The World Economy, Developing Asia, and the Pacific

THE WORLD ECONOMY

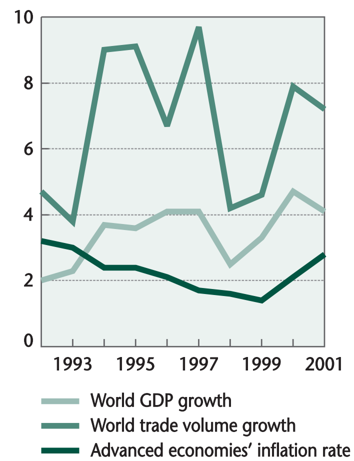
The performance of the world economy in the first half of 2000 suggests a further strengthening of the global recovery that started in 1999 and somewhat more evenly shared growth across the major regions. Global gross domestic product (GDP) growth in the first quarter of 2000 was higher than at any time since 1987. The performance points to a much stronger outcome for the global economy in 2000 than was foreseen at the time of the release of the Asian Development Outlook (ADO) in April this year. However, significant risks remain for sustaining this momentum through 2001. The principal factor underlying the much stronger global economic performance so far in 2000 is the continuing growth momentum of the United States (US) economy. While there are some signs of weakening consumer demand, GDP growth in the second quarter came in higher than in the first. However, events in the first six months have reconfirmed ADO's expectations that growth will be more evenly shared across the principal currency regions of the US, Euro area, and Japan and that the Asian economic recovery will be sustained. There are clear signs of a strengthening of the cyclical upturn in Europe, and even in Japan the recovery may be taking hold with growth in 2000 expected to be about 1.5 percent. Within Asia, all the crisis-affected countries are expected to achieve strong growth in 2000, while growth in the People's Republic of China (PRC) is now expected to be higher than earlier forecast. The Indian economy is also set to achieve higher growth this year than previously estimated. The other South Asian countries and the transitional economies in Asia are also expected to perform better, as they take advantage of improved global and regional conditions. Based on the stronger economic performance in the first half of the year, the forecast for global GDP growth in 2000 has been revised upward from 3.5 percent to 4.7 percent. Given the trend growth rate between 1970 and 1990 of 3.6 percent, the growth rates in 1999 and 2000 imply that about half the nominal loss in output will have been regained by the end of this year. The growth in world trade volume, which had declined quite sharply to 4.2 percent in 1998 and was 4.6 percent in 1999, is expected to rise to 7.9 percent in 2000. This reflects rising import demand in emerging market economies of about 9–10 percent, as growth recovers and capital-goods and intermediate-goods imports pick up after the slump in 1998. The continued strength of US domestic demand is also helping sustain global GDP growth, with US imports expected to increase by more than 8 percent in 2000.

Even as growth has strengthened, inflation rates in the advanced economies have remained subdued, edging up only modestly in response to higher energy prices. Continued favorable inflation reflects a number of factors. These include the available spare capacity in product and labor markets in the Euro area and Japan, as well as some productivity-enhancing effects of information and communications technology (IT). To keep inflation from accelerating, the US Federal Reserve raised short-term official interest rates on six occasions over the last 12 months. These increases not only reversed the interest rate cuts made in the second half of 1998—in the

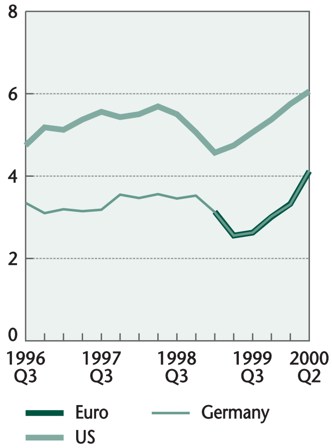
GDP Growth for 2000: ADO Projections

	ADO 1999 Update	ADO 2000	ADO 2000 Update
World	3.5	3.5	4.7
Developing Asia	5.5	6.2	6.9
NIEs	5.2	6.5	7.9
PRC	6.0	6.5	7.5
CARs	–	3.0	4.1
Southeast Asia	4.4	4.6	4.7
South Asia	6.5	6.4	6.5

