise in FDI inflows in the highly integrated developing Asian economies (Figure 2.3.4), and this relationship held true even during the Asian crisis period. FDI inflows for this group come from G3 economies (around 30% of the total inflows into the eight countries); from developing Asia (around 35%); and from other countries, including offshore financial centers (the balance). The importance of the international production network reinforces the link between foreign investment returns and the growth outlook of the G3 economies.

In terms of outward FDI, growth prospects of the FDI home country (highly integrated developing Asian economies) generally play a key role. Although G3 markets have become a more important investment destination as investors from the region acquire strategic assets, around four fifths of total outward investment is invested within developing Asia. Over the past two decades, the PRC has emerged as a key destination for many developing Asian economies’ FDI, mainly because of its relatively low labor costs. Cambodia and Viet Nam have also emerged as new destinations for the same reason. The important consequence is that the relatively small proportion of strategic asset–augmenting investment results in a limited role for the G3 economies as a destination for developing Asia’s FDI.

Other forms of capital flows. Balance-of-payments data for the capital and financial account (specifically portfolio investment and bank loans)
were analyzed for the highly integrated developing Asian economies during 1990–2008. The growth prospects in the G3 economies and key regional trading partners are clearly separate in the estimation model. The model also includes the internal factors mentioned earlier.

In contrast to FDI, the estimation results show that G3 economies’ growth prospects significantly influence movements of portfolio inflows and bank loans. A 1% increase in G3 GDP leads to a 5.7% rise in bank loan inflows and a 5.4% increase in portfolio inflows. The relationship is stable before and after the Asian crisis. An increasing number of institutional investors, including insurance companies, pension funds, and hedge funds from the major industrial economies, ensure that the economic prospects of these economies affect portfolio and bank inflows. Of the internal factors, the country’s growth prospects, financial openness, the investment–saving situation, and risks and returns on investment are also important in affecting portfolio investment and bank loans, although the coefficients corresponding to these variables tend to be lower than those for G3 GDP growth prospects.

As regards outflows, a 1% increase in G3 GDP stimulates portfolio and bank loan outflows by 8.6% and 5.2%, respectively. Economic prospects of the home country as well as government policy, especially on financial liberalization, are also crucial.

Some conclusions. The results show that external factors—growth prospects in the G3 economies—are generally still crucial in determining movements of short-term capital inflows (portfolio investment and bank loans) into developing Asia but their impacts on long-term capital (FDI) are relatively limited—as seen in the recent financial crisis. The importance of such external factors may suggest that global and regional policy efforts could become more important for developing Asia to reap the benefits of financial globalization. Nevertheless, the estimation results point to the importance of internal factors, especially for longer-term capital, suggesting that country-specific factors are still crucial for attracting such capital flows.

Policy considerations for managing financial globalization

Establishing a governing framework that would allow greater financial openness cannot be made independently from other macroeconomic policy objectives. The extent of capital account openness needs to be considered in light of the government’s objectives for exchange rate and monetary policy. This interdependence—the so-called policy “trilemma”—sets up an inherent trade-off among policy choices. The policy choices that authorities make among the three elements also have implications for exchange rate management.

The policy trilemma

The idea of the trilemma posits that a country cannot have independent monetary policy, maintain a fixed exchange rate regime, and simultaneously remain open to foreign capital flows (Figure 2.3.5). If policy makers opt for fixed exchange rates and financial openness,
monetary policy must be sacrificed to maintain the peg. A financially open economy can pursue independent monetary policy, but the exchange rate will have to bear the brunt of adjustment. And independent monetary policy can only be pursued under a fixed exchange rate regime if the country erects barriers to insulate itself from foreign capital markets.

Policy choices are rarely absolute. For example, central banks that actively manage money supply to achieve inflation objectives may occasionally intervene in foreign exchange markets to manage the level of the exchange rate—essentially shifting between two sides of the triangle.

There are two approaches to measuring a country’s openness to financial globalization. One approach looks at actual cross-border financial movements, which were the main criteria used to identify the highly integrated economies in this analysis. This “de facto” approach looks at the quantity of foreign capital flows as well as the accumulation of external assets and liabilities. The other approach considers the country’s policy framework governing cross-border capital flows—in its essence. This “de jure” approach relies on an analysis of the capital account restrictions in place.

The two measures can give divergent views of a country’s openness to financial globalization. De facto openness indicators can fluctuate due to price and exchange rate changes, while de jure openness indicators do not reflect the degree of enforcement of the legal framework. With its focus on policy, the trilemma discussion below is anchored in the de jure approach.

Three trilemma indexes are constructed to illustrate the extent to which each policy is used in developing Asia (Aizenman et al. 2008). The monetary independence index considers how closely a country’s interest rates are correlated with a base country, that is, the country for which its monetary policy is most closely linked. The exchange rate stability index uses annual standard deviations of monthly exchange rates between the country’s currency and that of the base country. Finally, the capital account openness index is a composite measure encompassing the presence of multiple exchange rates, restrictions on current account transactions, restrictions on capital account transactions, and requirements to surrender export proceeds (Chinn and Ito 2008). All indexes range between 0 and 1, and higher values indicate greater use of a particular policy.

For highly integrated developing Asian economies, all three policies are pursued to a certain degree. After the late 1980s, convergence of these three indexes illustrates that progress in opening up the capital account went hand in hand with exchange rate stability and more monetary independence (Figure 2.3.6). In the immediate aftermath of the Asian financial crisis, monetary independence was sacrificed in favor of greater exchange rate stability. This shift in emphasis from monetary independence continued well after the economies had recovered, with the policies again converging in recent years.

Given that these highly integrated developing Asian economies take the middle ground, combining these policies is crucial, since each of them has merits and demerits. Monetary independence allows monetary authorities to have autonomy over macroeconomic management,
potentially leading to sustainable economic growth. Exchange rate stability can lead to price stability by providing an anchor, and lessen risk premiums by mitigating uncertainty, thereby fostering investment and international trade. However, greater levels of exchange rate flexibility could allow policy makers to use the exchange rate as a tool to absorb external shocks (Prasad 2008).

Financial liberalization is probably the most contentious policy among the three in having clear benefits or goals. Theory predicts that more open financial markets should lead to economic growth, and that economies with greater financial openness should be able to stabilize themselves through risk sharing and portfolio diversification. However, as financial liberalization increased its pace over the last two decades, financial openness was blamed for economic instability, particularly during crises.

**Financial globalization and output volatility**

How does financial globalization affect macroeconomic stability? On the face of it, there seems to be a positive relationship (Figure 2.3.7). The industrial economies and the highly integrated developing Asian economies have had much less volatile output than the rest of the world in the last 35 years. Volatility clearly jumps for the highly integrated Asian economies during the 1997–98 crisis, and yet the recent global financial crisis, with the drying up of liquidity in foreign capital markets, did not translate into a financial crisis within the region. This suggests a complex underlying relationship between financial globalization and stability.

Moreover, financial openness must be considered in tandem with the other policy elements of the trilemma: monetary independence and exchange rate stability. Regression estimates show the effect that the various pairwise combinations of the trilemma policies have on output volatility (Table 2.3.1). The model controls for other macroeconomic variables. Actual capital inflows (the de facto measures) are also included to test for the impacts on output stability. Estimates for two different country samples—all developing countries and highly integrated countries only—highlight the different way that the financial openness–output volatility link operates in the economies that receive most of the global capital flows from the developing world.

The estimates for all developing economies show that greater de jure openness tends to be associated with lower output volatility. Exchange rate stability by itself is found to have a destabilizing effect on output stability, that is, a statistically positive coefficient corresponding to exchange rate stability is revealed. However, the interaction term of this variable with foreign reserves is found to have a statistically negative effect, suggesting that countries can mitigate the destabilizing effect of pursuing greater exchange rate stability if they hold levels of foreign reserves of about 20% of GDP.

In terms of composition of capital flows, which are accounted for by the de facto variables, bank lending (part of other capital flows) and net portfolio investment have a statistically negative impact on output volatility. In other words, increases in net “other” capital inflows or net portfolio inflows destabilize output, reflecting the “hot money” argument regarding cross-border bank lending and portfolio investment. FDI flows do not necessarily destabilize the economy, though stabilizing effects do
2.3.1 Explaining output volatility with trilemma variables

<table>
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<td>Private credit creation</td>
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<td>Total reserves (as % of GDP)</td>
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<td>MI x reserves</td>
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<td>ERS x reserves</td>
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<td></td>
<td>(0.044)**</td>
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<td>Capital Account Openness (KAOPEN)</td>
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<td></td>
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<tr>
<td>KAOPEN x reserves</td>
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<td>Net FDI inflows/GDP</td>
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<td>Net portfolio inflows/GDP</td>
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<td>(0.122)**</td>
<td>(0.129)**</td>
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<td>Net ‘other’ inflows/GDP</td>
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<td>(0.029)**</td>
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<td>Short-term debt (as % of total external debt)</td>
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<td>Total debt service (as % of GNI)</td>
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<td>Adjusted R-squared</td>
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ERS = exchange rate stability; FDI = foreign direct investment; GDP = gross domestic product; GNI = gross national income; KAOPEN = capital account openness; MI = monetary independence.

Note: Robust regressions are implemented on combinations of trilemma variables defined as: (1) MI and ERS, (2) MI and KAOPEN, (3) ERS and KAOPEN; * significant at 10%; ** significant at 5%; *** significant at 1%.


not seem to be significant either. However, this effect is not present when the sample of highly integrated economies is considered.

Role of domestic financial markets

One hypothesis suggests that a country needs to have certain minimum conditions in place to reap the benefits of financial globalization. In particular, Kose et al. (2009) find that the structure of the domestic financial sector matters greatly in harnessing the benefits of financial globalization. A country needs to pass a threshold level of financial institutional development before it can derive the indirect benefits and reduce the risks of volatile flows. Mendoza et al. (2007) also find that countries with less developed financial markets may experience
welfare losses by liberalizing capital markets unless the liberalization is accompanied by other benefits such as the transfer of technology, speedier financial market development, and risk sharing, which take time to be realized. This evidence is supported by Kim et al. (2008) and Fujiki and Terada-Hagiwara (2007), particularly on the issue of risk-sharing benefits such as consumption smoothing, of which very little has been seen in developing countries.

To test this hypothesis, indicators of domestic financial market development were incorporated into the model. Among highly integrated economies, lower levels of financial market development were associated with higher volatility when capital account openness was pursued. This result held whether this openness was paired with monetary independence or exchange rate stability in the regression analyses. A similar exercise was conducted using de facto measures for three different components of capital flows. The results generally support the main findings previously discussed: an underdeveloped financial market combined with a more open capital account tends to destabilize the economy.

These results indicate that highly integrated developing economies need to be equipped with deep credit markets if they want to see the benefits of financial liberalization on their output volatility. Having a higher level of capital account openness and a deep credit market can yield a synergistic impact to damp output volatility, presumably by facilitating allocation of capital and ameliorating information asymmetry, thereby reducing the cost of capital. The worst and more significant case is that a country with shallow credit markets can exacerbate output volatility caused by financial liberalization.

Where do developing Asia’s economies stand in terms of financial development? Figure 2.3.8 compares the level of financial development, measured by different aspects of the financial markets, across different groups of economies. In the banking sector or stock markets, the financial development of the highly integrated developing Asian economies is quite comparable to that in industrial economies, but among less integrated Asian countries it lags behind. This implies that the highly integrated developing Asian economies could liberalize their financial markets and reap the benefits, especially in terms of reducing output volatility, while gains from opening up the financial market for the less integrated developing Asian economies could be limited.

Yet the picture is completely different in terms of bond markets. Underdevelopment of bond markets is found in both highly and less integrated economies in developing Asia. Clearly, in both private and public bond markets, there is still room for developing Asia’s economies to catch up with industrial economies.

**Managing foreign reserves**

Progress in financial globalization has manifested itself on the asset side of developing Asia in the past several years as accumulated foreign reserves. The region’s reserves are held primarily in the form of assets denominated in US dollars; the US dollar has been the dominant reserve currency in the region. This section revisits how foreign reserves have so
Obstfeld et al. (2008) argue that reserves accumulation is a key tool for dealing with domestic financial instability as well as exchange rate variability under a managed floating plus policy regime. In other words, a primary reason for a central bank to hold reserves is to protect the domestic banking sector, and domestic credit markets more broadly, while limiting external currency depreciation.

The same paper also points out that the need for such protection is much greater in countries with a fragile financial system and a currency mismatch. As most developing countries are forced to hold external liabilities in foreign currencies, the currency mismatch problem of external assets and liabilities is more serious than in industrial economies. With underdeveloped local currency bond markets, developing Asia is no exception.

One measure of reserves adequacy is the ratio of reserves to broad money (Figure 2.3.9). By this criterion, the picture is still mixed with most economies having less full coverage. Yet other traditional measures of reserves adequacy—short-term debt cover and import cover—show that developing Asia now has high levels of foreign exchange reserves (Figure 2.3.10).

While the high level of reserves was crucial to cushion against external shocks during the recent financial crisis, carrying excessive reserves entails costs due to its poor management (Bird and Rajan 2003).

Regional central banks have made efforts to reduce the need for holding excessive foreign reserves. In particular, extensive banking sector reforms, with strict enforcement of regulation and supervision, have proven to be a crucial factor to shield against the volatile flows seen over the last year or so. Meanwhile, development of local currency–denominated bond markets has been promoted, mainly to mitigate the risk of currency mismatch.

**Recent approaches**

In developing Asia, a combination of a strong current account surplus and (to a lesser extent) capital inflows has resulted in a large expansion in foreign reserves holdings. In reserves management, holdings can be categorized into two portions—one that prioritizes liquidity for precautionary needs, and one that focuses on earning returns over a medium- to long-term investment horizon in less liquid markets.

In fact, most economies in highly integrated developing Asia already meet the adequacy criteria suggested by conventional measures in terms of precautionary needs. These indicators include whether a country has sufficient liquid foreign exchange reserves to cover foreign currency debts payable within 1 year and whether reserves are sufficient in relation to import needs.

For the portion of reserves held for precautionary needs, holding highly liquid assets is appropriate. For this reason, the practice has been to hold US securities (such as dollars and Treasury securities) as these markets are the most liquid. In 2008, US dollar assets made up 64% of world reserves, although there has been some shift toward more diverse holdings. While the country breakdown of the currency denomination...
of foreign reserves is not available, the share of US Treasury security holdings as a share of total reserves does indicate that developing Asia’s reserves are largely in dollar-denominated assets. This level is more than what is warranted by precautionary needs. Consequently, either liquidity considerations are overemphasized in the region or alternative financial instruments are not available.

For the portion where liquidity considerations are less important, any asset class consistent with their risk and return objectives are potentially appropriate. This portion might be managed on the balance sheet of the monetary authority or through a separate entity, such as a sovereign wealth fund. Such funds have been set up as a natural reaction to increasing concerns over returns forgone when central banks keep their foreign reserves in safe and liquid but low-yielding assets. Except for Singapore and Hong Kong, China, where sovereign wealth funds have established histories, most of the funds in the region have been created in the last decade, the period that coincides with the rapid accumulation of foreign reserves in these economies (Table 2.3.2). Assets of these funds are transferred from foreign reserves with the aim of making more strategic longer-term investments and of securing higher returns. However, the role and portfolio size of such sovereign wealth funds have been limited so far.

The bulk of developing Asia’s reserves therefore appear to be managed very conservatively. Given the current medium- to long-term concerns over the US fiscal position, this is beginning to worry policy makers. How might reserves be more efficiently managed?

**Issues for better reserves management**

Demand for US Treasuries from developing Asia remains strong (Figure 2.3.11). Especially in view of the devastation of the Asian crisis, this conservative stance makes sense because the US dollar remains the centerpiece of any reserves management policy in which liquidity is a principal determinant. But with the worrisome US fiscal outlook, if liquidity is gained at the expense both of possible overexposure to a

<table>
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<tr>
<th>Economy</th>
<th>Name of fund</th>
<th>Year of inception</th>
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<tr>
<td>Singapore</td>
<td>Temasek Holdings</td>
<td>1974</td>
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<tr>
<td>Singapore</td>
<td>Government of Singapore Investment Corporation</td>
<td>1981</td>
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<tr>
<td>Brunei Darussalam</td>
<td>Brunei Investment Agency</td>
<td>1983</td>
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<td>Malaysia</td>
<td>Khazanah Nasional Bhd.</td>
<td>1993</td>
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<tr>
<td>Hong Kong, China</td>
<td>Investment Portfolio (Hong Kong Monetary Authority)</td>
<td>1998</td>
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<tr>
<td>Azerbaijan</td>
<td>State Oil Fund</td>
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<td>Kazakhstan</td>
<td>National Oil Fund</td>
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<td>Taipei, China</td>
<td>National Stabilization Fund</td>
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<td>Korea, Rep. of</td>
<td>Korea Investment Corporation</td>
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<td>Timor-Leste</td>
<td>Petroleum Fund</td>
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<td>Uzbekistan</td>
<td>Fund for Reconstruction and Development</td>
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<td>China, People’s Rep. of</td>
<td>China Investment Corporation</td>
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potentially depreciating dollar and of reduced reserves diversification, the advantage of the stance becomes less clear cut.

Indeed, current debates reflect these concerns, and the global financial crisis has created incentives for central banks to reshape reserves management. For example, some analysts advocate greater use of special drawing rights to promote greater diversification.

One major mechanism for the region to manage its reserves more efficiently is regional reserves pooling. In particular, multilateralization of the Chiang Mai Initiative (CMI) is designed to create a single regional reserves pool among CMI members, that is, ASEAN+3. CMI multilateralization received a big boost in May 2009 when CMI members reached agreement on the size of the pool, respective member contributions, borrowing conditions, surveillance mechanism, and other key details. The agreement will be implemented before the end of this year. Given its substantial size at $120 billion, the regional reserves pool may help discourage CMI members from building up excess reserves.

Asian local currency bond markets could also play a bigger role if central banks insisted less on liquidity, particularly for their medium- to long-term investments. There are efforts in train to help develop Asia’s bond markets, for example the Asian Bond Market Initiative under the aegis of ASEAN+3 and the Asian Development Bank, as well the Asian Bond Fund initiative under the EMEAP (Executives’ Meeting of East Asia and Pacific Central Banks group, an organization for central banks in the region).

Nonetheless, the limited size of the region’s local currency bond markets is preventing intraregional trade in financial assets from becoming more comparable to extraregional trade. The share of portfolio investments to neighboring countries more than doubled from 2000 to 2007, but only to 13% of total investments (Figure 2.3.12). Several practical implementation issues remain, which include the difficulty of access to markets such as the PRC, and the difficulty of reserves reallocation to increase Asian bond exposure.

Further development of local currency bond markets, both in size and accessibility, is crucial for three main reasons. First, it would provide additional financial instruments to diversify risks. Second, it would help reduce the risk of currency mismatch by allowing countries to issue debts in their own currency, which in turn would reduce the need to accumulate excess foreign reserves. Third, it would generate additional financial channels that would foster Asian intermediation of its savings, and make Asia more attractive to outsiders.

Concluding remarks and policy implications

Developing Asia is now a very different economic entity in terms of financial flows from what it was little more than a decade ago. This is seen clearly in the different effects of the Asian financial crisis of 1997–98 and the recent global financial crisis and slump. Inward FDI, for example, declined in the recent turmoil but increased in the earlier period as non-Asian investors took advantage of “fire-sale” assets in the region. The boot may now be on the other foot: cheap assets worldwide present an

![Image](2.3.11 Change in US Treasury holdings, August 2008 to June 2009)

*Note: Foreign official pertains to holdings of US Treasuries by foreign officials and institutions.

![Image](2.3.12 Intraregional portfolio investments)

opportunity for Asian economies to undertake outward FDI, and some Asian countries seem to be seizing it.

Despite the steeper collapse of capital inflows than during the Asian crisis, strong economic fundamentals in developing Asia, especially among its financial institutions, helped its economies successfully manage most of the adverse effects. Greater exchange rate flexibility and huge foreign reserves played a major role, as did quick policy responses.

Gaining access to external financing by opening up the capital market can be beneficial if it is advanced in a cautious manner, and if it moves hand in hand with the development of domestic financial markets. However, bond market development, in particular, has been playing only a limited role so far. Better management of foreign reserves requires further development of local currency bond markets both in size and terms of accessibility. Such a move is crucial for three main reasons: it would provide additional financial instruments to diversify risks; it would help reduce the risk of currency mismatch; and it would create a pool of funds and additional financial channels to finance investments in the region.
Maximizing the benefits of labor flows

Introduction

Developing Asia is a major provider of foreign workers and beneficiary of remittances. The region received more remittances than any other part of the world in 2008, and remittance flows to the region have become an increasingly important source of foreign exchange. According to official estimates, international remittances to developing Asia multiplied about 18 times in a two-decade span—from $9.3 billion in 1988 (about 1% of regional GDP) to $162 billion in 2008 (about 2% of GDP). Part of this increase reflects greater use of official channels to remit funds and the improved ability of central banks to record these flows.

The region has evolved into both a source of, and a host to, migrant workers. Recent trends reveal that Asian migrants are no longer restricting themselves to industrial-country jobs, and intra-Asian migration has become more pronounced (ADB 2008).

As with cross-border flows of goods and capital, the fallout from the global economic turmoil has undermined international migration. Declining employment in the major industrial economies, the Middle East, and the Russian Federation is tempering the demand for migrant workers from developing Asia. Unskilled and semiskilled workers in highly cyclical sectors such as construction, finance, manufacturing, retail, and tourism are being hit particularly hard.

The global recession is slowing remittance flows to the developing world. Remittances to all developing countries grew by only an estimated 15% in 2008, compared with 25% in 2007 and 15% on average annually in the decade before that. The World Bank forecasts a decline of 7–10% in remittances in 2009 (Ratha et al. 2009).

Developing Asia has not been immune to the slowdown in remittances since the onset of the tumult, and the deceleration is affecting most subregions (Figure 2.4.1). Countries in Central, South, and Southeast Asia—where remittances contribute substantially to economic activity—are particularly exposed. Yet developing Asia has not suffered as severely from decelerating international labor migration and remittance flows as it has from the collapse in trade and the slowing of financial flows. But there has been a decline in the new deployment of migrants from most Asian countries, a fact that may undermine remittance growth in the near term.

The recession has lifted international migration high on the agenda of governments in host countries, which are trying to protect employment opportunities for their own nationals. In this environment, migrant workers are facing increasing discrimination and rising hostility, since they are seen as depriving local workers of jobs. Their problems are compounded by the tightening of immigration rules in some host...
countries in response to increasing unemployment due to the economic slump. Some countries have restricted immigrants’ access to the labor market (by, for example, cutting the numbers of migrant work permits), while others are offering incentives for unemployed migrants to return home (such as paying the cost of a return flight). The restrictions are being imposed by host countries both outside and inside the region (Fix et al. 2009).

These restrictions limit opportunities for developing Asia to benefit from increased labor mobility and the deepening integration of labor markets. Worsened economic conditions back home and the financial and social costs of returning may force many migrants to stay in host countries. While remitters are employing various strategies to cope with the recession, such measures will be ineffective against an extended period of poor employment opportunities. The uncertain conditions of migrants are adversely affecting their families that rely on remittances. Slowing remittance flows may both drag down economic growth in countries that benefit heavily from remittances and raise the risk of greater poverty.

Remittances as an engine of growth and poverty reduction?

As a source of financial capital in poor regions, earnings sent home by migrants can favorably affect the receiving country’s growth prospects. Remittances have been shown to foster economic growth by spurring entrepreneurial activity, improving labor productivity, and stimulating consumption and investment. Such receipts also help smooth consumption and promote human capital development by increasing the capacity of households to spend on education, health, and nutrition. Furthermore, if they raise incomes of poorer households, these flows may well reduce poverty and income inequality.

Using data from 29 developing Asian economies for the period 1998–2007, Vargas-Silva et al. (forthcoming) examine the link between remittances and growth as well as the link between remittances and poverty. The results indicate that a 1% increase in the ratio of remittances to GDP leads to about 0.03% increase in the per capita GDP growth rate (Figure 2.4.2).16

Further analysis of the data for developing Asia showed significant poverty-reducing benefits of remittances, in terms of decreasing the poverty gap (the income by which families fall short of the poverty line, expressed as a percentage of the poverty line). For example, a 1% increase in remittances as a share of GDP decreases the poverty gap in developing Asian economies by about 0.05%.17

Analysis of household survey data in Bangladesh, Philippines, and Pakistan—three Asian economies that rely heavily on remittances—support the cross-country regression findings (Ahmed et al. 2009; Ang et al. 2009; Raihan et al. 2009). The three country studies consistently revealed positive effects of international remittances on household income, consumption, investment, and poverty reduction. However, the studies also showed that the poorest of the poor households (the bottom
20%) benefit least from remittances. This stems from such factors as the relatively high cost of migration and the specific requirements for migrant workers (for example, the need for host-country language competency or required job skills).

In light of the slower growth in remittance flows, the links discussed above suggest that poor households are more likely to remain mired in poverty as a result of the recent global downturn. Moving on from a household perspective, what is the impact of remittances on economies more widely, especially in terms of smoothing out shocks?

Remittances as a source of stability in foreign currency inflows?

Recorded remittances are in general less volatile than other nontrade foreign currency inflows, and often shore up macroeconomic stability (Figure 2.1.4 above). The three country studies show that remittances foster macroeconomic stability by supporting domestic demand.

Migrants’ remittances have been particularly responsive to major crises in their home countries. For instance, Sri Lanka reported a substantial increase in migrant transfers following the 2004 tsunami. This jump occurred despite poorly functioning financial channels at the time (as many important money transfer agencies and banks were closed for a long period in some areas because of the tsunami). Remittances played a similarly supportive role after the 2005 earthquake in northern Pakistan. Similarly, remittances to the Philippines generally respond to rainfall-related shocks or disasters.

Remittances are by far the most stable source of private foreign currency receipts. From 1990 to 2008, the coefficient of variation of remittance flows to developing countries was 0.77 as against 0.80 for foreign direct investment, 1.34 for private debt, and 1.17 for portfolio equity flows (lower values indicating more stable flows). Remittances are by far the most stable source of private foreign currency receipts. From 1990 to 2008, the coefficient of variation of remittance flows to developing countries was 0.77 as against 0.80 for foreign direct investment, 1.34 for private debt, and 1.17 for portfolio equity flows (lower values indicating more stable flows). 18

The stability of remittance flows can counter the effects of falling FDI, debt, and equity flows during an economic downturn in the recipient country. Figure 2.4.3 compares remittances with other private capital flows in the Philippines. The relative stability of remittance flows stands out in the figure, even when the global turmoil began in earnest.

While remittances are less volatile than other flows, can the stronger claim be made that they can help smooth foreign currency flows over the business cycle? Here, the evidence is mixed. Studies such as Chami et al. (2005) find strong evidence in cross-country data that remittances are countercyclical. However, the behavior of remittances depends partly on the motives for remitting. For example, Lueth and Ruiz-Arranz (2007) find that remittances in Sri Lanka are procyclical, increasing when economic activity in the home country accelerates.

The recent global turmoil has led to a synchronous recession of the major industrial economies, which has led to a slowing in growth in most economies in the world. In such extreme circumstances, it is not surprising that remittances, too, have suffered. As with employment generally, the effect of the global downturn on remittances may be most severe after a lag. For example, remittances to Tajikistan, the world’s
largest recipient in terms of GDP, are projected to fall by 35% in 2009, equivalent to a huge 15% of GDP. In contrast, Bangladesh, Philippines, and Pakistan experienced sudden spurts in remittance receipts in mid-2009. However, this may reflect repatriation of the savings of returning migrants. If this turns out to be the case, this upward blip may be a harbinger of slower growth of remittances in the near future as their source shrinks.

During the past two decades, the only noticeable period of sluggish growth in remittances was during the aftermath of the 1997–98 Asian financial crisis. Nonetheless, they were quick to recover and returned to their long-term growth path in a year. Since 1997, there has not been a single year in which aggregate remittances to the region decreased in comparison with the previous year. While there may be a drop in the immigrant population in industrial economies due to return migration (as a result of lack of good employment opportunities there), these migrants are likely to return to the host country once the global economy stabilizes (Papademitrou and Terrazas 2009; Fix et al. 2009). Estimates of the impact of the crisis on remittances (for example, Ratha and Mohapatra 2009; Calì and Dell’Erba 2009) point to a fairly fast resurgence of these flows.

Overall, although migrants are being affected by the global downturn, remittances have held up so far. Even if migration flows were to stop at some point, remittances would continue to flow for many years, though their growth would likely stagnate (Funkhouser 1995). Based on past crises, growth in remittances is likely to bounce back quickly during the ensuing recovery.

Maximizing the benefits of labor flows

Economic migration has become an increasingly important element of the global landscape, and Asian countries are well known net exporters of labor. In fact, the six main emigration countries in the region have over 100 million of their citizens living abroad. Moreover, remittances are a more stable source of foreign currency than many other nontrade sources.

In this light, developing Asia’s governments should maximize the benefits of labor flows by ensuring that the migration channel is kept open, by enhancing the safety and security of funds transfers to home countries (through strengthening formal transfer systems), and by providing an environment that encourages households to create assets through investing more of their remittance income.

Keeping open the migration channel

The global turmoil has led to rising unemployment in host countries, which are now showing increasing preference for employing their own nationals. These countries are also discriminating against foreign workers, who in some places are suffering from tighter immigration rules. Some migrants will see out the current downturn in their host country without a proper job, while those migrants who have already returned home are likely to go back once the global economy stabilizes. Until then, what can developing countries do to make the most of migration’s benefits?
One of the reasons for the relatively quick recovery of remittances after the 1997–98 crisis was the wide diversity of countries hosting migrants from developing Asia. Those regional countries that send their workers to a wide diversity of destinations will likely see remittance flows bounce back faster than other sending countries. Governments should therefore work to keep the channels for foreign workers open, which will help preserve that diversity. In addition, regional cooperation to avoid protectionist policies would enhance the mutual interests of both home and host countries.

Governments of countries such as Bangladesh, Philippines, and Pakistan have initiated policy actions to help migrant families cope with the adverse impact of the global downturn. Notable among these are online transfers to ease the remittance flows and public–private partnerships for skills development projects in Bangladesh; financial assistance, investment, and education support in Pakistan; and alternative livelihood programs for economically displaced returning workers in the Philippines. Other countries could consider similar moves.

Boosting formal remittance flows

Faster, cheaper, and more secure ways of sending remittances can facilitate greater remittance flows through formal channels. The evidence on the large volume of remittances worldwide and the impact of these flows on receiving countries has encouraged many receiving-country governments to closely follow the patterns of these transfers. This increased supervision and tighter enforcement is also a reaction to concerns regarding money laundering and the financing of terrorism groups.

In the past, official channels for remitting in Asia failed to meet the needs of many migrants and households. The advantage of unofficial channels is ease of accessibility for migrants in the host country and their ability to reach remote areas of the home country. Official channels, in contrast, are usually concentrated in large metropolitan areas.

The situation is improving. The cost of remitting through formal channels has been decreasing and, as a consequence, wire transfers now account for a larger share of transfers. The reasons for the reduction in the cost of remitting include increased efficiency and a larger network of formal channels that involve both state-owned and private banks. The latter have been attracted by the prospect of revenue from the transfers themselves and the possibility of providing banking services to migrants and their families.

Central banks can record these formal channel transfers much more easily than the sums that individuals carry. Governments need to take care not to create disincentives to using the formal financial system for transferring funds. Policies that raise the cost of remitting, such as heavy taxes, mandatory remittance schemes, or fixed exchange rate policies, encourage remittance black markets resulting in unrecorded flows.

