



Developing Asia and the World

Developing Asia: Economic Highlights of 2004 and Prospects for 2005

The economies of developing Asia outperformed earlier forecasts in the first half of 2004. While there are divergences among countries, economic growth has been strong in all subregions, but particularly so in East Asia and Southeast Asia. In most countries, growth has become more broad based, with a fast-expanding external sector complemented by robust domestic demand growth, which, significantly for the first time since the Asian financial crisis of 1997–98, also included business investment.

During the first half of the year, exports expanded at a surprisingly strong rate as the recovery strengthened in major industrial countries and intraregional trade remained buoyant. East Asian and Southeast Asian exporters also benefited from the strong revival in the electronics market in particular, as a result of increased United States (US) investment demand. The strong growth momentum also translated into fast-rising imports during the period. With some exceptions, business investment, which had been lagging since the Asian financial crisis in many East Asian and Southeast Asian economies, picked up in the first half, further supporting growth in domestic demand. Relatively robust economic growth over the past 2 years and higher capacity utilization, surging export demand, low interest rates, and recovering business confidence supported the pickup in investment spending.

In countries where agriculture remains a large source of employment, the sector has generally benefited from favorable conditions, leading to rising rural incomes and consumption, notably in the People's Republic of China (PRC).

A feature of the first half of 2004 was that, in spite of strong growth and high oil prices, inflation, though generally on a rising trend, remained relatively subdued across the region. As a result, accommodative macroeconomic policy stances remained mostly unchanged from 2003.

While external demand is expected to abate somewhat during the second half of 2004 and the impact of high oil prices could be felt more strongly in many economies, gross domestic product (GDP) growth for the region is nevertheless projected to reach 7.0% for 2004, slightly above the forecast of 6.8% made in *Asian Development Outlook 2004 (ADO 2004)*, which was published in April this year (Table 1.1). The region's growth will equal that of 2000, which was the fastest after the Asian financial crisis.

Compared with *ADO 2004*, projections have essentially been raised by about half a percentage point in both East Asia and Southeast Asia, mainly on account of faster growth in Hong Kong, China; Malaysia; Philippines; Singapore; and Taipei, China, while the expected slowdown in the PRC will be smaller than earlier thought. In contrast, growth in Cambodia, Indonesia, and Korea has continued to lag.

In South Asia, with the exception of Nepal, growth remains generally robust. However, GDP growth for India in 2004 has been cut by about 1 percentage point from the *ADO 2004* projection. In Central Asia, oil exporters are benefiting from high energy prices, while non-oil producers, such as the Kyrgyz Republic and Uzbekistan, continue to experience slow growth. In the Pacific, there is some improvement in the second-largest economy, the Fiji Islands, but overall growth remains fairly low in the subregion.

Merchandise export growth in developing

Table 1.1 Selected Economic Indicators, Developing Asia, 2003–2005

	2003	2004		2005	
		ADO 2004	Update 2004	ADO 2004	Update 2004
Gross Domestic Product (annual % change)					
Developing Asia	6.5	6.8	7.0	6.7	6.2
East Asia	6.5	6.9	7.3	6.8	6.4
Southeast Asia	4.8	5.7	6.2	5.4	5.7
South Asia	7.6	7.0	6.4	7.2	5.9
Central Asia	8.4	8.1	7.9	8.4	8.0
The Pacific	4.3	2.9	2.9	2.4	2.4
Consumer Price Index (annual % change)					
Developing Asia	2.3	3.3	3.7	3.1	4.4
East Asia	1.2	2.6	3.0	2.4	3.8
Southeast Asia	3.1	3.6	4.2	3.8	4.2
South Asia ^a	5.1	4.9	5.5	4.6	6.5
Central Asia	5.4	8.6	6.9	8.3	6.4
The Pacific	8.5	5.6	5.1	6.0	4.4
Current Account Balance (% of GDP)					
Developing Asia	4.6	3.2	2.8	2.9	2.1
East Asia	4.5	2.8	2.3	2.6	1.4
Southeast Asia	9.0	8.2	7.2	7.6	6.6
South Asia	1.6	0.4	1.3	0.2	0.6
Central Asia	-2.3	-3.6	-3.9	-4.3	-2.1
The Pacific	-0.6	0.9	0.8	-1.3	-1.7

^a India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

Asia has significantly surprised, on the upside, the *ADO 2004* forecast. In spite of some leveling off projected for the second half of 2004, exports are forecast to expand by 18.1% in 2004, compared with 12.4% in *ADO 2004*. This follows on from a growth rate of 19.4% in 2003. However, partly as a result of higher oil prices, merchandise imports will also increase, by 20.8% in 2004, well above the rate of 14.8% of *ADO 2004*. Imports will rise very rapidly in Kazakhstan (35%), PRC (30%), Azerbaijan (27%), Korea (27%), Thailand (27%), Pakistan (21%), and India (20%). The region's overall current account surplus will decline as a share of GDP to 2.8%, about half a percentage point below the *ADO 2004* projection. Notably, the PRC current account is projected to show a deficit for the first time since 1993.

Besides external trade, the strong economic performance of many Asian economies during the first half of 2004 was also underpinned by

a marked recovery in fixed investment, especially in Hong Kong, China; Malaysia; Singapore; Taipei, China; and Thailand. In Korea, Indonesia, and the Philippines, the improvement was more modest. In Pakistan, there has been a sharp pickup in investment by the private and public sectors, while in Azerbaijan and Kazakhstan the rapid pace of investment in oil and gas projects continued. With consumption expenditures continuing their rapid expansion, growth in many countries has become more broad based with both external demand and domestic demand contributing more evenly to GDP growth.