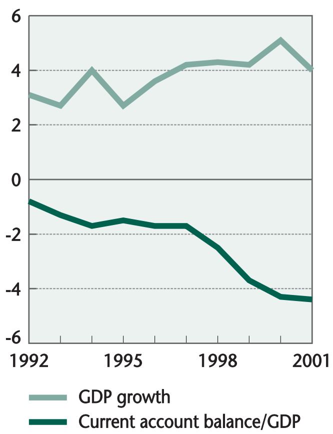
Growth in GDP and Trade Volume, and Inflation Rate (percent)



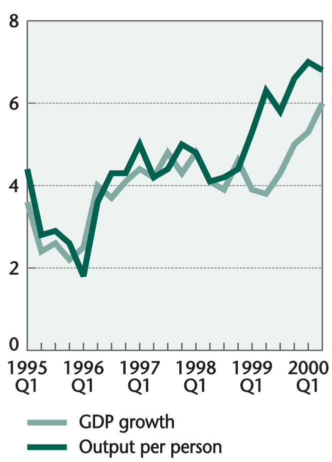
Interest Rates by Quarter: Euro Area, Germany, and US (percent)



GDP Growth and Current Account/GDP: US (percent)



GDP Growth and Productivity Gains by Quarter: US (percent)



wake of the Asian and Russian financial crises and the near failure of one of the largest US hedge funds—but also pushed short-term US rates 175 basis points higher than in November 1998. The European Central Bank (ECB) raised interest rates twice in the first half of 2000. As a result, Euro-area interest rates have also seen a net increase of one percentage point over the average rate in 1998. Meanwhile, the improved outlook for the Japanese economy and the steady shifting of growth momentum to more dynamic new economy segments prompted the Bank of Japan (BOJ) in August 2000 to reverse its exceptional zero interest rate policy and raise rates by 25 basis points. Globally, inflationary pressures are expected to increase somewhat in 2000 due to both recovery-induced demand effects and the strengthening of oil prices. However, the sensitivity of the monetary authorities in the US and the Euro area to inflationary expectations, together with the deflationary trend in Japan, is expected to result in global inflation remaining below 3 percent in 2000 and 2001.

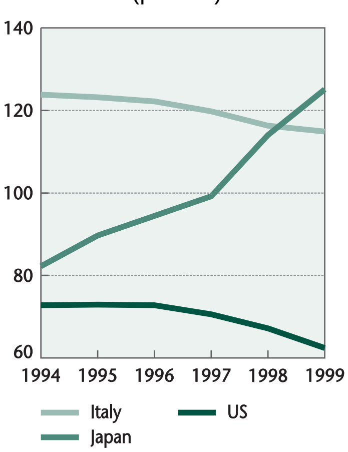
Unemployment rates in the advanced economies declined to 6.4 percent in 1999 and to 5.9 percent in the first quarter of 2000. These reflect the lowest unemployment levels in the US since the 1960s and a marked improvement in Europe. The fall in unemployment rates has created some wage pressures in Europe, but not in the US, where increases in average real earnings have been more than offset by productivity gains. In Japan, the corporations representing the "old economy" have yet to complete their substantial capacity rationalization and are still downsizing their work force. As a result, unemployment, already well above postwar averages, is set to increase further to about 4.7 percent by the end of 2000. Shortages of IT skills have emerged in both Europe and Japan, prompting a review of professional entry norms and practices, and of immigration policies.

