Developing Asia and the World

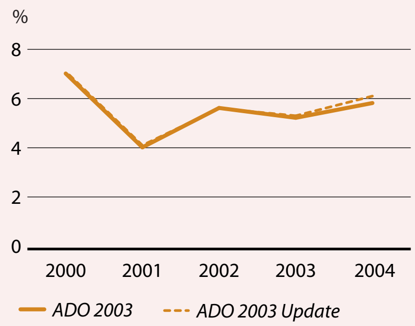
Economic growth in the Asia and Pacific region will continue to be the fastest in the world in 2003 and 2004. Despite significant shocks in the first half of 2003, including uncertainties linked to the conflict in Iraq, regional terrorist threats, higher global oil prices, and the severe acute respiratory syndrome (SARS) epidemic, most economies of the region—significantly the People's Republic of China (PRC) and India—expanded at close to the rate projected in the Asian Development Outlook 2003 (ADO 2003), *published in April this year.*

The forecast for aggregate gross domestic product (GDP) growth in the Asia and Pacific region in 2003 is maintained at 5.3%, with the subregions of South Asia and Central Asia growing somewhat faster than projected in ADO 2003. *This outturn is all the more remarkable as it will have occurred after recovery in the major industrial countries, notably the United States and the euro zone, was weak in the first half of 2003. However, the recovery in the industrial countries is now projected to firm up substantially during the second half of 2003, and particularly in 2004, benefiting the region's economies. Hence, aggregate GDP growth for the region in 2004 has been revised upward to 6.1%.*

Two distinct features are associated with the economic developments in the Asia and Pacific region in the first half of 2003. One is the continued rapidly increasing importance of the PRC as a driver of intraregional trade and economic growth—exports from East, Southeast, and South Asia to the PRC grew at startling rates during the first half of 2003. The other is the continued substantial accumulation of foreign exchange reserves by several countries over the past year.

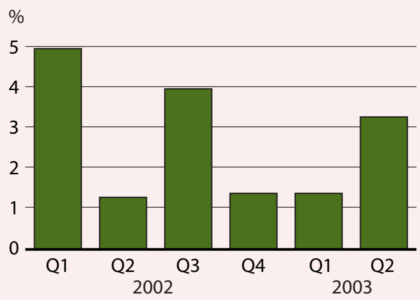
Looking ahead, fiscal consolidation, improvements in the investment climate to substantially increase business investment, and reforms of the financial sector pose significant policy challenges for sustaining rapid long-term growth in the region.

GDP Growth in Developing Asia



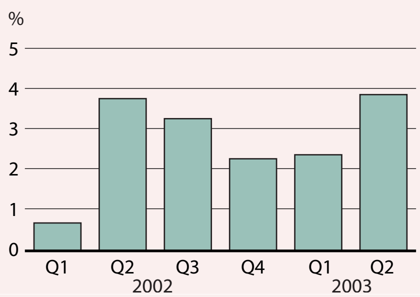
Source: *ADO* database.

GDP Growth, United States



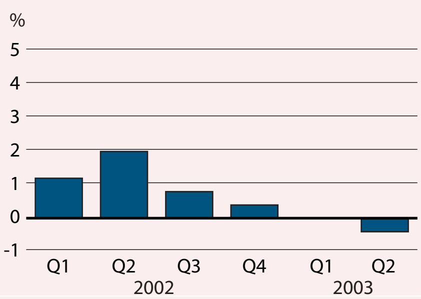
Source: www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp>SelectedTable=164&FirstYear=2002&LastYear=2003&Freq=Qtr.

GDP Growth, Japan



Source: www.esri.cao.go.jp/en/sna/qe031-2/gdemenuea.html.

GDP Growth, Euro Zone



Source: http://europa.eu.int/comm/eusostat/Public/datashop/print-product/EN?catalogue=Eurostat&product.

Table 1.1 Baseline Assumptions on External Conditions, 2002–2004

	2002 Actual	2003	2004
GDP Growth			
Industrial countries	1.4	1.6–1.9	2.6–2.9
United States	2.4	2.3–2.6	3.6–3.9
Euro zone	0.8	0.4–0.6	1.6–1.9
Japan	0.3	1.8–2.2	1.4–1.8
Memorandum Items			
United States Federal Funds rate (%)	1.7	1.1	1.1–1.3
Brent crude oil spot prices ($/bbl)	25.0	27.0–29.0	24.0–26.0
Global trade volume (% change)	3.2	4.0–5.0	6.5–7.5

Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic model.

Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/; Statistics Bureau & Statistics Center of Japan, available: www.esri.cao.go.jp/en/sna/menu.html; Eurostat Euro Indicators, available: www.europa.eu.int/comm/eurostat/; World Bank Development Economics Prospects Group; US Federal Reserve, available: www.federalreserve.gov/releases/n15/data/fedfund.txt.