For 2004 as a whole, inflation in the region is projected at 3.7%, about half a percentage point higher than forecast in *ADO 2004*. The economies in East Asia and Southeast Asia will experience the fastest acceleration in inflation, due to a combination of robust growth and high oil prices. As shown in Part 3, some of these economies are more vulnerable than others to high oil prices. In South Asia, the largest economies, India and Pakistan, will also see faster inflation, partly as a result of high oil prices. In a number of countries in the region, inflationary pressures continue to be exacerbated by rigid exchange rate policies that have kept import prices high and, in some instances, have led to rapid domestic liquidity expansion.

The aggregate regional GDP growth forecast for 2005 has been reduced to 6.2%, half a percentage point lower than in *ADO 2004*. This downward revision is mainly the result of more subdued growth predictions for the larger economies, notably India; Korea; and Taipei, China, as well as somewhat slower growth in the PRC.

In line with some leveling off of the expansion in major industrial countries and a further deceleration in the PRC economy, regional exports are now projected to increase more slowly than expected in *ADO 2004*. In spite of oil prices significantly higher than in the *ADO 2004* baseline, imports will rise at about the same rate as earlier forecast, i.e., by 13.2%, but from a higher base. The aggregate regional current account surplus will continue to shrink to 2.1% of the regional GDP. The PRC's current account is expected to show a deficit of 1.4% of GDP in 2005.

While the contribution of the external sector to the region's GDP growth is expected to be reduced in 2005, macroeconomic policies are also likely to become neutral or moderately contractionary as domestic interest rates rise in line with world interest rates and the margins for further fiscal stimulus in most economies are significantly reduced. In spite of the tightening of macroeconomic policies, inflation is forecast to rise much faster than envisaged in *ADO 2004*, at an annual rate of 4.4%. The pass-through of higher oil prices will be one of the reasons. The acceleration of inflation will be particularly marked in East Asia and South Asia.

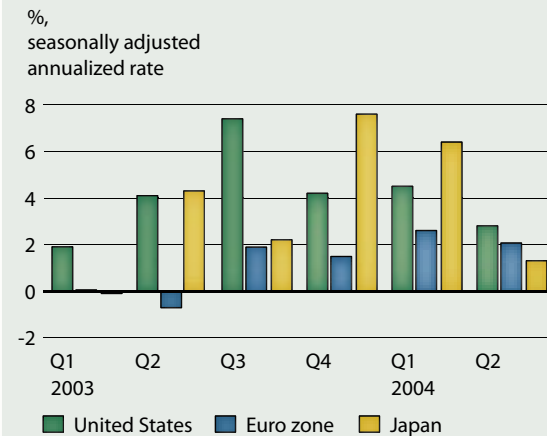
Overall, all main economic indicators for developing Asia, with the exception perhaps of inflation, remain bright for 2005. However, the pickup in inflation and the weaker external trade prospects, coming at the same time as macroeconomic policies need some tightening, call for measures to improve the investment climate in the various countries, enhance their competitiveness, and make them more resilient to withstand a (possibly) substantially weaker external environment in the second half of the decade. In addition, regional policy makers need to support the further expansion of domestic markets, in particular by raising the share of consumption in GDP.

Global Economic Update, 2004–2005

The impressive growth performance of major industrial countries since the second half of 2003 stretched into the first quarter of 2004, with growth projections well above trend rates for the US and Japan in particular. Although the performance of industrial countries has slowed somewhat since the second quarter, the baseline for 2004 is for robust GDP growth in industrial countries at 3.5–3.9%, about half a percentage point higher than in *ADO 2004* (Table 1.2).

Projections for 2004 have been raised substantially for Japan. For 2005 as a whole, the baseline now indicates slower growth compared with *ADO 2004*, with rates settling at around potential rates. Remarkably, for the first time since 2001, growth in major industrial countries has become much more synchronized, a sign of the strength of the current recovery (Figure 1.1).

Figure 1.1 Real GDP Growth Rate of the United States, Euro Zone, and Japan, Q1 2003–Q2 2004



Sources: US Department of Commerce, Bureau of Economic Analysis, available: <http://www.bea.gov/bea/dn/gdplev.xls>; Eurostat, available <http://www.europa.eu.int>; Economic and Social Research Institute of Japan, available, <http://www.esri.cao.go.jp>.

Despite this, significant imbalances remain embedded in the world economy, as growth in Japan and the euro zone has been driven largely by a stronger external sector, itself very much dependent on strong US expansion. But that expansion has been associated with a continued dramatic deterioration of both the fiscal and current accounts, as well as with historically low interest rates. These developments make the current strong performance of the world economy particularly prone to external shocks, whether they are prolonged, sustained, high oil prices—most likely leading to a sharp increase in inflation—or a loss of confidence in the US economy's ability to cope with the deficits—most likely accompanied by a collapse of the dollar. In industrial economies, there is little or no room left for fiscal expansion.

These imbalances and uncertainties necessitate a monetary policy return to a more neutral stance, in a continuation of the interest rate move that started in the US in the second quarter of 2004. The question is: Is the expansion in major industrial countries self-sustaining? The risk is that a synchronized strong recovery could turn into a synchronized slowdown. Growth prospects for industrial countries could well start weakening more significantly toward end-2005.