The most remarkable development in the first half of 2000 was the continuing and unexpectedly strong growth of the US economy. This longest period of peace-time expansion in the US, now in its ninth year, is based on historically high labor productivity gains. While the average annual productivity gains were 2.5 percent in the 1970s and 2.9 percent in the 1980s, in the last decade (1990–1999) productivity rose by 4 percent a year. This has focused attention on productivity gains arising from the technology-driven new economy (see the chapter on information technology and development). As a result, GDP growth of 5.3 percent in the first quarter and 6.0 percent in the second quarter of 2000 was achieved with a core rate of inflation (i.e., excluding food and oil prices) of about 1 percent and with exceptionally low unemployment rates. Including food and oil prices, the inflation rate was still a moderate 3.7 percent. The new economy effect can perhaps also be seen in the sharp gains made by technology stocks in the 1990s: their price to earnings (P/E) ratio when it peaked in March 2000 stood at 186 compared with a peak of 32 for Standard and Poor's 500 Index (the S&P 500) at the end of 1999. The share of technology stocks in total market capitalization in the US rose from about 18 percent in 1990 to 33 percent in 1999. This steep rise in the value of technology stocks, together with the more general increase in equity prices, has created strong wealth effects in the US economy that have contributed to private domestic demand growing by more than 5 percent annually over the last few years. Consumption demand, which has shown some signs of weakening in recent months, is increasingly being met by imports, resulting in large trade and current account deficits. The current account deficit of 3.7 percent of GDP in 1999 is above the previous highest figure of 3.4 percent in 1986 and 1987. But, unlike the earlier period, the deficit reflects the gap between private savings and investment, with the public sector fiscal balance showing a small but rising surplus. This external financial imbalance in the US and associated private sector indebtedness, which also persisted in the first half of 2000, is not sustainable over the medium term and is causing continued uncertainty as to whether the adjustment will be orderly.

Economic activity in the Euro area started on a cyclical upturn in the second half of 1999 when output grew by 2.8 percent. GDP growth in the first quarter of 2000 was 3.2 percent and is expected to be 4.0 percent in the second quarter. Growth is likely to remain robust in the second half of the year, resulting in GDP growth over the whole year of about 3.5 percent. With higher import prices as a result of the weaker Euro, core inflation may be edging toward the target ceiling of 2.0 percent, and so prompt the ECB to further tighten its monetary stance in the third quarter. Consequently, growth could settle down to a noninflationary level of about 3 percent in 2001. The Euro area has seen a marked improvement in unemployment with rates declining below 10 percent for the first time since 1993. This will strengthen domestic demand in the coming months and reinforce the cyclical upswing. The labor and product markets, which are more regulated and less flexible than those in the US, and the overall higher costs of business start-ups, are perhaps responsible for the slower absorption of IT in the European economies and may explain the slower increase in technology spending by European corporations. This is seen in a mere 6 percent growth in personal computer sales in the Euro area in 1999 and the first quarter of 2000, compared with a greater than 20 percent increase in global sales of personal computers over the same period. This technology lag suggests that the new economy effect has been felt less in Europe than in the US, and may partly explain the Euro area's difficulty in achieving a higher rate of noninflationary output growth.

The Japanese recovery, which seemed to stall in the second half of 1999, when GDP growth fell to 0.9 percent and to a negative 0.3 percent in the third and fourth quarters respectively, is now slightly firmer. In the first half of 2000, GDP grew at 0.9 percent, and is likely to strengthen further in the second half of 2000, as it will benefit from a low base effect. The Japanese economy is therefore expected to post a GDP growth figure of about 1.5 percent in 2000 and about 2 percent in 2001 as the recovery broadens. These will be the highest growth rates since 1996. The growth stimulus from 1999 fiscal packages has petered out. Another fiscal stimulus may be launched in September 2000, but given the high level of public debt at 125 percent of GDP, little scope is left for reflationary fiscal policies. Improved GDP growth performance in 2000 will be based primarily on a rebound in business investment, which increased by 13 percent in the fourth quarter of 1999, and by 7.5 percent in the first quarter of 2000. Consumption demand is expected to recover only gradually. A marked dualism may be emerging in the Japanese industry sector: new economy segments are being powered ahead by domestic and external demand as well as productivity gains, while the old economy is still going through a painful process of shedding excess labor, and of capacity restructuring and

Public Debt/GDP: Italy, Japan, and US (percent)