Improving investment from remittances

Policies that encourage remittances for productive use require an improved investment climate that allows markets to work efficiently. A well-organized financial system would also allow remittance-receiving families to leverage remittances so as to access small loans for investment.
Longer term, a favorable investment environment would help direct remittances to productive investments such as smaller businesses. Improving legal aspects to lessen the financial cost of international migration and to provide access to potential migrants from the lower income groups can also increase the equity-enhancing effect of remittances.

Millions of dollars of remittances to households in Asia can make a significant dent in poverty. Encouraging the use of remittances not only for consumption but also for investment in areas such as health and education can enhance domestic demand and boost economic growth, as well as develop human capital, contributing to long-term growth. In addition, remittance-boosted household consumption will generate extra demand in the receiving economy.
Policies to achieve more balanced openness

Enhancing intraregional trade

Strengthening intraregional trade can help reduce developing Asia’s excessive dependence on exports to the US and other industrial economies, and so provide an additional engine of recovery and growth. Trade in parts and components seems to have accounted for much of the intra-Asian trade in the past, though more recent trends indicate trade in final goods beginning to play a more important role.

In particular, the PRC has seen an increase in the share of final goods and a corresponding decline in the share of parts and components in its imports. Thus it may well be starting to show some signs of promise as an independent engine of growth for the region. Given this budding promise, developing Asian economies should take the initiative to speed up its realization. Some of these measures will be purely national while others will require a degree of regional coordination. Three specific steps are as follows.

Strengthening domestic economies. National governments should aim for this through a wide range of rebalancing policies (ADB 2009). This objective involves demand-side policies that encourage households to spend more and save less, as well as supply-side policies that promote smaller companies and service industries catering to domestic demand. A dynamic and vibrant domestic economy in each regional country will naturally lead to more intraregional trade based on final goods.

Stronger domestic economies and more vigorous intraregional trade can then form a virtuous circle. The result will be a more resilient regional economy that is less vulnerable to the vicissitudes of the global business cycle. But without robust domestic economies that have strong demand for final goods, there will be a limit to the capacity of intraregional trade to serve as an engine of growth.

Creating a more conducive trade environment. Intraregional trade liberalization has been under way for some time in Asia, as evident in relatively low tariff and nontariff trade barriers, and a growing number of regional trade agreements. However, a wide range of border and behind-the-border obstacles to trade still prevents the region from fully realizing the potentially large gains from intraregional trade. For example, complex rules-of-origin requirements and burdensome customs procedures may discourage countries from trading with each other.

The failure of the multilateral Doha talks gives an even greater sense of urgency to removing behind-the-border obstacles to trade. Therefore, governments must take additional supportive and complementary trade-facilitation measures, such as simplification and harmonization of customs procedures, to convert the growing intraregional trade liberalization moves into an overall trade-facilitating environment. Furthermore, regional governments should improve the transportation infrastructure
and take other measures to reduce effective geographic distance. However, promoting intraregional trade should not come at the expense of weakening vital trade links with the rest of the world. A more benign overall trade environment will promote both intraregional and extraregional trade.

**Boosting regional cooperation.** National governments are ultimately responsible for their own policies and for removing policy distortions that impede their trade with neighboring countries. However, closer and more systematic regional cooperation can help create an institutional framework that is conducive for intraregional trade.

For example, the six countries of the Greater Mekong Subregion formed a program of subregional economic cooperation in 1992 to promote better economic relations among themselves. The program has contributed to, among other things, the development of infrastructure that facilitates the freer cross-border flow of goods and people. Such infrastructure includes the upgrading of a key highway between Cambodia and Viet Nam. Another example is Central Asia Regional Economic Cooperation, which brings together eight Central Asian republics. Such programs provide a natural forum for discussing a wide range of intraregional trade issues.

**Managing financial globalization**

The repatriation of capital flows and the virtual shutdown of credit markets brought the role of financial globalization to the fore. In contrast to the Asian financial crisis in 1997–98, developing Asia has managed the adverse impacts successfully, for the most part. It was supported in this by the much healthier domestic financial system and quick policy responses.

However, the financial turmoil highlighted the fact that the financial globalization of developing Asia is still only half way—both in terms of intra- and interregional integration. This imposes significant constraints on the region’s macroeconomic management and sustainable growth. To better harvest the benefits of financial globalization, four policy actions are emphasized.

**Shifting the composition of capital flows.** Longer-term capital, such as FDI, is more desirable than short-term investment, given its stabilizing properties. Policies toward improving the investment climate would support such a shift and promote benefits from capital inflows in general and FDI in particular. Although external factors (the G3 economies’ growth prospects) remain important for all types of capital flows, internal factors, especially supply-side capability, tend to be more important for FDI than for other capital flows. Thus, policies strengthening supply-side capacity and a country’s competitiveness are also important for supporting the composition shift.

**Strengthening domestic financial markets.** When countries open their capital account, they should not remove all associated restrictions quickly, since such opening needs to progress hand in hand with domestic financial market development. Some developing Asian economies have relatively deep credit markets, enabling them to harness the benefits of financial liberalization. Efficient stock markets are particularly useful in stabilizing an economy by complementing external financing.

**Formalizing cooperative financing mechanisms.** Temporary actions,
such as establishment of bilateral swap arrangements with the Federal Reserve and cooperative initiatives for bilateral swaps among Asian countries, proved useful recently. Formalizing regional and international cooperation would help improve access to liquidity when immediate needs arise. Creating a multilateral reserves pool under the Chiang Mai Initiative could also mitigate US dollar shortages, and would reduce the need for excess reserves. This policy would allow a country to gradually pursue a more flexible exchange rate with less concern for external shocks.

Developing a local currency bond market. Foreign reserves management has been conservative in developing Asia largely because of the limited development of national and regional securities markets, and partly because liquidity needs are overemphasized.

A local currency bond market in particular needs to be developed further, both in size and accessibility, so that developing Asia can diversify the region’s assets and avoid overexposure to dollar-denominated assets. A fully developed local currency bond market would also address the currency mismatch problem of developing Asia that has, arguably, caused the excessive holding of foreign reserves.

Maximizing the benefits of labor flows
With economic migration an increasingly important element of the global landscape and remittances a more stable source of foreign currency than many other nontrade sources, it is in the interests of both home and host countries to maximize the benefits of labor migration. It is vital, especially now, that the migration channel is kept open. In addition, the safety and security of funds transfers must be enhanced. And an environment that encourages households to create assets through investing more of their remittance income needs to be encouraged.

Keeping open the migration channel. With rising unemployment in host countries, some of them are discriminating against foreign workers, and developing countries need to work assiduously to keep the migration channel for workers open. In addition, regional cooperation to avoid protectionist policies would enhance the interests of both home and host countries. Policy actions to help migrant families cope with the adverse impact of the global downturn should be expanded to more countries.

Boosting formal remittance flows. Faster, cheaper, and more secure ways of sending remittances can facilitate greater remittance flows through formal channels. Indeed, the situation is getting better in this regard: costs of remitting through such channels have been falling. But governments need to take care not to disincentivize use of the formal financial system for transferring funds (by imposing, for example, high fees). Policies that raise the cost of remitting encourage black markets, leading to higher volumes of unrecorded flows.

Improving investment from remittances. The millions of dollars that households in Asia receive in the form of remittances can help reduce poverty. Encouraging the use of remittances for investment in areas such as health and education can enhance domestic demand and boost economic growth, as well as develop human capital. Efficient financial systems in remittance-receiving countries would also allow families to leverage the remittance income so as to access small loans for investment.
Endnotes
1 A large and growing number of studies have used disaggregated trade data to examine the structure of intra-Asian trade. See, for example, Athukorala and Kohpaiboon (2009) and Athukorala and Yamashita (2006).
2 Eichengreen et al. (2007), and Greenaway et al. (2008), for example.
3 For example, Brown and Linden (2005), Brown et al. (2004), and Sturgeon (2003).
4 As discussed in, among others, Kimura and Ando (2005), Ng and Yeats (2003), McKendrick et al. (2000), Borrus (1997), and Dobson and Chia (1997).
5 Park and Shin (2009b) give details about the data used in the empirical analysis.
6 The reconciliation between the two sets of SITC codes and HS codes is explained in detail in Park and Shin (2009b).
7 www.adb.org/gms and www.adb.org/care provide more information.
8 Cambodia and Viet Nam are excluded from this group in this analysis because of data limitations. For example, FDI data for Viet Nam from IMF and the CEIC database began in 1996, while portfolio investment began in 2005.
9 Apart from Malaysia and Indonesia. In the former, FDI inflows were relatively flat during the crisis while in the latter they declined.
10 The multilateralization of the Chiang Mai Initiative, which is expected to be in operation by end-2009, will allow ASEAN countries plus PRC, Japan, and Korea to draw from 50% (large countries) to 500% (small countries) of their contribution to a $120 billion multilateral reserves pooling arrangement.
11 Details of the estimation methodology and a fuller discussion of the determinants of capital flows are found in Jongwanich (forthcoming).
12 Cambodia; Indonesia; Taipei, China; and Viet Nam are excluded from this group in this analysis because of data limitations for bilateral FDI.
13 Firms undertake strategic asset-augmenting FDI to create or strengthen their competitive position by acquiring the proprietary assets of another foreign company, often in industrial economies.
14 Cambodia and Viet Nam are excluded from this group in this analysis because of data limitations.
15 The data and estimations are detailed in Ito et al. (forthcoming).
16 The evidence of the remittances-growth link using larger samples of countries is mixed. Barajas et al. (2009), for example, using similar estimation techniques to Vargas-Silva et al. (forthcoming), examined a dataset for more than 80 countries worldwide, and find no growth effects. However, Giuliano and Ruiz-Arranz (2009), analyzing data for about 100 developing countries, note that remittances promote growth in less financially developed countries and thus present another way of financing investment. Catrinescu et al. (2009) use a dynamic panel estimation to show that remittances exercise a weak positive effect on long-term macroeconomic growth, and the impact increases in the presence of sound economic policies and institutions.
17 Adams and Page (2005) find that there is a link between remittances and poverty reduction, but that remittances reduce the depth of poverty more than poverty headcounts. In a similar study using data for developing Asian economies for 1993–2003, Jongwanich (2007) finds that remittances have a significant impact on poverty reduction by raising income, smoothing consumption, and reducing the capital constraints of the poor. Similarly, Brown (2008), using counterfactual experiments, suggests that remittances are important in reducing poverty in the Kyrgyz Republic and Tajikistan, but less so in Armenia and Azerbaijan.
18 Official development assistance flows have, in fact, the lowest coefficient (0.33), but are not really comparable because they include expenditure planned sometimes years in advance.
19 Sayan (2006) shows that remittances to Bangladesh and India are countercyclical, though with a 1-year lag for India. Frankel (2009), using several multicountry datasets, notes that remittances respond negatively to the cyclical position of the receiving country.
References


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Subregional summaries

Central Asia

Subregional assessment and prospects
The global downturn is having asymmetric impacts on the eight countries of Central Asia. Growth in the countries with more open economies and greater links to international financial markets in general is slowing. For these countries, lower oil and other commodity prices, marked reductions in workers’ remittances and investment inflows, and difficulties in the banking sector have undermined growth. But hydrocarbon-exporting countries with relatively closed economies and capital markets (primarily Turkmenistan and Uzbekistan) have been more insulated from the deterioration in the global economy (Figure 3.1.1).

Monetary authorities in many countries in the subregion have allowed their currencies to depreciate because their major trading partners—externally the Russian Federation and internally Kazakhstan—devalued their currencies early in 2009. Economic circumstances faced by the subregion in 2009 are bleaker than anticipated in the Asian Development Outlook 2009 (ADO 2009) in March, and the Update revises down the earlier projections. In 2009, growth is now expected to be only 0.5%, from 3.9% earlier, and in 2010 a 3.6% expansion is now forecast, from 4.8%.

Through trade and financial linkages, the Russian Federation’s deep recession this year has severely crimped trade, investment, and workers’ remittances to countries in the subregion, often with a substantial depressing impact. According to that country’s central bank, remittances to the eight countries fell by about 25.5% year on year during the first half of 2009. Since remittances are a major source of income for some subregional countries, lower flows adversely affect domestic demand and are deteriorating current account balances.

Furthermore, even though no official statistics are available, many of the migrant workers from Kyrgyz Republic, Tajikistan, and Uzbekistan who are employed in the Russian Federation (and in Kazakhstan) have...
started to return home. This will likely force the governments concerned to increase expenditure on social safety nets.

The sharp drop in domestic demand, together with lower energy and commodity prices, has helped curb inflation pressures in the subregion. The Update takes down the inflation forecasts for all countries for this year, and revises down the subregional projection to 7.6%, from 10.6% in ADO 2009 (Figure 3.1.2). For 2010, the forecast is adjusted only slightly to 7.3%, from 7.8%, to reflect reduced domestic demand pressures, as revised gross domestic product (GDP) growth was edged lower.

Despite its recession, the Russian Federation has continued to provide significant official assistance to many countries. A notable example is the Kyrgyz Republic, which received a $300 million loan for budgetary support that the Government has stated will be used to finance infrastructure projects and support small and medium-sized enterprises through a newly established development fund. In addition, the Russian Federation is to provide a $1.7 billion concessional loan for a hydropower project and a $94 million debt-for-equity swap. In May 2009, Armenia signed a $500 million loan from the Russian Federation. This loan will have a substantial impact on the economy since it equals about 20% of the state budget for 2009.

The People’s Republic of China (PRC) is also having an effect on the subregion through official assistance as well as investment. It is, for example, Tajikistan’s second-largest source country for imports, mainly related to its funding of infrastructure projects. Likewise, its investment in a gas pipeline project from Turkmenistan through Uzbekistan and Kazakhstan to the PRC will increase foreign direct investment (FDI) in those countries during the construction stage and provide gas sales and transit fees in the future. The China National Petroleum Corporation has set up a joint venture with petroleum corporations in Kazakhstan and Uzbekistan for the pipeline’s construction. Most of the foreign investment in Turkmenistan, too, is from the PRC.

Compared with ADO 2009, the current account surplus for the subregion is revised to 1.9% of GDP (Figure 3.1.3) from 3.8%. This reflects lower surpluses for two major hydrocarbon producers—Azerbaijan and Turkmenistan—and a widening in Armenia’s deficit. For 2010, the surplus is taken down to 2.7% of GDP, from 3.4%.

Country highlights

Armenia

The adverse impact of the global downdraft has taken a far greater toll on the economy than predicted in ADO 2009. Contraction in mining and the sharp downturn in the Russian Federation—Armenia’s dominant economic partner—hit the economy through lower exports, workers’ remittances, and FDI inflows. In March, the authorities undertook a wide-ranging economic adjustment program that was supported by the International Monetary Fund (IMF) and others to counter these external shocks.

Even then, GDP contracted 16.3% year on year in the first 6 months of 2009, reflecting a more than 50% drop in construction activity, the growth engine in recent years. Reduced external and domestic demand
pulled down industrial output by 10.5%, mainly because of decreased output in the export-oriented mining and chemical industries, as well as construction materials. Given the severity of these developments, Armenia’s projected GDP in 2009 is now revised to a 9.9% contraction from the marginal 0.5% expansion forecast in ADO 2009. For 2010, growth of 0.9% is penciled in, down from 3.0% projected earlier.

The dram depreciated by about 20% after the 3 March announcement by the authorities that they were returning to a flexible exchange rate regime, limiting intervention to countering extreme volatility. Inflation spiked but fell back to low single digits, reflecting very weak domestic demand conditions. Projected inflation is now revised down, to 3.0% from 7.5% in 2009 and to 3.5% from 7.5% in 2010, owing to a much weaker economy than ADO 2009 expected.

Exports shrank by 48.2% year on year in the first quarter, with sharp reductions in mining, metals, and processed-food exports. During this period, imports contracted by 22.9%, primarily due to decreases in prices of intermediate goods and oil products, as well as lower domestic demand. The services trade deficit widened and private remittances dropped heavily, mainly attributable to the downturn of the Russian economy, bringing the current account deficit to 18% of GDP in the first quarter. Given the major impact of external developments, the Update revises its forecast for the current account deficit to about 13% of GDP in 2009 and 2010, from about 9% in ADO 2009.

Azerbaijan

Azerbaijan has been experiencing repercussions from the global economic turmoil through continuing weaker oil prices and declining foreign and private domestic investment. GDP growth fell to 3.6% year on year in the first half of 2009 as growth in industrial output declined to 1.0% and fixed capital investment contracted by 7.1%. The public investment program and social spending remain key sources of economic growth and employment, but budget resources are under pressure from the lower oil prices. Despite a marked reduction in the central bank’s refinancing rate, credit to the economy is being constrained by commercial banks’ difficulties in raising funding from abroad. Largely in view of these problems, the GDP growth forecast for 2009 has been taken down from 8.0% in ADO 2009 to 3.0% in the Update; for 2010, expansion in GDP is revised to 4.5% from 6.7%.

Consumer prices fell in the first half of 2009. Weak domestic demand presents a risk of deflation pressures, though these will likely be countered by higher public expenditure for salaries and pensions. With a weaker economic expansion now expected, full-year inflation is also adjusted from 12.0% to 4.0% for 2009; for 2010 the projection is left unchanged at 7.0%.

Hydrocarbon export volume is expected to rise in 2009 and 2010, partly because the Russian state gas monopoly, Gazprom, agreed to purchase Azerbaijan gas from 2010. However, since global oil prices are much lower than in 2008, revenues from hydrocarbon exports are falling sharply, and the trade and current account surpluses have deteriorated, despite decreased spending on imports because of shrinking public infrastructure investments and delays in capital expenditure by non-oil investors. The Update lowers the current 

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**Figure: Current account balance, Central Asia**

A graph showing the current account balance for countries in Central Asia from 2008 to 2010, with values expressed as a percentage of GDP. The graph includes data for Azerbaijan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. Sources: Asian Development Outlook database; staff estimates. Click here for figure data.
account surplus projections from 25.5% to 15.0% of GDP in 2009, while maintaining the 2010 forecast at 17.7%.

Georgia

The Update revises the GDP projection for 2009 from a 2.5% expansion to a 4.0% contraction and for 2010, growth from 6.0% to 2.5%. The economy was hit hard by the simultaneous shocks of the conflict with the Russian Federation in August and the global slump. The revisions reflect the 5.9% fall in GDP in the first quarter of 2009 and continued weakness in the second. Damaged infrastructure, falling exports, lower remittance inflows, a drop in capital inflows, and reductions in bank lending are major contributing factors.

Fiscal revenue is falling sharply due to the weakening economy. Even with some reallocation from less prioritized items to social and capital spending, the fiscal deficit in 2009 is projected at 9.4% of GDP. It is expected that the budget deficit will be supported by external assistance; IMF in August augmented funding available under its standby arrangement.

Due to weak domestic demand as well as lower food and energy prices, inflation trended lower to 2.3% year on year in June. Reflecting depressed economic conditions, the Update lowers the inflation projection in 2009 from 7.0% to 1.8% and maintains the previous forecast of 7.5% in 2010.

Weak demand from the United States (US) and Europe has resulted in a large fall in Georgia's major exports, including ferrous metals and copper, while depressed economic activity has caused imports to shrink. These developments are in line with ADO 2009's projections. The Update maintains the forecasts for the current account deficit at 18.8% of GDP in 2009 and 20.0% in 2010.

Kazakhstan

GDP contracted by 2.3% in the first half of 2009. The major factors were a sharp drop in manufacturing output and a weakening of domestic and external demand. Retail sales plunged and unemployment climbed. However, industrial production rebounded sharply in June to grow by 7.0% year on year and, on the basis of improvements in manufacturing and mining, the contraction appears to have bottomed. ADO 2009 GDP projections are now revised to a 1.0% contraction in 2009 from a 2.0% expansion earlier, and expected growth in 2010 is downgraded to 2.5% from 3.3%.

Despite capital injections early in 2009 from the state, distress in the banking sector has intensified, and three large banks are negotiating with external creditors to restructure their debts. The Government responded to macroeconomic difficulties (that at first stemmed from excessive offshore borrowing by banks to fund domestic lending and that intensified in 2008 with lower oil prices) with a $10 billion anticrisis plan, financed by the National Oil Fund.

The tenge was devalued by about 20% in February 2009, matching a January adjustment by the Russian Federation. Subsequently, the monetary authorities have successfully maintained a de facto peg to the US dollar at 150 tenge per dollar without major loss of foreign reserves.
The viability of the banking system is playing a critical role in helping the economy recover from the current downturn as well as maintaining a stable exchange rate. Fiscal policy in 2009 is expected to remain expansionary in view of the downturn in the economy.

Weak domestic demand offset price pressures from the devaluation, and year-on-year inflation fell to 6.9% in July from 9.5% at end-2008. In view of a much weaker economy than foreseen earlier, the Update eases the inflation projection for 2009 from 10.0% to 8.0%, but retains the 2010 rate of 6.4%.

Even though oil prices have advanced from their December 2008 low and oil export volume has increased, a much sharper drop in exports than imports reduced the trade surplus in the first 5 months of 2009 to $3.1 billion, compared with $14.4 billion for the same period in 2008. Because these developments are consistent with the prognosis outlined in ADO 2009, the forecasts for the current account deficit of 2.0% of GDP in 2009 and 0.5% in 2010 are maintained.

**Kyrgyz Republic**

The Update revises down the GDP growth projections, from 4.0% to 1.0% in 2009 and from 6.0% to 2.0% in 2010. During the first half of 2009, GDP grew by only 0.3% and industrial production fell by 18.9%, year on year. This slowdown reflected a power supply shortage in winter and adverse spillover effects from Kazakhstan and the Russian Federation through the trade, investment, and remittance channels. In particular, Kazakhstan's financial sector difficulties had detrimental effects through the large Kazakh bank branches in the Kyrgyz Republic.

Grant assistance of $150 million from the Russian Federation allowed the Government to conduct a countercyclical fiscal policy by increasing government expenditure, mainly on social safety net programs.

Due to lower oil, commodity, and food prices as well as a general slowdown in economic activity, inflation has trended down. The Update revises its inflation forecasts, from 15.0% to 7.5% in 2009 and from 12.0% to 9.0% in 2010.

The local currency, the som, depreciated by around 9.4% in the first half of the year. To prevent excessive depreciation, the central bank intervened extensively, mainly by selling US dollars. Nevertheless, foreign exchange reserves rose by about one third to $1.6 billion during the first half of 2009. IMF has approved disbursement of $25.5 million of a $100 million facility.

Even though exports fell in the first half of 2009, imports dropped by even more and the current account deficit narrowed. The Update lowers the projected current account deficit for 2009 from 10.0% to 8.5% of GDP and that for 2010 from 10.0% to 9.5%. This revision reflects the expected slower growth of the economy.

**Tajikistan**

The global downturn has strafed this economy, largely because remittances plunged by about 50% in the first half of 2009 relative to the same period in 2008. Industrial output fell by about 13% in the first half of 2009 with the drop mainly attributable to demand for the country’s major export—aluminum. Agriculture has been an engine of growth this year due to good
weather conditions. GDP growth projections given in ADO 2009 are now revised for 2009 from 3.0% to 0.5% and for 2010 from 4.0% to 2.0%, mainly because of lower than expected workers’ remittance inflows.

Inflation decelerated to 6.1% year on year in June 2009. Reduced domestic demand, reflecting the drop in remittances as well as the low commodity prices, exerted deflation pressure; this was countered partly by the depreciation of the local currency. The Update revises down the inflation forecast from 15.5% to 12.5% for 2009, while it maintains the ADO 2009 forecast for 2010 of 9.5%.

In April 2009, IMF approved a $120 million loan for Tajikistan under a poverty reduction and growth facility for 2009–2012. This is to implement structural reforms, particularly for strengthening governance in the central bank and for agriculture, while facilitating external adjustment through exchange rate flexibility.

Exports depend heavily on sales of aluminum, cotton, and power. Problems in power supply are hampering aluminum production which, along with lower commodity prices, is depressing export revenue, which will fall in 2009. However, import demand is expected to be contained and the trade deficit to narrow. These features were captured in the ADO 2009 forecast for the current account deficit and so the forecasts are retained, at 8.8% and 7.0% of GDP, in 2009 and 2010.

Turkmenistan
The Government is becoming more open to foreign investment in the hydrocarbon sector. This may benefit those investors from the PRC and the Russian Federation that already have business experience in the country. Natural gas exports will continue to be the main engine of growth. An explosion of the main gas pipeline to the Russian Federation in April halted gas exports, and this will pull back GDP growth in 2009. The Update revises down the growth projection for 2009 from 10.0% to 8.0%, leaving unchanged the projection for 2010 at 10.0%.

The Update maintains inflation forecasts for 2009 and 2010 of 12.0% and 10.0%. The drop in global non-oil commodity prices gave rise to deflation pressures, which were partly offset by the increase in administered fuel prices and transportation costs.

The slowdown of gas exports will lower the trade surplus, and the Update revises down the current account surplus projections from 35.0% to 30.0% of GDP in 2009 and from 35.0% to 25.0% in 2010.

Uzbekistan
Despite a slowdown from 2008, growth was robust in the first half of 2009 (according to official statistics) at 8.2% year on year. Since construction activity is expected to slow in the second half, the Update maintains the ADO 2009 growth projections of 7.0% in 2009 and 6.5% in 2010.

The Government responded early to the global downturn and to reduced commodity export prices by putting into place a large-scale anticrisis fiscal expansion program that is yielding positive results. The central bank’s $400 million recapitalization of six major commercial banks spurred lending in rural areas. Moreover, the Government set up a $600 million investment program, financed by the Fund for Reconstruction and Development (the country’s sovereign wealth fund).
Investment contributed to 9.9% growth in industrial output and 142% growth in construction services in the first half of 2009.

Official statistics indicate that inflation in the first 5 months of 2009 was 4.5%, below the Government’s annual forecast of 7.9%. Global disinflation in consumer goods prices and a state-imposed cap on increases in utility tariffs helped alleviate price pressures. The Update maintains its 2009 forecast at 12.5%, while revising down the 2010 forecast from 13.0% to 11.0%.

The trade surplus narrowed as a result of a 4.8% decline in exports and a 24.1% increase in imports during the first 5 months of 2009. Imports rose due to higher demand for capital goods caused by intensified public and private infrastructure development. However, it is expected that rising demand for gas in Europe and a continuing high gold price will boost exports in the second half of 2009, allowing the country to sustain a strong trade surplus. The Update maintains the ADO 2009 current account surplus forecasts of about 11.0% of GDP for 2009 and 2010.

**East Asia**

**Subregional assessment and prospects**

Subregional economic growth will slow in 2009, but not as much as was forecast in ADO 2009. The biggest of the five economies in East Asia—PRC and Republic of Korea (hereafter Korea)—are performing better than was expected in March. Consequently, subregional GDP is now forecast to increase by 4.4% (Figure 3.1.4), revised up from 3.6%.

Nevertheless, the global financial crisis and slump in world trade have seriously dented growth in this subregion, which relies on export-oriented manufacturing to drive much of its expansion. The growth forecast for this year is less than half the rate of 2006–2007. Indeed, the forecasts for the three other East Asian economies—Hong Kong, China; Mongolia; and Taipei, China—are downgraded from ADO 2009. Economies will contract relative to 2008 in Hong Kong, China; Korea; and Taipei, China. GDP is expected to increase only a touch in Mongolia. Subregional growth this year is attributable to the PRC.

When world trade dwindled in late 2008–early 2009, merchandise exports plunged in all five economies. In Taipei, China, for example, exports dropped by 34.2% in the first half of 2009, and in Korea they fell by 22.7%. In reaction, manufacturers cut production, laid off staff, and delayed expansion plans. All these actions depressed investment and consumption, particularly in the first 3 months of 2009.

The PRC and Korea implemented particularly effective fiscal stimulus packages that kick-started domestic demand. Strong fiscal and debt positions in both countries enabled them to boost government spending and reduce some taxes. The PRC coupled fiscal stimulus with a very aggressive monetary stance, flooding the banking system with liquidity.

Taipei, China and Hong Kong, China also rolled out fiscal stimulus measures to varying degrees. However, Mongolia, which had run a procyclical fiscal policy during the commodity boom in recent years, faced a severe fiscal squeeze when global prices of commodities dived,
slashing its government revenue. The bigger economies also lowered interest rates as the economic downturn deepened. Partly as a result of these actions, there were indications that the downturn in East Asia reached a trough early in 2009.

Aggregate GDP growth in the subregion is forecast to speed up considerably next year, to 7.1% (raised from 6.5% in ADO 2009), based on the expected pickup in global trade, improvement in financial markets, and stronger domestic demand. Fiscal and monetary stances are expected to be expansionary, although not to the same extent as in 2009.

All five economies are projected to grow in 2010, with the PRC’s expansion rate now forecast at a vigorous 8.9%, supported by the continuation of its large fiscal stimulus. Growth in other economies will likely be suppressed by the projected modest recovery in industrial-country export markets. The Korean economy is forecast to expand by 4.0% next year, while growth in Hong Kong, China is put at about 3% and in Taipei, China at 2.4%, modest rates given that these economies will shrink in 2009, setting low bases from which to recover.

External accounts in East Asia are in surplus, except in Mongolia, where the drop in prices for its commodity exports will contribute to a current account deficit of 6–7% of GDP in the forecast period. In some economies, imports fell more sharply than exports in the first half of 2009, mainly a result of much lower prices for oil and commodities than in 2008 and a reduced need to import inputs for manufacturing industries. A substantial subregional current account surplus equivalent to 7.0% of GDP is projected for 2009, easing to 6.0% in 2010 as import growth picks up (Figure 3.1.5).

Inflation has faded this year: the subregional rate is forecast at just 0.2% (Figure 3.1.6), revised down from March. Consumer price indexes will fall a little from 2008 levels in the PRC and Taipei, China. (Again, Mongolia is an anomaly: its inflation has decelerated from over 20% in 2008, but is expected to remain in double digits.) The forecast for East Asian inflation next year is raised to 2.6%, mainly because PRC inflation is revised up to 3.0% in view of its highly expansionary monetary policy in 2008 and faster GDP growth than previously anticipated.

## Country highlights

### People’s Republic of China

Expansionary fiscal and monetary policies spurred a lift in economic growth to 7.9% in the second quarter of 2009 from a two-decade low of 6.1% in the first quarter. Growth for the first half was 7.1%. Investment in fixed assets soared in the second quarter, reflecting the impact of the large fiscal stimulus and rapid credit expansion. Industrial production picked up in that period too, as firms rebuilt inventories after a significant destocking that stemmed from the impact of the global economic slump. Consumption also rose, underpinned by rising household incomes and government subsidies, particularly for rural areas. However, a decline in net exports acted as a drag on growth through the first half.

The aggressive monetary stance adopted in late 2008 sparked a huge surge in new lending, equivalent to around 50% of GDP for the first 6 months of 2009. State-owned enterprises and large businesses
tapped most of the new lending. The fiscal stimulus measures, valued at CNY4 trillion, include extensive public investment and subsidies to farmers and some industries.

Public investment is expected to remain at high levels under the fiscal stimulus that runs through 2010. Private investment, though, may remain subdued, particularly in manufacturing, until external demand improves significantly. The Government proposes to increase access to credit for small and medium-sized enterprises, which should boost private investment. A recovery under way in the property market is sparking growth in construction. Robust growth is seen for consumption now that the labor market is recovering after rounds of layoffs seen late in 2008 and early 2009.

Taking these influences into account, the GDP growth forecast for 2009 is upgraded to 8.2%, from 7.0% in ADO 2009. Maintenance of the fiscal stimulus and a likely moderate recovery in the global economy in 2010 is seen lifting the PRC’s growth rate next year to 8.9% (revised from 8.0%).

The authorities fine-tuned monetary policy from July 2009, and growth in new lending eased in July and August. It is assumed that policy will be tightened somewhat when inflation returns and economic growth can be sustained without such a highly stimulatory monetary stance. If the monetary stimulus were to be pulled back faster than assumed, there would be a risk of an unintended abrupt slowing in growth. The challenge is to balance the need to maintain the monetary stimulus against the risks of the flood of bank lending, if extended for too long, becoming diverted into unproductive purposes, such as speculation in stocks and property and a misallocation of resources that erodes bank asset quality.