Table 1.2 Baseline Assumptions on External Conditions, 2003–2005

	2003	2004		2005	
		ADO 2004	Update	ADO 2004	Update
GDP Growth (%)					
Industrial countries	2.0	3.1–3.5	3.5–3.9	2.5–3.0	2.4–2.8
United States	3.0	4.2–4.7	4.1–4.5	3.2–3.7	3.1–3.5
Japan	2.4	2.5–2.8	3.8–4.2	1.5–2.0	1.6–2.0
Euro zone	0.5	1.7–1.9	1.8–2.0	2.1–2.4	1.8–2.2
Memorandum Items					
United States Federal Funds rate (average, %)	1.1	1.1–1.3	1.2–1.4	2.5–3.0	2.9–3.1
Brent crude oil spot prices (\$/barrel)	28.8	28.0–30.0	36.0–38.0	24.0–26.0	33.0–35.0
World trade volume (% change)	4.7	8.0–8.5	9.0–10.0	6.0–7.0	7.0–8.0

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

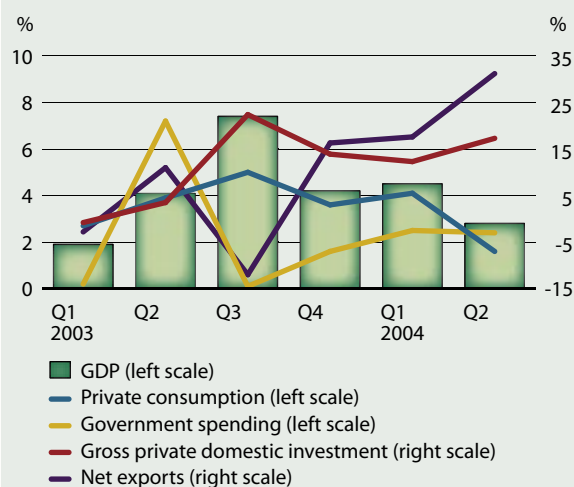
Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/index.asp; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/index-e.html; Eurostat, available: www.europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat; World Bank Development Economics Prospects Group; US Federal Reserve, available: www.federalreserve.gov/releases/; staff estimates.

United States

After a strong expansion starting in the second half of 2003, the US economy hit a soft patch in June–August this year amid rising concerns about high oil prices. GDP expanded at a quarter-on-quarter seasonally adjusted annualized rate (q-o-q, saar) of 2.8% in the second quarter of 2004, after registering solid 4.5% growth in the first. The main reason was a sharp slowdown in personal consumption expenditure, which grew by a mere 1.6% (q-o-q, saar) in the second quarter, falling from 4.1% in the first (Figure 1.2). However, relatively buoyant private domestic investment on the back of healthy corporate profits and strong business activities, as well as strengthening exports, continue to underpin the expansion in the US economy. Industrial production is still rising, though the earlier vigor has abated. The August Institute for Supply Management (ISM) composite index read 59, indicating generally vigorous economic activity, and was above 50 for the 15th consecutive month. The ISM manufacturing index has come down from a peak of 71.1 in January, but remains above 50 (Figure 1.3). Business activities also expanded in the nonmanufacturing sector, according to the ISM nonmanufacturing survey. New orders are growing, as are new export orders. Fairly upbeat business survey results suggest that economic fundamentals are intact, despite slowing consumption demand and rising oil prices.

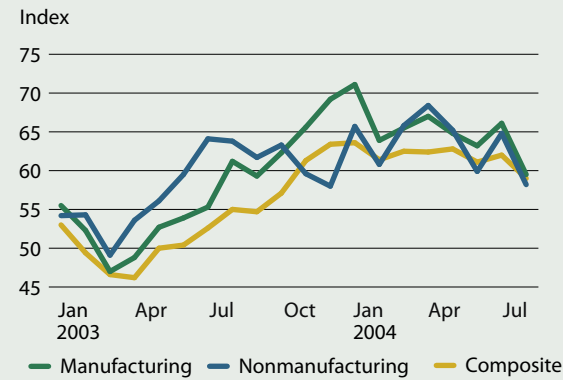
Business investment rose in the first half of 2004, taking advantage of improvements in export conditions and resilient residential construction numbers. Gross fixed investment surged in the second quarter, growing at 13.0% (q-o-q, saar). Corporate profits added modest gains in the same quarter, after a strong increase in the first. Capacity utilization is around 77%. Residential construction remained strong, but its long sustained vigor could wane next year.

Figure 1.2 Growth of GDP and its Demand Components, United States, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.
Source: Bureau of Economic Analysis, available: <http://www.bea.gov/bea/dn/gdplev.xls>.

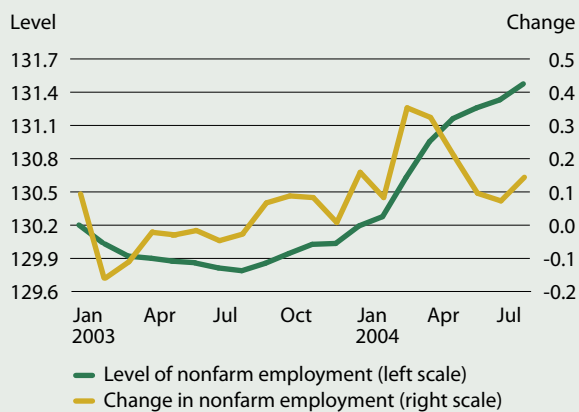
Figure 1.3 Institute for Supply Management Index, United States, January 2003–August 2004



Source: Datastream, downloaded 15 September 2004.

Developments in the labor market have been a major concern in the current US recovery. Nonfarm payroll numbers surged by 353,000 in March, and net increases averaged 295,000 a month during March to May. However, in July, nonfarm payroll gains were only 73,000, following a disappointing increase of 96,000 in June (Figure 1.4). Although August saw an additional 144,000 jobs, the job market situation in the US remains unsettled, and lack of job market growth could eventually exacerbate the slowdown in consumption. In addition, outstanding consumer credit, excluding mortgage debts, stood at more than \$2.0 trillion in July 2004, having risen by

Figure 1.4 Nonfarm Employment, January 2003–August 2004, million, seasonally adjusted



Source: US Bureau of Labor Statistics, available: <http://www.bls.gov>.

7.1% annually for the previous 5 years. Including mortgages, the figure shoots up to an estimated \$9.7 trillion or 83.7% of GDP.

The household debt-servicing burden is also creeping up. The estimated ratio of required debt payments to disposable income was 13.1 in the second quarter of 2004, but a broad measure of household financial obligations rises higher to 18.1. Hence, a household balance sheet correction is a possibility over the medium term.