Outlook for Industrial Countries, 2003–2004

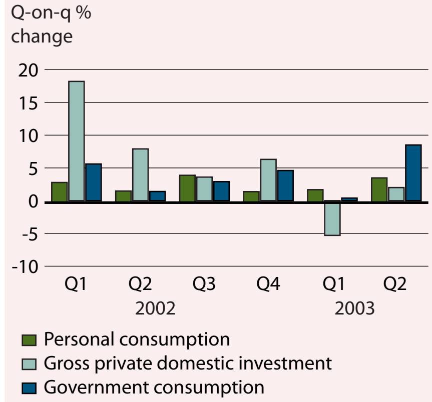
The weak recovery in the major industrial countries that took place in the first half of 2002 petered out in the second half of that year, and, as projected in *ADO 2003*, remained subdued in the first three quarters of the current year. A return to a growth rate closer to trend is not projected for the United States (US) economy until the first half of 2004, while growth in the euro zone and in Japan, which, although showing some signs of improvement in the third quarter, will lag and remain below potential. Hence, at the end of the third quarter of 2003, nearly 2 years after the official end of the 2001 US recession, the long-awaited firm recovery in the major industrial countries is still some time away. This is perhaps not surprising given the significance of the shocks experienced by the world economy since the end of 2000. While the world economy was adjusting to the burst of the "high tech" bubble and the corporate excesses of the late 1990s, the events of September 11, 2001, the conflict in Afghanistan followed by that in Iraq, deflationary conditions in some economies, and volatile oil markets, all substantially raised uncertainty in the world economy, thus hindering the recovery process. A notable feature of the current recovery is the lack of synchronization of growth among the major industrial countries, with the US economy significantly outperforming most other Organisation for Economic Co-operation and Development (OECD) economies. Overall, accommodative monetary and expansionary fiscal policies in the major industrial countries will contribute to higher growth. Hence, there is a stronger sense of optimism than just a year ago, although risks to the outlook remain significant.

In the US, quarterly GDP growth for 2003 has been weak but improving, indicating that the economy could expand at about the same rate as in 2002. After a relatively upbeat second quarter, third quarter 2003 GDP growth will probably be around 4.0%. A somewhat firmer rebound than the *ADO 2003* baseline forecast is projected in 2004, bringing GDP growth closer to potential (estimated at 3.5–4.0%). Many indicators point to an acceleration in economic activity at the end of the second quarter and in the third. Consumer spending remains robust and consumer confidence appears generally to be improving, partly as a result of substantial tax cuts and a rallying stock market. The Conference Board's Consumer Confidence Index bounced back to 81.3 in August from 77.0 in July. The residential real estate market has stayed surprisingly strong as indicated by housing starts in August (about 1.8 million). However, leading indicators, such as building permits issued, indicated potential future slowing in construction as mortgage rates started rising. While increases in government spending, particularly defense spending, are underpinning faster growth, what is important is that business investment has shown signs of revival, though it remains relatively weak. Business confidence indexes have all been pointing to improved sentiment. However, while the real economy has improved, a worrisome development has been the substantial widening of the fiscal deficit, which could reach about $400 billion in fiscal year 2003, up from $158 billion in 2002. At the same time, the estimated $553 billion current account deficit for 2003 does not show signs of improvement, in spite of a continued weakening of the dollar against major currencies in the first half of the year. Further, the sluggish US economic recovery of the past year and a half has been characterized as a jobless recovery. As quarterly economic growth accelerated in 2003, the unemployment rate hardly declined, while data for August show that the economy actually shed jobs. The unemployment rate remained high, at 6.1%. The job losses appear to be structural rather than cyclical. Productivity growth remained very strong however, increasing by an estimated 6.8% in the second quarter, but ironically this good news means that the US economy will have to grow faster and for longer to generate employment—which should be seen as GDP expands more rapidly in 2004. In the meantime, productivity growth has been boosting corporate profitability.

As projected in *ADO 2003*, the euro zone is likely to post a very weak economic performance in 2003 as several of its economies (Belgium, France, Germany, Italy, and Netherlands) experienced a contraction in the second quarter of 2003. Quarter on quarter, the euro zone economy shrank by 0.1% in April–June 2003, but year on year grew by 0.2% (a figure marginally improved on by all the 15 European Union [EU] countries, at 0.5%, largely because of the United Kingdom's solid growth). Private consumption, investments, and exports all decreased in the second quarter in the euro zone. Many business confidence indicators in the zone point to relatively sluggish growth in the second half of 2003 in spite of modest signs of improvement in some of the larger economies. Germany's IFO business confidence index improved for a fourth consecutive month in August to 90.9 from 89.3 in July, buttressing hopes of a better performance in the second half of 2003. In France, leading indicators have also improved in recent months.

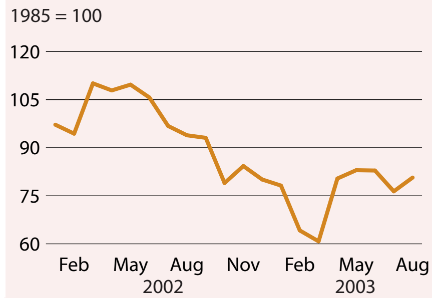
The euro's appreciation has been hurting exports, and governments have been slow to implement fiscal stimulus. However, a more proactive fiscal policy can be expected over the next few months as Germany,

GDP Growth by Expenditure Account, United States



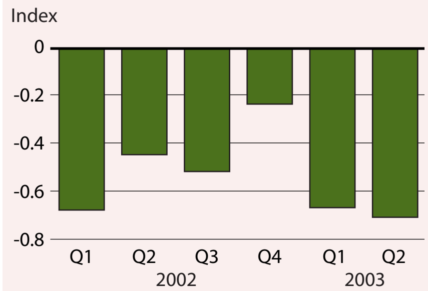
Source: www.esri.cao.go.jp/en/sna/qe031-2/gdemenuea.html; www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp>SelectedTable=164&FirstYear=2002&LastYear=2003&Freq=Qtr.