Merchandise exports fell by about 22% in the first 7 months of 2009, and imports dropped by about 23%, but the pace of the monthly declines bottomed by midyear. Trade surpluses look likely to be smaller than expected in March, and the forecasts for the current account are revised down slightly to a surplus of 7.1% of GDP this year and 6.5% in 2010. Nevertheless, foreign exchange reserves are expected to rise to $2.6 trillion by end-2010.

Lower food prices and increases in food production were largely behind a 1.2% year-on-year fall in the consumer price index during the first 7 months of 2009. For the whole year, the index is forecast to decline by 0.5% (revised from a rise of 0.8% in ADO 2009). Considering the pickup in growth, low-base effect from a deceleration in inflation late in 2008, and large monetary stimulus, the index is expected to turn upward by the end of 2009, and to rise by about 3.0% during 2010 (this forecast is also revised up).

**Hong Kong, China**

Buffeted by the global financial crisis and the slump in world trade, this economy, which is based on trade in goods and services (particularly trade, travel, and financially oriented services), contracted for three consecutive quarters, year on year. The pace of contraction eased considerably in the second quarter of 2009 from the first, to 3.8% from 7.8%. For the January–June period, GDP fell by 5.8%, with private consumption and fixed investment both declining.
Employment stabilized in the second quarter, slowing the pace of increase in the seasonally adjusted unemployment rate (it was 5.4% in the second quarter compared with 3.3% a year earlier). Wages remained under downward pressure through the first half.

The better second-quarter performance (GDP rose by 3.3% on a sequential basis) was attributed to a quickening of growth in the PRC and was assisted by fiscal stimulation measures taken in Hong Kong, China. Public sector investment is expected to pick up in the second half to provide some offset to slack private investment. The stock market rose by 37.1% in the first 8 months of 2009 and the market for residential property is strengthening, supported by low interest rates.

However, the sharper than expected GDP decline in the first half has led to a revision in the forecast for the full-year GDP contraction to 4.0%, from 2.0% in ADO 2009. Modest growth of about 3.0% is projected for 2010, when world trade in goods and services will likely be much more robust.

Inflation decelerated to 0.5% in the first 7 months of 2009, a result of lower prices for imported oil and food, muted domestic demand, and a temporary subsidy for household electricity bills. For the whole of 2009, inflation is expected to be about 1.0%, edging up to about 2.0% in 2010. Substantial current account surpluses of about 10% of GDP are projected for both years.

**Republic of Korea**

GDP declined for three consecutive quarters, year on year, through mid-2009. However, the pace of contraction slowed considerably in the second quarter of 2009, to 2.2% from 4.2% in the first. For the first half of the year, the economy contracted by 3.2%.

Recession in major industrial economies and a consequent fall in Korea’s exports was the immediate cause of the downturn. This external shock spread to already sluggish private consumption and fixed investment: in the first half of 2009 the former fell by 2.6% and the latter by 5.1%. In contrast, government consumption spending rose by 7.2% as budget disbursements were stepped up. Also, the Government rolled out a substantial fiscal stimulus package to temper the economic downturn.

Exports of goods and services in volume terms slid by about 7% in the first half, but imports shrank at double that rate, boosting net exports. Exports received some support from a significant depreciation of the won against the US dollar in 2008.

Among signs that a rebound is under way, private consumption, fixed investment, imports, and exports all increased in the second quarter relative to the first. In July, the index of industrial production broke through its prior-year level for the first time this year, and the seasonally adjusted unemployment rate eased to 3.8% from 4.0% in June (although it was still 0.6 percentage points higher than its year-earlier rate). Indexes of business and consumer confidence also turned up early this year.

These indicators point to a stronger recovery than was previously anticipated, and the GDP forecast for 2009 is revised to a shallower contraction of 2.0% from 3.0%. Growth is expected to resume in 2010 at about 4.0%, reflecting a likely recovery in both external and domestic demand.
Merchandise exports in US dollars fell by 22.7% in the first 6 months of 2009, but this was more than offset by a drop in imports of 34.5%. The outcome was a first-half trade surplus of $20.8 billion and a current account surplus of $21.8 billion, compared with deficits in the same period of 2008. A current account surplus equivalent to about 5% of GDP is expected for 2009, and a surplus of 3% in 2010, both revised up.

Inflation eased to 2.2% year on year in August 2009, from 5.6% in August 2008. The forecasts for this year and next are raised to 2.5%. The easing of inflation helped clear the way for the Bank of Korea to reduce its policy interest rate in five steps to 2.0% from October 2008 to February 2009 in a move to stimulate economic activity.

**Mongolia**

The slump in commodity prices that accompanied the contraction in world trade hit the economy hard, slashing both export earnings and government revenue, and requiring major policy adjustments. The global price of copper, Mongolia’s main export, tumbled by 65% in the 12 months to March 2009, while prices of its other main exports, such as cashmere, coal, crude oil, and zinc, also dropped.

Macroeconomic policy had been overly expansionary and procyclical during the commodity boom years, leading to internal and external imbalances. In 2008 relative to 2007, the current account switched from a surplus equivalent to 6.7% of GDP to a deficit of 9.6%, and inflation soared from 7.5% to 26.8%. Furthermore, the commodity-driven boom-bust cycle, in combination with rapid credit expansion and poor regulation and supervision, caused serious stresses last year in the banking sector.

The Government in March 2009 reached agreement to adjust fiscal, monetary, exchange rate, and banking policies, supported by a $229 million loan under an 18-month standby arrangement with IMF. Other development partners pledged $170 million in funding.

After a weak first quarter, GDP grew slightly in the second quarter of this year. Copper prices have rallied and the price of gold, another export, has strengthened. The GDP forecast for the whole of 2009 is for growth of 2.8% (compared with an average of 9% in recent years). Growth is seen picking up modestly to 4.3% in 2010. Both forecasts are revised down slightly from ADO 2009.

Merchandise exports collapsed by about 37% in US dollar terms in the first 7 months of 2009, mainly a result of lower prices for commodity exports. Imports fell by about 40% in this period, with imports of industrial inputs particularly weak, reflecting slack industrial production. The trade deficit and the current account deficit narrowed in the second quarter. For the whole year, the current account deficit is forecast to narrow from 2008 to about 7% of GDP, and to about 6% in 2010.

Lower prices for imported food and fuel, plus the downturn in domestic demand, caused inflation to decelerate to 4.7% year on year in June 2009, from a peak of 34.2% in August 2008. Inflation for 2009 is forecast at 10.0%, easing to just under 8% next year.
Taipei, China

This economy, which depends heavily on exports of machinery and electronic products, contracted year on year for four consecutive quarters through mid-2009. GDP went down by 8.8% in the first half of 2009 from the same period of 2008, the steepest contraction for this period in East and Southeast Asia. Exports and imports both fell by more than 20% in volume terms in the first 6 months, and fixed investment plunged by about 28%. Private consumption was weak, hurt by a deterioration in the labor market (the unemployment rate rose by 2 percentage points to 6.1% in July 2009 from a year earlier). Only public consumption recorded growth on the demand side.

The downturn reached a trough in the first quarter, when GDP plunged by 10.1%. In the second quarter, private consumption stabilized and the pace of decline in trade and investment eased, moderating the GDP contraction to 7.5%. Typhoon Morakot, which hit the island in early August, left more than 700 people dead or missing and inflicted damage to agriculture, infrastructure, and tourism. Its impact on GDP in 2009 will depend on how fast reconstruction efforts get under way.

Fiscal stimulus measures have been implemented to support both consumers and businesses, and the monetary authorities cut the policy interest rate by a total of 238 basis points to 1.25% from September 2008 to February 2009. The economic performance began improving in the second half of 2009, but in view of the steeper than expected first-half decline, the full-year outcome is expected to be a contraction of 4.9%, worse than was projected in ADO 2009. Growth is forecast to resume in 2010 at 2.4%, based on a pickup in global demand and supported by strengthening business links with the robustly expanding economy of the PRC.

While merchandise exports slumped by 34.2% in the first 6 months of 2009, imports crashed by 42.3% as demand shrank for imported intermediate goods for the export industries and as prices fell for imported oil and commodities. The trade surplus nearly doubled from the year-earlier period. The forecast for the current account surplus is revised up to 9.1% of GDP for this year, easing to 7.9% in 2010 as imports bounce back.

Weak domestic demand and lower prices for imported oil and commodities pulled the consumer price index below prior-year levels from February to August this year. The index is forecast to fall by 0.7% in 2009, and to rise by only 0.2% in 2010.

South Asia

Subregional assessment and prospects

Although South Asia is less integrated in the global economy than East Asia and Southeast Asia, the global financial crisis and economic downturn have still had an impact on the subregion, via two main channels: capital outflows and limited access to financing; and weak external demand. Capital began to flow out right after the financial crisis intensified in September 2008, particularly from India and Sri Lanka.

Regional economies faced a sudden reversal of portfolio investment associated with the sharp drop in equity prices in the major stock markets in the region, particularly India and Sri Lanka, which have
relatively more advanced financial systems and substantial international investments. Many of them also had difficulties in accessing normal trade finance. Moreover, cross-border bank lending fell, reflecting the deleveraging process by major international banks.

Quarterly balance-of-payments data show that both India and Sri Lanka suffered from a net outflow in their financial accounts—$4.3 billion and $5.3 billion for India, and $1.1 billion and $0.3 billion for Sri Lanka, during the fourth quarter of 2008 and the first quarter of 2009, respectively. As a consequence, many investment projects in these two countries were suspended due to lack of private funding. Many ongoing projects financed by short-term funding have also been put on hold as such funding has not been rolled over. Since March 2009, stock indexes in India and Sri Lanka have rallied along with most markets worldwide. There has been some recovery in portfolio investment, reflecting a recovering risk appetite among global investors. However overall, capital inflows have not marked a substantial recovery, and cross-border commercial bank lending remains restricted. Bangladesh and Nepal, in contrast, did not experience significant capital outflows.

Weak external demand exerted its impact on South Asian economies as industrial economies fell into recession. Merchandise exports contracted in India, Nepal, Pakistan, and Sri Lanka, while Bangladesh export growth slowed substantially over the year through June 2009. The Maldives saw a drop in tourism.

Workers’ remittances, which play a major role in Nepal, Bangladesh, Sri Lanka, and Pakistan (accounting for 20%, 11%, 7%, and 5% of GDP, respectively), have shown considerable resilience to date compared with exports, supporting domestic consumption demand and the current account. Remittance growth slowed but has maintained double-digit growth in Bangladesh and Nepal, although in Sri Lanka, remittances expanded by about 5%. Weak external demand (together with a power supply deficit in some countries) is reflected in regional countries' manufacturing indexes, with year-on-year growth turning negative in Pakistan, while in India and Sri Lanka industrial production decelerated, almost reaching zero growth in early 2009.

Reflecting the downward trend in industrial production in the year through March, GDP growth slowed to 2.5% in Sri Lanka during its first quarter of 2009, while India maintained 5.8% growth during the January–March quarter and saw an improvement to 6.1% in the April–June quarter, although demand-side indicators showed slowing private consumption and investment. In all countries except Afghanistan, statistical indicators show a marked decline in economic activity from 2008 levels.

While the global economic difficulties had a significant adverse impact on India, Maldives, Pakistan, and Sri Lanka, it was somewhat less on Afghanistan, Bhutan, Bangladesh, and Nepal. Central banks in South Asia generally adopted more accommodative monetary policy and lowered policy rates to promote private investment and boost growth, the decline in inflation pressures from falling commodity prices bolstering their room for action. Countries with a currency peg to the Indian rupee (Bhutan and Nepal) have been able to benefit from the accommodative monetary policy stance followed by the Reserve Bank of India.
Some countries adopted fiscal stimulus measures to complement monetary policy. Bangladesh announced a stimulus package in April 2009 (worth 0.6% of GDP). Measures include increased subsidies in agriculture; enhanced cash incentives for recession-affected sectors such as jute, leather, and frozen food; and higher allocations for social safety net programs. The budget for FY2010 continued these measures, expanding their size by 0.8% of GDP.

India’s three stimulus packages (announced in December 2008, and January and February 2009) have general interventions with policy measures that include a substantial cut in their value-added, service, and excises taxes; additional infrastructure and social safety net expenditure; measures to support an infrastructure financing institution; and an increase in the state government borrowing limit. India’s revised federal budget for FY2009 announced in July 2009 continued its expenditure-led growth strategy.

Pakistan announced a large increase in its public sector development program (PSDP) in its FY2010 budget, about 62% over the actual PSDP in the previous fiscal year. Sri Lanka also announced two stimulus packages: one in December 2008 and the other in May 2009 (worth 0.2% and 0.4% of GDP, respectively), which targeted the flagging tea, rubber, cinnamon, and garments export sectors for incentives (as well as including a fertilizer subsidy), and boosted rewards under an export development program.

South Asian economies suffering from structural constraints prior to the global turmoil and weak macroeconomic fundamentals have proven to be more vulnerable to external shocks and have more limited policy options to counter the global economic downdraft. In early 2008, many countries used fiscal measures to mitigate the pass-through of higher international commodity prices (especially for oil, fertilizer, and basic food) at substantial cost.

Large fiscal deficits in Maldives, Pakistan, and Sri Lanka have led to acute external imbalances and large losses of international reserves. In August 2009, IMF announced a staff-level agreement with the Maldives for a standby arrangement. In November 2008, IMF provided a $7.6 billion emergency financing package to Pakistan (which was augmented to $11.3 billion in August 2009). Sri Lanka also sought IMF assistance and a $2.6 billion standby arrangement was approved in July 2009.

The South Asian GDP growth projection is revised upward to 5.6% in this Update from 4.8% in ADO 2009 (Figure 3.1.7). This reflects the improved growth prospects in India (which accounts for 80% of GDP in South Asia), as India’s growth projection was raised to 6.0% from 5.0%. Growth projections were revised down for Maldives, Pakistan, and Sri Lanka, while the outlooks for Afghanistan, Bangladesh, Bhutan, and Nepal were upgraded, though generally by small amounts.

Inflation pressures were markedly reduced except in Nepal and Pakistan following the drop of international oil prices in the second half in 2008. The Update revises down the inflation projection for South Asia to 4.7% for 2009 (Figure 3.1.8) from 5.6% in ADO 2009 despite the upward growth revisions on account of lower international commodity prices in 2009; the estimate for 2010 is slightly changed to 4.9% (from 4.4%).

Nevertheless, concern over inflation should not be completely off the
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radar as year-on-year monthly inflation rates are bottoming (as the high base passes) and oil prices have moved up. The outlook for price stability will therefore crucially depend on the authorities’ ability to withdraw fiscal stimuli and central banks’ highly expansionary monetary policies in a timely manner, as economic activity revives.

Despite lower exports, the decline in oil prices provided substantial import relief (supplemented by weak domestic demand), and trade deficits of South Asian countries have shrunk in Bangladesh, India, Pakistan, and Sri Lanka. Moreover, while growth in workers’ remittances has slowed, amounts remain substantial and have grown in relative importance with respect to the large drop in the trade deficit. In India, information technology and business processing sales have been resilient.

Reflecting these developments, the current account deficit for South Asia is now projected at 1.7% of GDP for 2009, slightly improved from 2.0% forecast in ADO 2009 (Figure 3.1.9). The projected current account deficit for 2010 is now estimated at 2.2% of GDP, marginally lower than forecast earlier.

Country highlights

Afghanistan
The best harvest of the decade is likely to be achieved in FY2009 (started on 21 March 2009) due to good rainfall and partly improved irrigation. This, along with continued external assistance, will bring GDP growth to 15.7% in FY2009 compared with the projection of 9.0% in ADO 2009. The average annual change in the consumer price index will likely show deflation, which is now estimated at 8.9% as a result of the large drop in global food prices, while end-period inflation for FY2009 is estimated at 6.0%.

The current account deficit (including grants) is now estimated at 1.7% of GDP for FY2009, slightly improved from the earlier estimate. The large trade deficit—associated with donor-financed activities and security spending as well as foreign currency expenditure on development projects and consumer imports—is offset by inflows of donor grants.

Since Afghanistan’s financial system and economy are small and weakly integrated with global markets, external economic impacts are slight. The amount of donor assistance available for the country, however, might be affected by the recessionary conditions in donor countries.

In FY2010, assuming good weather and further improvements in irrigation systems, GDP growth is likely to be 8.5%, higher than the 75% forecast in ADO 2009. Inflation will stabilize at around end-FY2009 levels, averaging 6.5% during FY2010, and the current account deficit (including grants) is now estimated at 2.7% of GDP. Both these revised forecasts represent slight improvements in performance from earlier projections.

Political uncertainty stemming from the presidential election in August 2009 could have an adverse impact on the Government’s reform agenda and on growth. However, this point is not expected to be a significant drag on growth in the current fiscal year. Creating a base for sustainable economic growth, dealing with insecurity, improving weak governance, suppressing the opium trade, overcoming infrastructure bottlenecks, as
well as improving overall aid management and its effectiveness, remain key challenges for the economy.

**Bangladesh**

GDP growth for FY2009 (ended June 2009) is estimated at 5.9%. Agriculture performed better than expected, benefiting from favorable weather conditions and strong policy support from the Government, which enabled farmers to access inputs and credit. Industrial growth was affected by slower export growth because of the global slowdown and damped investor sentiment. Expansion in services was hindered by slowing export and import activities.

The growth in the import bill decelerated faster than that for export receipts, narrowing the trade deficit. Still, strong remittance growth offset the smaller trade deficit and raised the current account surplus (to 2.8% of GDP). Inflation eased, averaging 6.7% in FY2009, down from 9.9% in FY2008. The sharp decline in import prices, the rise in domestic food production, and the successive cuts in domestic fuel prices led to the drop in inflation.

For FY2010, the *Update* maintains the earlier GDP growth projection of 5.2%. Industry and services are unlikely to pickup in the first half of the fiscal year, and remittance growth is expected to slow, which will contain consumer spending. The *Update* also retains the earlier inflation projection of 6.5%, as increases in import prices are moderate and the crop outlook remains healthy. Growth in exports will slide further and the import bill will rise, but remittances will eliminate the trade deficit, to enable the current account to post a small surplus (0.8% of GDP) rather than a deficit (0.5% of GDP) as projected in *ADO 2009*.

**Bhutan**

The global financial crisis and economic downturn have had a limited impact on Bhutan as the economy is driven largely by construction of hydropower stations and power production exported to India. Power exports grew by 9% during July 2008–May 2009 compared with the same period the previous year. Given power hunger in India, it is unlikely that these exports will be affected by the global slump.

The budget estimate for FY2009 (ended June 2009) included additional grants from the Government of India triple the original budgeted amount. As a result, the fiscal deficit was contained at 3.0% of GDP from the original estimate of 11.0%. The budget for FY2010 focuses on achieving core objectives related to poverty reduction. It plans higher expenditure than in the FY2009 estimate, while maintaining the fiscal deficit at 5.0% of GDP.

Against this backdrop, the *Update* adjusts the projection of GDP growth to 6.0% from the earlier forecast of 5.5%. The current account deficit for FY2009 is unchanged from that given in *ADO 2009* (5.5% of GDP), while average inflation is now expected to be around 7%, reflecting the impact of inflation in India. No change is made in projections for FY2010: the economy will grow by 6.5%, with a current account deficit of around 9% of GDP as imports rise, reflecting a gradual increase in domestic demand and international oil prices, while inflation will ease to 4%, marking price developments in India.
Although Bhutan is largely immune to global economic events, it has a concentration risk in power production and exports to India. Any disruption to operations due to technical problems, natural disasters, or rainfall shortages could have a large impact on overall growth.

**India**

Macroeconomic management continues to remain pivotal in India against the backdrop of an uncertain global economic situation. With slow transmission of policy-rate cuts to lending rates, India's countercyclical policy options focused on a public expenditure–led growth strategy. The central Government provided fiscal stimulus to boost growth over and above the monetary accommodation provided by the central bank. There are clear signs of a recovery in the economy and in business confidence. External funding constraints have also eased notably.

These developments have led to an upward revision in growth to 6.0% in FY2009 (started in April 2009). Exports are running substantially below prior-year levels because of recession in industrial economies, though a larger fall in imports is expected to keep the current account deficit in check at 1.5% of GDP as projected in ADO 2009. For FY2010, the Update upgrades projected growth to reflect a greater strengthening of the recovery than earlier foreseen. It makes no change in the inflation forecast.

Although the growth strategy is appropriate given global economic weakness, it could prove counterproductive if the large fiscal deficits are not reined in over the next few years (as the Government intends to do). Apart from global uncertainty, the key downside risk to the outlook emerges from financial crowding out of private investment. This issue is most likely to arise in FY2010 and underscores the need for the Government to concretize its plans to consolidate fiscal policy.

Inflation in FY2009 is now forecast to be 2.5%, slightly below the forecast in ADO 2009; however, year-on-year inflation is expected to be 4–5% by March 2010, and inflation pressures are likely to persist, driven by high food prices and expansionary monetary and fiscal policies. Monetary management needs to strike the right balance between providing adequate liquidity to support economic recovery yet keep inflation at bay. There is a risk that domestic food price inflation may create a dilemma for monetary management in FY2009, but late rains appear to be filling water reservoirs to an adequate level to ensure a reasonable winter crop. A return to sustained high growth will require the Government to address the country's infrastructure deficit and implement structural reforms.

**Maldives**

The economy has suffered from expansionary fiscal policy after the tsunami in 2004. Rising public sector wages and power subsidies in Malé pushed up current spending, resulting in a deterioration in the fiscal balance, which is exerting significant pressure on the balance of payments. The economy is particularly vulnerable to the global slowdown because tourism accounts for more than a quarter of the country's GDP and has significant knock-on effects on aggregate demand. Notably, tourist bednights contracted by 10% during the first seven months in 2009.
The new Government elected in November 2008 revised the budget in May 2009 to reflect its political manifesto. The revision makes a first attempt to rationalize expenditure within constrained resources and lowers expenditure to 67% of GDP from 71% in the original budget. The Government plans to introduce new taxes, such as an airport tax and a green tax, as well as to start privatizing state enterprises to offset some of its revenue shortfall and contain the fiscal deficit to 7.4% of GDP. However, it is uncertain that these taxes can be fully implemented within 2009. It is also unlikely that the privatization revenue will be realized in view of delay in privatizing the airport at Malé.

Faced with a revenue shortfall, the Government is expected to contain its current expenditure. In August 2009, it reached a staff-level agreement with IMF for a standby arrangement of $60 million to address these structural constraints.

In this economic context, the Update revises downward the projection of 1.0% growth in ADO 2009 to a contraction of 3.5%. The earlier forecasts of inflation at 4.5% and the current account deficit at 30.0% of GDP are maintained. In 2010, economic growth is projected to rebound by 3.5% (up from 1.5% forecast earlier) as tourism begins to revive. Projections for inflation and the current account deficit remain unchanged from ADO 2009.

**Nepal**

GDP growth slowed to 3.8% in FY2009 (ended mid-July 2009) from 5.3% in FY2008, as prolonged drought affected the winter crop and as continued political strikes, labor unrest, and power shortages impeded industrial growth. Persistent food shortages, exacerbated by domestic distortions such as hoarding and cartelizing, kept average inflation high at 13% in FY2009, despite rapid moderation in India's inflation (which Nepal's inflation normally trails given the currency peg, strong trade links, and porous border). Domestic structural weaknesses and some decline in global demand are holding back export growth but remittance-induced import growth remains robust. The trade deficit was more than offset by remittances, increasing the current account surplus to about 3.0% of GDP in FY2009 from 2.9% in FY2008.

In FY2010, agricultural growth is expected to be hampered by the late monsoon, which delayed the cultivation of paddy, the major crop accounting for more than 20% of total agricultural output. Industrial growth, while improving, will remain well below its potential in the uncertain political environment. Services will offset some of the deceleration in agricultural and industrial output given the limited impact of the global economic downturn on the key drivers of services, namely remittances and tourism.

Overall GDP growth is now forecast at 4.0%, slightly better than in FY2009 and the 3.5% forecast in ADO 2009. Inflation will moderate to 9.0% in FY2010 mainly due to the unwinding of the base effect (from high fuel prices that prevailed in the earlier period); further moderation to the 8.0% estimated in ADO 2009 will be difficult given the possible reduction in summer crop production. Tighter monetary policy and the Government's reforms aimed at removing the domestic constraints may, however, offset some of the upward pressure on prices. The current account surplus is expected to contract modestly to 2.0% of GDP in FY2010.
Pakistan

Macroeconomic stress was mitigated in FY2009 (ended June 2009) as the IMF-backed stabilization program took effect in November 2008. Fiscal and external imbalances improved—the fiscal deficit fell to 5.2% of GDP from 7.6% in the previous fiscal year, and the current account deficit declined to 5.3% of GDP from 8.4%. The exchange rate stabilized and foreign reserves revived. However, inflation remained stubbornly high and averaged 21% in FY2009, even as year-on-year inflation started to see a trend decline from March 2009.

The growth rate fell precipitously, and at 2.0% was less than the ADO 2009 projection of 2.8%. The impact of large power outages, tight domestic demand management, and global recession contributed. The reduction in imbalances itself was largely a consequence of the slowdown of the domestic economy and expenditure cutting rather than an improvement in economic fundamentals. Otherwise, domestic revenue generation and export performance remained weak.

A modest rebound in growth to 3.0% is expected in FY2010, supported by a planned larger public expenditure program and an anticipated further easing of monetary policy. Agriculture is expected to continue robust growth but it will not be as high as the previous year. Growth in industry is expected to turn marginally positive and the services sector is also expected to record modest growth.

Inflation is expected to decline to 10.0%, and the current account deficit to shrink to 4.8% of GDP, in FY2010. The economy, however, remains vulnerable to the impact of expected higher international oil prices, its significant energy supply–demand gap, and lagging competitiveness of its exports, which are also affected by weakness in global economic conditions. Structural reforms at the macroeconomic and sector levels need to be consistently implemented and accelerated to put the economy on a sustainable growth path.

Sri Lanka

Although the economy remains under severe strain, partly because of the global financial crisis and recession, the outlook has improved with the end to a quarter-century of civil war in May 2009. Still, the current economic situation remains fraught with large fiscal and external imbalances that have accumulated over the years. In addition, the country faces the costs of postconflict relief and reconstruction efforts.

Following a marked fall in foreign exchange reserves, in July 2009 IMF approved a $2.6 billion standby arrangement and released the first tranche of $332 million in support of the Government’s ambitious program of fiscal, monetary, and exchange rate reforms. With movement toward economic stability envisaged in the program, potential investors will receive a positive signal for undertaking the investment needed for recovery and rapid economic growth.

First-quarter GDP growth slowed to 1.5%, with all sectors experiencing a downdraft. Falling global prices and weakening demand pulled down Sri Lanka’s high inflation significantly during the first half of 2009, with point-to-point inflation falling to 0.9% in June 2009 from 14.4% in December 2008. This allowed the central bank to reduce policy interest rates three times during the period.
Preliminary estimates indicate that second-quarter growth improved. Economic activity is expected to gradually pick up over the rest of the year to bring full-year expansion to 4.0%, a shortfall from the 4.5% projected in ADO 2009. With strong economic management and an improving global economy, GDP growth is expected to reach 6.0% in 2010 as projected earlier.

With price pressures abating faster than expected, average inflation is now estimated to be 5.0% in 2009 rather than 8.0% projected in ADO 2009; the forecast of 6.0% in 2010 is maintained. Reflecting weak investment, lower oil prices and reduced demand for inputs for plummeting export activity, imports have dropped rapidly and the trade deficit contracted sharply through the first half of 2009. Given the deterioration in economic conditions, the current account deficit is now estimated to be 3.0% of GDP in 2009; expanding to 5.0% in 2010 as the economic growth revives (from 7.5% and 7.0% of GDP, respectively, in ADO 2009).

Southeast Asia

Subregional assessment and prospects
Economic output in this subregion is now expected to be virtually flat in 2009, its weakest performance since the Asian financial crisis in 1997–98 when subregional GDP fell. Growth has decelerated from 4.1% in 2008, and this year is projected at just 0.1% (Figure 3.1.10), a result of the global slump in demand for manufactures and commodity exports, as well as the financial crisis. Half the Southeast Asian economies are projected to shrink this year, with those most exposed to international trade—Malaysia, Singapore, and Thailand—contracting the most.

The aggregate growth forecast is revised down from the ADO 2009 forecast given in March, of 0.7%. However, Indonesia—the largest economy in Southeast Asia—and Viet Nam are performing better than ADO 2009 foresaw.

The collapse in external demand in late 2008 and early 2009 led to double-digit contractions in exports across the region. Lower exports prompted cutbacks in manufacturing production that, in turn, sparked layoffs that eroded consumption spending. As businesses delayed their expansion plans, investment dived. Lower commodity prices damped production and incomes in rural areas, while inward remittances decelerated or actually declined, depending on the country.

Some offset to the long list of negative factors has been provided by increased government spending (most countries rolled out fiscal stimulus programs), and by a plunge in imports that in several cases outpaced the export fall, generating higher net exports. Interest rates have been cut across the subregion, but with limited economic impact given generally depressed domestic demand.

The Southeast Asian economies that are expected to shrink this year are the three larger trade-oriented ones listed above, plus Brunei Darussalam, which relies on energy exports, and Cambodia, which is vulnerable to slowdowns in tourism, clothing exports, and FDI. Downturns relative to 2008 are more moderate in Indonesia, Lao PDR, Philippines, and Viet Nam, which are generally less dependent on

![](chart.png)
exports. Myanmar’s performance is expected to be hurt by downward pressure on prices for its exports of natural gas and agricultural products, and by a fall in remittances (though a lack of reliable data makes it difficult to assess this economy).

In addition to the fiscal stimulus programs, other local factors played an important role in the performance of some economies. In Thailand, for example, political turbulence aggravated already depressed investor and consumer confidence. In Indonesia, a strong harvest and spending associated with elections in April and July helped maintain consumption spending at robust levels.

In many countries, the slowdown or decline in GDP bottomed in the first quarter of 2009. Singapore’s GDP contraction, for example, eased from 9.5% year on year in the first quarter to 3.5% in the second. Month-on-month data toward midyear saw a rise in manufacturing output in, among others, Indonesia, Malaysia, Philippines, Thailand, and Viet Nam, in part to meet increased domestic demand generated by government stimulus measures, and to restock depleted inventories.

Expansionary fiscal and monetary policies adopted by governments and central banks contributed to this stabilization. Improved fiscal positions and declining public debt since the Asian financial crisis have given to several Southeast Asian countries the flexibility needed to adopt more forceful policy measures during the downturn. Banking systems are also in a stronger position, enabling them to withstand the impact of the financial crisis and global slump and to finance widening fiscal deficits.

Lower international oil and food prices this year, coupled with considerably weaker domestic demand, have led to a sharper than expected pullback in inflation. The economies shrinking the fastest have experienced declines in their consumer price indexes in some months in 2009, on a year-on-year basis. Thailand will likely experience mild deflation for the full year (Figure 3.1.11). Price pressures have been subdued also because of reasonable harvests in most countries and broadly stable exchange rates vis-à-vis the US dollar. Viet Nam is an exception: while its inflation rate has decelerated from a high of 23.0% in 2008, inflation momentum has been stronger than expected, and the 2009 forecast is raised to 6.8%. The forecast for subregional inflation in 2009 is lowered to 2.5%, from 3.3% in ADO 2009.