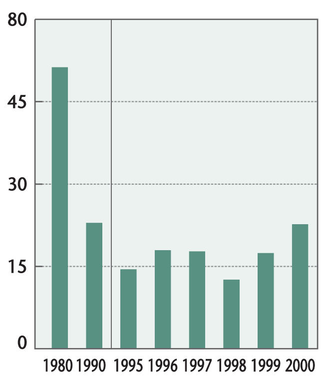


consolidation. The BOJ expects that its recent decision—reflecting its newly acquired autonomy—to raise interest rates by a quarter of 1 percent will also provide a symbolic but necessary nudge to capacity restructuring. The business confidence index (the so-called Tankan index), which was exceptionally strong in June 2000, was not expected to weaken as a result of this move and the Nikkei stock market index also did not falter after the interest rate increase. The wholesale price index, which declined by 0.7 percent in the last quarter of 1999, has shown signs of firming up. It registered a marginal but positive rise of 0.3 percent in the second quarter of 2000.

The robust performance of the global economy can continue if private demand in the US can be slowed down to sustainable levels and if growth is shared more evenly across the principal currency areas. Although a remote possibility for 2000, the US economy could still experience a hard landing in 2001. Some recent signs suggest that US growth is slowing—the number of new housing starts has begun to decline and it was inventory buildup that provided the major boost to second quarter growth. Given the expansion of private debt to historically high levels in the US, any unforeseen negative shock, for example a sharp increase in oil prices or a higher than expected interest rate rise by the Federal Reserve, could transform consumer expectations of future earnings and prices. This could lead to a sharp correction in equity prices in the US, a weakening of the dollar, serious debt-servicing problems in the private sector, and consequently, a precipitate decline in US import demand. This will hit the rest of the world hard as other equally robust sources of external demand are not clearly visible. However, with the accumulation of fiscal surpluses in recent years, the US Government is much better placed to implement counter-cyclical measures, provided the switch in market sentiment is recognized and addressed early enough.

There is a risk that both the Japanese and European monetary authorities may tighten their monetary stance either prematurely, or too strongly, or both. This could abort their recoveries. The recent interest rate hike in Japan, though modest, could trigger a weakening of consumer and business confidence and halt the nascent turnaround. The initial market reaction to the interest rate increase by the BOJ was, however, not negative. For its part, the ECB may be forced to raise interest rates more than expected if inflationary pressures become too strong, and this could bring an early end to the cyclical upswing.

Oil Prices
(constant 1990 $/barrel)



A further rise in oil prices in the second half of the year is a concern as stocking begins for meeting the winter demand. Given that oil prices have persisted at $26–$30 a barrel—touching $32 a barrel in mid-August—despite production increases, and that US oil stocks are reportedly at their lowest in 24 years, the prospects of severe winter weather or even a minor disruption in supplies could send oil prices spiraling upward. The direct impact on global economic activity of a further moderate rise in oil prices may not be significant though, because of the lower oil intensity of global GDP than in the 1980s, and because in real terms oil prices are still substantially below the levels of the 1980s. However, the impact on consumer business expectations of yet higher oil prices could be significant and may, potentially, disrupt economic activity. A closer watch on oil price trends and market conditions is therefore warranted.