The impact of sustained high oil prices on disposable incomes, the absence of further fiscal stimulus over the next 18 months, as well as rising interest rates, are all likely to damp consumer spending growth over the rest of 2004 and 2005. The Federal Reserve will continue to raise its policy rate at a “measured” pace over this period, with rates likely to be in the range of 3.5–4.0% by end-2005. Inflation has remained in check, despite the threat of sustained high oil prices. Headline inflation came in at 2.7% in August, while the Federal Reserve’s preferred core inflation measure—based on the price deflator of personal consumption expenditure, excluding food and energy components—was about 1.5%. Should inflation further increase, the Federal Reserve could accelerate its tightening of monetary policy.

Given these likely developments, the baseline GDP growth forecast for the US economy for the whole of 2004 is 4.1–4.5%—a solid performance. Private consumption growth will moderate over the forecast period, as households rebuild their savings. Business investment will likely be sustained, based on relatively sound corporate fundamentals. Exports will support growth through 2005. In that year, economic activity will moderate, with growth projected at 3.1–3.5%.

Japan

Growth in the first half of 2004 accelerated surprisingly in Japan, beating all projections. The external sector was the engine of growth, but growth has increasingly become more broad based as business investment and consumption expenditures also strengthened. Exports to Asia rose by 19.9% in the first half of 2004 from a year earlier, taking up the slack created by weaker demand from the US. An export-led increase in machinery and equipment investment contributed significantly to Japan’s unexpected growth. The

recovery in investment also responded to the substantial increase in industrial production, increased capacity utilization, and low levels of inventories.

Although GDP growth, on an annualized basis, slowed to 1.3% in the second quarter from 6.4% in the first (Figure 1.5), improved corporate sector fundamentals suggest that the expansion will likely continue for at least the rest of 2004. Public investment, though, dropped in the second quarter, reflecting ongoing fiscal consolidation. In contrast, private nonresidential investment continued to increase, as corporate profits remained healthy and machinery orders surged in the second quarter.

Corporate sector improvements slowly permeated through to the job market. New job openings have arisen, leading to a decrease in unemployment. However, firms remained cautious in hiring after such a long economic slump. Many of the gains were in temporary or part-time employment, thus limiting the recovery in wages. This picture should brighten over the coming quarters as labor market conditions further tighten on the back of changing demographics, although productivity growth and corporate efforts to cope with rising labor costs will mitigate the demographic impact. Moreover, the current

escalation in production and corporate profits will exert a positive influence on hiring decisions.

Private consumption recovered very modestly in the first half of 2004 and will likely continue its gradual recovery. Despite the poor performance of wage income, consumer spending maintained a slight gain, rising 2.6% (q-o-q, saar) in the second quarter after posting 4.2% growth in the first. The resilience of private consumption helps support GDP growth prospects. Consumer confidence has also been on an uptrend since the second half of 2003. With job market conditions improving and wages picking up over the coming quarters, the recovery in private consumption should gain firmer ground in 2005.

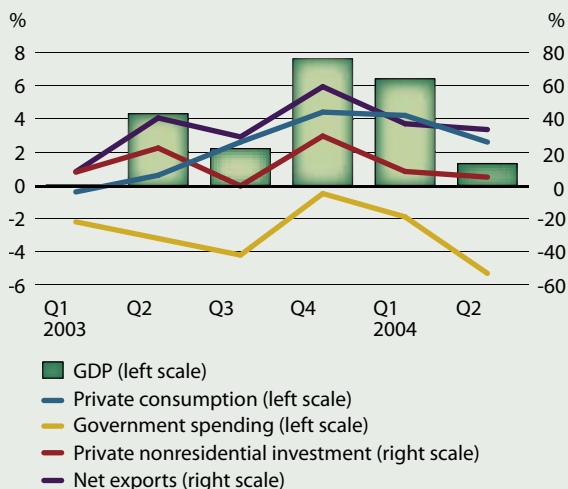
Deflation remains an issue. The consumer price index declined by an average of 0.2% in the first half of 2004 from a year earlier. The price level remained depressed despite rising oil prices and a mild depreciation of the yen, which fell by 1.6% from the start of the year through end-June, but the yen is still strong compared with its level of a year ago. Although the deflationary risk will gradually dissipate over time with a robust economic recovery, it remains an important factor to watch with regard to the strength and durability of the consumption recovery.

A strong export performance complemented by rising domestic demand—investment and increasingly consumption—has led to a revision of baseline GDP growth for Japan to 3.8–4.2%, significantly higher than in *ADO 2004*. As export growth moderates and business investment stabilizes in 2005 but the gradual recovery in consumption continues, Japan will settle to growth closer to its potential of 1.6–2.0%.

Euro Zone

A mild recovery is under way in the euro zone, driven mainly by a rebound in export demand. The euro zone economy grew at 2.1% (q-o-q, saar) in the second quarter of 2004, following growth of 2.6% in the first (Figure 1.6). Despite the sustained strength of the euro, exports surged by 15.7% (q-o-q, saar) in the second quarter following a 5.6% rise in the first. Robust external demand boosted industrial production across the euro zone, particularly in Germany, Italy, Netherlands, and Spain. Business sentiment has been improving, as has manufacturing production.

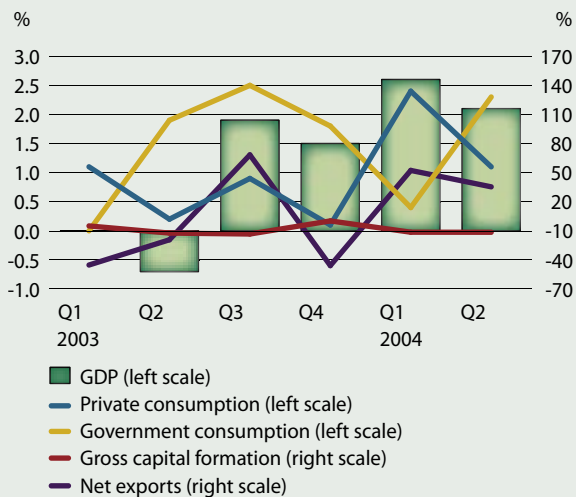
Figure 1.5 Growth of GDP and its Demand Components, Japan, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.