The aggregate current account surplus will fall this year, but not by as much as was projected in ADO 2009. The Update raises this forecast to 5.4% of GDP (Figure 3.1.12), from 4.4% in March. The precipitous decline in exports has been more than offset by an even sharper decline in imports in several economies, bolstering their trade balances. Indonesia is now expected to record a current account surplus rather than a deficit, while Viet Nam’s deficit is projected to narrow considerably from 2008 and from the ADO 2009 forecast.

Next year, all the Southeast Asian economies are expected to grow, with aggregate GDP rising by 4.3% in 2010, similar to the projection in ADO 2009. This would represent a rapid acceleration from 2009, but growth would still be relatively subdued compared with the 6.3% average of 2006–2007. A gradual recovery of the global economy and increased trade flows will impart some growth momentum to the subregion.
Expected higher average world prices for oil and commodities in 2010 than in 2009 will benefit countries including Indonesia and Malaysia. Expansionary fiscal and monetary policies will underpin growth in most economies, although these policies will likely become less expansionary as the year progresses.

Still, only Indonesia, Lao PDR, Malaysia, and Viet Nam are forecast to grow by more than 4% in 2010. In some economies, imports will rise faster than exports. Firms will rebuild depleted stocks of imported intermediate goods and public investment programs will require imported capital equipment. At the same time, export markets in industrial countries are expected to improve only modestly.

Inflation in Southeast Asia is forecast to pick up and average 4.1% in 2010, unchanged from the March projection. The gradual economic recovery, the expected rise in commodity prices, and low-base effect brought about by declines in price indexes in 2009 will all have an impact on inflation. However, price increases are likely to remain subdued as economies will still be operating with considerable excess capacity. Here, too, Viet Nam is an exception. Its inflation forecast is raised to 8.5%, with a risk that it could go higher.

The current account surplus in the subregion in 2010 is projected at 4.6% of GDP (4.9% in ADO 2009). Although exports will rise from this year’s low levels, the recovery will remain modest, especially for manufactured goods. Imports are likely to grow more rapidly than exports.

**Country highlights**

**Indonesia**

Performance was stronger than expected in the first half. GDP growth of 4.2% was driven by solid expansion in private consumption, stimulated by slowing inflation, good harvests that supported farm incomes, and government cash transfers to poor households. Government consumption increased sharply, a result of pay increases for civil servants and spending related to elections in April and July. Imports of goods and services contracted faster than exports, so that net exports added to GDP. Investment growth, however, was meager in the context of the weak international outlook and tighter bank credit. On the supply side, services grew quite strongly, while agriculture, manufacturing, and mining increased output slightly.

A fiscal stimulus package, coupled with cuts in the policy interest rate, has supported growth. The 2009 GDP growth forecast is raised to 4.3% (from 3.6% in ADO 2009). Government efforts to maintain relatively high levels of infrastructure spending in 2010 and the modest global rebound are expected to lift economic growth to 5.4% next year, also revised up from March.

The slump in world trade and falling prices for export commodities pushed down merchandise exports by 27.9% in the first half of 2009. Imports declined even more sharply, by 38.7%. The ensuing large trade surplus outweighed the decline in current transfers, including remittances. Current account surpluses equivalent to about 2% of GDP are now projected for both 2009 and 2010, revised up from ADO 2009.
Inflation has been lower than expected, brought down from double-digit levels last year by falls in global commodity prices, good domestic harvests, and a firm rupiah. Forecasts for inflation are revised down to 5.0% this year and 6.0% next.

**Malaysia**

The economy contracted by 5.1% in the first half of 2009, more sharply than expected, as the impact of a plunge in exports spread to fixed investment and private consumption. Exports in volume terms fell by 16.3%, reflecting much weaker global demand for Malaysia’s exports of manufactures and commodities. Private consumption declined marginally and fixed investment fell by about 10%. On the production side, only services grew (even then, only just), while manufacturing output, which is dominated by export-oriented industries, contracted sharply and agricultural production declined.

The pace of GDP contraction slowed in the second quarter relative to the first, partly owing to increased public spending. The Government launched two fiscal stimulus packages (although some measures got off to a slow start), and interest rates were lowered to spur the economy. However, GDP is expected to shrink by 3.1% in 2009, revised from a contraction of 0.2% in *ADO 2009*. Year-on-year GDP growth is likely to return toward end-2009 and gradually pick up to average 4.2% in 2010. The better outlook is underpinned by the fiscal stimulus and the expected recovery in world trade and commodity prices.

A declining trade surplus will likely trim the current account surpluses to a still-substantial 14.0% of GDP this year and 12.5% in 2010.

Inflation decelerated to just 1.7% in the first 7 months of 2009 owing to lower global commodity prices and slack domestic demand. While the consumer price index has declined year on year in some months, it is picking up on a monthly sequential basis. Inflation for the whole year is pegged at 1.1% (a touch lower than *ADO 2009*) and is projected to gather pace to 2.6% in 2010, in tandem with higher domestic demand and global commodity prices.

**Philippines**

GDP growth of 1.0% in the first half of 2009 was weaker than expected. Private consumption growth pulled back abruptly from a year earlier as concerns over job security eroded consumer confidence. Remittances, a major prop for this economy, continued to grow in US dollar terms, but at a much reduced pace. Government spending grew, supported by a fiscal stimulus package, but fixed capital investment fell and net exports acted as a drag on GDP growth. By sector, services constituted the main contributor to growth. Agriculture and public construction also expanded, but industrial production and private construction contracted.

A somewhat better performance is projected for the second half of 2009. Consumer confidence has turned upward because of low inflation, an easing in interest rates by the central bank, and an improved international economic outlook. Public investment is gaining impetus under the fiscal stimulus. GDP growth for the whole year is projected at 1.6%, about 1 percentage point below the *ADO 2009* forecast.

In 2010, the modest rebound in global trade and firmer domestic
demand are expected to raise growth to 3.3%. Business confidence should improve after national elections in May 2010, on the assumption that the election process and transition in government go smoothly. Given fiscal and debt constraints, the Government plans to rein in its budget deficit in 2010, which may mean that fiscal support for the economy will not be as strong as in 2009.

Merchandise exports slumped by just over 30% in the first 6 months of 2009—led by a sharp drop in shipments of electronic products—and imports fell by a similar degree. As in other subregional economies, the contraction in trade appears to have bottomed early in 2009. The full-year merchandise trade deficit will likely be narrower than expected in March. Trade in services is projected to be in surplus, largely reflecting earnings from business process outsourcing. Combined with growth in remittances, these influences are expected to produce a current account surplus of 2.8% of GDP this year and close to this level in 2010.

In view of a steep deceleration in inflation in the first 8 months of 2009, the inflation forecast is revised down to 3.2% for this year, picking up to 4.5% in 2010.

**Singapore**

As a financial center and manufacturing hub, this economy was particularly hard hit by the global financial crisis and slump in world trade. GDP plunged by 9.5% year on year in the first quarter of 2009 and by 3.5% in the second. The relatively better performance in the second quarter (GDP expanded by 20.7% on a seasonally adjusted annualized basis from the very weak first 3 months) was driven by a pickup in production of pharmaceutical products and by inventory restocking. For the first half of the year, GDP contracted by about 5%.

A better performance is expected in the second half. Manufacturing production rose in July from the prior-year level and the slide in exports moderated. A large fiscal stimulus is working its way through the economy. GDP is expected to contract by about 5% for the whole year, unchanged from ADO 2009. In 2010, the forecast global upturn, coupled with the fiscal stimulus, is expected to return the economy to growth, of about 3.5%.

Inflation slowed sharply to just 0.6% in the first 7 months of 2009, suppressed by lower global oil prices and weaker domestic demand. The consumer price index fell year on year for several months around midyear and is now forecast to be flat on average in 2009 (revised from 0.5% inflation projected in ADO 2009). Next year, higher average oil prices and firmer domestic demand are seen lifting inflation to about 2%.

The current account surplus fell to $9.0 billion in the first half of 2009, from $14.7 billion a year earlier, a result of reduced surpluses in both goods and services trade. For the whole year, a still-large current account surplus equivalent to 10.0% of GDP is expected, rising to 14.0% in 2010 in tandem with the improvement in trade in goods and services.

**Thailand**

The onset of the global trade slump sparked a steep decline in Thailand’s exports, which drove down industrial production and investment in the first half of 2009. Business and consumer sentiment was further
undermined by political uncertainty: private consumption and private fixed investment both contracted. Reflecting these factors, GDP fell by 6.0% in January–June, a sharper fall than was forecast in March.

To moderate the decline, the Government quickened the pace of budget disbursements and raised wages for its employees, which boosted government spending. From March, the Government also rolled out the first of two fiscal stimulus packages. By production sector in the first half, output of services and industry fell, while agriculture was virtually flat.

As elsewhere in the subregion, the slump in trade and manufacturing reached a trough early in the year. The fiscal stimulus, plus interest-rate reductions by the Bank of Thailand and the improved global outlook, will likely stabilize GDP in the second half of 2009. The full-year forecast is for a contraction in GDP of 3.2%, still a deeper decline than expected in ADO 2009. The economy is expected to grow by about 3% in 2010, a very modest rate given the low base set in 2009. The Government plans a substantial public investment program from October 2009 to underpin the recovery. However, that program would be at risk if political turbulence disrupts policy making and fiscal disbursement.

Merchandise exports fell by about 23% in the January–June period of 2009 as external demand dwindled. Imports tumbled by just over 35%, reflecting reduced purchases of imported inputs for manufacturing industries, lower oil prices, and soft domestic demand. The trade surplus ballooned and the current account surplus was more than three times the prior-year level. A current account surplus of about 6% of GDP is forecast for this year, narrowing to about 1% in 2010 in the context of rising costs for imports both of capital goods for investment projects and of oil.

The consumer price index fell by 1.9% in the first 7 months of this year, from high levels in 2008 when global food and oil prices surged. Prices are expected to turn upward by year-end. Still, the consumer price index is now forecast to fall by 0.5% in 2009, revised from March when slight inflation seemed likely. Next year, inflation is put at around 2%, on the basis of higher oil and commodity prices and a gradual recovery in domestic demand.

**Viet Nam**

Expansionary fiscal and monetary policies supported growth of 3.9% in the first half of 2009. Fiscal stimulus measures bolstered public consumption and domestically financed investment. Import volumes fell more steeply than exports, so that net exports contributed to GDP growth. Furthermore, oil production turned up, after several years of decline. The impact of the global turbulence was reflected in a fall in merchandise exports and in remittances, layoffs, and weaker inflows of FDI.

Growth accelerated in the second quarter from the first, suggesting that the economy bottomed early in the year. Given that the fiscal stimulus, net exports, and oil output outstripped expectations, the 2009 GDP growth forecast is bumped up to 4.7% from 4.5% in ADO 2009. Next year, growth is seen stepping up to 6.5%. Investment is likely to strengthen in view of the fiscal and monetary stimuli put in place in 2009 and an expected revival in FDI as the global economy improves. A pickup in hiring and incomes will stimulate consumption.

Imports dropped much faster than exports in the first half, reflecting
the slowdown in economic activity, lower import prices, reduced availability of trade credit, and a shortage of foreign exchange in the formal market. The current account deficit for 2009 is now projected at about 7% of GDP, narrower than projected in March. It will likely widen to about 9% in 2010 because growth in imports is expected to outstrip that in exports as the economic expansion picks up pace.

Inflation decelerated to 8.3% in January–August 2009 from 23.0% in all 2008 owing to lower world oil and food prices and softer domestic demand. Still, the high-inflation inertia was stronger than expected. The 2009 inflation forecast is raised from that given in ADO 2009 to 6.8%, and the 2010 forecast revised up to 8.5%, in part owing to rapid growth in money supply this year.

Other economies

Brunei Darussalam
This economy, which relies on exports of oil and natural gas for about half its GDP, is expected to contract by 1.2% in 2009 owing to lower world demand for energy and the fall in energy prices from last year. That would be a more moderate decline than the 1.9% fall in GDP estimated for 2008. Government spending is tempering the contraction and the nonenergy sector is expected to perform better in 2009.

Growth is set to resume in 2010 at just over 2%, supported by higher global energy demand and prices and by the start of exports from a $450 million methanol plant. The Government is stepping up its efforts to diversify the economy: one result will be an increase in the number of Brunei Halal Brand products exported next year.

Inflation is expected to stay subdued in view of lower prices this year for imported commodities and the Government’s policy to subsidize a broad range of products and services. The inflation projections are maintained at 1.5% for 2009 and 1.2% for 2010. Large current account surpluses based on exports of energy are expected to moderate in the forecast period as a result of lower oil prices and reduced income flows from investment abroad.

Cambodia
A sharper than expected downturn in clothing exports, construction activity, and tourist arrivals has prompted a downward revision in the GDP forecast. The economy is now expected to contract by 1.5% in 2009, rather than record slight growth as anticipated in ADO 2009.

US Department of Commerce data show that Cambodian clothing exports to the US—the leading market—dropped by 27% in the first 5 months of 2009 from the corresponding period of 2008, and order books for clothing in May were significantly lower than a year earlier. Construction activity declined as a consequence of falling FDI, notably from Korea. Tourist arrivals fell by 3% in the first 4 months of 2009.

Growth is projected to resume in 2010 at about 3.5%, as a gradual recovery in the global economy stimulates clothing exports and tourism. That should provide support for growth in incomes and consumption.

Inflation has decelerated faster than expected, owing to lower international oil and food prices and weaker domestic demand as the
economy contracts. The inflation rate for 2009 is now forecast at just 0.8%, revised down from ADO 2009. It is expected to quicken to about 5% in 2010, reflecting higher prices for imported oil and the improvement in domestic demand.

In the external accounts, imports fell by 18.1% in the first half of 2009, a sharper decline than that recorded for exports (10.3%). Tourism arrivals are expected to pick up in the second half of 2009 and the rate of decline in exports may well slow. The current account deficit will be narrower than forecast in March, at about 5.0% of GDP this year and 7.0% in 2010. Gross international reserves edged up to $2.18 billion at midyear, from $2.16 billion at end-2008.

**Lao People’s Democratic Republic**

Economic growth is easing in 2009 from rates in excess of 7%, driven by expansion of mining and hydropower, seen over recent years. Lower global mineral prices have damped mining activity and construction has been dented by reduced flows of FDI. The global economic downturn has also hurt clothing exports and tourism earnings.

Government spending, including outlays on infrastructure for the Southeast Asian Games scheduled to be held in Vientiane later this year, is helping moderate the slowdown. The budget deficit target has been widened to 5.0% from an original target of 3.4%. Economic growth is forecast at 5.5% in 2009, in line with the ADO 2009 projection, picking up to 5.7% in 2010 as world commodity prices recover and investor sentiment improves.

Lower food and fuel prices caused inflation to slow to 0.2% in the first half of 2009. Inflation forecasts are revised down to 0.7% for 2009 and 4.5% in 2010.

The current account deficit is now projected to narrow to 14.6% in 2009, reflecting a faster fall in imports than in exports owing to lower fuel and commodity prices and reduced imports of construction materials and machinery. A narrower trade deficit will be partly offset by a smaller surplus in services due to lower tourism receipts. The current account deficit is expected to remain at around 14% next year. External reserves of $583 million in May 2009 represented 3.5 months of nonresource import cover.

**The Pacific**

**Subregional assessment and prospects**

The aggregate growth projection for 2009 is edged down to 2.8% (Figure 3.1.13) from the 3.0% that was forecast in March’s ADO 2009. This year’s likely outcome represents a sharp slowdown from 5.2% growth in 2008, when resource exporters in the Pacific benefited from high global oil and commodity prices. Only the region’s mining and hydrocarbon exporters (Papua New Guinea and Timor-Leste) and a key reformer (Vanuatu) are expected to grow at a reasonable rate in 2009.

Five economies (Cook Islands, Fiji Islands, Palau, Samoa, and Tonga) are projected to contract, primarily because the global economic slump has eroded income from tourism and remittances. Solomon Islands is...
now expected to record no growth because its log exports have dropped sharply. The growth outlook for Papua New Guinea has improved since March in tandem with the pickup in global prices for mineral and petroleum products. Timor-Leste also is set to grow significantly, based on its income from hydrocarbons.

Governments in the Pacific have generally been overoptimistic this year in their revenue projections and slow to counter the deterioration in the economic outlook. Weaker tax and other revenues are hampering the ability of some of them to meet budget commitments. Most governments have made across-the-board cuts to funding for goods and services and maintenance as revenue weakened. This nonprioritized approach to adjustment is expected to impair the delivery of basic services and damp economic recovery. While restraint has generally been achieved on public sector pay, thereby avoiding a further source of fiscal pressure, in some cases unsustainable increases have been made. Only a few governments have been able to increase needed capital expenditure in order to support investment and aggregate demand.

In 2010, the subregion is expected to post aggregate growth of 3.1%, a slightly higher outturn than projected in ADO 2009. Forecasts for the three biggest Pacific economies—Fiji Islands, Papua New Guinea, and Timor-Leste—are raised from March. Higher average global oil and commodity prices assumed for 2010 in the Update are behind the improved outlook for Papua New Guinea and Timor-Leste, while Fiji Islands is expected to resume growth after this year’s contraction in GDP. Average growth for the Pacific islands (the countries excluding Papua New Guinea and Timor-Leste) is projected to remain low at 0.8% in 2010 in the context of a slow, gradual pickup in earnings from tourism and remittances. The speed of recovery will also depend on further policy responses to this year’s slowdown.

Lower prices this year for imported fuel and food have trimmed inflation from the high average level of 9.5% seen in 2008 (although inflation has increased in Fiji Islands this year because of devaluation). Subregional inflation is projected to slow to 6.1% in 2009 (Figure 3.1.14), slightly below that anticipated in ADO 2009. The higher average global oil and commodity prices assumed for 2010 have bumped up the 2010 aggregate forecast from March to 5.2%.

The decline in prices this year for food and other essentials is providing some relief to vulnerable groups that were seriously hurt by high prices of these items in 2008. Such groups include people living in squatter settlements, those lacking their own fertile land, and those living in the most remote areas.

**Country highlights**

**Fiji Islands**

The economy is expected to contract in 2009, weakened by a decline in earnings from tourism and exports partly a result of the global economic slowdown. Political uncertainties have hurt the economy since a military coup in 2006 installed an interim government. Lack of progress toward a government commitment to holding elections since then has led donor countries to hold back economic assistance and has damaged investor
The decline in tourism worsened in the first quarter of 2009 after flooding in January reduced tourist arrivals, with some tourists choosing to go elsewhere in the Pacific. Exports of clothing, mineral water, and sugar have declined. Furthermore, the implementation of planned public works has been slow.

The contraction in GDP forecast for this year is revised to 1.0%, from 0.5% in March. Growth is expected to resume in 2010 at about 0.5%, helped by the projected pickup in the external environment and, therefore, tourism.

External accounts remain under pressure: exports dropped by 21.0% and imports by 6.8% in the first 4 months of 2009, widening the trade deficit by 4.3%. The Government devalued the Fiji dollar by 20% in April in an effort to stimulate exports and tourism and so boost declining foreign reserves. Reserves have increased since April, but remain less than half the target of 4 months of import cover.

The devaluation also spurred inflation, to 5.0% year on year in June. Other upward pressures on inflation came from a 32% hike in retail fuel prices in the first 5 months of 2009 and an increase in the minimum wage in June. Consequently, the Update revises up forecasts for year-average inflation to 7.0% in both 2009 and 2010. Rising inflation could erode export competitiveness, which would undermine any gains from the devaluation.

Tax revenue collections fell below budget estimates in the second quarter of 2009 owing to the slowdown in the economy, and the Government cut its spending below budgeted levels. A rise in external debt servicing costs in Fiji dollar terms—a result of the devaluation—and high domestic interest rates (10% on 10-year government bonds) have increased the cost of servicing the public debt, which reached 47.9% of GDP in 2008. There is a risk that fiscal constraints will further delay much-needed public works and, more broadly, reduce development spending unless the Government reins in its operating costs.

GDP has declined since 2006 and poverty incidence has increased, to an estimated 39% of the population in 2008 from 34.4% in 2006 and 25.5% in 1990.

**Papua New Guinea**

Rising global prices of agricultural commodities, metals, and crude oil have bolstered the outlook for this resource-rich economy since March. The higher export prices will flow through to support private consumption as well as government revenue and spending. Forecast GDP growth for 2009 is revised up to 4.5% from 4.0% (still well below the 7.2% growth estimated for 2008, when commodity prices were booming for much of the year).

Nonmining GDP is expected to grow by about 5.0% this year, mainly reflecting continued expansion of the communications and construction industries, assisted by preliminary work on a large liquified natural gas project that is expected to start production in 2013. Agricultural production is also likely to grow, although severe flooding in early 2009 in the Highlands region hurt plantation production there. Mining’s contribution to GDP growth is revised down from March owing to lower than expected output from the Ok Tedi and Porgera gold mines that was...
caused by technical problems at the mines, but that will in part be offset by higher than expected output from the Lihir mine.

Reflecting the global slowdown and commodity price declines, the value of exports fell by an estimated 33% in the first half of 2009 from the prior-year period, suppressing incomes and government revenue and lowering GDP growth from the pace set in 2008. Growth in private sector credit slowed to about 25% year on year in June 2009 (from 40% in June 2008) and growth in employment moderated to about 6% in the 12 months to March 2009 (from 10% in the 12 months to June 2008).

The Government, faced with lower than expected income from commodities, widened its targeted budget deficit to 3.3% in 2009, funded by additional drawdowns from public trust fund savings generated during the commodity boom. It has broadly maintained its operating expenditure, but cut development spending by about 3%.

Next year, GDP is forecast to grow by 3.9%, raised a touch from ADO 2009 on the basis of the Update’s assumptions of higher average global oil prices.

Inflation has decelerated in step with the fall in global food and fuel prices, and the 2009 forecast is maintained at 7.0%. Monetary and credit growth rates remain high, but have decelerated from late-2008 levels. In 2010, inflation is forecast to ease to 5.5% as the economy slows.

The current account fell into deficit in the first quarter of 2009 as export values dropped. A deficit is still projected for the whole year, although the pickup in prices of exports, coupled with weaker than expected imports, has prompted a revision to 6.0% of GDP (from 7.0% in March, Figure 3.1.15). The external deficit is forecast to stay at around that level in 2010. Foreign reserves rose to $2.2 billion (about 14 months of nonmineral imports) at end-May, supported by central bank buying of foreign currencies in the market to moderate an appreciation of the kina.

**Democratic Republic of Timor-Leste**

The preferred measure of this economy, that is, excluding petroleum production and the operations of the United Nations, was revised up for 2008 from the preliminary estimate of 10.0% to 13.0%. Development is based on high levels of public spending that is funded mainly by the Government’s revenue from hydrocarbon production. In view of efforts to trim public spending to more sustainable levels since the easing of world oil prices, economic growth is expected to slow to about 8% in 2009, lowered from the ADO 2009 forecast.

This still-robust rate is supported by increases in public sector salaries and gradual improvements in agriculture, which accounts for about 85% of employment. Economic growth is expected to edge higher to about 9% in 2010.

Inflation has subsided at a much faster rate than forecast in ADO 2009, driven by sharp falls in international prices of food and fuel. (The use of the US dollar as the national currency has helped in this regard.) The consumer price index fell by 1.3% on a year-on-year basis in the second quarter of 2009. For the full year, inflation is now forecast at 1.5%, revised down sharply from ADO 2009, and for 2010 the forecast is lowered to 3.1%.

Withdrawals this year from the Petroleum Fund, which holds national
savings exceeding $4 billion from offshore hydrocarbon production, are budgeted to exceed estimated sustainable income. The key challenge is to use these withdrawals for broad-based development to reduce poverty, while ensuring that adequate savings are retained to fund the budget for future generations. Agriculture will likely be the main source of income for most of the population for some decades and further investment is required in this sector. However, current government intervention in the market as a buyer and seller of agricultural produce may not be as productive as conventional policies to invest in agricultural extension services, improvements to access to markets, and human capital.

Other Pacific economies

Samoa

The outcome for 2008 has been revised down to show a contraction of 3.4%. Several negative influences had a more severe impact than had been estimated. These included job losses at the Yazaki plant that assembles automobile parts for export, a fall in remittances, weakness in tourism, and the erosion of purchasing power due to high inflation.

This year, tourism has benefited from Fiji Islands’ problems of flooding and political uncertainty, as well as from increased airline services and recent hotel developments in Samoa. These effects, combined with the filming in Samoa of the television series “Survivor,” are expected to raise tourism receipts. However, the real value of remittances fell by about 9% in the 12 months to June.

The economic contraction is projected to extend through this year and next, although the pace is projected to moderate to 0.8% in 2009 and 0.6% in 2010. Government spending on infrastructure will avert a sharper contraction.

Inflation eased to 9.2% year on year at June 2009, half last year’s peak. The full-year forecast is revised down to 5.7%. Inflation is expected to decline further to 3.2% in 2010 (but raised from the March forecast because of the higher oil price assumption in the Update). International reserves increased to the equivalent of 5.1 months of imports as of June 2009, above the target of 4.0 months. However, the outlook for the current account is of concern. The Government’s macroeconomic framework suggests current account deficits of 14–16% of GDP in the next 2 years. That would put extra pressure on debt levels and so requires a plan to prioritize capital investment and strengthen revenue.

Solomon Islands

The economy has been hit by the global downturn as well as by bad weather in 2009. Exports (mainly logs), fish, palm oil, and copra fell by 11% in value in the first quarter of this year. Logging volumes dropped sharply in the first half and look likely to fall by about 30% to 1.1 million cubic meters in 2009. GDP is expected to be flat in 2009, revised from an expansion of 2.2% projected in ADO 2009.

Growth is now seen resuming in 2010 at 2.6%, a slightly faster pace than previously forecast, provided there is a determined response from the Government to the economic slowdown. Agricultural production is expected to pick up and the decline in logging in 2010 might not be as
severe as in 2009. Still, high population growth implies no per capita GDP growth in the forecast period. Prospects for overall economic growth remain modest thereafter given a long-term decline of native forest resources caused by overlogging.

The weakness in exports suggests that current account deficits will be worse than foreseen in March, now projected at 10.6% of GDP this year and 18.6% in 2010. Foreign reserves stabilized at about 3 months of import cover in July 2009, after falling to 2.5 months earlier in 2009, in part a result of substantial aid disbursements. These effects will wane as the aid funds are spent, and foreign reserves may again come under pressure.

Flooding in Guadalcanal caused inflation to surge to 16.5% in the first quarter of 2009, before it decelerated to 9.3% in June. The year-average forecast for this year is lowered a shade to 8.3% in the context of the slack economy. However, the forecast for 2010 is revised up to 6.9% on the basis of assumed increases in global prices of oil and other imported commodities.

Government revenue fell short of expectations by 11% in the first quarter of 2009, the result of an erosion of tax income caused by the slowing economy and drop in oil prices, coupled with the sharp decline in logging revenue. The Government is committed to avoid borrowing, so will need to consider a combination of trimming expenditure, raising additional revenue, and refocusing public resources to prioritize basic needs such as health and education.

**Tonga**

Remittances fell by 14% in the 12 months to June 2009, reflecting recessions in two main source markets, the US and New Zealand, and softening demand for seasonal workers in Australia. Furthermore, bank lending is constrained because commercial banks tightened credit policies after a rapid increase in bad loans. The economy probably contracted by about 0.5% in FY2009 (ended 30 June 2009), but by less than was forecast in March.

Growth is expected to resume in FY2010 at about 0.5%, a revision from the *ADO 2009* forecast for a continued contraction. The domestic content of capital works that are being supported by concessionary funding from the People’s Republic of China is now expected to be higher than originally thought, raising its contribution to GDP. However, the economy remains highly vulnerable to external conditions, notably changes in remittance inflows.

Inflation in FY2009 is estimated at 6.2%. The inflation forecast for FY2010 is raised to 3.1%, given the increase in global oil prices over recent months.

Government revenue and grants received at the end of the first quarter were about 20% under budget. Total expenditure was also below budget, resulting in a fiscal surplus at end-May 2009. The surplus appears to reflect controls on spending for operation and maintenance, which could reduce delivery of public services, rather than controls on the Government’s wage bill. In the external accounts, the level of foreign reserves rose to 4.7 months of import cover in the first half of 2009.
Vanuatu

Tourist arrivals rose in the first 5 months of 2009: those on cruise ships by 58% and those via air travel by 18%, partly a result of the problems experienced in Fiji Islands. The strength in tourism and signs of a firming in domestic demand suggest that GDP growth will be about 4% in 2009 and 3.5% next year, both revised up from ADO 2009.

The economy expanded by an average of 6.5% in the 5 years to 2008, driven largely by private-sector investment in tourism and construction and underpinned by policy reforms that included the opening of the telecommunications and aviation markets.

However, the pace of credit growth is worrisome. Credit to the private sector grew by 35.3% over the 12 months to May 2009, slowing only slightly from 44.0% earlier this year. Entry of new banks in the economy has contributed to this surge in credit. There is a risk that the level of nonperforming loans will rise as economic growth pulls back.

Fiscal surpluses and strong economic growth have reduced the ratio of public debt to GDP by more than half over the past 7 years to 18.4%. This gives the Government room to take countercyclical fiscal measures if the economy slows more sharply than expected.

Inflation remained quite high at 6.1% year on year in the first quarter of 2009, despite lower global prices for food and fuel. The forecast is revised up to 4.3% for this year and to 3.0% in 2010, based on upward revisions to GDP as well as to international oil prices.

Foreign reserves, equivalent to 5.0 months of import cover in June 2009, were down from 5.8 months at end-2008 but above the central bank’s minimum target of 4 months.

Others

For Cook Islands, the outcome for 2008 and outlook for 2009 are revised down. Economic data for last year, when tourist arrivals fell, has been revised to show a GDP contraction of 1.2%, rather than a slight expansion as previously estimated. Low investment and the erosion of real incomes from high inflation point to the contraction extending into 2009. But the extent of the decline is expected to moderate to about 0.1%, with tourism getting some support from subregional sporting events and conferences held in the Cook Islands. Growth is forecast to return in 2010 at the low rate of 0.8%. The Update raises the inflation forecast to 6.5% for 2009, but still foresees a deceleration of price pressures next year.

Updated GDP estimates for Federated States of Micronesia in FY2008 (ended 30 September 2008) now show a sharper GDP contraction of 2.9%, compared with a 1.0% decline in ADO 2009. Nevertheless, the outlook has improved because of a pickup in externally funded infrastructure projects. Tourism and remittance inflows are sluggish, largely owing to recessions in the US and Japan. GDP is now expected to grow by about 0.5% in FY2009, revised from a March forecast for a slight contraction, and also expand by about 0.5% in FY2010.

The growth estimate for Nauru is downgraded to 1.0% in FY2009 (ended 30 June 2009) and its GDP in FY2010 is forecast to be flat. Downward revisions (from 1.5% growth in both years in ADO 2009) stem from a slowdown in external demand for Nauru’s phosphate, particularly from Australia, and the consequent decline in phosphate prices. In line
with slowing growth and inflation in Australia (the main source of Nauru’s imports), inflation in FY2009 and FY2010 is now put at 1.8%, lower than forecast in *ADO 2009*.

The Republic of Palau’s economic prospects have deteriorated because of weakness in tourist arrivals, a slowdown in infrastructure spending, and delays in planned private investment in tourism facilities. GDP is expected to contract by 3.0% in FY2009 (ended 30 September 2009) and by 1.0% in FY2010, both sharper contractions than forecast in March.