US Conference Board's Survey of Consumer Confidence



Source: Bloomberg L.P. downloaded 8 Sep 2003.

Euro Zone Business Confidence Indicator

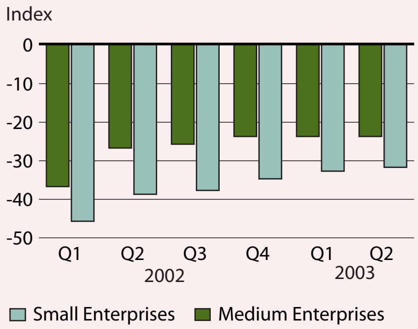


Source: Bloomberg L.P. downloaded 27 Aug 2003.

$/€ Exchange Rate, 2003

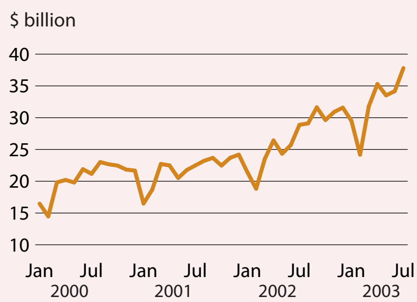
Source: Bloomberg L.P. downloaded 8 Sep 2003.

Tankan Business Confidence Index



Source: Bloomberg L.P. downloaded 27 Aug 2003.

Total Exports, PRC



Source: CEIC Data Company, Ltd. downloaded 9 Sep 2003.

France, and probably Italy announce some tax cuts. The Stability and Growth Pact, limiting euro zone budget deficits to 3.0% of GDP remains, however, a major hurdle to a more expansionary fiscal policy. On the monetary side, there is more room for maneuver as inflation has fallen to about 2.0%. Overall, the euro zone economy will probably expand by 0.4–0.6% in 2003, well below the projected range in *ADO 2003*. The euro zone should experience recovery in 2004, but with growth in the range only of 1.6–1.9%, despite a stronger forecast expansion seen in the US, the euro zone's largest export market. Growth in the United Kingdom is expected to hold up somewhat better than in the euro zone, but still below par, at a rate of around 1.7% in 2003, improving to 2.6–2.9% in 2004. Growth in the 15 EU economies is projected to be about 1.7–2.0% in 2004.

A number of encouraging factors have significantly raised Japan's growth prospects compared to the *ADO 2003* forecast. GDP is now projected to expand by around 2.0% in 2003. Both net exports and domestic demand contributed to the acceleration in growth in the first half of 2003 when GDP expanded at an annual 3.9%. In nominal terms, GDP growth was more modest at 1.2%, due to a continued negative GDP deflator. While consumer demand showed some improvement, business investment gained substantially, growing at an annual 7.0%. Moreover, exports to the PRC and the US appear to be growing strongly. The Tankan index of business confidence also continued to improve, although it remains negative. On the stock market, the Nikkei 225 index passed the 10,000 mark, indicating some return of investor confidence. However, the consumer price index showed a continued decline, and, for 2003 as a whole, it could fall by about 0.5%.

In spite of positive developments, projections for 2004 indicate better but relatively modest GDP growth in Japan. Faster growth in the country's export markets will have a positive impact. However, many fundamental issues still need to be addressed in the economy, including the problem of continuing deflation, record high unemployment, the resolution of nonperforming loans, large public debt (estimated at about 160% of GDP), and slow financial and corporate restructuring. Until these are tackled firmly, projections over the medium term indicate no major acceleration of economic growth beyond 2.0% in 2004 and the following years.

Developments in World Trade and Commodity Prices

Slower than expected GDP growth in the major industrial countries has led to a downward revision in aggregate world trade as measured by world export volume. The *ADO 2003* projection of 5–6% expansion in 2003, already on the pessimistic side in April 2003, has been brought down a full percentage point, while projections for 2004 have been adjusted slightly downward as growth in the world economy remains uneven, with persistent underperformance in the euro zone and in Japan. Nevertheless, trade growth in 2003 is an improvement over the outturns for 2001 and 2002, but remains well below the 1993–2002 average. Export volumes from developing countries are expected to expand at a rate close to double digits, with much of this concentrated in the Asia and Pacific region. In nominal terms, aggregate exports from developing Asia, accounting for around 18% of world exports, grew at a rate of almost 20% in the first half of 2003. The PRC's exports (accounting for over 5% of world exports) expanded by 34% in the same period.

In *ADO 2003*, oil prices were projected to remain volatile while declining somewhat from their first quarter peak. The unsettled situation in Iraq, low inventory levels in the US, and some cutback in production by Organization of Petroleum Exporting Countries (OPEC) members have kept pressure on oil prices, implying a sizable risk premium. The average Brent price up to mid-September stood at $28.8 per barrel. Average prices for 2003 and 2004 are now likely to be on the upper bound of the *ADO 2003* forecast range (Table 1.1). For many of developing Asia's economies, this will push up earlier projections for imports, particularly PRC, India, Korea, and Thailand. These countries have, however, comfortable current account surpluses, while the macroeconomic model simulations discussed in *ADO 2003* (p. 26) indicate that current projections for oil prices will have only a very limited impact on growth.