Source: Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp>.

Figure 1.6 Growth of GDP and its Demand Components, Euro Zone, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.
Sources: Eurostat, available: <http://www.europa.eu.int>;
Datastream, downloaded 7 September 2004.

The upward trend in economic activity has also exerted a positive influence on consumer spending. Private consumption grew by 2.4% and 1.1% (q-o-q, saar) in the euro zone in the first and second quarters, respectively. Reflecting the gradually broadening recovery, together with a turnaround in consumption, GDP is expected to grow in a range of 1.8–2.0% this year and 1.8–2.2% in 2005.

In Germany, the largest euro zone economy, GDP grew by 2.0% (q-o-q, saar) in the second quarter, accelerating slightly from 1.6% in the first. Net exports contributed about 2.1 percentage points to GDP growth in the second quarter, down from 5.0 percentage points in the previous quarter. Domestic demand, however, continued to stagnate in the second quarter, with consumer spending expanding at a meager 0.3% (q-o-q, saar). On an annualized basis, capital spending fell again by 3.4% during the second quarter, after plunging by 14.6% in the first.

While the weakness in domestic demand in Germany remains extensive, there are signs of improvement. Consumption, though still very weak, has recovered from a severe contraction in 2003. Industrial production is picking up speed, as new orders, both domestic and foreign, continue to increase. The Ifo business climate

index points to an improving business environment, reaching 95.7 in the second quarter, though this is a slight fall from 96.4 in the first. Based on a slow recovery in consumption and investment over the coming quarters, the German economy is expected to grow by 1.5–1.7% in 2004 and continue to expand at 1.7–1.9% in 2005.

Economic growth in France is more broad based and balanced. GDP expanded by 3.2% (q-o-q, saar) in the first and second quarters, fueled by strong consumption and exports. Private consumption slowed slightly to 2.9% growth (q-o-q, saar) in the second quarter, following 3.6% in the first. A rally in consumer spending boosted retail sales, providing a lift to industrial production and investment. Industrial production rose further in the second quarter, having contributed 0.8 percentage points to GDP growth in the first. However, the increase in consumer spending exceeded the growth in real income, making the rebound in consumption vulnerable to developments in the job market. At present, business sentiment is high, on the basis of increasing profits and buoyant economic activity, which will likely enhance job market prospects. Against this backdrop, the baseline for the French economy is to expand at a fairly respectable 2.2–2.4% in 2004 and 2.0–2.2% in 2005.

As some of the larger euro zone economies—notably Germany and Italy—still rely heavily on exports, the ongoing recovery remains vulnerable. Furthermore, domestic demand performance across the euro zone remains very uneven, limiting any scope for a harmonized policy approach to support the tentative recovery. For example, while gross fixed investment has improved in many euro zone countries since late 2003, Germany and the Netherlands saw a decline in investment. Consumer spending was particularly strong in France and Spain, but lagged in Germany.

The hesitant recovery in consumer spending remains key to a further strengthening of the euro zone. A major downside risk to the recovery in consumption is the situation in the job market, particularly at a time when unemployment benefits are being curtailed. The euro zone unemployment rate remained static, regis-

tering 9.0% for the fourth consecutive month in July. Policy makers' procrastination with regard to structural reforms is partly responsible for limited job creation in the current economic expansion. Indeed, the number of unemployed steadily increased from 12.6 million in January to 12.7 million in July. If job conditions do not improve as expected, consumer confidence, which has gradually picked up since the second half of 2003, could sharply deteriorate, clouding the growth prospects for 2004–2005.

The headline inflation rate jumped above the European Central Bank (ECB) target rate of 2% in the second quarter, mainly on account of rising oil prices. Although high oil prices are a significant risk in the short term, a slow recovery in domestic demand and a strong euro will likely pull back inflation toward the target over the forecast period. Nevertheless, with inflation above the target rate, ECB will be inclined to raise its policy rate, perhaps in late 2004 or in the first half of 2005. Fiscal policy is also constrained by the euro zone Stability and Growth Pact. Government consumption in the euro zone increased by 2.3% (q-o-q, saar) in the second quarter, following 0.4% in the first, but is expected to remain restrained over the forecast period.

Outside the euro zone, the United Kingdom (UK) grew at an above-trend rate of 3.6% (q-o-q, saar) in the second quarter, rising from 2.8% in the first. Domestic demand remained strong, though consumer spending has moderated somewhat along with what may be a less buoyant housing market. House prices, rising at a monthly average of 1.7% during the first quarter, have apparently started to slow in recent months. Investment recovery is gathering pace, growing by 1.7% in the first quarter and 1.4% in the second. Business confidence is staying high, pointing to continued economic expansion. However, due to high oil prices, inflation has picked up with the consumer price index rising in August by 1.3% year on year.

Robust economic expansion in the UK, coupled with tight labor market conditions, suggests that inflationary pressures will likely remain in place for some time. Reflecting largely buoyant global economic conditions, the UK is projected to grow by 3.2–3.4% in 2004 and 2.8–3.0% in 2005.

World Trade and Commodity Prices

World trade expanded rapidly in the first half of 2004, owing to a synchronized global economic recovery that was supported by strong industrial production growth in major industrial countries and in developing Asia. According to World Bank estimates, growth in world trade as measured by world export volume reached 9.0% in the first half of 2004. Drawing on the strong performance of the year to date, world trade is expected to expand at 9–10% over the full year, before moderating to 7–8% in 2005.