Forecasts for Kiribati, Republic of the Marshall Islands, and Tuvalu are unchanged from *ADO 2009*. Kiribati’s GDP growth estimate for 2008 has been raised to 3.4% from a preliminary 0.6% in *ADO 2009*. Growth is pegged at 1.0% in 2009 and 0.9% in 2010, slower than in 2008 owing to the impact of weakened world trade volumes on the employment of Kiribati seafarers and their remittances. For the Marshall Islands, revised GDP estimates for FY2008 (ended 30 September 2008) show a contraction of 2.0%, instead of 1.5% growth estimated in *ADO 2009*. Growth of less than 1% is still projected for FY2009 and FY2010.
Bangladesh

Bangladesh experienced adverse effects from the global downturn, primarily through slower growth of exports and workers’ remittances, and damped investment sentiment. Still, it has maintained relatively strong expansion, reduced inflation, and kept a current account surplus. For FY2010, this Update maintains the projections made in March for moderately slower growth and inflation relative to FY2009, but now forecasts a small current account surplus rather than a deficit. The medium-term trajectory will depend heavily on the Government’s ability to implement reforms, which include substantially boosting budget revenue and raising infrastructure investment.

Updated assessment

GDP growth of 5.9% is estimated for FY2009 (ended June 2009), below the performance of the previous year but somewhat higher than the projection of 5.6% made in the Asian Development Outlook (ADO 2009) released in March this year (Figure 3.2.1).

This stronger outturn is due to better than expected agricultural expansion, at 4.6%. The output of *aman*, the second rice crop (harvested in November–January), rose to 11.6 million tons, a 19.6% rise over the previous fiscal year and reflecting a strong recovery from the severely damaged FY2008 crop. *Boro*, the major rice crop (harvested in April–May), is estimated at 17.8 million tons, marginally exceeding FY2008’s record output. Crop production benefited from favorable weather conditions as well as strong support from the Government that enabled farmers to access inputs and credit. Services sector growth (at 6.3%, down from 6.5% in FY2008) moderated, largely as a result of slower export and import activity.

Industrial growth of 5.9% fell below both the ADO 2009 projection of 6.6% and the 6.8% outturn of FY2008, as export production in the second half of the fiscal year slowed more sharply than expected. Weakening construction activity and power outages pulled back manufacturing growth. Slow implementation of energy projects continued to restrict industry’s expansion, although the new Government (elected in January 2009) has given power generation and gas development a high priority, as outlined in the ruling party’s election manifesto and reflected in a new public–private partnership (PPP) scheme.

GDP growth in FY2009 was again driven by consumption expenditure (Figure 3.2.2). Accounting for about four fifths of GDP, it grew by 5.8%, up from the previous year’s 5.4%. Growth in private consumption, which constitutes about three quarters of GDP, was, at 6.0%, stronger than FY2008’s 5.5%. Public consumption as a share of GDP declined for the third consecutive year.

Private investment, growing by 7.2%, lifted its share from 19.3% of GDP...
in FY2008 to 19.6% in FY2009, reflecting improved business confidence following the orderly return to elected government. Public investment, in contrast, declined further, sliding from 5.0% of GDP to 4.6%, as implementation of the annual development program (ADP) remained weak. Overall investment remained unchanged at 24.2% of GDP.

If Bangladesh is to attract greater investment, particularly from abroad, it will need to address some increasingly binding constraints. These are felt especially in infrastructure and the business environment, and include acute power shortages, transportation bottlenecks, inadequate and inefficient port facilities, high business startup costs, and slow institutional reforms.

Inflation fell steadily through the fiscal year, from 10.8% year on year in July 2008 to 2.3% in June 2009 (Figure 3.2.3). Annual average inflation declined to 6.7% in FY2009 (slightly lower than the ADO 2009 projection of 7.0%), from 9.9% in FY2008. The sharp decline in import prices and the rise in domestic food production were the main factors. The successive cuts in domestic fuel prices in October and December 2008 and in January 2009, in line with the fall in global oil prices, also helped (though the fixed administrative prices of fuel have not since been raised as oil prices rose subsequently). Although food inflation has declined sharply, nonfood inflation has edged up since January 2009, reflecting the accommodative monetary policy of Bangladesh Bank, the central bank.

Reaching 24.0% in June 2009, the growth of net credit to government was high throughout FY2009, reflecting lower availability of external financing. The 19.2% growth in money supply (M2) in June 2009 was higher than the central bank’s annual program target of 17.5%. Private sector credit rose by 14.6% in June 2009; this was less than the annual program target of 18.5% and was largely on account of the slowdown in credit demand as the global recession damped domestic economic activity (Figure 3.2.4).

Yields on Treasury bills rose marginally during the year to March 2009, but then fell sharply along with commercial banks’ call money rates as bank liquidity surged (Figure 3.2.5). Banks’ weighted average lending rate remained unchanged at 12.3% from the beginning of the fiscal year.

To bolster credit conditions and the economy, Bangladesh Bank cut both the reverse repo and repo rates (1–2-day maturity) by 25 basis points in March 2009 to 6.5% and 8.5%, respectively. Moreover, in the March–June quarter, it adjusted its open-market operations to allow a marked runup in reserve money, which immediately fed through to much lower short-term money market rates. However, with no corresponding decline in commercial lending rates, Bangladesh Bank decided to use mandatory measures and directed banks to lower their maximum lending rate to 13% in a further effort to lower the rate structure and boost credit to the private sector. (Until that decision, the maximum rate had been 16% on agricultural loans.)

The weighted average deposit rate rose to 7.5% in March 2009 from 7.0% in June 2008. The interest spread of the banking system narrowed to 4.8 percentage points in March 2009 from 5.7 percentage points in March 2008.

Revenue collection in FY2009 is estimated at 11.2% of GDP, similar to FY2008 (Figure 3.2.6). Revenue growth missed its target because of a fall...
in import prices that eroded the import-stage tax base, which accounts for over 40% of tax receipts. Domestic indirect taxes also performed below target as economic activity decelerated in response to the global economic downturn. The revenue outturn is low compared with countries at a similar stage of development and limits essential public spending on infrastructure and human development. The poor performance stems from the narrow tax base, excessive exemptions, and weak tax administration.

The new Government announced several tax measures in the FY2010 budget, among others expanding the tax base, withdrawing exemptions and exclusions, simplifying procedures, amending laws, and streamlining tax administration. As a step toward eliminating tax holidays, it introduced a system of reduced corporate tax rates for certain sectors in lieu of existing tax holiday schemes. In an effort to expand the tax base, the Government will also conduct surveys covering cities, districts, and subdistricts to identify those who have avoided tax (by not filing). It also announced a tax amnesty program for FY2010: a modest 10% tax is levied on the declared amounts if they are invested in areas specified by the authorities, such as the stock market.

Savings on food, fuel, and fertilizer subsidies enabled by the fall in international commodity prices and by underspending in the ADP saw FY2009’s public spending come in at 15.3% of GDP, lower than the budget target of 16.3%. As savings on public spending were larger than the shortfall in revenue, the fiscal deficit of 4.1% of GDP was narrower than the budget target of 5.0%. Of the total deficit, 2.3% of GDP was financed domestically and 1.8% externally.

In FY2009, the net losses of the 44 nonfinancial state-owned enterprises shrank sharply from $1.5 billion to only $22.5 million. A high profit earned by the Bangladesh Telecommunication Regulatory Commission (from auctioning licenses to telecoms utilities) and higher earnings by Bangladesh Oil, Gas and Mineral Resources Corporation (from international oil companies after cost recovery was completed) largely offset the combined losses of all other enterprises (Figure 3.2.7). Bangladesh Petroleum Corporation generated a profit for part of the year when international oil prices were low, but incurred losses again when these prices rose but administered domestic prices were left unchanged. Its overall loss in FY2009 was about $520 million, compared with about $1.4 billion a year earlier. The corporation is expected to record large losses in FY2010 if oil prices remain high and administered prices unadjusted. Bangladesh Power Development Board also registered sizable losses in FY2009.

The trade deficit narrowed markedly in FY2009 (by 1.4% of GDP from a year earlier) as import payments grew more slowly than export earnings. Export growth decelerated steadily as FY2009 unfolded due to weak global demand and declining prices, from 42.4% in the first quarter to 19.4% in the first half and further to 10.3% for all FY2009 (Figure 3.2.8). Weak retail sales in industrial economies caused a slowdown in garment export orders over the year. Moreover, as product prices fell by more than raw material prices, exporters’ profit margins shrank, retarding sales of some products. Earnings from “other” exports fell from a year earlier, largely due to a sharp drop in demand for processed leather,
and for frozen food, which is an item with a high income elasticity of demand.

Imports rose by only 4.1% in FY2009 because of falling commodity prices, particularly for oil, and a sharp decline in rice imports attributable to the excellent domestic crop harvests (Figure 3.2.9). Although growth in remittances slowed, inflows from that source still climbed by 22.4% to $9.7 billion in FY2009 (Figure 3.2.10), in view of the jump in workers who went abroad in 2007 and 2008 (and who are sending money back home). Given the substantial improvement in the trade deficit and the continued increase in remittances, the current account surplus ballooned to $2.5 billion (2.8% of GDP), from $680 million in FY2008.

The combined capital and financial account switched to a deficit of $357 million in FY2009 from a surplus of $119 million in FY2008, reflecting a net outflow in portfolio investment, a decrease in net inflows of medium- and long-term loans, and an increase in net outflows of short-term loans, trade credit, and other assets, despite the rise in net foreign direct investment. Net of errors and omissions and valuation changes, gross foreign exchange reserves rose to $7.5 billion at end-June 2009, about $1.3 billion above the level a year earlier (Figure 3.2.11).

The exchange rate remained largely stable against the US dollar in FY2009, with the taka depreciating by about 0.8%. The real effective exchange rate appreciated by around 8%, in part reflecting relatively higher domestic inflation and implying some erosion in export competitiveness.

The Dhaka Stock Exchange general index experienced ups and downs in FY2009, though its end-June level was essentially unchanged from a year earlier (Figure 3.2.12). As at end-July 2009, the index had registered a gain of 4.3% in 7 months. The expected listing of GrameenPhone, the country’s largest mobile phone company, in October 2009 will deepen the market, encourage other large companies to list, and boost investor confidence. Lower corporate tax rates in FY2010 for mobile phone operators, provided that they list on the stock exchange, should encourage other mobile phone companies to follow. Market capitalization rose by 36.1% during FY2009 to reach $19.0 billion in June 2009 (or over 21.0% of GDP), reflecting the listing of companies and declaration of bonus shares in lieu of cash dividends.

**Prospects**

The forecasts for FY2010 depend on some key assumptions. It is assumed that political stability will prevail, and that the Government will be able to move forward in fulfilling its development priorities, sustain its focus on prudent macroeconomic management, and deepen economic reforms. It is also assumed that the measures outlined in the FY2010 budget to accelerate ADP utilization (streamlining project approval processes and raising institutional capacities in key line ministries) will be implemented, and that the private sector will invest more in infrastructure through the new PPP scheme.

It is further assumed that the Government will be able to mobilize adequate external assistance and improve revenue mobilization, and
avoid crowding out the private sector through excessive bank borrowing. Growth projections also assume normal weather conditions.

The GDP growth rate in FY2010 is forecast at 5.2%, the same as in ADO 2009, given that the impact of the global downturn is being felt broadly as envisaged. With the assessment of sector performance remaining unchanged, growth projections for agriculture, industry, and services have been maintained at their ADO 2009 levels. Agricultural growth is expected to remain strong at 4.1%, though this is somewhat less than the FY2009 expansion of 4.6%, reflecting farmers’ response to lower farmgate prices.

A pickup in industry to above the ADO 2009 projections is unlikely, as both external and domestic demand are expected to be sluggish, especially in the first half of FY2010. Although industrial growth should improve in the second half with the expected strengthening in the global economy and more activity in domestic construction, annual growth is projected at 6.0% in FY2010. With virtually no gain in industry’s performance, agricultural growth slowing, and moderation in domestic demand as growth in inflows of workers’ remittances tapers off, expansion in services is expected to continue sliding to 5.5%.

The FY2010 budget takes an expansionary stance, and includes measures for shoring up growth and protecting the poor and vulnerable from the effects of the global economic downturn. These measures, if implemented promptly, might boost GDP growth beyond the projection of 5.2%, but their full effects would likely be realized only in subsequent years.

To encourage local industries, the Government has reduced import duties on raw materials while keeping duties on finished goods unchanged, thus raising the level of effective protection. Higher protection for local industries has also come in the form of regulatory import duties on some items and higher supplementary duties at the import stage for numerous other items. The Government has also raised the turnover threshold for value-added tax on smaller enterprises.

Other expansionary measures in the FY2010 budget include large infrastructure investment programs under the ADP and the new PPP initiative (Box 3.2.1) as well as a widening of social safety net operations. The fiscal stimulus package of Tk34.2 billion (about $500 million) announced in April 2009 to support the sectors affected by the global slump is continued through FY2010, with an additional allocation of Tk50 billion (about $725 million).

The budget has also strengthened existing safety net programs and introduced several new programs, including an enhanced employment-generation program for the hardcore poor. Allocations for food subsidies (0.2% of GDP in FY2010) were raised by 21.1% relative to FY2009.

The FY2010 revenue target of 11.6% of GDP (compared with 11.2% in FY2009) may prove hard to meet because of the expected continued moderate expansion in imports and subdued economic growth. The large one-off collection by the Bangladesh Telecommunication Regulatory Commission in FY2009, which was paid as a dividend to the Government, will not be repeated this fiscal year. While the opportunity to legalize undeclared income should generate additional income for the year, it could potentially act as an incentive to taxpayers.
for concealing normal income so as to take advantage of the much lower tax rate applied, and could further undermine compliance as taxpayers underpay current tax in anticipation of future amnesties. The new revenue-enhancing measures in the budget may also take time to yield results.

Because of the substantially higher public expenditure (16.6% of GDP), the overall deficit will rise to 5.0% of GDP from 4.1% in FY2009 (Figure 3.2.13). Foreign financing is 2.0% and domestic financing 3.0% of GDP, with over four fifths coming from the banking system. The absence of an active secondary bond market limits nonbank investors’ interest in this source of noninflationary financing. Stunted tax receipts are proving costly as borrowing shrinks the fiscal space through high budgetary allocations for interest payments, which amount to 18.2% of revenue in FY2010. In the event of shortfalls in revenue and external financing, the Government would either have to borrow more heavily from banks—squeezing private investment and fueling inflation—or cut public spending, which would affect its growth and poverty reduction programs.

For FY2010, this Update retains the ADO 2009 average inflation projection of 6.5% (slightly lower than FY2009’s actual 6.7%), as import price increases are expected to be moderate and the projected growth in crop output, though decelerating from FY2009, will remain healthy. In addition, moderation in domestic demand growth due to slower remittance inflows will soften price pressures. This projection does not, however, take into account the possibility of an adjustment to domestic fuel prices or the effects of any excessive government borrowing from the banking system.

In its half-yearly Monetary Policy Statement for July–December 2009, the central bank sought to continue its accommodative policy: supporting the Government’s borrowing needs to finance its countercyclical development program while ensuring an adequate flow of credit to the private sector. Its monetary program is aimed at 6.0% growth with inflation projected at 6.5% by June 2010, largely on continuation of the lowered policy rates, open-market operations, and the banks’ ceiling lending rate. The statement indicated that the monetary policy stance would be modified if inflation or growth prospects were to substantially deviate from program goals.

Imports in FY2010 are expected to grow by 10.0%, in part reflecting increased global commodity prices. Export growth is projected to be sluggish at 8.0% because of falling garment export orders and the lower prices offered by buyers, as well as the declines in most other export categories. Growth in workers’ remittances is expected to slow to 12.5% because of increasing numbers of overseas workers returning home and because of the marked slowdown in the outflow of migrant workers. Yet, because of the likely moderate trade deficit, a current account surplus of 0.8% of GDP is still forecast.

Bangladesh faces several risks that could result in the economy failing to achieve the projections: a delay in the global economic recovery; shortfalls in revenue collections and mobilization of external financing, especially given the high targets set on each; political turmoil; and natural disasters.
People’s Republic of China

Expansionary fiscal and monetary policies have softened the blow of the global slump on the economy. A surge in bank lending and vigorous fixed-asset investment have maintained growth at a higher pace than was expected in March. GDP growth will be stronger for both 2009 and 2010 than was then anticipated. The consumer price index is now forecast to decline this year, but inflation in 2010 will be higher than previously thought. The authorities face the challenge of balancing the need to maintain the aggressive monetary stimulus until growth is sustainable against the risk that the flood of bank lending will be diverted into speculation and excess industrial capacity.

Updated assessment

GDP growth accelerated to 7.9% in the second quarter of 2009 (Figure 3.3.1) from a two-decade low of 6.1% in the first quarter, reflecting a massive CNY4 trillion fiscal stimulus package and aggressively expansionary monetary policy aimed at moderating the impact of the global downturn on the People’s Republic of China (PRC). Growth for the first half was 7.1% compared with 10.4% in the first half of 2008. The expansion in the first 6 months was driven by investment, which contributed 6.2 percentage points of the total. Consumption contributed 3.8 percentage points, but a decline in net exports subtracted 2.9 percentage points.

Industrial production regained momentum in the second quarter as firms began to rebuild inventories after a significant destocking that stemmed from the impact of the global economic slump in the fourth quarter of 2008 and early 2009. Growth of industrial value added picked up from an average of 3.8% in January–February to 10.8% in June–July (Figure 3.3.2). However, weak external demand and overcapacity in industries such as steel, cement, and machinery saw total profits of industrial enterprises fall by 22.9% in the first 5 months of 2009. For the first half of 2009, services sector growth of 8.3% exceeded that of industry (6.6%). Agriculture expanded by 3.8%.

Fixed asset investment in real terms soared by 41.2% in the second quarter (Figure 3.3.3), 27 percentage points above a year earlier, reflecting the impact of the large fiscal stimulus and rapid credit expansion. As a sign of the Government’s priorities, investment in the first half in agriculture rose by 68.9%, followed by services at 36.6% and industry with 29.0%. Investment in infrastructure surged by 50.3% and public funding for projects related to health and social security leaped by 71.3%. Investment and GDP growth generally were higher in the less developed central and western regions than in coastal areas.

A vigorous increase in consumption was underpinned by rising household incomes—real per capita urban incomes were up by 11.2% in
the first half and real rural incomes by 8.7%, both above GDP growth. Retail sales grew by 16.2% in real terms in the first half (Figure 3.3.4), supported by these income gains and by government incentives to buy household appliances and, in rural areas, motorcycles. Automobile sales rose by 28.5% in nominal terms in the first 8 months of 2009. The Government cut the purchase tax on smaller passenger cars and offered subsidies in cities to replace older cars.

Residential property sales jumped by 57.1% in value terms during January–June (though the prior-year base figure was fairly low, a result of policy tightening through 2007 and early 2008 to damp a surge in housing prices). This recovery was spurred by low interest rates, abundant credit, tax breaks, and lower down-payment requirements. Residential construction starts, as measured by floor space, increased by 11.4%, as a result of strong demand.

The global trade slump hit external trade: merchandise exports started to fall from prior-year levels in November 2008, and dived by about 22% year on year in the first 7 months of 2009. The pace of contraction bottomed in May (Figure 3.3.5). Merchandise imports also dropped, but by June the decline in import values, too, had slowed, a result of the pickup in industrial production. The decline in import volumes was more moderate than their values, reflecting the slump in world prices for raw materials. At $34.9 billion, the trade surplus in the second quarter was the smallest in 3 years.

Foreign direct investment (FDI) inflows were also affected by the global financial crisis and economic downturn. FDI declined year on year each month, for a fall of 20.3% to $48 billion in the first 7 months of 2009. Foreign exchange reserves, climbing by $185.6 billion to $2.13 trillion in the first 6 months, grew faster than the trade surplus and FDI, prompting concerns about rising speculative capital inflows. The nominal yuan exchange rate was virtually pegged to the US dollar in the first 7 months, while the real effective exchange rate depreciated by 4.5% (Figure 3.3.6).

With global prices for commodities and fuels well below year-earlier levels, both the producer price index and the consumer price index (CPI) fell, by 6.2% and 1.2%, respectively, in the first 7 months of 2009 (Figure 3.3.7). The CPI decline largely reflected lower food prices and higher food production than in the previous year. Prices of residential property, after several months of declines, rose by an average of about 1% year on year in July in 70 big cities as demand gained momentum.

The expansionary monetary stance adopted in late 2008 sparked a huge surge in lending in the first 6 months of 2009 (Figure 3.3.8). New lending jumped to CNY7.37 trillion, or $1.08 trillion in January–June from CNY2.45 trillion in the year-earlier period, far exceeding the Government’s full-year target of CNY5 trillion. Indeed, new lending was equivalent to around 50% of GDP for the 6 months, double the average levels of the previous 2 years.

State-owned enterprises and large private businesses were the major borrowers, particularly those involved in infrastructure, business services, and real estate development. The Government approved a large number of investment projects as part of its fiscal stimulus and it reduced the minimum equity requirements for fixed-asset investment projects.
Growth in broad money supply (M2) accelerated to 28.4% in July, exceeding the Government’s annual target of 17%, and M1 rose by 26.4% (Figure 3.3.9). Rapid growth in money supply and bank lending supported increases in stock and property prices. Shanghai’s Composite Index of stocks rose by about 47% in the first 8 months of this year. The stronger market prompted the authorities in June to lift a ban on initial public share offerings that was imposed in October 2008 in an effort to support a weak market at that time.

The flood of credit also raised concerns about its potential to inflate asset bubbles and to raise the nonperforming loan ratio at banks. In July, the China Banking Regulatory Commission asked lenders to lift reserves to 150% of their nonperforming loans by end-2009 from 135% at midyear and urged banks to ensure that loans for investment in fixed assets are not diverted to speculative activities. The People’s Bank of China, the central bank, drained excess liquidity from the money market and guided money market interest rates higher in July.

The pace of growth in new lending slowed in July and August from the torrid rate set in the first 6 months. Data from the central bank show new lending of CNY355.9 billion in July and CNY410.4 billion in August, compared with a monthly average of CNY1.23 trillion in January–June.

Fiscal stimulus measures being rolled out from November 2008 through end-2010, costing about CNY4 trillion (13% of 2008 GDP), include social and infrastructure spending, reconstruction of public facilities damaged by the May 2008 Sichuan earthquake, and subsidies to farmers and some industries. The Government has committed CNY1.18 trillion; the rest comes from local governments, banks, and state-owned enterprises. According to the Ministry of Finance’s disbursement schedule, about half the central Government’s contribution will be spent by end-2009 and the other half in 2010.

About 24 million new jobseekers will enter the labor market in 2009, at a time when millions of workers have lost their jobs as a result of the economic slowdown. The Government estimated in February that about 20 million migrant workers were unemployed at that time. The labor market started to pick up in the second quarter; about 6.7 million jobs were created in the first 7 months. Many of the migrant workers who lost their jobs have been rehired since February, although some of the new jobs are in lower-wage positions or involve reduced working hours. Out-of-work migrant workers have been at risk of falling into poverty because they are ineligible for social protection programs (Box 3.3.1).

The PRC has taken steps in 2009 to gradually increase the role of the yuan in international finance and trade. In September, the Ministry of Finance disclosed plans to sell yuan-denominated government bonds in Hong Kong, China for the first time. That followed the granting of permission for banks there to issue yuan bonds. The People’s Bank of China established bilateral currency swap agreements with several other central banks, mainly in Asia, that will enable foreign firms to pay for imports from the PRC in yuan. It has also allowed the yuan to be used in certain trade settlements.
3.3.1 Social assistance for migrant workers

The fiscal stimulus package includes measures to preserve employment, assist city-registered residents who are jobless, and provide reemployment services. However, migrant workers, who are more likely than others to lose their jobs during a downturn, are often excluded from such programs in both labor-receiving cities and labor-exporting rural areas.

For example, most migrant workers are ineligible for vocational training allowances. Also, as many are young adults, their children are often too young to qualify for free primary school education.

Those most at risk of falling into poverty are jobless migrant workers who either stay in cities and lack access both to government support programs and to their family networks, or those who return to the countryside but do not have suitable farming land or a means of livelihood.

Limited data make it difficult to estimate the magnitude of these two groups, but they are clearly sizable. A senior official at the National People's Congress in March estimated that a quarter to a third of migrant workers were unemployed in some regions. According to a survey by the National Bureau of Statistics, the total number of rural migrant workers was 225 million at end-2008, of whom 140 million had moved outside their counties to seek jobs in cities while 85 million had moved to work in village and township enterprises within their counties.

The Government has the capacity to tackle the most urgent vulnerabilities by building on existing programs. Some measures the Government could consider include:

- Providing migrant workers without incomes access to temporary income assistance programs;
- Providing assistance for the education and nutrition of their children;
- Allowing migrant workers access to vocational training and reemployment services; and
- Coordinating social assistance programs provided by different levels of government to ensure that migrant workers are covered.

These interventions could complement existing employment initiatives, such as support for labor-intensive small and medium-sized enterprises and provision of public service jobs.

Prospects

The forecasts assume that the fiscal stimulus will be maintained through 2009 and 2010. It is also assumed that monetary policy, after some fine tuning, will be kept at highly stimulatory levels until inflation returns and economic growth can be sustained without such strong monetary stimulus, when policy will be tightened somewhat.

Public investment will remain at high levels under the fiscal stimulus package. Furthermore, as part of a program to improve the efficiency of industries including steel and textiles, the Government plans to contribute CNY600 billion toward research and technical innovation in these industries. Expansionary monetary policy is expected to provide ample funding for state-owned enterprises, especially those engaged in infrastructure development.

Private sector investment may remain subdued, particularly in manufacturing, until external demand improves significantly. Official proposals to widen access to credit for small and medium-sized enterprises, if realized, should stimulate private investment. So will the rebuilding of inventories. In real estate, recoveries in sales and prices of residential property are encouraging developers to invest in new projects, and the outlook for commercial property is also improving.

Drawing these strings together and taking into account that government-led investment in the first half of 2009 was stronger than was anticipated in ADO 2009, investment growth this year will rise faster than foreseen in March.

Solid growth is expected in private consumption. Rural incomes are benefiting from government subsidies for agriculture and for purchases of...
durable goods, higher government grain purchase prices, and higher pork production (after diseases reduced pig numbers in 2008).

As in rural areas, consumption in cities is underpinned by rising incomes and subsidies, and to some extent by the wealth effect generated by recoveries in residential property and stocks. These positive influences are partly offset by continued weakness in the labor market and relatively low, though improving, consumer confidence (Figure 3.3.10). Consumption so far in 2009 has been stronger than was expected in March, and its growth for the whole year is revised up.

On the basis of all these factors, and coupled with the bottoming of trade and industrial production in the first half of 2009, the full-year GDP growth forecast is upgraded to 8.2% from 7.0% in ADO 2009. The expected maintenance of fiscal stimulus and moderate recovery in the international economy in 2010 is seen lifting the PRC’s growth rate next year to 8.9% (Figure 3.3.11). The major drivers of growth will be infrastructure investment, recovery in construction, and expansion of consumption; net exports are likely to make only a minor contribution. As 2010 progresses, the pace of growth is expected to moderate slightly, reflecting both the rising base effect from 2009’s accelerating growth as well as the assumed gradual tightening of monetary policy.

Mild deflation is likely to continue through most of 2009, and the CPI is now projected to decline by 0.5% this year (revised from a rise of 0.8% in ADO 2009) (Figure 3.3.12). Taking into account the large monetary stimulus, declining base for the CPI in late 2008, and a possible increase in administered prices for natural gas, electricity, and water supply, the CPI is forecast to turn up by end-2009. Higher economic growth next year will contribute to lifting inflation to a forecast 3.0%.

This year’s government steps to assist exports—an increase in export tax rebates and expansion of export credit and insurance—will support the export effort in the second half of 2009. Exports will likely rise slightly year on year in the fourth quarter of 2009. For all this year, though, merchandise exports are expected to fall by 17.5%, before rebounding to grow by 8.0% in 2010 as global trade expands again. Merchandise imports are projected to fall by 15% in 2009, and then grow by about 6% in 2010. As a result, the merchandise trade surplus will decline this year, but remain large, and is projected to pick up next year.

The surplus in the income account will be substantial in the forecast period, as a result of earnings from foreign reserves and international investment. However, the services account is projected to remain in deficit. Trade surpluses look likely to be smaller than expected in ADO 2009, and therefore the forecasts for the current account surpluses are revised down slightly. Nevertheless, foreign exchange reserves are expected to rise to $2.6 trillion by end-2010.

The surge in public spending from the fiscal stimulus comes at a time that government revenue growth has slowed because of lower economic activity and tax concessions. This year’s budget deficit is projected to widen to 3.1% of GDP. While still moderate, that would be the deepest gap in 30 years. The deficit should narrow in 2010 as revenue picks up in tandem with economic activity.

Risks to the outlook center on the external environment and the domestic fiscal and monetary stimulus programs. If the global rebound...
were significantly weaker than currently foreseen, PRC exports and industrial production would be lower than anticipated, as would GDP growth.

The fiscal stimulus package looks likely to be maintained through 2010. There seems little risk of an earlier than expected withdrawal, which would damp growth. As for the monetary expansion, some moderation in the aggressive stance is assumed. Policy fine tuning was seen from July 2009 and officials have said that they are considering a range of policy tools to adjust bank lending.

At some point, the authorities will also likely reconsider the cuts made in late 2008 in the bank reserve requirement ratio and in the base lending rate (Figure 3.3.13), implemented when the global financial crisis and economic slump intensified. If the monetary stimulus is withdrawn at a faster pace than assumed, and before economic growth can be sustained at high levels without the stimulus, an unintended abrupt slowing in economic growth becomes a risk.

The authorities face the challenge of balancing the need to maintain the monetary stimulus against the risk that the flood of bank lending, if extended for too long, may be diverted into unproductive purposes—speculation in stocks and real estate and a misallocation of resources that erodes bank asset quality and eventually causes inflation pressures. Such a scenario might trigger a round of severe monetary policy tightening in the medium term that would pull growth down again.

The response to the global economic slump—ratcheting up investment through highly stimulatory fiscal and monetary policies—has interrupted the longer-term effort to restructure the economy away from investment and export-led growth toward more private consumption. Indeed, investment in 2009 will contribute a much higher proportion of GDP growth than in recent years (Figure 3.3.14).

Regression is likely this year in some other rebalancing goals as well, such as energy saving and environmental protection. (The slump in global demand has at least temporarily reduced the economy’s reliance on exports for growth, and the trade surplus will decline this year.) The Government’s midterm evaluation last year of its 11th Five-Year Plan (2006–2010), which set goals for restructuring, already showed that progress lagged in several areas. A challenge is, therefore, for the Government to swing attention back to the restructuring efforts after the economy is weaned off the fiscal stimulus.
India

Owing to limited traction from an earlier aggressive easing in monetary policy, more recent countercyclical efforts have focused on a public expenditure–led growth strategy. Signs of improvement are now emerging in economic activity, private business confidence, and access to external funding, though exports remain depressed. In FY2009, a weak monsoon will likely stunt agricultural output. Nevertheless, the growth forecasts are revised upward from those made in March, largely because adroit economic management has minimized damage and preserved relatively strong expansion of the economy. Although the growth strategy is appropriate given global economic weakness, it could prove counterproductive if the Government fails in its intention to rein in the large fiscal deficits over the next few years.

Updated assessment

Macroeconomic management remains challenging for India's policy makers. They face a continuing subdued global economic environment that has affected the economy mainly through diminished capital flows and trade volumes, and eroded investor confidence.

As in most other developing countries, the financial crisis slowed economic growth significantly, as reflected in a marked weakening in exports and a downdraft in private consumption and investment. GDP grew at 6.7% in FY2008 (ended 31 March 2009) compared with 9.0% a year earlier. An expansionary fiscal policy underpinned the economy. Government consumption expenditure increased by 20.2%, contributing almost one third of GDP growth. At the sector level, the downdraft was especially evident in an industrial slump in the third and fourth quarters.

GDP growth of 6.1% in the first quarter of FY2009 signaled a modest improvement from 5.8% expansion in the previous 2 quarters (Figure 3.4.1). The upturn reflected a recovery in industrial growth to 5.0% from less than 2% in the previous 6 months. Growth in the large services sector slowed to 7.8%, mainly because of slower expansion in social and personal services; the other business-oriented subsectors retained their momentum.