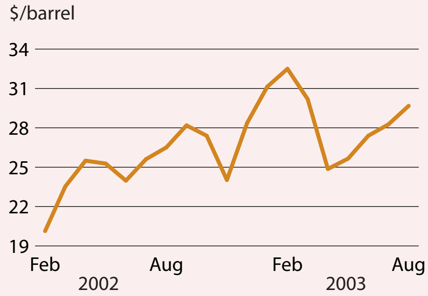
The strengthening of metals and mineral prices (in dollar terms) as discussed in *ADO 2003* has continued, due to recovering demand and a weaker dollar. Prices of aluminum, copper, steel, and tin increased significantly in the first half of 2003. As world economic growth improves in 2004 and as markets become tighter, metals and mineral prices are expected to continue to rise. In contrast, most agricultural commodity prices—many of which had risen significantly in 2001–2002 due to adverse weather conditions or reduced supply after a period of low prices—generally softened in the first half of 2003 as supply conditions improved sharply (for, e.g., cocoa, coffee, fats and oils, and grains). Overall, non-oil commodity prices are likely to increase moderately for the rest of 2003 and in 2004. For one commodity of particular importance to the region, rice, projections are, however, for a modest price increase in 2003 and 2004.

Prices of electronics components, which collapsed in 2001 and 2002, appeared to show some very modest revival in 2003. Prices for DRAM chips, integrated circuits, and microprocessors recovered somewhat in 2003, with a further improvement projected for 2004 as the recovery strengthens and business investment improves. For those Asian economies which are large electronics exporters, this is a welcome development.

Developments in Financial Markets

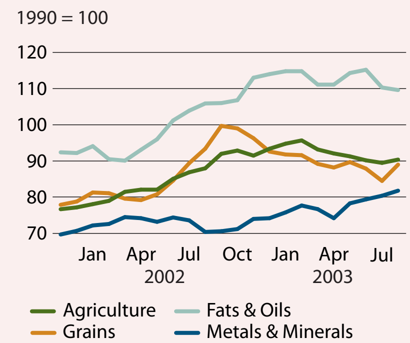
As projected in *ADO 2003*, inflation, particularly core inflation, remained very low in the major industrial countries in the first half of 2003, mainly as a result of the very weak recovery and continued overcapacity in some industries. On a quarterly basis in 2003, inflation has edged up somewhat in the US compared to 2002 but remains at around 2.0%. In the euro zone, inflation is also about 2.0% while in Japan, deflationary conditions persist. Core inflation in the major industrial countries could fall further in 2003 and early 2004 and the danger of a short bout of global deflation, though not yet fully written off, is receding as signs of a stronger worldwide recovery are becoming more evident. Monetary authorities have acted proactively, particularly in the US, where the Federal Funds rate is currently 1% and will most likely average 1.1–1.3% for 2003. The exception is Japan, where the policy rate is already close to zero. A further cut in the US Federal Funds rate is possible if recovery is yet again retarded. In the

Crude Oil Price (Brent spot)



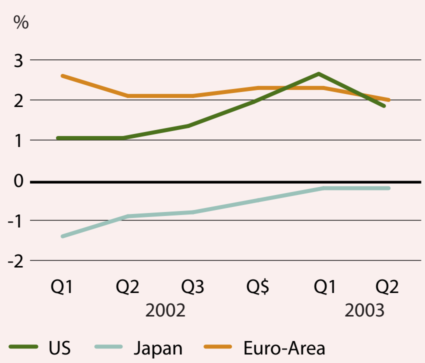
Source: www.worldbank.org/prospects/pinksheets/.

Selected Commodity Prices



Source: www.worldbank.org/prospects/pinksheets/.

Inflation Rate, G3

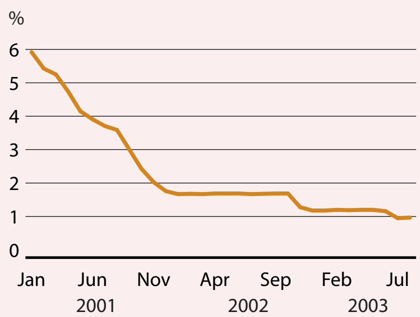


Sources: US Department of Commerce, Bureau of Economic Analysis; Statistics Bureau and Statistics Center of Japan; Eurostat Euro Indicators.

Price-Adjusted Broad US Dollar Index

Source: Federal Reserve Statistical Release, available: www.federalreserve.gov/releases/H15/data/m/fedfund.txt.

US Federal Funds Rate



Source: Federal Reserve Statistical Release, available: www.federalreserve.gov/releases/H15/data/m/fedfund.txt.

US 10-Year Bond Yield

Source: Bloomberg L.P. downloaded 8 Sep 2003.

euro zone, the European Central Bank has more room for maneuver as the average inflation rate remains low and several major economies of the euro zone are stagnating.

In line with the continued loosening of monetary policy in major markets, benchmark international interest rates are expected to be somewhat lower in 2003 than in 2002. The London interbank offered rate (LIBOR) ($, 6 months) is projected to average 1.3% in 2003, down from 1.9% in 2002. A progressive increase is projected from 2004 onward with the average rate estimated at 2.0% in 2004. On the foreign exchange markets, the US dollar depreciated significantly against the euro, reaching a trough of $1.19/€1 on 29 May 2003. The dollar has since strengthened to over $1.10/€1. The dollar depreciated by about 2.3% against the yen over the January–September 2003 period. The trade-weighted price-adjusted broad dollar index appreciated by 2.3% over the same period.