As the global recovery gained traction, imports of industrial countries expanded in nominal terms by 18.0% in the first quarter from the same period of a year earlier, according to the August 2004 International Monetary Fund *Direction of Trade Statistics*. The value of exports from developing Asia surged by 27.5% in the same period. In particular, exports from the PRC grew by 34.0% in the first quarter of 2004 from a year earlier while those from India expanded by 27.5%. More impressively, intraregional Asian trade increased by 26.8% to \$196.3 billion in the first quarter from \$154.7 billion in the year-earlier quarter.

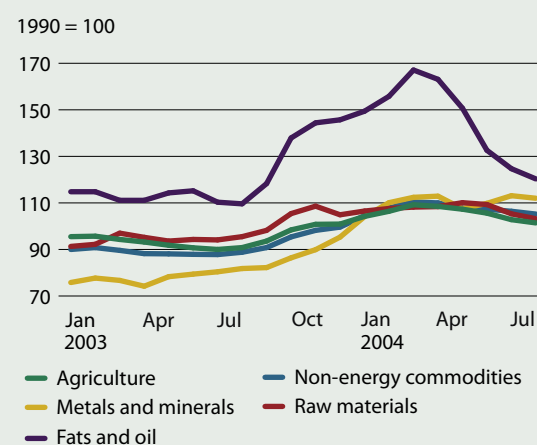
A cyclical upswing in high-technology industries has also boosted world trade in 2004. Demand for information and communications technology (ICT) products, such as wireless communications devices, digital cameras, and consumer electronics goods, has been increasing since late 2003. Worldwide sales of semiconductors rose to \$53.4 billion in the second quarter, increasing by 40.3% from a year earlier; Asia posted the strongest annual sales growth at 60.9% in June, followed by North America at 29.7%, the European Union (EU) at 28.9%, and Japan at 26.3%. DRAM chip prices were especially firm, reflecting strong demand and limited supply. Capacity utilization for related products, such as integrated circuits and processors, reached over 95% worldwide in the second quarter of 2004, while inventories remained low. According to the World Semiconductor Trade Statistics, the world semiconductor market is estimated to grow by 28.4% in 2004, amounting to \$213.6 billion in trade value. The growth momentum in the semiconductor and high-technology industries is expected to moderate over the next year.

Oil prices surged in 2004 on tight market conditions and geopolitical uncertainties (see Part 3). The latest data on oil production and consumption suggest that tight oil market conditions are likely to remain for some years to come. Strong demand, despite rising oil prices, coupled with speculative positions have pushed prices higher this year, with prices above \$40 a barrel in August. The International Energy Agency estimate for 2004 world demand, made in August, was 82.2 million barrels a day (mb/d), representing an increase of 2.5 mb/d in 2004. A further increase of 1.8 mb/d is projected in 2005. World supply rose by 0.6 mb/d to 83.5 mb/d in July. Spare capacity among members of the Organization of the Petroleum Exporting Countries (OPEC) fell to an estimated 1.2 mb/d in August compared with about 2.0 mb/d a year earlier. In these circumstances, oil prices for the *ADO Update* baseline have been substantially revised upward from the *ADO 2004* baseline (Table 1.2). The benchmark Brent crude price is put at an average of \$36–38 a barrel in 2004, easing somewhat to \$33–35 in 2005.

Prices of non-energy commodities stayed high during the first half of 2004 (Figure 1.7) as a result of the strong global recovery and sustained demand from the PRC, particularly for raw materials and metals. Prices of raw materials, including timber and rubber, further increased in the first half, with the notable exception of cotton, which sharply declined due to recent favorable output forecasts for 2005. Although still at relatively high levels, rubber prices started to stabilize in July. Overall, the World Bank price index of raw materials increased 15.2% year on year in the second quarter, following a 13.8% rise in the first. Prices of metals and minerals surged by 41.5% in the second quarter from a year earlier. Steel prices shot up by 68.3% over the same period, while prices of other metals such as copper, lead, and tin, all rose by more than 50%.

Agricultural and food commodity prices have generally eased recently, as forecasts for the next crop year have mainly been strong. Prices of grains, including maize, rice, and wheat, which had posted strong gains in the previous 12 months, started to retreat in July on the back of favorable crop prospects. The price rally in fats and oils seen in 2003 reversed during the first quarter and continued to stabilize, as supply

Figure 1.7 Non-Energy Commodity Prices, January 2003–August 2004



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

conditions improved. Coffee prices continued recovering in the first half, while cocoa prices fell sharply in the second quarter, due to a freer price regime in the Côte d'Ivoire, the world's top producer of cocoa. Fertilizer prices remained firm.

Looking forward, the prices of non-energy commodities, though stabilizing, are likely to remain relatively high in 2005 as demand from developing Asia, and the PRC in particular, appears to have shifted the demand/supply dynamics in commodities markets in a fundamental way. Despite a moderation of cyclical demand later this year, non-energy commodity prices are estimated to increase by about 5–6% in December 2004 from December 2003.

Financial Market Developments

Around midyear, global financial markets had generally cooled, as the strong expansion in the world economy softened in the second quarter of 2004. The bullish runs in equity prices since the latter half of 2003 paused in July and August to reassess the strength of the global recovery. Bond yields, which edged higher in April and May on anticipation of a phased monetary tightening, fell back in July and August.

Despite healthy earnings in major industrial countries in the second quarter, concerns about growth prospects over the medium term, together with high oil prices, depressed equity prices around the globe (Figure 1.8). A moderation

Figure 1.8 Major Stock Market Price Indexes, 2004

Source: Datastream, downloaded 16 September 2004.

in global ICT industry earnings further led to a weakening of markets in July and August. Finally, reflecting less certainty in a strong growth outlook, long-term government bond yields in the US and EU have come down. Yield curves have generally flattened.