From the demand perspective, preliminary data indicate that the contributions to growth by private consumption and investment as well as by government spending fell heavily in the first quarter of FY2009, while an unusually large positive contribution came from net exports, primarily due to an import slump (Figure 3.4.2).

An important sign that accommodative monetary policies and fiscal stimulus have brought the economic slowdown to an end is seen in the movement of the industrial production index. The year-on-year increase in the index fell to near zero in March and then staged an impressive rebound to 8.2% in June 2009, a rate that was essentially sustained in
July, according to preliminary reports (Figure 3.4.3). However, subdued performance in April and May restricted growth in the index to only 3.9% in the first quarter, though the consumer durable goods sector recorded robust expansion. Significantly, the upturn in the index was broad-based with basic, capital, and intermediate goods registering impressive growth, indicating a general revival in activity.

A preliminary analysis based on 3,126 companies shows that their net profits climbed by 19.9% in the first quarter of FY2009 from a 2.5% increase in the same period of FY2008, apparently mainly due to cost savings. The quarter also marked a return of ready access to international capital markets. Nearly $4 billion was raised by Indian companies through qualified institutional placements and more than $2 billion through global and American depository receipts in June–July 2009. External commercial borrowing rose by 19% to $1.92 billion in June 2009, the highest since September 2008.

Year-on-year wholesale price inflation turned negative (1.6%) in June 2009, a rate largely unchanged in July (Figure 3.4.4). The latter month’s deflation reflected lower fuel prices than a year earlier, even though the Government increased domestic prices of gasoline and diesel by almost 10% in June. The impact of the fuel hikes was offset by a fall in manufactured goods prices to below year-earlier levels. By the October–December quarter of FY2009, the upward pressure on prices will likely exceed the downward pull from the high base of a year earlier. Indeed, the authorities expect year-on-year inflation to be 4–5% by March 2010.

A worrying feature of the price structure is that primary commodity food inflation remains high at around 7.1%. In addition, a weak monsoon (likely to be the worst in 7 years) and droughts in many parts of India are stunting food production and so will exert upward pressure on food prices in the coming months. The Government expects to cushion the weather impact by using its large foodgrain stocks (at 53 million metric tons, well above the buffer stock norm) and by importing essential commodities. High food prices (with a heavy effect on the poor) in an economy operating well below capacity further complicates the monetary management required to keep inflation expectations in check.

From October 2008 through April 2009, the Reserve Bank of India (RBI) cut its main lending rate, the repo rate, by 425 basis points to 4.75% (when it made its last adjustment). It cut the rate for reverse repos—the RBI facility that absorbs bank reserves—to 3.25% and lowered the cash-reserve ratio during this period (Figure 3.4.5). It made no change in policy instruments in the July monetary policy review, signaling an end to monetary easing.

The policy measures had a discernible effect on the call money market rate, which fell from 10.6% in September 2008 to 3.2% by April 2009 (a rate maintained through August), and term deposit rates, which declined by up to 375 basis points. However, the five largest banks reduced benchmark prime lending rates by only 200–225 basis points, from 13.25–14.0% to 11.0–12.0%, over the same period.

The RBI has expressed dissatisfaction about the sluggish transmission of the changes in policy rates to the changes in the benchmark prime lending rates. Bank credit increased by only 1.0% in the first 5 months of FY2009, compared with about 3.3% in the year-earlier period. While RBI

3.4.3 Growth of industrial production index

3.4.4 Contributions to inflation

3.4.5 Policy rates
open market operations have been highly expansionary, banks have used the reverse repo facility to park (rather than lend) much of the funding that was provided. This situation is indicative of weak demand for credit and illustrates a limit on the effectiveness of monetary policy during a slowdown in activity.

Reflecting high commodity prices, the budget deficit ballooned in FY2008 under the weight of large subsidies for oil, fertilizer, and food early in the period, while shortfalls in revenue and the need for fiscal stimulus were felt later on as economic growth slowed (Figure 3.4.6). Apart from initial payments from a large hike in wages for civil servants stemming from the Sixth Central Pay Commission award, the fiscal stimulus effort (about 1.5% of GDP) focused on a substantial reduction in indirect taxation, social security programs, and rural infrastructure spending.

The revised central government budget for FY2009, presented on 6 July (following parliamentary elections in May) was prepared against the background of a marked slowdown in the domestic economy and the global recession. The budget, however, envisaged a recovery in growth to 7.0% for the fiscal year from 5.8% recorded in the second half of FY2008.

The central government fiscal deficit is targeted to increase to 6.8% in FY2009 from 6.0% in FY2008 and from 2.7% in FY2007. Total expenditure is planned to rise by 16.1% (to 17.5% of GDP), including large increases for public investment in infrastructure, the National Rural Employment Guarantee Scheme (which provides 100 days of employment for a member of a rural household below the poverty line), and Bharat Nirman—a program for rural infrastructure (Figure 3.4.7). Spending priorities reflect the Government’s goal to support the rural poor and to accelerate infrastructure development while continuing the fiscal stimulus. Off-budget outlays are expected to amount 0.2% of GDP in FY2009 compared with 1.8% a year earlier, as lower commodity prices allow a sharp reduction in the cost of support for fuel and fertilizer price subsidies.

The revised budget projects revenue to grow by 12.8%, to 10.5% of GDP, but proposes no new major tax changes. Yet a revamp is under way: the Government plans to introduce a national goods and services tax on 1 April 2010 (to replace the multiplicity of central and state indirect taxes and rate structures) in efforts to move toward a unified national market and to strengthen the revenue base. Separately, the Ministry of Finance has proposed for public discussion a significant reform of the direct tax system, which would markedly lower corporate and personal tax rates while ending a complex web of special exemptions and exclusions. The new system is expected to be in effect from 1 April 2011.

The central government deficit (including off-budget financing of subsidy programs) is targeted at 7.0% of GDP for FY2009, a decline from 8.0% a year earlier and reflecting the fall in off-budget financing. Including the state governments, the overall deficit for FY2009 would likely be about 10–11% of GDP. While India’s deficits are no wider than in some other major economies that have mounted strong countercyclical efforts, the Government recognizes that they cannot be sustained as the combined federal and state public debt amounted to nearly 73% of GDP at end-FY2008. It has announced plans to reduce the federal deficit to 5.5% of GDP in FY2010 and to 4.0% of GDP in FY2011, relying on the mooted tax changes and a strengthening economy.
An expert group “to advise on a viable and sustainable system of pricing oil products” was announced at the presentation of the FY2009 budget. In view of large swings in global oil prices, reform in the present administered pricing of petroleum products is essential for control of the deficit, sound macroeconomic policies, and the long-term health of the domestic petroleum industry. Difficulties in the present system were evident in FY2008: off-budget bond issues to fund subsidies to oil-marketing companies amounted to 1.3% of GDP in FY2008; and state-run upstream companies’ price discounts (for which they were not compensated by the Government) amounted to 0.6% of GDP.

The global financial crisis and economic slowdown caused a marked deterioration in the external position in FY2008. Monthly exports dropped sharply from October 2008 depressing their growth for the fiscal year to only 5.4%, while net capital inflows plummeted to about $10 billion from nearly $110 billion a year earlier. A drop in imports, in part owing to lower oil prices, held the current account deficit to $29.8 billion or 2.6% of GDP (1.4% in FY2007). Nevertheless, foreign exchange reserves fell sharply by $58 billion (including large valuation losses).

Balance-of-payments estimates for the first quarter of FY2009 are not yet available. Monthly customs data indicate a bottoming in the fallow in trade flows and marked improvements in both net capital inflows and foreign exchange reserves. Unlike some other Asian countries, India saw little improvement in export performance in the first quarter of FY2009. Exports during the first 4 months averaged $12.0 billion, little different from the average of the previous 4 months and still about 30% below levels seen a year earlier (Figures 3.4.8 and 3.4.9). Still, a steady improvement was recorded from the April low of $10.7 billion to July’s $13.6 billion.

Imports weakened after July 2008 with falling oil prices and slower economic growth, to touch a low in March 2009 of $15.6 billion. They subsequently rebounded to $19.6 billion in July 2009, though they remain substantially below year-earlier levels (Figure 3.4.10).

Portfolio investment has recorded a sharp turnaround with a net inflow of $8.3 billion in the April–June quarter compared with net quarterly outflows in FY2008 that averaged $3.5 billion. Foreign direct investment at $7.1 billion in the same quarter essentially maintained the previous year’s solid performance. Nonresident Indian deposits have been boosted by RBI’s upward adjustments in interest rates for such savings. Foreign exchange reserves increased by $12.6 billion in the first quarter and to $19.5 billion in the first 5 months of FY2009 (compared with a $13 billion fall in the same period the previous year), indicating a substantial improvement in the overall balance of payments to date in FY2009 (Figure 3.4.11).

Following a downward drift in the rupee during the previous fiscal year against the US dollar, the local currency appreciated by about 4.4% during the first 5 months of FY2009 to Rs48.8/$1 (Figure 3.4.12). This gain reflected renewed capital inflows and the Government’s reelection. As of August, in real effective terms the exchange rate was roughly 8% below that of a year earlier. While the increase in global investor risk appetite augurs well for continued capital inflows, the authorities are likely to
resist further strengthening in the domestic currency given the continued weakness in exports.

Following substantial gains over several years, the Sensex, the main index of the Bombay Stock Exchange, lost about 60% of its value from its all-time high in early January 2008 through about mid-March 2009. Subsequently through end-August, the Sensex (and Asian stock markets in general) participated in a worldwide rally in equities, and was up by about 63% for the year (Figure 3.4.13). Apart from a reduction in risk aversion by global investors and an upturn in portfolio investment, the market has benefited from a general renewal of Indian investors’ confidence based on the country’s ability to handle the global turmoil with minimal dislocation (to post the second-highest growth rate for a major economy in 2009), a strong consensus on improved domestic growth prospects, and nascent signs of recovery in the world economy.

Prospects

ADO 2009 Update’s forecasts for FY2009 and FY2010 are based on five key assumptions: monetary conditions will continue to be accommodative; agricultural output will be stunted in FY2009 but the domestic food supply will remain adequate; oil prices will average about $63 per barrel in 2009 and $73 in 2010; nonfuel commodity prices will decline in 2009 but rise in 2010; and industrial economies will show a moderate growth recovery in 2010. The main differences in assumptions between this Update and ADO 2009 are a sharper contraction in 2009 for major industrial economies; higher than expected oil prices in both 2009 and 2010; and a steeper decline in world trade volume in 2009 and a sharper rebound in 2010.

The positive response to monetary policy adjustments and fiscal stimulus as well as a quicker than expected return of capital inflows have provided a lift to the domestic economic environment. This rising optimism has been reflected in numerous business sentiment surveys as well as the Industrial Outlook Survey that the RBI conducted in April–May 2009 (Figure 3.4.14). Moreover, the Purchasing Managers Index in April changed its signal to expansion after indicating contraction in the previous 5 months.

Improved business confidence is primarily attributed to reduced stress in financial markets with easing of credit availability; the large fiscal stimulus; strong financial performance of the corporate sector in the first quarter of FY2009; and expectations of strengthened economic policies based on an enlarged and more cohesive coalition majority in Parliament.

The combination of countercyclical fiscal policies and renewed investor confidence is expected to sustain growth in private consumption and investment in FY2009. The impact of the poor monsoon and drought on rural incomes and consumption will be partly offset by various programs to aid rural households in the budget and, possibly, by supplementary assistance for farmers, which is under study by the Government.

Growth will continue to be driven by government spending but its impact in FY2009 will be less than in FY2008 when expenditure and the deficit ballooned. GDP growth in the second and third quarters is expected to fall below the 6.1% first-quarter expansion because of weak...
agriculture, but to recover sufficiently in the fourth to post a 6.0% annual expansion. This is an upward revision from 5.0% in ADO 2009 but still represents a slowing from the 6.7% expansion in FY2008. Normal rainfall in FY2010, a pickup in exports (as the recession ends in industrial economies), and strengthened investor confidence are now projected to lift GDP growth to 7.0% in FY2010.

The Update revises inflation to average 2.5% in FY2009, a percentage point below that projected in ADO 2009, reflecting the high base of the wholesale price index in FY2008 and unforeseen weakness in prices for manufactured goods. However, these factors are expected to fade in the second half and, with greater pressure on food prices, year-on-year inflation is expected to climb to 4–5% by end-FY2009. No change is made in the FY2010 forecast for inflation.

Weak global demand will continue to weigh on exports, though some strengthening in the second half of FY2009 is expected. That should limit their decline for the year to about 5% from the FY2008 level. Weak sectors such as apparel have reported a revival in orders, while exports of manufactured goods appear to be benefitting from the strengthening seen in some industrial countries.

Lower oil imports and growth are expected to compress imports by about 5% in FY2009 from the previous year. Moderate improvements in software services exports and in workers’ remittances will also help rein in the current account deficit, which is expected to shrink to 1.5% of GDP. In FY2010, a moderate upturn in global oil prices and a renewed thrust in manufacturing growth are expected to push import growth higher, leading to a wider current account deficit of 2.0% of GDP.

Apart from the global uncertainty, the key downside risk to the outlook emerges from financial crowding out of private investment. This issue is most likely to arise in FY2010 and underscores the need for the Government to concretize its plans to undertake fiscal adjustment. There is also a risk that domestic food price inflation may create a dilemma for monetary management in the second half of FY2009 as RBI seeks to keep inflation expectations in check but not to choke off a fragile recovery.

There must be revival in private investment spending, which is highly sensitive to credit conditions, so that fiscal stimulus can be throttled back without jeopardizing a recovery and a quickened pace of growth. The late monsoon rains may fill water reservoirs to an adequate level to ensure a reasonable winter crop, aiding RBI. For the longer term, further structural reforms in agriculture and the food distribution system are needed to improve efficiency, lower costs, and alleviate price pressures.
Robust growth in private consumption, underpinned by easing inflation and a surge in election-related government spending, drove better than expected economic growth in the first half of 2009. Fiscal stimulus measures supported growth. Net exports also contributed to the expansion as imports contracted faster than exports. Investment weakened. Relative to forecasts made in March this year, the full-year growth projections are revised up for 2009 and 2010, and inflation will likely be lower. Risks to the outlook include higher than expected oil prices, which would propel inflation and hurt consumption, and dry weather, which could damage harvests.

**Updated assessment**

With year-on-year GDP growth of 4.2%, Indonesia outperformed other major economies in Southeast Asia in the first half of 2009, mainly because its large domestic market and its relatively low dependence on external trade (exports represent about 30% of nominal GDP) provided some insulation from the global economic turmoil. However, the impact of the global financial crisis and the slump in world trade took growth to well below the 6.3% rate recorded in the first 6 months of both 2007 and 2008.

Private consumption, accounting for almost 60% of GDP, grew by 5.4% in the first half of 2009, only slightly below the year-earlier rate, and made the biggest contribution to GDP growth on the demand side. Consumption received a lift from slowing inflation, good harvests that supported farm incomes, and election-related spending (parliamentary elections were held in April and presidential elections in July). Also, the Government provided cash transfers to 18.5 million poor households in January and February and lowered some taxes as part of a fiscal stimulus package aimed at mitigating the impact of the global downturn. Nevertheless, tighter credit hurt sales of consumer durables such as motor vehicles.

Government consumption soared by 18.0% during the first half (Figure 3.5.1), or four times as fast as a year earlier, a result of pay increases for civil servants, the election-related spending, and an improvement in the disbursement rate of budgeted outlays. Imports of goods and services contracted faster than exports, thereby generating positive net exports, which also contributed to GDP growth. This was in contrast to the first half of 2008, when a fall in net exports acted as a drag on growth.

But investment, after growing by double-digit rates since mid-2007, edged up by a meager 0.9% in the first half of this year. Fixed investment rose by only 3.0%; investment in buildings increased by 6.3% but investment in machinery and equipment fell by 10.1%. Borrowing

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for investment contracted, reflecting firms’ unwillingness to expand production and the tighter bank credit.

On the production side, the services sector grew by 5.9% in January–June and contributed 2.6 percentage points of total growth (Figure 3.5.2). Continued rapid expansion of the communications subsector offset slowing growth in some other services. Industry grew by only 2.6%, with the important manufacturing subsector increasing output by just 1.5%, largely a consequence of weak export demand. Mining output (including crude oil) increased by 2.4%. Oil production rose to 957,000 barrels a day from 846,000 barrels in the first half of 2008. Industry as a whole contributed 1.1 percentage points to GDP growth.

Agriculture expanded by 3.7% in the first half and this added 0.5 percentage points to GDP growth. Food crops performed well, but production increases from plantations (mainly natural rubber and palm oil) decelerated because of a decline in global demand. In 2008, agriculture expanded at the fastest rate in about one and a half decades (by 4.8%), in response to high prices for agricultural commodities and good weather.

Falling world prices for export commodities and the slump in global trade pushed down merchandise exports by 27.9% in the first 6 months of 2009. Merchandise imports fell even more steeply, by 38.7%. Monthly trade data suggest that the pace of decline for exports and imports bottomed out during the first half (Figure 3.5.3). In particular, exports of primary commodities including coal, copper, and crude palm oil picked up in tandem with world demand and prices for these products.

The trade surplus, against a backdrop of the steep slide in imports, increased by 21% in the first half of 2009 from the prior-year period and by nearly 60% from the second half of 2008, to $15.7 billion (Figure 3.5.4). The current account recorded a surplus of $6.0 billion (2.5% of GDP), reflecting the big trade surplus and narrower income and services deficits, which outweighed a decline in current transfers (including remittances).

Net foreign direct investment inflows, mainly driven by investments in oil and gas and acquisitions in telecommunications, totaled $3.5 billion, about the same as in the first half of 2008. Net portfolio investment inflows of $3.3 billion marked a turnaround from net outflows in the first half of 2008, a sign of improved international investor confidence. The overall balance of payments recorded a surplus of about $5 billion.

The portfolio investment outflows in 2008 were the main reason for a decline in Indonesia’s international reserves to $50.6 billion by October. By June 2009, the reserves had recovered to $57.6 billion, or 5.5 months of imports of goods and services and official debt service payments. The external situation has been further bolstered through a memberwide allocation by the International Monetary Fund of special drawing rights, of which Indonesia received $2.7 billion, as well as by currency swap arrangements totaling more than $30 billion.

Inflation abated from 12.1% year on year in September 2008 to 2.7% in July 2009 (Figure 3.5.5), as global prices of fuel and commodities fell. The Government lowered the subsidized prices of fuels and reduced some commercial electricity tariffs. A slowing in food price inflation, assisted by the good harvests, was a welcome relief for the roughly half
of the population who live on less than $2 a day. The poverty incidence measured by the national poverty line declined to 14.1% in March 2009 from 15.4% in March 2008, reflecting the January–February cash transfers, easing food price inflation, and cuts in fuel prices.

Domestic fiscal stimulus measures and other government spending helped support the labor market, at least early in the year. The unemployment rate fell to 8.1% in February 2009 from 8.4% in August 2008. The informal sector accounts for about 70% of the workforce and usually absorbs most layoffs from the formal sector.

In the context of the slowing in economic activity and inflation, Bank Indonesia cut its policy interest rate by a total of 300 basis points from December 2008 to August 2009, to 6.5%. Commercial banks lagged in lowering lending rates, so that from February to May rates charged for working capital and investment declined by less than 60 basis points, and lending rates for consumption increased slightly during that time.

Year-on-year growth in lending to businesses and individuals slowed during November 2008 to May 2009 from 45% and 30%, respectively, to 16% and 22%. This deceleration reflected both lower demand for credit in the face of a slowing economy and still-high bank interest rates, and banks’ greater caution. Commercial banks’ nonperforming loans increased from 3.8% of the total in December 2008 to 4.5% in June 2009 (Figure 3.5.6). Year-on-year broad money supply growth picked up from 14.9% to 16.1% over the same period (Figure 3.5.7).

Totaling Rp73.3 trillion or about 1.4% of GDP in 2009, the fiscal stimulus package consists mainly (83.7%) of tax breaks and subsidies that could be implemented quickly to support private consumption and businesses. Within the first quarter of 2009, most of this fast-disbursing stimulus had been implemented. The measures included waivers of income and value-added taxes, subsidies for cooking oil and generic medicines, waived import duties, a diesel subsidy, electricity discounts, and a credit facility for small and medium-sized enterprises.

Nearly all the rest of the stimulus package (15.5%), is for labor-intensive infrastructure works involving water supply projects, low-cost housing, roads, and ports. It is intended that most of this part will be disbursed in the second half of 2009. Efforts by the Government to accelerate capital spending raised the disbursement rate slightly in the first half of this year to 23.2% of budgeted spending from 20.9% a year earlier.

Stimulus package funds (0.8%) were also allocated to extend a community empowerment program, which encourages village participation in planning and carrying out infrastructure, education, and health projects.

The Government is sourcing funding for the additional expenditure, as well as for debt-amortization payments, from debt markets and from budgeted funds that were not spent in 2008. By mid-August, it had raised more than 80% of this year’s gross financing needs. Moreover, it insured itself against a worsening financing climate by securing access to contingency financing from development partners, which can be drawn if financial markets become restrictive again.

Budget revenue in the first half of 2009 was about 14% below prior-year levels, mainly because of lower receipts from oil and gas, the tax breaks, and reduced income from value-added tax and from import
and export duties. The fiscal deficit in 2009 is expected to widen to a still-manageable 2.6% of GDP.

In line with global trends, Indonesia’s financial markets started to recover in March 2009. The stock market index, which dropped by 50% in 2008 as investors moved out of emerging markets, surged by more than 70% in the first 8 months of 2009 (Figure 3.5.8). The rupiah depreciated by about 15% against the US dollar in the last 3 months of 2008, then appreciated by 12% in the first 8 months of 2009, partly bolstered by confidence in macroeconomic management.

Yields on government bonds have fallen significantly since March and credit default swaps are almost back to levels seen before the global financial crisis that erupted late last year (Figure 3.5.9). Moody’s raised Indonesia’s foreign and local-currency sovereign debt ratings in September 2009 to Ba2 from Baa3.

Prospects

Projections for 2009 and 2010 assume that the Government will implement major policies outlined during the election campaign, such as fostering infrastructure development and reforming the bureaucracy. The Government plans to support development of infrastructure in 2010 through new tax incentives and expenditure of Rp93.9 trillion ($9.4 billion). An additional fiscal stimulus package for 2010 is not planned, but the proposed 2010 budget provides space for further growth-stimulating measures if required.

As for monetary policy, the policy interest rate is assumed to remain around current levels until inflation picks up together with the global recovery, so that the authorities will likely need to start tightening monetary policy during 2010. The forecasts further assume that planning for a likely El Niño weather pattern, which could cause drier than usual weather and damage harvests, succeeds in preventing food prices from rising rapidly and in maintaining food sufficiency.

Private consumption growth is expected to be maintained, supported by the easing of inflation. Confidence indexes were showing upturns at midyear (Figure 3.5.10). The rollout of projects under the infrastructure part of the stimulus package will bolster public investment. Private investment is expected to pick up from low levels given the solid economic growth, successful completion of the elections, and the rebound in the stock market. Banks are expected to lower their lending rates, too.

Prices of several important export commodities, such as coal, copper, oil, and palm oil, have turned up and, as noted, the pace of decline in monthly exports has bottomed out. This improved outlook should stimulate commodity production. Furthermore, the index of manufacturing production has been rising since early this year (Figure 3.5.11).

Taking these factors into consideration, GDP growth is forecast to edge up to 4.4% in the second half of 2009 relative to the first. Given that the economic performance has been stronger than expected in Asian Development Outlook 2009 (ADO 2009) in March, the full-year forecast is raised from 3.6% to 4.3% (Figure 3.5.12).
In 2010, the expected modest rebound in global economic growth and stronger world financial markets are seen underpinning expansion in external and domestic demand (particularly some further recovery in investment), lifting GDP growth to 5.4%, which is also above the ADO 2009 forecast. The corporate tax rate is scheduled to be lowered by 3 percentage points to 25% next year, which should also support investment. GDP growth could exceed this projection if the Government manages to accelerate its rollout of infrastructure investment by addressing constraints such as legal uncertainties and land acquisition for projects.

Trade surpluses are forecast to remain high, although they will decline in 2010 as imports pick up in tandem with economic growth. The income account deficit is seen widening as foreign firms that benefit from rising commodity prices repatriate profits. Remittances from Indonesian workers abroad are expected to decline moderately in 2009, but to recover in 2010. These factors are projected to leave the current account in surplus at around 2% of GDP this year and next, revised up from ADO 2009. The overall balance of payments is forecast to remain in surplus, partly a consequence of the return of portfolio inflows since global financial markets stabilized.

Lower than expected inflation in the first half of 2009, coupled with the firm rupiah and good harvests (July’s rice stocks, for example, stood at 2.6 million tons, or 9 months of consumption) have prompted a downward revision in the inflation forecast for 2009 to a year-average 5.0%, which would be the lowest rate since 2000. Inflation is projected to edge up next year to about 6.0%, reflecting firming economic growth and higher global commodity prices.

While the Government aims to rein in its budget deficit to 1.6% of GDP in 2010, a more expansionary fiscal position could be accommodated if the global economic recovery falls short of expectations. Central government debt (foreign and domestic) is estimated to decline from 33% of GDP in 2008 to about 31% in 2009 and to just above 30% in 2010.

One risk to the forecasts is a much higher than expected world oil price. This outturn would add to the cost of the Government’s energy subsidies, leading to cuts in other public spending (on development and social support), a wider fiscal deficit, or a mixture of the two.

The rupiah is sensitive to investor sentiment, as shown by its sharp depreciation in October 2008. Another bout of global risk aversion would undermine the currency, hurting investment and raising inflation.

A further risk relates to the expected El Niño conditions and associated dry weather. An El Niño event in 1997 caused serious damage to crops that sent up the price of rice by 30%. Given that rice, as the country’s staple food, has a significant weight in the consumer price index, such a price rise would lift inflation and push more people into poverty. A serious El Niño event would also hurt rural incomes and spending. Finally, security issues and natural disasters are continuing risks.
Malaysia

The economy contracted more sharply than expected in the first half of 2009, the result of a plunge in exports that spread to domestic demand such that both fixed investment and private consumption fell. Government action to mitigate the decline included two fiscal stimulus packages (though a few of the measures got off to a slow start), an easing of monetary policy, and a relaxation of local-equity requirements for some foreign investment. The GDP contraction forecast for 2009 in this Update is steeper than anticipated in March, and the recovery in 2010 a shade slower than was then projected. Inflation is predicted to remain low and current account surpluses high in both years.

Updated assessment

Against the backdrop of the severe slump in global trade, GDP contracted by a steep 6.2% year-on-year in the first quarter of 2009. (The economy is particularly sensitive to changes in world trade: exports and imports of goods and services are equivalent to more than 100% of GDP.) The output decline eased to 3.9% in the second quarter (Figure 3.6.1). During the first 6 months of this year, the economy contracted by 5.1% in a broad-based downturn that saw weakness spread from exports to investment and private consumption (Figure 3.6.2). Only a decline in imports and increased government consumption provided some offset.

Exports in volume terms fell by 16.3% in the first half of 2009 from the prior-year period, reflecting dwindling demand from most of Malaysia’s important export markets. This was, however, offset by a 21.5% fall in import volumes, and thus net exports registered growth for the period. Fixed investment contracted by 10.3%, a sign that many firms deferred or canceled proposed investments, seeking to safeguard their balance sheets. Private consumption, which accounts for around one half of GDP, declined by 0.1% on account of a fall in disposable incomes in several sectors of the economy.

Manufacturing, which is dominated by the export-oriented electrical and electronics subsector, contracted by 16.2% in the January–June period in tandem with the downturn in external demand. Falling global prices for palm oil and other agricultural commodities led to reductions in production, such that agricultural output fell by 2.0%. In contrast, the services sector grew by a marginal 0.7%.

The more moderate pace of GDP contraction during the second quarter owed much to increased public expenditure and growth in private consumption. Public consumption rose by 1.0% in the quarter as the Government implemented two fiscal stimulus packages, the first drawn up in November 2008 and a second, larger set of measures in March 2009. The higher public spending, together with some stabilization in the labor market and lower consumer prices, improved consumer

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sentiment and led to a 0.5% increase in private consumption, after a

decline of 0.7% in the first quarter.

All production sectors performed better in the second quarter than

the first. Services recorded slight growth due to a pickup in finance and

insurance activity. The rate of decline in mining moderated because of

smaller cuts in output of crude oil and natural gas. Construction activity

expanded by 2.8%, supported by stimulus measures, and the contraction

in manufacturing eased owing to the pickup in exports and increased

inventory replenishments following significant cuts in production

and inventory drawdowns in the first quarter. Month-on-month

manufacturing activity strengthened by 2.9% in June 2009 (Figure 3.6.3).

Reflecting the economic slump, the number of people employed fell

slightly from December 2008 to March 2009 and the unemployment rate

increased from 3.1% to 4.0% during this period. More recent data point

to a turnaround in some labor market indicators: the number of new job

vacancies exceeded the number of jobseekers at end-June 2009. Apart

from agriculture, where seasonal factors dominate employment patterns,

all sectors recorded increased vacancies. Manufacturing, which employs

around 20% of the workforce, saw the largest upturn.

Inflation has decelerated sharply from a peak of 8.5% in July–August

2008 (year on year), so that the consumer price index rose by just 1.7% in

the first 7 months of 2009. Indeed, the index declined by 2.4% from

its year-earlier levels in July 2009 (Figure 3.6.4) due to falling global

commodity prices, slower domestic demand, and the base effect of an

increase in administered fuel prices in June 2008. However, on a month-
on-month basis consumer prices edged up by 0.1% in July, suggesting an

easing in deflation pressures.

Available data for the first quarter of 2009 show a large current

account surplus of S$8.6 billion (20.2% of GDP), up S$1.4 billion from the

corresponding period of 2008. This rise was mainly due to a higher

surplus in the trade and services accounts, which reinforced a narrower
deficit in the income and transfer accounts. Merchandise exports fell

by 20% on account of a slowdown in global demand for electrical and

electronic products and lower prices for palm oil, liquefied natural

gas, and crude oil. The export decline was more than offset by a 25%

contraction in merchandise imports stemming, in large measure, from a

steeper drop in imports of intermediate goods, most of which are used in

making electrical and electronic goods.

The improvement in the services account was mainly attributable to

lower net payments on freight and other services; tourism receipts

remained stable. The narrower deficit in the income account was due to

lower net payments on investment income, while the more moderate
deficit in the transfer account was due to lower remittances sent abroad

by foreign workers in Malaysia. The higher current account surplus

was, however, partly offset by a wider deficit on the financial account as

significantly higher net outflows of portfolio investment outweighed a

more modest net inflow of foreign direct investment. As a result of these

developments, the overall balance-of-payments surplus fell to S$895 million

at end-March 2009 from S$153 billion in March 2008.

Trade data for the first 6 months of 2009 show that the trade surplus

in the second quarter narrowed from the first quarter because the
year-on-year contraction in exports outpaced that of imports. However, month-on-month data indicate that both exports and imports have picked up since February (Figure 3.6.5 above), with import growth generally outpacing that of exports. International reserves at mid-August amounted to $91.4 billion, a comfortable 9 months of retained imports and 3.8 times short-term external debt.

In response to the deteriorating domestic economy and slowing inflation, Bank Negara Malaysia, the central bank, reduced its policy interest rate in steps from 3.5% at the beginning of November 2008 to 2.0% in February 2009, and its reserve ratio for commercial banks to a record low of 1.0% from 3.5% in November 2008. A trade-weighted depreciation of the currency has further relaxed financial conditions. The monetary authorities said in July that the easing of monetary policy, coupled with the two fiscal stimulus packages, are sufficient to support economic activity.