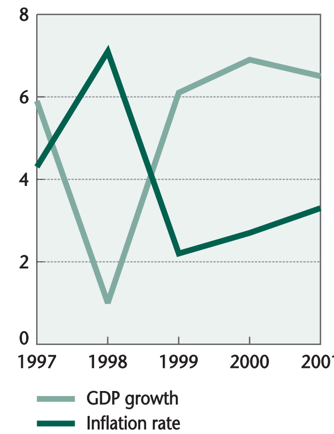
DEVELOPING ASIA AND THE PACIFIC

After the V-shaped economic recovery in 1999, developing Asia and the Pacific consolidated its gains with sustained GDP growth in the first half of 2000. The available data show that the growth momentum, although shared across all subregions within Asia, has significant variations. The volatility in equity markets and currency valuations in some developing Asian economies point to some underlying concerns that need to be addressed if growth is to be sustained over the medium term. Among the crisis-affected economies, except for Indonesia and Thailand, output lost during the financial crisis of 1997–1998 is likely to be recouped by the end of 2000. In Thailand, it will take perhaps another year for per capita GDP to reach precrisis levels. It may take even longer in Indonesia, as economic and political uncertainties have become somewhat interwoven and are hindering a more robust recovery. The newly industrialized economies (NIEs) are expected to achieve growth of 7.9 percent in 2000 and 6.6 percent in 2001. The two largest economies in developing Asia, namely the PRC and India, are likely to improve upon their performance of 1999. The smaller ASEAN economies are being carried upward by the tide of better regional performance, as increasingly stronger intraregional trade links generate positive spillover effects to the rest of developing Asia. The Central Asian republics (CARs) are benefiting from improved economic performance in Russia as well as higher prices for oil and gas, which are the leading exports of some of these economies. Only the Pacific developing member countries (PDMCs) have shown weaker performance in the first half of the year owing to political uncertainties and continued softness in world commodity prices.

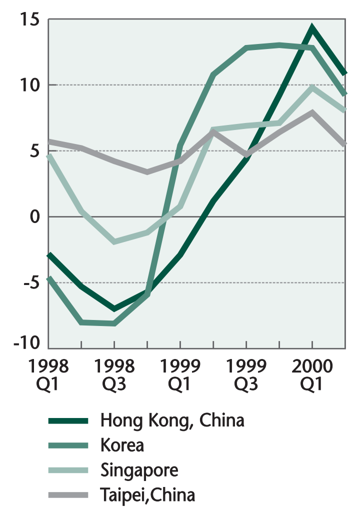
In the above context, developing Asia's GDP growth is forecast to increase to 6.9 percent in 2000 before moderating to 6.5 percent in 2001. The growth will be based on further improvement in domestic demand and sustained growth in external demand. Domestic investment demand, while still below precrisis levels in a majority of developing Asian economies, is likely to strengthen as excess capacity is utilized and competitive pressures force production capacity to be upgraded. Improved consumer sentiment will bolster private consumption which is expected to offset slackening public sector demand as governments restore fiscal balances within the region. External demand is likely to remain buoyant on account of stronger growth in interregional trade, a consolidation of recovery in the Euro area and Japan, and continued, though slower, demand growth in the US.

Among the NIEs, the performance of the Republic of Korea (henceforth Korea) has been exceptionally strong. GDP growth of 10.7 percent in 1999 was followed in 2000 by growth of 12.8 percent in the first quarter and 9.6 percent in the second quarter. Recent growth has been based primarily on resurgent domestic demand rather than growth in net exports. Gross investment demand, after declining for seven successive quarters in 1997–1998, increased at an average rate of more than 30 percent every quarter in 1999. Private consumption demand also increased, but at an average rate of about 10 percent each quarter in 1999. The upsurge in investment demand in Korea reflects the positive effects of deregulation and restructuring of the financial and corporate sectors, which have

GDP Growth and Inflation: Developing Asia and the Pacific (percent)



GDP Growth by Quarter: Newly Industrialized Economies (percent)



attracted substantial foreign investment. Investment activity has also increased because of a spurt in growth of small and medium new economy firms, and because of technological upgrading of production capacities in the information technology sector.

The recovery of Hong Kong, China, which started later than elsewhere in the second half of 1999, has strengthened in 2000 with first quarter growth of 14.3 percent followed by 10.8 percent in the second quarter. Reflecting continued slack in the economy, consumer prices have continued to decline, making interest rates, closely linked to rising US rates, among the highest in real terms in the region. This has held back domestic demand, which registered negative growth of 4.6 percent in 1999. While equity prices have improved since hitting their lows in August 1998, real estate prices have continued to decline, seriously worsening household balance sheets.