Bond markets in the first half of 2003 reflected the expectations for monetary policies, but they also mirrored the developments in stock markets. After hitting a 45-year low in mid-June 2003 and following the 25 basis point policy rate cut by the Federal Reserve Bank on 25 June and its signal that deflation is unlikely, bond prices started to fall and yields surged by more than 100 basis points on 10-year US treasury bills within about a month. These yields are expected to stay at around 4.5% for the remainder of 2003. The yield curve in the US has thus steepened significantly over the past few months. At the long end of the market, rates are likely to be higher in the US than in the euro zone, while the reverse is probable at the short end. The US bond market situation also reflects expectations for the huge US treasury financing requirements over the medium term.

Bond market developments are a source of serious concern. US 10-year treasury bills are the benchmark for corporate bonds and mortgage rates. If yields were to rise rapidly, housing refinancing in the US and consumer spending could slow significantly, while at the same time capital spending, already weak, would become more expensive. Higher mortgage rates would affect the housing market, lowering prices and leading to the possible bursting of what some are calling a housing bubble. In the case of the US and in particular Japan (where public debt is very high), debt servicing could become a major burden. The euro zone economies would also be affected by higher long-term rates, although perhaps to a lesser extent. The bond market will thus have to be closely watched over the next few months.

To some extent, in a related development, the earlier fall in bond yields, low short-term interest rates, and a more positive outlook on a recovery in industrial countries spurred a second quarter rally in most major stock markets both in the industrial countries themselves and in many developing countries, particularly in Asia. Although price-earnings ratios in the US remain well above historic averages, the developments on stock markets are a positive sign. However, a strengthening stock market rally could further depress bond prices.

Low yields in major financial centers in the first half of 2003 led investors to seek higher returns in emerging markets. Hence, risk premiums for developing Asian borrowers decreased somewhat and inflows of capital increased significantly. Developing Asian stock markets and bond issuers benefited from these developments. Even with stock markets improving in industrial countries and bond yields rising, capital availability for developing Asian countries should not be a major issue, but the cost of capital could increase somewhat in 2004. Hence, spreads in emerging markets might widen a little as yields become more attractive in mature markets.

Regional Trends and Prospects for Developing Asia

ADO 2003 concluded that "the Asia-Pacific region will remain a bright spot on the world economic map". Developments in the region over the first three quarters of 2003 confirm this assessment. These demonstrate the generally strong economic fundamentals of the region and its increased resilience against shocks. Significant economic shocks characterized the first half of 2003. These included the uncertainties relating to the conflict in Iraq and higher oil prices, while the destabilizing impact of the SARS epidemic directly and indirectly affected many economies in the region. These shocks were felt at the same time as the Group of Seven leading industrial countries experienced a substantial slowdown in their economic recoveries.

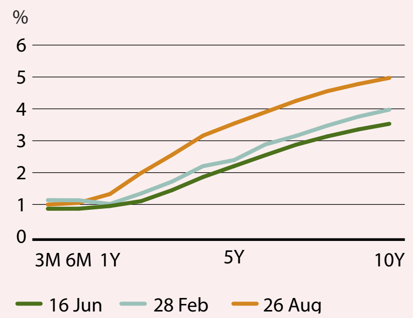
While great diversity in performance across countries remains, economic growth for the region as a whole is projected at a robust 5.3% for 2003, unchanged from the *ADO 2003* forecast. Average inflation will remain low at 2.4%. Finally, the current account surplus for developing Asia is forecast at a comfortable 2.7% of aggregate GDP.

Following a strong performance in the first half of the year, GDP growth projections for 2003 have been significantly raised for PRC, Kazakhstan, Pakistan, and Thailand. Among the larger economies, high growth is still slated for India (6%) and Viet Nam (6.9%), in line with the *ADO 2003* projections. In the PRC, as well as in South Asia, growth was evenly spread between domestic and external demand. In the PRC, a surge in private and public investment was also supported by robust consumer demand. Upward revision of Thailand's projected GDP growth in 2003 is partly the result of a progressive recovery in private investment activity. The dynamism in investment is also a major factor in Viet Nam's rapid growth. In South Asia, domestic factors were the main drivers of growth, particularly as agricultural output and incomes are on the upswing with a return of normal weather in the region. External factors played an increasingly supportive role as South Asia's current account surplus is projected at 0.8% of GDP. While export growth has generally been strong in South Asia, it has been offset by increased imports, with the strengthening in the current account balance in most countries largely resulting from marked increases in worker remittances. In India, the current account surplus is expected to moderate from the 2002 level to about 0.4% of GDP. Developments to date indicate a continuation of a large capital account surplus.

In Southeast Asian countries (except Singapore), consumer demand remained strong in the first half of 2003, while the contribution of investment and net exports to growth was mixed. In Indonesia, Malaysia, and Philippines, lower investment (level and growth) had a negative impact on growth in the second quarter. In contrast to most other countries, net exports have negatively affected the economy of the Philippines, as its mainstay exports—electronics—have been performing poorly.