The financial system remains liquid: year-on-year growth in deposits and loans stood at 6.2% and 8.4%, respectively, in July 2009. Banking system capitalization is healthy: the risk-weighted capital-adequacy ratio rose to 14.2% in July 2009 from 12.6% in December 2008. The net nonperforming loan ratio fell slightly to 2.1% in June 2009 from that at end-2008.

The ringgit, having depreciated by 5.2% against the United States (US) dollar between end-2008 and end-March 2009—when increased risk aversion and deleveraging by international investors increased demand for US dollars—then appreciated by 3.6% up to end-August 2009. The strengthening of the ringgit was mainly due to an easing in risk aversion following signs of stabilization of some US economic indicators, and growing confidence that the global economic downturn had bottomed. Having remained broadly stable during the first quarter of 2009, the Kuala Lumpur Composite Index of stock prices increased by 34.5% through end-August 2009, reflecting lower risk perceptions on emerging market assets, a recovery in commodity prices, and a government decision to liberalize some investment (Box 3.6.1).

Yields on government bonds, which stayed remarkably stable amid the turmoil in global financial markets, edged up as the Government raised debt issuance to finance the fiscal deficit. Spreads on credit default swaps fell from 230.1 basis points at end-2008 to 97.0 basis points at end-August 2009 (Figure 3.6.6).

As for the fiscal stimulus, an RM7 billion package in November 2008 was followed in March 2009 by a larger RM60 billion (9% of GDP) set of measures to be disbursed over 2009 and 2010. The second package mainly involves additional direct budget spending and guarantee funds for corporations, especially small and medium-sized enterprises. It also provides funding for public–private partnerships and other off-budget projects, and includes some tax breaks.

During the first half of 2009, revenue collection came in at 47% of budgeted receipts. Operational and development expenditures were 46% and 36%, respectively, of budgeted amounts, indicating delays in rolling out some of the fiscal stimulus. The full-year budget deficit is projected to exceed the target of 7.6% of GDP given that the economy has contracted more severely than the Government envisaged.

### 3.6.1 Boosting competitiveness

In an effort to improve the efficiency of the economy and promote investment, particularly in the services sector, the Government made several changes to investment regulations in the first half of 2009.

Among other moves, it relaxed a 30% bumiputra (ethnic Malay) equity requirement for investment in 27 services subsectors, including health and social services, tourism, transport services, and business services.

The economy has in recent years recorded a surplus on the external services account, but this stemmed largely from growth in tourism. There have been persistent deficits in the transport and other services category: the latter includes all services subsectors not related to transport and travel, a number of which are covered under the new investment policy.

In other changes, the Government reduced the minimum stake to be reserved for bumiputra investors in initial public offerings to 12.5% from 30%, and eased rules on foreign investors buying stakes in Malaysian companies and property.

Furthermore, the central bank liberalized foreign investment in financial companies to support finance sector growth, which has averaged 8.8% a year in the past 3 years. Changes cover the issuance of new licenses; increases in foreign equity limits; and greater operational flexibility for locally incorporated foreign commercial banks, insurance companies, and takaful (Islamic insurance) operators.

One emphasis of the reforms has been to promote Malaysia as an international Islamic financial hub. Over the next 3 years, the central bank plans to issue new licenses for two Islamic banks, five commercial banks, and two Islamic insurance institutions.

Islamic finance is increasingly seen as providing stability to the financial system by anchoring banking practices to underlying economic transactions and by limiting leverage.
The ratio of central government debt to GDP, at 48% of GDP in June (Figure 3.6.7), is relatively high and market concerns over the size of the deficit and an apparent lack of a fiscal consolidation plan led to the first local currency debt downgrade since the 1997–98 Asian financial crisis. Fitch rating agency in June 2009 lowered Malaysia’s long-term local currency rating from A+ to A, citing a rise in the overall and primary deficits, falling government revenue, and slow progress in implementing revenue reforms. Fitch maintained Malaysia’s long-term foreign currency rating at A- with a stable outlook. Most of the public sector debt is domestic debt—only 4% was external debt at end-June 2009.

Prospects
The forecasts are predicated on the authorities maintaining an expansionary fiscal policy during 2009 and into 2010, and the fiscal stimulus gaining traction from the second half of 2009 (given its generally slow start). Monetary policy is expected to remain broadly accommodative, with the policy interest rate remaining unchanged for the remainder of 2009 in a context of muted inflation and excess production capacity. In view of the economy’s heavy reliance on global demand, growth prospects will, to a large extent, be influenced by external developments.

In this regard, deep and prolonged contractions in the US, Japan, and eurozone will suppress Malaysia’s exports because together these economies absorb around 35% of its exports. Moreover, GDP in Singapore, the country’s largest trading partner, will contract sharply in 2009, implying that growth in Malaysia will remain below trend during the forecast period.

GDP now is expected to shrink by 3.1% in 2009, revised from a forecast decline of 0.2% in March’s Asian Development Outlook 2009 (ADO 2009), mainly because the deep slump in world trade and commodity prices had a much bigger impact on Malaysia than expected. However, the first-quarter contraction of 6.2% was likely the bottom of the recession, and prospects appear to have been picking up from the second quarter. The Government’s index of leading and coincident indicators showed month-on-month gains in June, while the 6-month smoothed growth rate of both indexes also improved from May to June (Figure 3.6.8). Consumption growth is likely to gradually strengthen during the rest of 2009 as a consequence of a firmer labor market and low inflation.

While exports are seen continuing to contract year on year, albeit at a declining rate, they are expected to pick up month on month, given the inventory buildup in the US. Imports on the latter basis are likely to rise faster than exports in the context of Malaysia’s dependence on imported inputs for its export industries and a pickup in consumer confidence. The external sector is therefore likely to remain a drag on GDP. Although business sentiment is set to gradually improve over the rest of 2009, private investment will remain in negative territory due to excess capacity in the economy.

Inflation pressures are forecast to remain subdued through 2009, reflecting soft domestic demand, excess capacity, lower imported

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3.6.6 Credit default swaps, 5-year

Source: Bloomberg, downloaded 7 September 2009.

Click here for figure data

3.6.7 Public finance indicators


Click here for figure data

3.6.8 Growth of leading and coincident indexes


Click here for figure data
inflation, and the base effect of high consumer prices in 2008. However, monthly data show signs of inflation picking up and, in the context of the expansionary monetary and fiscal policies, the economy is unlikely to remain in deflation for long. Average inflation this year is forecast at 1.1%, a touch lower than projected in ADO 2009.

The current account surplus will decline, but in 2009 it will remain large at about 14.0% of GDP (unchanged from the March forecast). Both exports and imports will contract this year, but exports by more. Consequently, the trade surplus will fall.

Year-on-year GDP growth is likely to return toward end-2009 and gradually pick up to average 4.2% for 2010 (Figure 3.6.9), slightly lower than expected in ADO 2009. The outlook is underpinned by the Government’s fiscal stimulus and the expected recovery in world trade and commodity prices. Domestic demand will strengthen in 2010 as improved labor market conditions lead to higher private consumption, while a gradual closing of the output gap will encourage some increase in private investment toward the end of next year.

Public investment will be supported by spending under the fiscal stimulus packages. Investment-to-GDP ratios will, nevertheless, remain modest compared with those of recent years as the output gap will remain large. The pace of recovery would have been faster were it not for the fact that the expected pickup in exports and domestic demand will lead to a significant increase in consumer, intermediate, and capital goods imports, which will generate a further deterioration in the net external balance and continue to be a drag on GDP growth.

Inflation is projected to gather pace to average 2.6% in 2010 (Figure 3.6.10), reflecting higher domestic demand, a rise in global nonfuel commodity prices, and the disappearance from the year-on-year comparison of the steep drop in commodity prices.

In the external accounts, a decline in the trade surplus following an expected rise in imports is forecast to moderate the current account surplus to 12.5% of GDP in 2010 (Figure 3.6.11). The services balance should improve as a stronger global economy leads to an increase in tourist arrivals, but the deficit in the income account will likely widen if outflows of profit remittances and dividend payments increase, pacing the economic recovery.

The main risk to these forecasts involves the nature and duration of the global recession. If global demand is weaker than assumed in this Update, the prospects for Malaysia’s exports and therefore its economy will be eroded. The country’s high level of external reserves and its strong banking sector would position it relatively well to deal with any renewed bout of global financial instability, provided that it was short.

On the domestic front, there is a risk that slow disbursement of the fiscal stimulus measures could undermine confidence and demand. If the global recovery in 2010 gains momentum and leads to stronger than expected domestic demand, monetary policy could tighten abruptly and interest rates could rise quickly before the output gap begins to close. This, in turn, could hurt domestic consumer confidence and slow the economic recovery.
Pakistan

The country’s economic crisis eased a little in FY2009 as the Government’s stabilization program took effect. Fiscal and external imbalances narrowed, the exchange rate stabilized, and foreign reserves rose. But inflation remained stubbornly high and growth plunged as the economy reeled from the impact of crippling power outages, tight domestic demand management, uncertain security, and the global recession. The reduction in imbalances was a consequence of expenditure cutting and economic slowdown rather than improvements in underlying economic fundamentals. Military operations against extremists and spending related to the welfare of internally displaced people put additional strain on the budget. A modest improvement in growth is expected in FY2010, but even that is subject to substantial risks. Major macroeconomic and structural reforms must be decisively implemented if the economy is to climb onto a sustainable growth path.

Updated assessment

The growth rate in FY2009 (ended 30 June 2009) plummeted, and at 2.0% was even less than the low projection of 2.8% given in Asian Development Outlook 2009 (ADO 2009) in March this year. (Recent data revisions have markedly lowered FY2008 growth from the 5.8% used in ADO 2009.) This recent weak performance comes after an average expansion of over 7% during FY2004–2007 (Figure 3.7.1).

The main demand-side contributor to slower growth in FY2009 was falling investment, which subtracted from growth; investment’s share in GDP declined in comparison to the previous fiscal year (Figure 3.7.2). Private investment as a share of GDP fell for the third consecutive year to 13.2% of GDP; reasons for this decline include tighter demand management policies, lower availability of domestic credit, continued power shortages, the uncertain security situation, and the global economic slowdown. The impact of lower private investment on growth was compounded by a decline—for the first time in 7 years—in the share of public investment in GDP, as the Government curtailed its budget for the public sector development program (PSDP) to control the fiscal deficit.

Public consumption in FY2009 also declined as the federal Government cut subsidies and contained operating expenditure. Consequently, the share of total consumption in GDP fell compared with the previous fiscal year, even as private consumption remained strong. The terms of trade improved following lowered oil prices, and with a sharp compression in imports (relative to a smaller decline in exports) the share of net exports in GDP rose.

From the production side, a large part of the decline in growth in FY2009 was attributable to a sharp contraction in large-scale manufacturing, which caused a 3.6% fall in industrial growth (Figure 3.7.3). Almost all major industry heads slumped, including textiles,
automobiles, food and beverages, and electronics. While some exporting industries, such as textiles, were affected by slower or stagnant export orders because of recession in trading partners, industrial production catering to domestic markets also fell. The country’s economic slowdown, power shortages, and increased financial costs arising from higher interest rates affected all industries. The large cut in the PSDP was a factor that caused construction output to contract sharply.

Poor performance of manufacturing overshadowed an otherwise solid recovery in agriculture, which saw 4.7% growth in FY2009. The recovery was led by a bumper wheat crop of over 23 million tons, abetted by a 52% increase in the Government’s procurement (support) price for farmers. The rice crop set a new record at 7 million tons, allowing a strong $1.8 billion contribution to exports. Farmers incentivized by higher prices were able to beat the odds posed by water and fertilizer scarcity.

In FY2009, the fall in manufacturing production and the contraction in imports stunted growth in services, a sector that accounts for over 50% of GDP. At 3.6%, it expanded at around half the rate of the previous fiscal year with decelerating growth in all subsectors. In finance, after several years of strong performance, expansion slowed as the subsector absorbed the impact of the economic downdraft in the shape of lower profitability, higher nonperforming loans, and reduced deposit mobilization. Banks became more risk averse against a backdrop of poorer lending portfolio performance and more attractive terms that the public sector offered for financing the fiscal deficit. Consequently, private sector credit stagnated in FY2009, having grown strongly in recent years.

While nominal tax revenue grew by 15% relative to the previous fiscal year, recessionary conditions in industry, coupled with the slowdown in finance and telecommunications—all large tax sources—resulted in a significant shortfall in tax collection by the Federal Board of Revenue (FBR) vis-à-vis the budgetary target. Falling imports lowered customs duties. All major tax heads recorded shortfalls in achieving budget targets. With an inflation-bloated nominal GDP (up by 27%), the tax-to-GDP ratio for FBR taxes fell to only 8.8% in FY2009 (Figure 3.7.4).

Although part of the FBR revenue shortfall was made up by proceeds from the petroleum development levy, the FY2009 deficit target of 4.3% of GDP was missed by 0.9 percentage points. The deficit, however, was significantly narrower than the 7.6% of GDP recorded a year earlier (Figure 3.7.5). The improvement was a result of cutting spending—largely on the public sector development program—which came in at 28% below target for the year. Expenditure on subsidies also fell as a share of GDP compared with the previous fiscal year. Defense spending however, although contained as a share of GDP, overshot the budget allocation due to additional costs incurred in military operations against extremists in the tribal areas and North-West Frontier Province. Moreover, provinces showed overruns in current expenditure.

Looking ahead, the fiscal position needs to be strengthened by improvements to revenue performance and reductions to nonproductive expenditure. Cutting development spending is not a desirable or sustainable way to reduce the deficit. Indeed, Pakistan has to ramp up such spending if it is to upgrade basic infrastructure and foster growth and investment. Such high development outlays are also
necessary to strengthen access to, and quality of, social services (so as to reduce poverty).

Inflation pressure persisted in FY2009 despite the economic slowdown, falling international commodity prices, a tight monetary policy, and significantly reduced central bank financing of the fiscal deficit. Overall consumer price inflation shot up to an average of 20.8% from 12% the previous fiscal year and from only single-digit inflation in earlier years. Much of FY2009’s inflation was driven by higher domestic food prices, which eventually seeped into core inflation through upward pressure on wages.

This pressure was evident in a significant hike in the house rent index where the cost of labor has a 40% weight. Marked depreciation in the currency and price adjustments to reduce subsidies also contributed to inflation. Inflation peaked year on year in August 2008 at 25.3% and fell thereafter, although only at a measured pace as stabilization measures slowly took hold (Figure 3.7.6). By July 2009, overall and core inflation rates had fallen to 11.2% and 14.0%, respectively.

The State Bank of Pakistan increased the policy discount rate by as much as 450 basis points to 15% during February–November 2008 (Figure 3.7.7) with the main objective of stemming inflation. The resulting higher market rates made government debt attractive for commercial banks (reducing demand on the central bank for financing), restrained imports, and helped build foreign exchange reserves. The central bank subsequently lowered the discount rate by 100 basis points in both April and August 2009 as a countercyclical measure, even though inflation pressure persisted. Interest rate policy will have to continue balancing the demand for price stability and the need to revive the economy.

Tighter demand management policies and lower international oil prices led to a contraction in imports in FY2009 by over 10% from a year earlier and an improvement in the trade account, but in the context of a 5.9% drop in exports (Figure 3.7.8). The power crisis and the global economic downturn hit textile exports in particular, which account for about half of exports. (The Pakistan rupee fell by 18.7% against the dollar in FY2009, essentially offsetting the impact of high inflation on competitiveness.) The drop in exports would have been even larger had it not been for an increase in rice exports made possible by the bumper crop. Cement exports also surged (by 71%) on the back of strong demand from Afghanistan and India and from expanding new markets in Africa and elsewhere.

Despite expectations to the contrary, workers’ remittances showed a 21% increase in FY2009. This, together with the improvement in the trade and services accounts (the latter helped by payments by the United States for logistical support) translated into a sharp narrowing in the current account deficit to 5.3% of GDP from 8.4% in FY2008.

However, a marked weakening in the financial account made it difficult to finance this narrower current account deficit. Foreign direct investment fell by a third in FY2009 and portfolio investment recorded a large net outflow of nearly $1.1 billion (Figure 3.7.9). Still, credit from the International Monetary Fund (IMF) under a standby arrangement agreed to in November 2008 and increased disbursements from multilateral and bilateral institutions boosted foreign financing.
With the narrowing in the current account deficit and the increase in external official disbursements, foreign exchange reserves, which had fallen to a low of $6.7 billion in October 2008, recovered to $12.3 billion by end-FY2009 (Figure 3.7.10). At this level they were sufficient to cover about 5 months of imports. By 15 August 2009, foreign reserves had increased further to $13.0 billion.

**Prospects**

Pakistan’s economic outlook in FY2010 will be shaped by both internal policies and global economic developments. Internally, economic outcomes will depend on the Government’s ability to achieve the desired balance between fiscal consolidation and revival of growth. Externally, the outlook will depend on the degree of improvement in major trading partners; the consequent impact on Pakistan’s exports and on receipts of workers’ remittances; and developments in global oil prices.

On balance, a modest revival in economic growth to about 3.0% is projected for FY2010, predicated on the planned larger public expenditure program announced in June 2009 in the budget for FY2010 and on some easing of monetary policy. Agriculture is expected to continue its strong growth on the back of higher procurement prices for the main crops and increased public spending in the sector as announced in the budget. But agricultural growth will not be as high as in FY2009 due to the high base effect and continued water scarcity that will limit crop expansion.

Growth in industry is expected to turn marginally positive in FY2010 as the commissioning of new power plants reduces electricity outages, and as adjustments in power tariffs generate cash flow for power companies to expand their operations. The pace of growth in the main exporting industrial subsectors, such as textiles, will depend on the extent of a pickup in consumer spending in main trading partners. The services sector is expected to post moderate growth in FY2010 on the back of good agricultural growth and the modest pickup in industry.

To fuel expansion, the Government has set a fiscal deficit target of 4.9% of GDP in the budget for FY2010, a level higher than the 3.4% of GDP originally targeted under the standby arrangement. Of the new fiscal deficit target, up to 1.2% of GDP of additional financing is expected to be made available under the pledges made by donors at the Friends of Democratic Pakistan meeting in Tokyo in April 2009. This pledged assistance is to provide the fiscal space necessary for implementing a countercyclical response in the form of higher development spending.

Consequently, a massive 54% hike is planned for the PSDP in FY2010. (Under an augmentation of the standby arrangement approved by the IMF Board on 7 August 2009, IMF has agreed to provide bridge financing of up to 0.8% of GDP to support the budget in case of delays in the receipt of funds pledged at Tokyo.) The Government in FY2010 also plans additional spending of 0.3% of GDP funded by donor grants to support rehabilitation of internally displaced people in areas affected by operations against militants.

The large planned development expenditure overshadows the real contraction in current spending envisaged in the budget and results in an overall expansionary fiscal stance (Figure 3.7.11). The budget

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**3.7.9 Net foreign investment**

- **Direct**
- **Portfolio**

- **$ million**

- **2004**
- **2005**
- **2006**
- **2007**
- **2008**
- **2009**


**Click here for figure data**

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**3.7.10 Foreign exchange reserves**

- **Reserves with State Bank of Pakistan**
- **Total liquid reserves**

- **$ billion**

- **Jan**
- **Apr**
- **Jul**
- **Oct**
- **Jan 09**
- **Apr**
- **Jul**

**Sources:** State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 31 August 2009.

**Click here for figure data**

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**3.7.1 Selected economic indicators (%)**

<table>
<thead>
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<th>2009 ADO</th>
<th>Update</th>
<th>2009 ADO</th>
<th>Update</th>
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<td>2.0</td>
<td>4.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Inflation</td>
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<td>20.8</td>
<td>6.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Current acct. bal. (share of GDP)</td>
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<td>-5.3</td>
<td>-4.5</td>
<td>-4.8</td>
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**Source:** Staff estimates.
proposals project a modest effort to generate additional tax revenue. Development expenditure is set to increase by 1.6 percentage points of GDP in FY2010, while additional receipts to be raised by the FBR amount to 0.4 percentage points of GDP. The external resource requirement in the budget is therefore large and equivalent to about 80% of the planned PSDP, indicating an unsustainable dependence on foreign inflows. A failure to obtain external resources at the planned level could consequently lead, once more, to a sharp drop in development spending.

The increases in the consumer price index showed a trend decline to 11.2% in July 2009, year on year. The anticipated robust agricultural crops, the economic program’s demand management policies, and a high base effect from the previous year are factors expected to lead to a further moderation in inflation in FY2010. Conversely, planned increases in electricity tariffs and government wages announced in the budget will provide some upward pressure. On balance, inflation is forecast to average 10% in FY2010, falling to about 9% (year on year) by June 2010.

Lower domestic inflation and continued nominal depreciation of the exchange rate are expected to help sustain export competitiveness (Figure 3.7.12). While some stabilization in exports is seen, they are seen contracting by 2.5% owing to subdued demand in trading partner countries and continued structural bottlenecks, such as power shortages and lack of product diversification. Imports are expected to continue shrinking (by about 2%), although that pace will slacken as the economy recovers modestly and as international oil prices increase. The trade deficit will narrow marginally from a year earlier.

The services account is projected to improve, mainly reflecting higher logistical payments. It is uncertain whether the trend increase in workers’ remittances will be sustained (Box 3.7.1). However, based on the continued strong growth of workers of 25% in the first 2 months of FY2010 and evidence of strong numbers of workers proceeding abroad for employment, workers’ remittances are assumed to hold steady in FY2010. The current account deficit is expected to be 4.8% of GDP in FY2010, somewhat improved from a year earlier (Figure 3.7.13).

As non-debt-creating inflows in the form of new foreign direct and portfolio investment remain little improved in FY2010, the financing of the current account deficit will need to continue relying on debt-creating inflows. These will include financing through the standby arrangement, augmented by disbursements from development partners.

The economic outlook carries downside risks and challenges. Although Pakistan’s economic imbalances were reduced in FY2010, structural improvements in the underlying fundamentals are needed, without which it will be difficult to sustain financial stability and growth.

In particular, fiscal sustainability requires critical measures to improve revenue mobilization through broadening the tax base and removing exemptions, improving tax policy and administration, and quickly adopting a full-fledged value-added tax. Meeting the fiscal deficit target purely by cutting development expenditure is not a viable policy option for a country that requires large-scale spending on infrastructure and social sectors to sustain growth and reduce poverty.

Likewise, improvement in the current account through a contraction in imports alone is unsustainable. The current account will be
fundamentally improved only when the Government pushes through with effective measures to build a much larger export base that is sufficient to finance oil, machinery, and other essential imports. This issue is crucial in an era of rising global oil prices.

Pakistan’s growth prospects continue to be stymied by its lingering power crisis. Both immediate and long-term measures are required to address the crisis with improving governance; reducing leakages and losses; rationalizing electricity tariffs to cover sector costs and eliminate subsidies; and resolving the problem of “circular debt” (arrears that have developed among participants in the sector), which has drained the finances of the power companies and has forced cuts in their operations and investments.

Multilateral development partners are supporting power sector reforms and are financing critical investments to improve and augment electricity transmission, distribution, and generation systems. However, the size and effectiveness of this assistance will depend on the Government’s ability to implement its reform agenda.

Global recession, if prolonged, poses an obvious risk to Pakistan’s economic recovery and stabilization through weakening exports, workers’ remittances, and inflows of private capital. It is critical that the pledges made by donors in Tokyo are realized to finance the PSDP in support of Pakistan’s growth and poverty reduction strategy.

Finally, revival of higher growth is predicated on continued improvement in the domestic security situation, which is critically important to foster both domestic and foreign investment and to strengthen private sector participation in key sectors of the economy.

### 3.7.1 Workers’ remittances

Workers’ remittance inflows have been on the rise since FY2001 and have played a key role in supporting growth and reducing poverty in the country. Growing more than sixfold since FY2001, they amounted to 4.7% of GDP in FY2009, up from 1.5% in FY2001.

Such inflows have been instrumental in boosting private consumption of households and have supported a property and real estate boom. They amounted to over 5% of private consumption expenditure during FY2003–2009.

The United States, Saudi Arabia, and the United Arab Emirates are the largest source countries of remittances, contributing almost two thirds of total inflows. Remittances from these countries increased significantly due to reaction to the events surrounding 11 September 2001, when, among other factors, governments placed heavy emphasis on official channels for international payments (Box figure).

In particular, remittances from the United States rose very strongly and their share in the total more than doubled during FY2001–2008, rising from 12% to 27% of total receipts, before falling to 22% in FY2009. The latter relative decline was made up for by an increased share of remittances from the United Arab Emirates, which rose to 22% in FY2009 from 17% a year earlier.

Remittance inflows have provided critical support to Pakistan’s balance of payments by helping keep its current account deficit in check. In FY2009, they financed 63% of the trade deficit and were equivalent to twice the level of foreign direct investment. In the two previous fiscal years, remittances on average financed about half the trade deficit and were higher than foreign direct investment.
Philippines

A sharper than anticipated slowdown in private consumption in the first half of 2009, coupled with a slump in exports and weakness in fixed investment, cut the GDP growth rate more than expected such that full-year growth will be lower than forecast in March. Activity should pick up through the second half of 2009 and reach modest growth rates in 2010, supported by fiscal stimulus measures and the gradual global recovery. Inflation has declined more steeply than was earlier expected and the forecasts for 2009 and 2010 are revised down. Current account surpluses will be maintained for these 2 years.

Updated assessment

GDP growth slowed to 1.0% year on year in the first half of 2009 from 3.8% in full-year 2008 (revised down from an originally reported 4.6%). Gross national product growth also decelerated, although at 3.8% in the first half it was well above the GDP rate owing to relative strength in net factor income from abroad. In a sign that the slowdown may have bottomed earlier this year, year-on-year GDP growth accelerated from 0.6% in the first quarter to 1.5% in the second. The Philippines is less reliant on external trade (the export-to-GDP ratio is about 30%) than other economies in Southeast Asia that contracted in the first half of 2009 as a result of the global recession.

Private consumption growth in the first half pulled back to 1.8% year on year, from 4.6% in the first half of 2008. The pace of increase in remittances from overseas workers slowed to 2.9% in United States (US) dollar terms, although this translated to growth of 17.1% in pesos. Concerns over job security eroded consumer confidence. Still, the remittances plus lower inflation provided the basis for the expansion in private consumption, which remained the major contributor to first-half GDP growth.

Government spending, supported by the rollout of a fiscal stimulus package, grew by 7.0% in the first half of 2009, though this was amplified by the low base in government outlays in the prior-year period. Investment, however, was weak. Total fixed capital investment declined by 4.4% and investment in equipment slumped by 18.6%, illustrating the reluctance of firms to expand capacity at a time of global recession and slowdown in domestic demand. Net exports fell and acted as a drag on GDP growth.

On the production side, services constituted the major contributor to GDP growth in the January–June period, though its expansion rate of 2.5% was about half that of the same period in 2008 (Figure 3.8.1). This deceleration reflected sluggish private consumption and weakness in transport, finance, and trade-related services, partly offset by growth in communications and business process outsourcing.

This chapter was written by Teresa Mendoza of the Philippines Country Office and Purnima Rajapakse of the Southeast Asia Department, ADB, Manila.
Industrial production contracted by 1.3% in the first half, weighed down by a 7.4% drop in manufacturing caused in large part by weaker global demand for electronic goods and clothing and by much slower expansion of food processing. Public construction jumped by 24.1%, spurred by the fiscal stimulus program, but private construction contracted by 1.4%.

Agriculture, accounting for about a third of employment and a fifth of GDP, grew by only 1.3% in the first half. Rice production increased by 3.6%, but corn output fell by 2.3% as its low price led some farmers to switch to rice and other crops. A slowdown in agricultural exports to industrial economies, which account for nearly two thirds of total agricultural exports, damped production of coconuts and sugar.

Labor-market data suggest that unemployment was contained, mainly because laid-off workers moved into low-quality jobs. The unemployment rate fell from 8.0% in April 2008 to 7.5% in April 2009. But close to a million full-time jobs were lost in that period, while 2.4 million part-time jobs were created (the proportion of part-time workers increased to 41% of the employed population from 36%) (Figure 3.8.2). Many of those made unemployed in manufacturing and services switched to lower skilled work, and others reported working fewer hours or becoming self-employed. There were also signs that more members of households sought work to supplement family incomes, after a family member had been laid off or had working hours cut.

Inflation declined rapidly to 0.1% year on year in August 2009 (the lowest in over two decades) from a peak of 12.4% in August 2008. This was attributable to the drop in global prices for oil and commodities and subdued domestic demand.

On the trade front, merchandise exports in US dollar terms slumped by 32.8% in the first 6 months, on a customs basis. Electronic products (57% of total exports) plunged by 35.5% as recession bit in the two largest export markets (the US and Japan). Other exports to register double-digit declines were agro-based products, clothing, and minerals.

Merchandise imports fell to a similar degree (31.1%), with steep contractions in the raw materials and intermediate goods used in making exports such as semiconductors, and weaknesses in imports of capital goods. The value of oil imports dropped by 69.4%, largely owing to the fall in global oil prices. These developments left the trade deficit at $3.1 billion in the first half, narrowing from a year earlier.

The contraction in trade appears to have bottomed early in 2009 (Figure 3.8.3). Month-on-month data show exports increasing by about 10% in both May and June. Shipments of electronics on a month-on-month basis edged up from January to June. Imports on this basis increased in May (by about 19%) and June (14%).

Available data for the first quarter of 2009 show that the current account surplus rose to $2.2 billion. A narrower merchandise trade deficit was reinforced by a larger surplus in services. Earnings increased from business process outsourcing (such as back-office accounting and payroll support), while payments for transportation services fell in tandem with lower trade volumes. The surplus on net transfers increased modestly, given that remittances grew, but at a much slower rate than a year earlier. The higher current account surplus was partly offset by a deficit in the capital
and financial accounts caused by net outflows of direct and portfolio investments, leaving an overall balance-of-payments surplus of $1.73 billion. Foreign direct investment has recovered in more recent months, recording a net inflow of $1.0 billion in January–May 2009, still low but above the year-earlier level, while foreign portfolio investment has also picked up, with a net inflow of $265 million in January–July 2009, in contrast to an outflow in the previous year (Figure 3.8.4). Gross international reserves at $41.3 billion as of end-August represented a high 7.1 months of retained imports.

In response to the weakened economic outlook, the Government in January 2009 unveiled a P330 billion ($7 billion) fiscal stimulus package. About half is allotted to labor-intensive infrastructure and social welfare programs, 30% to public–private partnerships for building large infrastructure projects, and the rest to tax reductions for individuals and businesses.

These additional outlays bumped up national government expenditure by 18.1% in the first 7 months of 2009 (relative to the same period in 2008). Revenue fell by 4.1% in this period, partly a result of the economic slowdown and the tax breaks. The Government revised its 2009 fiscal deficit target from 2.2% of GDP in March to 3.2% in June, but the actual gap may be slightly wider than that, given weakness in revenue. The first-half fiscal deficit was 4.3% of GDP (Figure 3.8.5) and the primary balance, excluding interest payments, fell into deficit for the first time since 2003. Ample liquidity should enable the financial system to absorb any necessary increase in the Government’s gross borrowing requirement. The Government projects that requirement for 2009 to be 8.5% of GDP (P451 billion in domestic financing and about $4 billion in external financing), higher than 6.7% in 2008.

In July 2009, the Philippines tapped international capital markets for a second time this year with a $750 million, 10-year bond issue with a yield of 6.625%, or 332.6 basis points above comparable US Treasuries—a narrowing from about 600 basis points above US Treasuries for a January 2009 10-year bond issue. With the additional borrowings, the ratio of public debt to GDP is seen increasing by about 1 percentage point this year to 57.6% (but that is still well below the 78.2% level reached in 2004).