GDP growth in Singapore of 5.4 percent in 1999 was partly due to rising productivity levels which increased by 5.8 percent that year. Inflation has remained subdued, and unemployment levels declined both in 1999 and in the first half of 2000. Singapore, which is seeing a rapid growth of its IT industry, is benefiting from the positive impact of government policy to transform it into a "wired" economy in which growth impetus comes from high technology and service industries. As a result, a significant transformation of economic activity is currently under way.

Both for the NIEs and Southeast Asia, the contribution of external demand as reflected in the growth of net exports has weakened considerably after an initial boost that triggered economic recovery in 1999. This is an expected result as import demand has picked up in line with the recovery in GDP growth. The major factors underlying the rise in import demand have been both inventory rebuilding and growth in consumer demand in the region. Domestic demand is now emerging as the principal source of growth in the NIEs and Southeast Asia. This is also true of the PRC where retail sales growth, after slowing for six consecutive years, rose by 6.8 percent in 1999 and by 10.4 percent in the first five months of 2000. The deflationary trend in consumer prices in the PRC, which persisted throughout 1998 and 1999, also seems to have been reversed in the first half of 2000. The estimate for GDP growth for the whole of 2000 for the PRC is 7.5 percent, based on first half growth of 8.2 percent. The PRC's entry into the World Trade Organization (WTO) is expected to provide a further push toward structural reforms.

Economic recovery in the CARs that started in 1999, was supported by improved economic performance in Russia and rising oil and gas prices. While inflationary pressures are declining, they still remain strong in Uzbekistan where the unification of the exchange rate has raised import prices. Unemployment still remains at relatively high levels in a majority of CARs due to the ongoing restructuring of production capacities as part of the transition to a market-based economy. Further improvements in the macroeconomic situation and external balances in the subregion are contingent on the success in addressing the substantial unfinished agenda of structural reforms.

GDP growth in South Asia is expected to improve to 6.5 percent in 2000 and increase marginally to 6.6 percent in 2001, based on improved export performance, further deregulation, privatization, the opening-up of new sectors for private domestic and foreign equity participation, and a stable performance in the agriculture sector. Dynamic software exports and a depreciating rupee helped Indian exports increase at double-digit rates in 1999/2000. Economic performance in South Asia can be raised significantly if measures to improve tax regimes, rationalize public expenditures, and reduce fiscal imbalances are given the priority they deserve. These measures are key to bringing down inflationary pressures and releasing greater resources for private capital formation rather than crowding them out to finance public consumption and debt servicing.

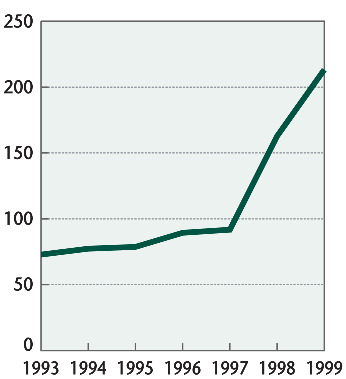
Events in Fiji and the Solomon Islands have overshadowed the PDMCs' economic performance in the first half of 2000. The political and ethnic strife in these two countries has led to large-scale disruption in economic activity that is expected to precipitate a decline of nearly 15 percent in economic growth in 2000. As a result, the overall performance of the PDMC economies as a group, though positive in the first half of this year, will be pulled down. Fortunately, the political instability has been isolated and shows signs of being resolved. This is a precondition for any improvement in economic prospects for the region. Papua New Guinea is beginning to benefit from the structural reforms undertaken in the latter half of 1999. GDP growth, which turned positive in 1999 after two years of decline, is likely to be sustained in 2000. Inflation, though declining, still remains a worry but may be curbed as a result of the tough monetary stance of the central bank that saw money supply declining by 5 percent in the first five months of 2000. Political stability and consistency in policies are necessary for the PDMCs and Papua New Guinea to achieve higher growth in coming years.