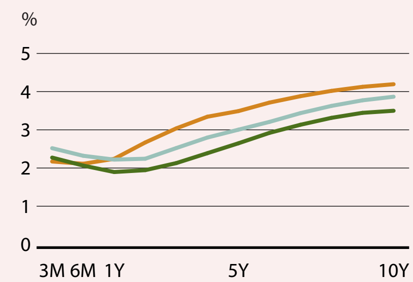
Economic growth has been significantly scaled back for Korea and Singapore, as domestic demand in both countries weakened dramatically.

US Yield Curves, 2003



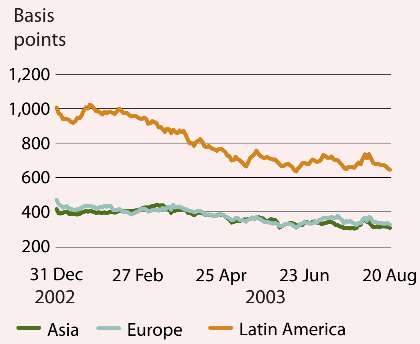
Note: Data for 3 and 6 months refer to US Treasury Actives; all other maturities refer to US Government Strips.
Source: Bloomberg L.P. downloaded 26 Aug 2003.

Euro Benchmark Yield Curves, 2003



Source: Bloomberg L.P. downloaded 26 Aug 2003.

Sovereign Risk Spreads



Source: www.jpmorgan.com downloaded 26 Aug 2003.

Table 1.2 Selected Economic Indicators, Developing Asia, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	*Update*	*ADO 2003*	*Update*
GDP Growth					
Developing Asia	5.6	5.3	5.3	5.9	6.1
East Asia	6.5	5.6	5.6	6.2	6.5
Southeast Asia	4.1	4.0	3.9	4.8	4.9
South Asia	4.2	5.7	5.8	6.1	6.1
Central Asia	7.3	5.8	7.5	5.8	5.9
The Pacific	-0.3	2.4	2.5	2.5	2.7
Inflation Rate (CPI)					
Developing Asia	1.5	2.5	2.4	2.7	2.6
East Asia	-0.1	1.1	1.0	1.4	1.5
Southeast Asia	4.1	4.2	3.1	4.0	3.5
South Asia	3.7	4.9	5.5	5.0	4.9
Central Asia	11.3	13.9	10.4	14.2	9.8
The Pacific	7.1	6.3	8.9	-	5.1
Current Account Balance/GDP					
Developing Asia	4.1	2.9	2.7	2.6	2.4
East Asia	4.1	3.0	2.4	2.7	1.9
Southeast Asia	7.8	6.3	6.1	6.0	6.7
South Asia	0.9	0.0	0.8	0.0	0.6
Central Asia	-1.3	-4.2	-1.5	-5.1	-2.4
The Pacific	0.5	-	-	-	-

- = data not available; CPI = consumer price index; GDP = gross domestic product.

Sources: *ADO* database; staff estimates.

For Korea, this was due to falling consumption demand and the impact on investment of geopolitical uncertainties; for Singapore, it stemmed from a combination of the SARS fallout and structural issues. In Singapore, the contribution of consumption and investment to economic growth in the first two quarters of 2003 was negative. In both countries, net exports will provide sufficient stimulus to achieve GDP growth in 2003. Both Hong Kong, China and Taipei,China, which have been facing major restructuring problems in their economies over the past few years, will also see their growth performance in 2003 determined mainly by improvements in net exports as domestic demand in both economies remains depressed.

In Central Asia, high subregional growth continues to be driven mainly by large investments in oil and gas production facilities in some of the exporting countries. However, both the Kyrgyz Republic and Tajikistan also scored credible gains underpinned by strengthened macroeconomic management and structural reforms in their economies.

A very distinctive and notable feature of economic developments in the region over the past 2 years has been the emergence of the PRC as a major growth engine for intraregional trade. This trend accelerated for most countries in the first half of 2003. For economies in East Asia, the PRC has become the largest export market while for those in Southeast Asia, the PRC has become an important export destination. Typically, for all these regional economies, the share of total exports going to the PRC

Table 1.3 Quarterly GDP Growth, Selected DMCs, %

	Q1 2002	Q2 2003	Q3 2002	Q4 2002	Q1 2003	Q2 2003
Economy						
China, People's Rep. of	7.6	8.0	8.1	8.1	9.9	6.7
Hong Kong, China	-0.6	0.8	3.4	5.1	4.5	-0.5
Korea, Rep. of	6.2	6.6	5.8	6.8	3.7	1.9
Taipei,China	0.9	3.7	5.2	4.5	3.5	-0.1
Indonesia	2.7	3.9	4.3	3.8	3.4	3.8
Malaysia	1.3	4.0	5.8	5.4	4.6	4.4
Philippines	3.8	4.1	3.8	5.8	4.5	3.2
Singapore	-1.5	3.8	3.8	3.0	1.7	-4.2
Thailand	3.9	5.1	5.8	6.2	6.7	5.8
India[a]	6.3	5.3	5.2	2.3	4.9	-
Sri Lanka	0.5	3.0	5.9	6.2	5.5	-

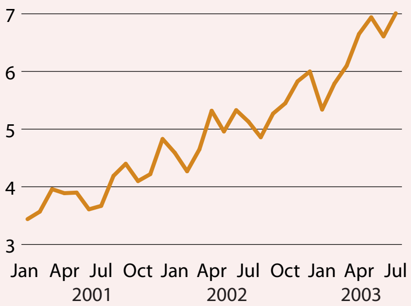
- = data not available. [a] Converted to calendar year basis.