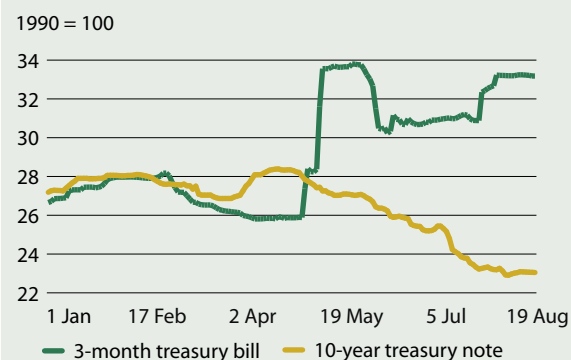
While policy rates around the world are still very low, central banks in major industrial countries have increasingly weighed the risk of inflated asset prices and high oil prices in deciding monetary policy. During the first half of 2004, surging oil prices put upward pressure on overall consumer price levels in major industrial countries except Japan, though core inflation has remained relatively subdued. At the same time, the strength of the world economy in general and the US economy in particular made the case for a tightening of monetary policy more compelling.

The Federal Reserve raised the target Federal Funds rate in June, August, and September, each time by 25 basis points, to 1.75%. (The central banks of Australia and the UK had raised rates earlier.) On the assumption of no sharp acceleration in inflation, the Federal Reserve is expected to continue raising its policy rate at a “measured” pace over the forecast period with the rate projected to reach 3.5–4.0% by end-2005. This is slightly higher than the baseline rate in *ADO 2004*. Based on the gradual increases at least until the first half of 2004, the 6-month London interbank offered rate is projected to reach 3.0% by June 2005, while, after more than 15 months of keeping the target rate at 2.0%, ECB is now also

likely to raise its policy rate in the near term as inflation in the euro zone reached 2.3% in July and as a stronger recovery takes hold there. The December futures for 3-month Euribor, priced at a discount rate of 2.3% as of 9 September, also point to a rate rise in early 2005. The Bank of Japan is struggling with deflation, which makes it unlikely that the zero-interest rate policy will change soon. As private consumption is yet to prove self-sustainable, the Bank of Japan will certainly wait until domestic demand pressures have a visible impact on inflation.

Although financial markets had expected a rein-in of very expansionary monetary policy for some time, uncertainties surrounding the turn of the monetary cycle nonetheless fueled financial volatility in April and May. Volatility for 3-month US treasury bills surged and remains high, reflecting unsettled issues on the outlook for the US economy and its impact on further interest rate increases (Figure 1.9). On the other hand, the volatility of 10-year US treasury notes has steadily decreased, indicating well-anchored inflationary expectations based on modest economic growth and the Federal Reserve’s clear intention to curb future inflationary pressures.

The impact of a US interest rate rise was felt more severely in emerging financial markets. Exceptionally low interest rates in support of the global recovery in 2003 heightened institutional investors’ risk appetite and led them to take on more leverage and venture into riskier assets. Emerging markets, particularly Asian equity and fixed-income markets, benefited from these speculative inflows throughout much of 2003

Figure 1.9 Volatility of US Treasury Securities, 2004

Source: Bloomberg L.P., downloaded 23 August 2004.

until mid-March 2004. As a result, equity prices bounced back from their lows and sovereign bond credit spreads narrowed sharply in the latter half of 2003 through March 2004. Against this backdrop, the prospect of rising short-term interest rates, together with the emergence of more attractive safe assets in mature markets, triggered a broad unwinding of speculative positions in emerging financial markets. A heavy sell-off of emerging market assets during April and May resulted, sharply lowering equity prices and widening credit spreads across Asia. Higher oil prices and the prospect of a slowdown in the PRC further weighed on investor confidence in Asia: equity market indexes across Asia fell in the second quarter (Table 1.3). Asian bond prices in general retreated from the rally seen in the second half of 2003, leading their credit spreads to widen more than those of high-yield corporate debt in mature markets (Figure 1.10).

New offerings from Asian issuers, which surged in the first quarter of 2004 to take advantage of favorable funding conditions prior to the rate increases, continued in the second quarter. Major issuers of emerging market sovereign bonds, including the PRC and Korea, also frontloaded their funding programs for the year. Overall the prospects for capital flows to

Figure 1.10 Sovereign Risk Spreads of Emerging Asian Markets and High-Yield Corporate Spreads, January 2003–August 2004



Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. High-yield corporate spreads are Merrill Lynch high-yield corporate bonds over US treasury bonds. Emerging Asia consists of PRC, Korea, Malaysia, Pakistan, Philippines, and Thailand.

Source: Datastream, downloaded 16 September 2004.

Table 1.3 Percentage Change in Stock Market Prices (from end of previous period)

	2003	March 2004	June 2004	July 2004	August 2004
PRC					
Shanghai A Shares	10.6	16.4	-19.6	-1.0	-3.2
Shenzhen A Shares	-4.0	21.6	-22.9	-0.7	-5.1
Hong Kong, China					
Hang Seng	34.9	0.8	-3.1	-0.4	5.0
Hang Seng China Enterprises	152.2	-4.8	-10.2	1.0	-1.0
India					
BSE 30 Sensitive	72.9	-4.3	-14.2	7.8	0.4
Indonesia					
Jakarta Composite	62.8	6.3	-0.4	3.4	-0.3
Korea					
KOSPI	29.2	8.6	-10.8	-6.4	9.3
Malaysia					
KLSE Composite	22.8	13.6	-9.1	1.7	-0.7
Pakistan					
KSE 100	65.5	14.2	3.4	0.2	1.1
Philippines					
PSE Composite	41.6	-1.3	10.9	0.3	-0.3
Singapore					
Straits Times	31.6	5.3	-1.1	2.9	1.4
Taipei, China					
TWSE	32.3	10.7	-10.5	-7.2	6.4
Thailand					
SET	116.6	-16.2	-0.1	-1.5	-1.9
Memorandum Items					
Dow Jones Industrial Average	25.3	-0.9	0.8	-2.8	0.3
Nasdaq Composite	50.0	-0.5	2.7	-7.8	-2.6
NYSE Composite	28.8	2.5	0.1	-3.0	0.8
Nikkei 300	23.0	11.5	0.4	-3.7	-1.0
Nikkei 225 Stock Average	24.5	9.7	1.2	-4.5	-2.2

Source: Datastream, downloaded 15 September 2004.

the Asia-Pacific region remain positive over the forecast period as economic growth in the region is expected to be robust.