Monetary and fiscal policies remained broadly relaxed in the first half of 2000 as authorities in the region allowed the recovery to consolidate. Moreover, inflationary pressures have so far remained subdued as capacity utilization rates have yet to reach maximum levels. These conditions are beginning to change in the wake of positive GDP growth in the last six quarters and rising public debt levels in most economies. As a result, monetary and fiscal policies are likely to change direction, becoming less expansionary in the second half of 2000 through 2001. Some initial signals of this were visible when the Reserve Bank of India announced an increase in interest rates and a tightening of the credit supply in the third week of July 2000. Fiscal balances were already on the mend in the first half of 2000 as reflected in the smaller fiscal deficits in many countries. This will imply weaker role for public expenditure in raising domestic demand but a greater reliance on private domestic and external demand for generating growth in the coming years.

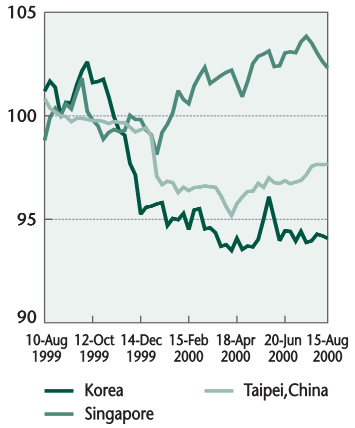
The ratio of foreign exchange reserves to short-term external debt which is a good indicator of external account vulnerability has improved significantly in almost all developing Asian economies. This will reduce their vulnerability on the external account in coming years. However, the buildup in reserves, as a result of large current account surpluses that were generated in 1998 and 1999, is likely to slow down in 2000 and 2001. Current accounts are expected to show smaller surpluses and even move into deficit in some cases, as import growth outstrips export growth to provide for domestic demand expansion and higher GDP growth.

There are some major risks to sustained economic growth in developing Asia and the Pacific. These risks are varied across subregions

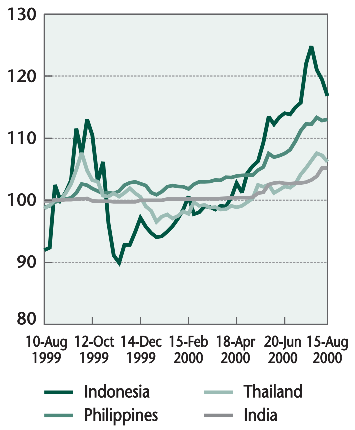
Ratio of Reserves to Short-Term External Debt: Developing Asia and the Pacific (percent)



Exchange Rates Index
by Week: Korea, Singapore,
and Taipei,China



Exchange Rates Index
by Week: Indonesia, Philippines,
Thailand, and India



depending upon their degree of integration with global financial markets, the stage of their recovery, and progress in structural reforms. First is the continued volatility in the region's financial markets that may affect the availability of capital resources in some developing member countries. To a significant extent, this is due to the rising interest rates and investor perceptions of higher returns in the principal currency markets. In some countries such as India, Indonesia, Philippines, and Thailand, equity and currency markets have perceptibly weakened in recent weeks. Apart from exogenous reasons, this may also be a result of country-specific factors such as political uncertainty, inadequate progress of structural reforms, or perceived inability of the governments to address macroeconomic imbalances. Undertaking measures that will restore business confidence and reassure investors, as well as closer monitoring of emerging trends, are necessary to prevent these incipient weaknesses from intensifying into another crisis of confidence.

To some extent, the current weakness in business confidence and in the equity and foreign exchange markets may reflect a negative response to a slower than expected pace of structural reforms in these economies. This leads on to the second set of risks: the inadequate pace of reform in the financial and corporate sectors; the continuing problem of high levels of nonperforming loans in the banking sector which are restricting credit expansion; the inability of some governments to reduce their endemic fiscal deficits; and large and inefficient public sectors. These structural issues need to be urgently and comprehensively addressed if growth is to be sustained in the medium term.

The third set of risks arises from domestic political problems which have, to a degree, intensified in some countries in both South and Southeast Asia. An uncertain political situation, or a perception that policy is not focused on economic issues, discourages investment. Governments therefore need to ensure that ongoing political and social problems do not distract them from implementing the necessary reforms.