Sources: People's Rep. of China: *China Monthly Economic Indicators*, July 2003; Hong Kong, China: www.info.gov.hk/censtad; Rep. of Korea: www.bok.or.kr; Taipei,China: www.stat.gov.tw; Indonesia: www.bps.go.id; CEIC Data Company, Ltd.; Malaysia: www.statistics.gov.my; Philippines: www.nscb.gov.ph; Singapore: www.singstat.gov.sg; Thailand: www.nesdb.go.th; India: Central Statistical Organization; Sri Lanka: Central Bank of Sri Lanka.

has doubled since the start of 2000. The PRC has overtaken the US as the main export market for Korea, contributing significantly to the growth momentum of the Korean economy in the first half of 2003. Korean exports to the PRC soared at 47% year on year in the first 7 months of 2003. Taipei,China's exports to the PRC were growing even faster at 108.3%. For the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Singapore, and Thailand), the share of the PRC export market rose from 3.0% at the beginning of 2000 to over 7.0% in July 2003. Again, on a year-on-year basis, exports of the ASEAN-5 to the PRC surged by 41.9% in the 7 months of 2003. In South Asia, where the export share of the PRC market is much lower, exports to the PRC shot up for Pakistan and, in particular, India, where exports to the PRC have surged at well over 50% year on year since the middle of 2002, albeit from a low base (even now the PRC accounts for only about 1% of India's exports). It should also be noted that exports of the PRC to these regional economies are also growing rapidly, but at a much slower pace than imports from them. These extraordinary figures indicate significant economic changes in the region as intraregional trade becomes a major force to be reckoned with. If these trends continue and regional economies continue to focus on policies to achieve faster growth in domestic demand, Asia's economic outlook should become less dependent on economic developments in the major industrial countries.

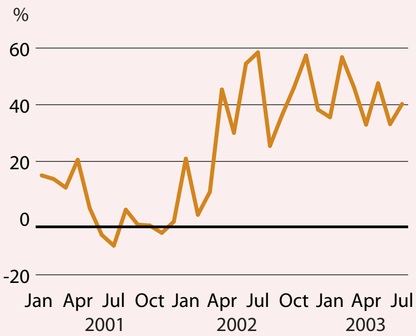
For the region as a whole, estimates of GDP growth incorporated a 14.1% expansion in exports in 2003, markedly above the 7.9% forecast of *ADO 2003* and the 9.5% growth recorded in 2002. Nevertheless, as imports, now projected to rise by 16.3%, largely offset this export expansion, the current account surplus is projected to be about 2.7% of GDP (about $104 billion for the year), well below the 4.1% of GDP surplus

Share of Exports to PRC, ASEAN-5



Source: CEIC Data Company, Ltd.

Growth Rate of Exports to PRC, ASEAN-5



Source: CEIC Data Company, Ltd.

Growth Rate of Exports to PRC, East Asia

Source: CEIC Data Company, Ltd.

estimated for the region in 2002. Though the current account balance is moderating, official reserves in the first half of 2003 increased at about the same rate as in this period a year ago, rising by about $115 billion.

ADO 2003 noted the rapid accumulation of foreign exchange reserves in the region. This trend continued, in some cases strongly so, in the first half of 2003. The large increases in many country's official reserves in the past 18 months have fostered more rapid monetary expansions, despite efforts at sterilization, and also put upward pressure on floating exchange rates. Currencies appreciated against the dollar in most countries without a fixed exchange rate, from January to September 2003. Moreover, in all countries with large reserve gains, residents are now adjusting their normal payment practices as a hedge and this appears to be a factor in the pace of reserve accumulation.

On the macro policy front, an important feature of recent economic developments in Asia, further demonstrated in 2003, is the determined and judicious use of short-term demand management policies. Relatively low inflation has allowed monetary authorities to progressively lower interest rates, although the impact appears to have been stronger on consumer spending than on business investment in many economies. With a few exceptions, notably the PRC, where the Government implemented some monetary tightening in line with perceived overheating, monetary policies continued to be loosened in 2003 and, in several countries, the positive response of investment started to be felt, particularly in Thailand. More important, fiscal policies have been quite expansionary in most of developing Asia over recent years—originally born out of the financial crisis and subsequently implemented to mitigate the impact of the global economic slowdown.

Many countries in the region have announced programs for a period of fiscal consolidation, to reduce their budget deficits and bring down high public debt to GDP ratios. In South Asia, with the exception of India, some fiscal consolidation was accomplished in 2003. However, the need to respond rapidly to the economic shocks (of the Iraq conflict, oil prices, and SARS) has generally delayed such consolidation efforts in most economies in both East Asia and Southeast Asia as many governments introduced supplementary budgets or stimulus packages in the first part of the year. Supplementary budgets were introduced in Hong Kong, China; Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. While these stimulus programs were an appropriate policy response, fiscal consolidation will again need to be a priority as the underlying growth momentum strengthens in 2004.