Easing inflation and growth paved the way for Bangko Sentral ng Pilipinas, the central bank, to lower its policy interest rates in steps by 200 basis points from December 2008 to July 2009, taking the reverse repo rate to 4.0% (Figure 3.8.6), the lowest in two decades. The central bank also reduced bank-reserve requirements and took other steps to support banking system liquidity and depositor confidence in late 2008, when the global financial crisis intensified. The peso depreciated by 2.9% against the US dollar in the first 8 months of 2009, after a 12.8% decline in 2008.

With ample liquidity in domestic markets, more firms turned to the debt market for funding. The private sector sold P94 billion of bonds in the first half, more than double the prior-year level. The stock market rallied in line with many of its regional peers: the composite index of stock prices rose by 54% in the first 8 months of 2009 (Figure 3.8.7).

Improved investor sentiment was also shown in the narrowing of yield spreads between US and Philippine Treasuries, to 299 basis points at end-August from 546 basis points at end-2008 (Figure 3.8.8).
Prospects

The outlook assumes that there will be a smooth political transition in 2010 following national elections scheduled for May, and that the new government pursues a credible economic program. As for monetary policy, the central bank kept its key policy rates steady in August and noted that the impact of the substantial monetary easing seen through July had yet to be fully felt in the economy. The forecasts assume that the monetary stance will remain accommodative, and gradually tighten in 2010, with the timing depending on inflation and growth trends.

Private consumption is projected to pick up in the second half of 2009. The consumer confidence index published in September showed an improvement in sentiment, based on low inflation, easing interest rates, and firmer international economic conditions. Illustrating this improvement, motor vehicle sales rose by 6.8% in August year on year, the fastest pace so far this year.

Remittances have held up better than expected, reaching a record $1.5 billion in June (up 3.3% from a year earlier—Figure 3.8.9) and aggregating to $8.5 billion in the first half of 2009. The Philippine Overseas Employment Administration estimated that from October 2008 to June 2009 less than 1% of the 8.7 million Filipino workers abroad lost their jobs. New job orders held up well in January–June, with just over half the available jobs intended for professional and service workers, generally more secure jobs than lower-skill ones.

Public investment is expected to gain impetus as fiscal stimulus measures are stepped up (some faced delays in the first half of 2009). The index of business confidence for the third quarter of 2009 increased for the first time in a year (Figure 3.8.10). Still, uncertainty leading up to the elections, as well as the still-weak export environment, will likely keep private investment subdued. Investment pledges reported for the first half of 2009 by the Board of Investments and the Philippine Economic Zone Authority, which cover most of the investment pledges for the country, fell by about two thirds from prior-year levels.

From the supply perspective, services are forecast to expand by 3.0% in 2009. Modest growth in private consumption and election spending will support retail trade as well as transport and communications services. The industry association for business process outsourcing expects 23% growth in revenue to about $7.5 billion this year. Manufacturing will recover gradually: an index of manufacturing volume shows a slowing in the pace of decline since January. Moreover, average capacity utilization rose from 78.1% in January to 81.5% in June (Figure 3.8.11). However, agriculture faces an expected El Niño weather pattern, which can dent farm production.

Taking these influences into account, GDP growth is projected to step up to 2.2% in the second half of 2009. That would put full-year growth at 1.6%, below that anticipated in Asian Development Outlook 2009 (ADO 2009) in March, a consequence of the weaker than expected first half performance and the downgrading of the global trade volume assumed in this Update.

In 2010, domestic demand will strengthen, supported by election spending through May and some expected improvement in the labor market resulting from a lift in business sentiment in the second half, on
the assumption of a smooth election and transition in government. The modest rebound assumed for next year in global growth and world trade will provide some impetus. Net exports are expected to make a slight contribution to GDP growth. Due to modest funding increases in social services and a decline in infrastructure spending under the proposed 2010 budget, the level of fiscal support to the economy may not be as strong as in 2009. Economic growth next year is forecast at 3.3%, still a half percentage point shy of the 2008 pace (Figure 3.8.12).

Merchandise exports in the fourth quarter of 2009 are projected to edge higher as demand abroad improves. Imports will also pick up, in line with a firming in private consumption and the restocking of inventories. The trade deficit for full-year 2009 will likely be narrower than was expected in March. Trade in services is projected to produce a surplus, largely reflecting the performance of business process outsourcing. These factors, coupled with remittance inflows, are forecast to keep the current account in surplus equivalent to 2.8% of GDP for 2009 (revised up from ADO 2009), and at a similar percentage in 2010.

Inflation is projected to gradually increase from August’s 0.1% rate, given the base effect caused by the peaking of the consumer price index in August 2008. It is now forecast to average 3.2% this year, revised down from ADO 2009 because domestic demand has been weaker than anticipated. The inflation forecast for 2010 is also lowered a touch, to 4.5%.

The Government aims to rein in its fiscal deficit to 2.8% of GDP in 2010, targeting an increase in tax revenue to 14.3% of GDP from 13.9% in 2009 (this year’s goal looks ambitious considering the tax breaks and sluggish economic growth). Actual tax revenues were around 14% in 2007 and 2008. However, the Government has not been able to win legislative approval for revenue-strengthening proposals (such as excise tax reforms and changes in fiscal incentives to investors).

Moody’s upgraded its sovereign credit rating for the Philippines in July 2009, from B1 to Ba3, citing the resilience of the financial system and external payments position in the face of the global slump. The rating is nevertheless below investment grade.

A key risk to the outlook is a weaker than anticipated global economic recovery. That would hurt exports, foreign investment inflows, and consumer and business sentiment which, while showing early signs of improvement, remain fragile. On the domestic front, maintaining investor and consumer confidence requires the elections to go smoothly.
Thailand

A steep fall in exports caused by the global trade slump drove down industrial production and investment in the first half of 2009. Business and consumer sentiment was further undermined by political tensions. Although there were signs the worst had passed by midyear, the economy is expected to contract by more than was projected in March. Modest growth is seen resuming in 2010. The tempo of recovery will depend in large part on the Government fully implementing two fiscal packages, including a new public investment program. Those plans would be at risk if political disruptions recur. The consumer price index is now forecast to decline this year, before low-level inflation returns next year.

Updated assessment

Domestic political turbulence has aggravated the economic impact of the global recession. On a sequential basis, GDP contracted by a steep 5.9% (seasonally adjusted) in the fourth quarter of 2008 and by a further 1.8% in the first quarter of 2009, before picking up by 2.3% in the second. Economic output for the first half of 2009 fell by 6.0% from the prior-year period, one of the sharpest declines in Southeast Asia.

This economic contraction was primarily caused by a drop in industrial production (Figure 3.9.1) following the slump in global demand, and by a decline in consumer and investor confidence. The Government adopted expansionary fiscal and monetary policies to temper the contraction.

Private consumption fell by 2.4% year on year in the first half of 2009, the result of a weakening labor market, a fall in export prices of agricultural commodities that hurt rural incomes, and feeble consumer confidence, particularly during times of political turmoil. Antigovernment street protests in April, which followed an extended period of rising political tensions, led to a temporary state of emergency in the capital, Bangkok.

In contrast to the fall in private consumption, government consumption rose by 4.8% in the first half of 2009 as the Government quickened the pace of its budget disbursement and raised wages for its employees, and rolled out its first fiscal stimulus package from March.

However, investment slumped in the first half and this contributed most to the contraction in GDP on the demand side. Private fixed capital investment dropped by 16.9%, reflecting weak external demand, the impact on business sentiment of the political uncertainty, as well as more cautious lending by banks. Foreign direct investment applications declined in value by 47% in the first 7 months of 2009.

Public investment fell by 9.1% in the first quarter, then rebounded by 9.6% in the second on faster disbursement by the Government and state enterprises (Figure 3.9.2). A steeper fall in the volume of imports than...
in exports meant that net exports of goods and services had a positive influence on GDP in the first half.

From the supply side, industrial production fell sharply as exports dived. The important manufacturing component of industry dropped by 11.4% in the first half, with motor vehicles down a precipitous 40%. In signs that the slump was bottoming, the decline in the manufacturing production index slowed to 18.5% in the second quarter from 32.7% in the first, and the rate of industrial capacity utilization increased to 59.2% from 58.1% in the same period (Figure 3.9.3).

Construction activity, which declined for four consecutive quarters through end-March, started to pick up in the second quarter when the Government and state enterprises accelerated their investment.

Services were hampered by subdued consumer confidence and a fall of about 16% in tourist arrivals in January–June. Output from the sector declined by 2.8%. Transportation and communications, hotels and restaurants, and wholesale and retail trading were among the weakest subsectors. Agricultural and fisheries output, damped by the drop in world commodity prices, grew by just 0.4% in the first half. That meager increase was mainly attributable to an expansion of livestock and shrimp production. Rice production in the second quarter fell from the year-earlier level, which was elevated as a result of high rice prices at that time.

In the external accounts, the value of merchandise exports fell by 23.1% in the first half from the corresponding period in 2008 (Figure 3.9.4). Steep falls were recorded for shipments of automobiles and parts, electronic and electrical appliances, as well as maize, natural rubber, rice, and tapioca. Exports fell to the main destinations—United States, European Union, Japan, and Southeast Asia—but some other markets such as Australia and the Middle East were relatively firm. For exports, too, the pace of decline eased in the second quarter from the first, particularly for shipments to People's Republic of China, India, and Republic of Korea.

Merchandise imports tumbled by 35.2% in the first half, mainly a reflection of reduced purchases of imported inputs used by manufacturing export industries, much lower prices for imported oil than a year earlier, and the slack domestic demand. This faster fall in imports than exports propelled the trade surplus from $1.8 billion in the first half of 2008 to $11.7 billion in the first half of this year. Net outflow of $5.5 billion in the capital and financial accounts stemmed from a rise in Thai investment in overseas securities and from debt repayments.

Largely as a consequence of the ballooning trade balance, the current account surplus of $11.4 billion was more than three times that recorded a year earlier, and the overall balance of payments registered a surplus of $8.7 billion. Foreign reserves rose to $123.4 billion at end-July, equivalent to 5.6 times short-term foreign debt and 10 months of imports (Figure 3.9.5).

Large current account surpluses contributed to a 2.7% appreciation of the baht against the US dollar in the first 7 months of 2009, and to a rise of about 1.0% in the nominal effective exchange rate of the baht. The Bank of Thailand in August relaxed regulations on Thai investment in foreign securities and derivatives, a move aimed at facilitating capital outflows and easing upward pressure on the baht.
Employers responded to the plunge in export orders and subsequent weakness in domestic demand by reducing working hours and employment, contributing to a rise in the unemployment rate to 2.1% in the first quarter of 2009 from 1.3% in the preceding quarter. The rate eased to 1.8% in the second quarter of 2009 when hiring started to pick up, particularly in construction and some services.

Inflation, which shot up to an 11-year peak in July 2008, fell away as global prices for oil and food slid, so that the consumer price index fell by 1.9% in January–July 2009 year on year. The fall in July was a steep 4.4% on this basis (Figure 3.9.6). Government policies introduced in 2008 to assist those on low incomes at a time of high inflation, including free electricity and water supply for small households and subsidies for public transportation, were extended twice to stimulate private consumption.

The first fiscal stimulus package aimed at moderating the economic contraction involved measures costing B116.7 billion ($3.4 billion, or about 1% of GDP). Coming into effect in March this year, it included cash payments and subsidies for low-income people and assistance for rural small enterprises. Almost half the total amount was disbursed by July.

The additional spending, at a time of weakness in government revenue, is projected to widen the fiscal deficit to about 4% of GDP in FY2009 (ended 30 September 2009), from 0.3% in FY2008. Revenue has fallen well below target during FY2009 as the domestic recession eroded government income from sources such as import duties and value-added tax. Parliament in June passed emergency legislation authorizing additional government borrowing beyond limits set under the budget law, and it approved new debt issues of up to B800 billion.

Monetary stimulus came from aggressive reductions in interest rates by the Bank of Thailand: from the start of December 2008 to April 2009 it lowered its policy rate by 250 basis points to 1.25% (Figure 3.9.7). Nevertheless, the impact on lending was muted. Commercial banks, concerned about credit risks in a contracting economy, were cautious in lending, while private sector demand for credit generally declined in tandem with economic activity. The rate of increase in loans by commercial deposit-taking institutions slowed from 8.4% in the first quarter to 6.1% in the second.

Stock prices as reflected in the SET index, after falling by 48% in 2008, picked up in the second quarter of 2009. The index rose by 45% in the first 8 months of this year (Figure 3.9.8), a gain in line with other Asian markets.

Citing the political unrest, S&P in April lowered Thailand’s long-term local currency debt rating to A- from A. Fitch downgraded the long-term foreign currency rating to BBB from BBB+ that month, on the grounds that political strife undermined the ability of the Government to implement policies.

Prospects

The forecasts assume that there are no disruptive changes in government in the forecast period and that fiscal policy is implemented as planned. In addition to the first fiscal stimulus package, the Government has approved a second package that comprises public investment and that will cost B1.43 trillion ($42 billion) over 3 fiscal years starting in October.
this year. This is equivalent to about 5% of GDP in each of the years. The Government estimates that the projects will create 1.5 million jobs, stimulate private consumption, and spur a rebound in industries such as steel and cement that supply construction firms.

Projects with high priority under the program are water management and reservoir development, highways, rural roads, and mass-transit systems. It also involves additional investment in education, health, and tourism.

The fiscal and monetary stimulus, coupled with the gradual improvement in the international economic climate, point to economic performance picking up during the second half of 2009 and into 2010. As noted, the slump in trade and manufacturing reached a trough in the first half. Consumer confidence and business sentiment has also improved (Figure 3.9.9). For the full year, GDP is forecast to contract by 3.2%, a sharper decline than projected in March’s Asian Development Outlook 2009. The revision is based on the weaker than expected outcome in January–June 2009 and the downgrading of the 2009 outlook for major industrial economies and world trade.

Economic growth is expected to resume in 2010 at about 3.0% (Figure 3.9.10), a very modest rate given the low base laid in 2009. The growth will be underpinned by the Government’s public investment plans, which will provide some encouragement for private investment. Private consumption will benefit from a gradually firming labor market and expected gains in prices of agricultural commodities.

Strengthening economies abroad will raise demand for Thailand’s exports of automobiles, electronic and electrical goods, and agricultural products. After falling by a projected 18.0% in 2009, exports are forecast to recover by around 15% in 2010. Merchandise imports will rebound strongly if the public investment projects get under way as planned and if private investment rallies. A 28% bounce is forecast for imports in 2010. In services trade, tourism is expected to improve, with the pace of recovery depending in large part on the rebound in the international economy and on global efforts to contain the swine flu (H1N1) pandemic.

A substantial current account surplus equivalent to 6.0% of GDP is forecast for this year in view of the large trade surplus. Next year, the rising cost of imports of capital goods for projects and for oil is forecast to pull down the trade surplus. The current account surplus is forecast to decline to about 1.0% of GDP.

Consumer prices, after declining by more than expected so far in 2009, are projected to turn upward by year end, in part a result of a low-base effect brought about by a steep decline in inflation late in 2008. The consumer price index is forecast to fall by 0.5% this year, revised from Asian Development Outlook 2009 when slight inflation was anticipated. Next year, inflation is projected at 2.0% (Figure 3.9.11), based on the expected gradual recovery in domestic demand and higher average oil prices in 2010. Inflation might be slightly below this rate if the Government were to again extend the concessions on charges for electricity, water, and public transportation.

After lowering the policy interest rate to 1.25% in April 2009, the Bank of Thailand maintained this rate through August. If economic activity and inflation revive as projected, the central bank could start
to edge the policy rate back up in the second half of 2010. The main financial constraint for many firms is access to credit, rather than its cost. Addressing this issue, the Government has asked state-owned financial institutions to give more attention to firms facing a liquidity squeeze and provided credit guarantees to small and medium-sized enterprises and exporters.

Most of the financing for the 3-year public investment program will be off-budget, sought from domestic debt markets and public–private partnerships. Borrowing for the program is expected to increase the ratio of public debt to GDP to a still-manageable 58% of GDP by 2012, from 37.4% in 2008. The FY2010 budget targets a reduction in spending from FY2009, but when planned outlays for the public investment program are added, the combined fiscal deficit for FY2010 will be as high as 7.4% of GDP.

Domestic risks to this outlook center on possible renewed political turbulence that would disrupt policy making and delay disbursement of budget spending and the public investment program. Bolstering domestic demand is particularly important, considering that the outlook is for only modest growth in industrial-country markets. (Thailand has often relied on exports to drive growth, but this is less likely to be an option in the forecast period.)

The public sector bears a heavy responsibility in reviving investment, largely because the private sector has been weakened by recession and political uncertainty. But the mediocre record of public investment in recent years underlines the risk of relying on it too much. A $40 billion “megaprojects” infrastructure plan that was formulated in 2005 and that carried a similar responsibility was largely uncompleted because of frequent changes in government and political tensions. Some of that plan’s projects have now been incorporated into the new 3-year program. Overall, public investment has been relatively low since the 1997–98 Asian financial crisis (Figure 3.9.12).

Any renewed political turmoil that disrupts the rollout of the public investment program (and policy making in general) would hurt growth directly and erode still-fragile consumer and investor confidence. In these circumstances, GDP growth would be lower than forecast, as would fiscal revenue, which would put additional pressure on the budget.
Viet Nam

The economy is weathering the global economic crisis relatively well due largely to swift and strong policy responses. The GDP growth forecast for 2009 is revised up from that made in March and the 2010 forecast is maintained, with growth expected to accelerate in the second half of 2009 and into 2010. The projections for inflation are raised, chiefly because of higher world commodity prices. Forecasts for current account deficits are narrowed, though the overall balance of payments is still expected to be in deficit this year, before it returns to surplus next year. Therefore, the Government needs to strike a balance between stimulating growth through demand-side measures and safeguarding macroeconomic stability.

Updated assessment

Despite the weak external environment, the economy has continued expanding this year, albeit at a slower rate. GDP grew by 3.9% in the first half of 2009, as against 6.2% in 2008 and more than 8% in 2005–2007 (Figure 3.10.1). Expansionary fiscal and monetary policies boosted public consumption and domestically financed investment. Imports fell more steeply than exports, so that net exports contributed to GDP growth. At the same time, a rise in unemployment and fall in remittance inflows damped growth of private consumption, and a downturn in inflows of foreign direct investment (FDI) caused a decline in foreign-financed investment.

Viet Nam’s economic slowdown appears to have bottomed out early in 2009, with year-on-year GDP growth quickening to an estimated 4.5% in the second quarter from 3.1% in the first. Growth of agriculture pulled back sharply in the first quarter because of bad weather, but rebounded in the second quarter, aided by a bountiful winter–spring rice harvest. Manufacturing, which contracted in the first quarter on account of weak external demand, started growing again in the second, as expansionary monetary and fiscal policies strengthened domestic demand. Growth of services and construction accelerated in the second quarter owing to a pickup in private consumption and domestically financed investment.

Following several years of decline, output of crude oil grew by 17.9% in the first half of 2009 (Figure 3.10.2). Falling output at some old fields was more than offset by increases at new fields.

A softening in the labor market that started in late 2008 continued in early 2009, as economic activity slowed and businesses shed labor. Although most layoffs occurred in urban areas, unemployment and underemployment increased in both urban and rural areas, as some of those from villages who had lost their jobs in cities returned home. Declines in remittance receipts and wages pushed some households into poverty. Toward mid-2009, however, demand for labor appeared to pick up again.

Inflation has decelerated sharply owing to lower world commodity prices and relatively slow domestic economic growth. Period-average

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This chapter was written by Bahodir Ganiev of the Viet Nam Resident Mission, ADB, Hanoi.
inflation eased to 8.3% in January–August 2009 from 23.0% in 2008. Year-on-year inflation fell to 2.0% in August 2009 from 28.3% in August 2008 (Figure 3.10.3). However, inflation pressures reemerged in the second quarter as commodity prices edged up and growth accelerated. Seasonally adjusted month-on-month inflation rose to 0.8% in the June–July period, a fairly high rate given that world commodity prices were well below their peaks.

To stimulate economic activity and limit the rise in unemployment, the State Bank of Viet Nam (SBV), the central bank, eased monetary policy significantly in late 2008 and early 2009 and has kept it relatively loose since then. Year-on-year growth of reserve money quickened from 13.7% in the third quarter of 2008 to 26.7% in the first quarter of 2009, before a decline in SBV’s foreign assets pulled it back to 21.2% in the second quarter (Figure 3.10.4). Spurred by the introduction of government interest rate subsidies, growth of credit and money supply accelerated in the first half of 2009; in particular, growth of total liquidity (M2) stepped up to 35.8% in the second quarter from 20.3% in the fourth quarter of 2008.

Since the easing of monetary policy was not enough to prevent a sharp slowdown in growth, the Government approved several fiscal stimulus measures in the first half of 2009 (Box 3.10.1). They include a temporary 30% cut in the corporate tax rate for small and medium-sized enterprises, additional financial assistance to poor households, a 4 percentage point interest rate subsidy on certain bank loans, and a boost in planned infrastructure spending. The total cost of these measures is estimated at D145.6 trillion, more than was expected when Asian Development Outlook 2009 (ADO 2009) was launched in March this year.

The tax breaks, coupled with a fall in oil income caused by lower world oil prices, reduced budget revenue and grants in the first half of 2009 (Figure 3.10.5). Budget expenditure decreased as well, because the fiscal stimulus mainly increased off-budget spending and lending. The budget fell into deficit, from a surplus a year earlier. The overall fiscal deficit (including off-budget expenditure and lending) was likely much larger than the budget deficit.

SBV has kept its reference foreign-exchange rate fairly stable since December 2008 (Figure 3.10.6). Declines in exports as well as in remittance and foreign capital inflows have reduced the supply of foreign exchange, while expansionary monetary and fiscal policies have increased demand for it. Consequently, there has been a shortage of foreign exchange in the formal market and the dong’s exchange rate against the US dollar has remained at the upper bound of its trading band since October 2008. The band was widened to +/-5% from +/-3% around SBV’s reference rate in March 2009, resulting in depreciation against the US dollar by about 2% in the formal market. However, this depreciation was insufficient for the market to clear. The black market exchange rate has stayed above the upper bound of the trading band most of the time since October 2008.

The shortage of foreign exchange in the formal market has helped narrow the trade deficit by suppressing imports. But it has also created difficulties for businesses, given rise to indirect payments for foreign exchange in the formal market, and hurt the business environment. Furthermore, the shortage has fueled expectations of devaluation and put depreciation pressure on the dong in the black market. The spread between SBV’s reference rate and the black market widened to more...
3.10.1 Fiscal stimulus measures and the 2009 budget

The Government approved various fiscal stimulus measures in January–May 2009 to ease the impact on the economy of the global economic slump. Given the consensus-based decision making system, it approved policies in a piecemeal fashion to speed their implementation, rather than wait to get agreement on a package of measures.

This approach enabled the Government to start carrying out some stimulus measures as early as February. However, it also created some uncertainty about the impact of the stimulus on the budget, and the total amount raised questions about the implications for macroeconomic stability and sustainability of public debt.

The total amount is indeed large, estimated at D145.6 trillion, or 8.7% of projected 2009 GDP (Box table 1). However, the direct impact on the 2009 budget will be less than this amount, even if all measures are fully carried out. This is because the measures include housing assistance to the poor that will be mostly financed by the Viet Nam Bank for Social Policies and interest rate subsidies that will be partly disbursed in 2010.

The potential direct impact of the measures on the 2010 budget is positive, given that they include both deferment of some tax payments and budget loan repayments from 2009 to 2010 and the bringing forward of some expenditure from 2010 to 2009.

In June 2009, the National Assembly lowered the official GDP growth target for 2009 from 6.5% to 5.0% and raised the ceiling on the budget deficit (based on the Government’s definition) from 4.8% of GDP to 7.0% of GDP (Box table 2). This in effect increased the planned overall fiscal deficit (including net off-budget expenditure and lending) from 6.9% to 15.7% of GDP. However, the Government’s revised budget plan is based on conservative projections of world oil prices and revenue performance. Actual revenue is likely to exceed the planned amount owing to higher world oil prices and improved tax administration.

<table>
<thead>
<tr>
<th>Measure</th>
<th>Amounta</th>
<th>Potential direct impact on the budgetb</th>
</tr>
</thead>
<tbody>
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<td>Measures affecting government revenue</td>
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<td>-28.0</td>
</tr>
<tr>
<td>Measures affecting government expenditure and net lending</td>
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<td>114.5</td>
</tr>
<tr>
<td>Total</td>
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<td>-141.5</td>
</tr>
<tr>
<td>Billion US dollars</td>
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<td>-8.3</td>
</tr>
<tr>
<td>% of GDP</td>
<td>8.7</td>
<td>-8.5</td>
</tr>
</tbody>
</table>

a Excludes quasi-fiscal stimulus measures undertaken through the Viet Nam Development Bank (such as guaranteeing bank loans to small and medium-sized enterprises).
b Staff estimates based on the assumption that the announced fiscal stimulus measures will be fully implemented. Excludes the indirect impact of the measures on the budget through their effects on public debt, growth, etc.

The potential direct impact of the measures on the 2010 budget is positive, given that they include both deferment of some tax payments and budget loan repayments from 2009 to 2010 and the bringing forward of some expenditure from 2010 to 2009.

In addition, planned capital spending is unlikely to be fully disbursed due to implementation and financing constraints. Accordingly, the ADO 2009 forecast of the overall fiscal deficit in 2009 is revised up only slightly, from 9.8% of GDP to 10.1% of GDP. The gap is expected to be financed mainly by drawdowns on the Government’s deposits at SBV and at commercial banks, and by borrowing from multilateral and bilateral development agencies.

The fiscal deficit is therefore unlikely to put sustainability of public debt at risk. Nor is it expected to jeopardize macroeconomic stability, assuming that SBV starts tightening monetary policy toward the end of 2009.
34.1%, reflecting the slowdown of economic activity, lower import prices, reduced availability of trade credit, and the shortage of foreign exchange. A downturn in FDI inflows contributed to the sharp decline in imports of capital goods. The trade deficit (balance-of-payments basis) narrowed to $0.2 billion in January–June 2009 from $11.4 billion in the same period of the previous year. Despite declines in remittance inflows and tourism income, the current account recorded a surplus of 0.4% of GDP in the first half of 2009, compared with a deficit of 23.8% in the same period of 2008 (Figure 3.10.8). (The first-half current account balance would be a deficit of 5.7% of GDP if reexports of gold were excluded.)

The capital account balance turned from surplus into deficit due to a downturn in FDI inflows and outflows of portfolio investment and short-term capital. The overall balance of payments recorded a deficit, and gross official reserves fell to $17.6 billion at end-June 2009 from $23.0 billion at end-2008. In terms of import coverage, however, gross official reserves increased to 16.4 weeks of imports at end-June 2009.

For the rest of 2009, it is assumed that the Government will not take additional fiscal stimulus measures. It is further assumed that SBV will start tightening monetary policy toward the end of this year, as the balance of risks shifts from growth to macroeconomic stability. Output at new oil fields that came on stream in late 2008 is now expected to reach its peak in 2009, rather than in 2010. Hence, total oil output is projected to rise to 16.5 million metric tons in 2009, revised up from March.

Based on these assumptions, the GDP growth forecast for 2009 is raised to 4.7% from 4.5% in ADO 2009, mainly as a result of the larger than expected fiscal stimulus, oil output, and net exports. Growth in the second half is forecast to accelerate to 5.4%. Inflation in 2009 is now seen averaging 6.8%, above that predicted in March because of stronger than expected inflation inertia as well as higher projections of global commodity prices. The current account will return to deficit in the second half as exports shrink further and imports pick up. For all 2009, the deficit is likely to be 7.6% of GDP, revised from 11.5% in view of larger exports of oil and rice, gold reexports, the sharper decline in imports, and larger GDP than projected in ADO 2009. The overall balance of payments is still expected to record a deficit this year.

Prospects

Forecasts of 2010’s outcomes are based on the assumption that the Government will not adopt additional fiscal stimulus measures next year and that SBV will pursue moderately tight monetary policy. It is further assumed that SBV will eliminate the shortage of foreign exchange through greater flexibility of its reference rate, tighter monetary policy, and increased sales of foreign exchange. The projection for oil production in 2010 is maintained at 15.5 million metric tons, an easing from this year’s level.

On this basis, GDP growth is forecast to increase to 6.5% in 2010 (Figure 3.10.9), in line with the ADO 2009 projection. Growth of consumption and domestically financed investment will speed up as the 2009 monetary and fiscal stimuli work through the economy. The anticipated improvement of global financial conditions will bring about an upturn in foreign-financed investment. At the same time, net exports of goods and services will fall, with imports growing faster than exports.
The labor market will pick up on the back of accelerating growth, and incomes will increase. Inflation is now forecast at 8.5% next year, revised up from 5.0%. The reason is the rapid growth of money supply in 2009 and expected increases in world commodity prices.

The overall fiscal deficit is likely to narrow to about 4.5% of GDP next year (Figure 3.10.10). The forecast rise in world oil prices (hence oil revenue), faster economic growth, and deferral of some tax payments from 2009 to 2010 as part of the fiscal stimulus will boost government receipts. Expenditure will fall because some outlays initially planned for 2010 are being brought forward to 2009 (also part of the 2009 fiscal stimulus), and no additional fiscal pump priming is expected next year.

Viet Nam’s stock of public and publicly guaranteed debt is likely to be slightly higher than was forecast in March, at about 46% of GDP in 2010, compared with 48% in 2009 and an estimated 44% in 2008 (Figure 3.10.11). Since much of the debt is on concessional terms, its present value will remain below 20% of GDP.

The current account deficit is forecast to widen from 7.0% of GDP this year to 9.0% in 2010. Stronger external demand and higher prices for goods shipped abroad will lift exports, and remittance inflows will increase as economies in source countries improve. However, these factors will be more than offset by increases in imports resulting from stronger economic growth, improved availability of trade credit and foreign exchange, and higher import prices. The overall balance of payments should return to surplus if capital inflows rebound as anticipated.

Risks to this outlook are mainly on the downside. A weaker than expected global economic recovery would damp growth in Viet Nam, and an unexpected spurt in world commodity prices would mean higher inflation. A conceivable domestic risk is that inflation pressures and expectations of devaluation could build up to an extent that they significantly reduce demand for dong-denominated assets. In such an event, the black market exchange rate would depreciate sharply and inflation could return to double digits. The current account deficit would be wider than projected in this Update because speculative imports would surge, as they did in the first half of 2008. The resultant macroeconomic turbulence and stabilization measures would likely cause slower economic growth than forecast in the ADO 2009 Update baseline scenario.

Moving to guard against such an outcome, SBV has started taking measures to keep inflation in check and to damp devaluation expectations. In particular, it has committed to limit growth of banking system credit and total liquidity (M2) to 30% in 2009; asked state-owned commercial banks to limit loan growth to 25% in 2009; and urged all commercial banks to tighten credit for consumer spending and purchases of real estate and stocks. It has also committed not to devalue its reference exchange rate in the near future and has increased the supply of foreign exchange in the formal market. As noted, SBV is also likely to start tightening monetary policy toward the end of 2009. It is expected to pursue moderately tight monetary policy in 2010 to support the dong and to counter inflation pressures stemming from accelerating growth and rising world commodity prices.
Statistical appendix
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 2006 to 2008 and forecasts for 2009 and 2010.

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 2009 and 2010 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. Republic of Palau reports balance-of-payments data 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 2006–2007 were obtained from the World Bank’s World Development Indicators Online. Weights for 2007 were carried over through 2010. 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 non-deductible 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 is based on non-oil, non-United Nations GDP.

**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, and Nepal is for urban consumers.

**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 USD. In the case of Cambodia, and Lao People’s Democratic Republic, official transfers are excluded from the current account balance.
Table A1 Growth rate of GDP (% per year)

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