The immediate outlook for many countries in Asia continues to indicate rather weak business investment, with important exceptions such as the PRC, Viet Nam and, to some extent, Thailand. While substantial overcapacity still exists in many economies, a variety of factors are causing business investors to hesitate. In East Asia and Southeast Asia, the aftermath of the Asian financial crisis of 1997-98 is still very much felt though to varying degrees. The economies of Hong Kong, China; Singapore; and Taipei,China are going through a period of deep structural transformations that has affected investment. In Southeast Asia, financial sector restructuring after the crisis, particularly banking sector reform, is still a work in progress, affecting lending to businesses. Various institutional, legal, and policy constraints still weigh on the investment climate in most countries of the region. Moreover, political uncertainties linked to upcoming national elections in several countries are probably causing a wait and see attitude over investment. In South Asia, especially in India, relatively large budget deficits, which have continued into 2003 despite some fiscal consolidation, resulted in some crowding-out of private investment. In short, to accelerate growth over the medium term, structural reforms require high priority in many Asian economies.

Against this background, GDP forecasts for developing Asia as a whole have been increased to 6.1% in 2004, compared to 5.9% in *ADO 2003*. Higher forecast growth reflects mainly a strong performance of the PRC economy, which is now projected to expand at close to 8.0% in 2004, in addition to a significant improvement in some of the Southeast Asian economies, particularly Singapore and Thailand. The outlook for the Pacific could also be somewhat better than forecast earlier. Except in Central Asia, and the Lao People's Democratic Republic, inflation is projected to remain quite low, particularly in East Asia and Southeast Asia. Reflecting the projected stronger recovery in the major industrial countries, export growth for the region in 2004 is now forecast to be higher at about 11%. Similarly, imports will expand faster, thus leading to a somewhat smaller current account surplus, for the region as a whole, of 2.4% of GDP in 2004 compared to the 2.6% forecast in *ADO 2003*. Growth in developing Asia will thus continue to improve in 2004, approaching the average growth rate for the period 1981–1996. While in East Asia and Southeast Asia the performance will remain below these historical averages, it appears that GDP growth in South Asia will be trending up but still remain below the targets set by most countries to substantially reduce the incidence of poverty.

Assessment of Risks and Uncertainties to the 2003–2004 Outlook for Developing Asia

ADO 2003 identified three sets of risks and uncertainties for developing Asia: global economic, geopolitical, and SARS-related. All of these continue to be relevant at the end of the third quarter of 2003 albeit in a somewhat different setting.

First of all, on the positive side and as discussed in Part 3, the impact of SARS was relatively limited, except in Hong Kong, China and in Singapore, and most Asian economies appear to be rebounding rapidly. This will have a positive impact on the outlook for developing Asia in the second half of 2003, thus adding to the positive effect of somewhat stronger activity in the major industrial countries. A recurrence of SARS is of course not excluded, but the impact should be milder as governments are now better equipped to deal with such epidemics and travel monitoring mechanisms remain in place or have even been improved since the SARS epidemic finished. The lack of information and uncertainties that largely caused the economic impact of the SARS epidemic would thus probably be attenuated in any recurrence.

With regard to geopolitical uncertainties, the threat of terrorism remains of course an issue for developing Asia as shown by the recent bomb explosions in Jakarta. Because of their dependence on tourism as well as on foreign direct investment, many countries in the Asia and

Pacific region are particularly vulnerable to terrorist acts. While the direct impact of the conflict in Iraq appears to have been rather limited, as predicted in *ADO 2003*, oil markets have clearly not settled down. In addition to a rather tight demand-supply situation and low stock levels, the risk premium on oil prices is likely to remain high over the forecast period.

While current global economic uncertainties remain similar to those identified in *ADO 2003*, a somewhat different perspective might color the outlook for the remainder of 2003 and for 2004. First of all, the danger of deflation, which had been identified as a risk, appears to be increasingly fading, but still not totally excluded. In fact, the increase in yields on US treasuries discussed above suggest that inflationary expectations are somewhat rising in parallel with expectations for a stronger recovery starting in the third quarter of 2003. The—so far—mild upward pressure on long-term rates is perhaps more strongly driven by the realization of the need to finance a huge and increasing US budget deficit. Long-term interest rates are thus being pushed up in still a very weak upswing phase of the business cycle in the US. Were long-term rates to increase significantly, this could stall the recovery itself. Higher long-term rates would also affect prospects for a strong recovery in the euro zone and in Japan. In the latter, a significant increase in servicing its large public debt would be a particular issue. The sharp swings in financial markets in the first half of 2003 are probably signs that many uncertainties still underlie the world economy. The risks of a continued weak and unbalanced recovery in major industrial countries remain real, particularly if budget deficits are allowed to balloon. These risks are intensified by the uneven nature of the recovery, with the US economy expected to grow much faster than the euro zone and Japan. The above developments point to the dollar not adjusting much compared to its current value against the euro and the yen, and this in spite of the large US twin (fiscal and current account) deficits.

Finally, a distinct feature of the mild recovery in industrial countries has been the lack of job creation in the major industrial countries. Unemployment rates in these economies are either rising or remain stubbornly high. In the US economy where the recovery has taken a stronger hold over the past few months, jobs continue to be lost, mainly because growth is being fueled by significant productivity increases. While this development is positive for corporate profitability, it raises concerns for the prospects of continued strong consumption spending, which has been the main driving force of US economic growth. If production continues to rise without job creation, even employed workers might anticipate lay-offs and reduce spending and borrowing. Hence, there is a risk that private spending might weaken before the economy starts creating jobs. This could dampen the recovery once again. A decrease in consumer spending in the US would directly impact Asian countries, which are major exporters of consumer goods to the US market.