Since midyear, emerging markets have been on the rebound. In contrast to weakening sentiment in mature markets, growth fundamentals in emerging Asian markets remain strong, providing support for higher equity and bond prices. Equity prices recovered some of the losses and emerging market spreads narrowed in July and August 2004. Capital flows resumed, in the form of syndicated loans and portfolio investment. Despite the large twin deficits in the US, the dollar's depreciation against other

major currencies and Asian currencies came to a halt in the first quarter of 2004 and started to reverse slowly in the second. The unwinding of speculative positions in riskier assets appeared to favor the US currency, as institutional investors and hedge funds reduced their emerging market positions, switching back into dollar assets. Historical evidence also shows that higher oil prices tend to accompany a stronger US dollar, mainly due to increased demand for dollar-denominated assets by oil-exporting countries.

The relative strength of the US dollar will likely be sustained, at least in the short term, as uncertainties surrounding oil price developments continue. However, downside risks to the dollar remain significant in the medium and longer term, mainly due to the large macroeconomic imbalances in the US. Large US current account deficits require substantial capital inflows to be sustained, and these inflows have increasingly been supplied by Asian central banks, appearing as large increases in their official reserves. A faltering of the US recovery could significantly change investor sentiment toward US assets. A reversal of capital flows away from the US, though more of a medium-term risk, could trigger a steep slide in the dollar, as well as a sharp rise in long-term bond yields.

Developing Asia: Subregional Trends and Prospects

East Asia

East Asian economies posted strong growth averaging 8.4% in the first half of 2004, helping lift the overall growth rate for developing Asia. The surge in exports in the second half of 2003 continued into 2004, and was joined by a strong pickup in domestic demand in most of the economies. Despite macroeconomic tightening in the PRC, its GDP expanded by 9.6% in the first half, slowing by just 0.2 percentage points between the first and second quarters. The economies of Hong Kong, China and Taipei, China also prospered, with GDP growth of 9.5% and 7.2%, respectively.

Higher levels of investment have been a major driver of growth in the PRC; Hong Kong, China; and Taipei, China. In the PRC, investment growth slowed in the second quarter, but was still high at 22.3%. Private investment surged

in Hong Kong, China and Taipei, China, fueled by strong exports, increased corporate profits, rising capacity utilization, and low interest rates. Consumption growth in the PRC strengthened as a result of rising urban and rural incomes. In Hong Kong, China and Taipei, China, too, private consumption rose after several sluggish years, spurred by the recoveries in labor and property markets.

Merchandise exports from the subregion, particularly of IT products, are forecast to rise by about 20% in nominal US dollar terms over all of 2004, or 7 percentage points faster than projected in *ADO 2004*. Merchandise imports also are much stronger than expected because of higher oil prices, stronger consumer demand, and East Asia's hunger for industrial inputs to its export sectors. Import growth for the full year will be around 23%, also 7 percentage points above the earlier projection. The contribution of net exports to GDP growth has declined in the PRC; Hong Kong, China; and Taipei, China, as growth in imports outpaces that in exports. At the same time, the contribution of domestic demand to GDP growth has increased in all three economies. The subregion's current account surplus will fall to 2.3% of GDP, half the level recorded in 2003. Korea's experience is less encouraging. Its exports are buoyant but domestic demand remains weak. Private consumption is constrained by a heavy household debt burden. Its gross fixed capital formation increased only moderately in the first half of 2004. As a result, Korea's GDP grew by 5.4% in the 6 months, well below the pace of the other three economies.

Strong domestic demand and high oil prices revived inflation in the PRC and Taipei, China. Price deflation concerns faded during the first half in Hong Kong, China, and year-on-year inflation was recorded in July for the first time since late 1998. Korea's inflation rate picked up because of higher oil prices and wage pressures, despite its weak domestic demand. The projection for average inflation for the subregion is raised to a still moderate 3.0% for 2004.

In view of improved economic performance, most East Asian governments cut back on fiscal and monetary stimuli. The PRC Government used monetary, fiscal, and administrative measures to slow investment in sectors that it considered

overheated. In order to achieve more balanced growth and to avoid a hard landing, the PRC Government also adopted measures to lift growth in lagging sectors as well as in poorer provinces. The authorities in Hong Kong, China pledged to rein in the deficit in the medium term and are considering a broad-based goods and services tax as a way to stabilize revenues. In Taipei, China, a Ministry of Finance tax reform committee proposed increasing the value-added tax, and a new pension reform package was passed to address fiscal and social security issues. In Korea, on the other hand, fiscal and monetary policies have remained expansionary in an effort to bolster domestic demand. The Bank of Korea lowered its policy interest rate, while the Government introduced a supplementary budget and is considering a further fiscal package.

For all of 2004, aggregate GDP growth in East Asia now is forecast at 7.3%, nearly half a percentage point higher than in *ADO 2004*. Going into 2005, growth is projected at 6.4%, with downward revisions for the PRC and Korea. That puts next year's expected subregional growth about 1 percentage point below this year's.

Export growth in 2005 will slow from 2004's rapid pace, but will remain robust at about 13%. Similarly, the burst in imports will decelerate. The subregion's current account surplus will shrink further to 1.4% of GDP. Domestic demand is expected to remain strong in most of the economies. In the PRC, investment growth is slowing, though the large amount of construction approved or ongoing means that growth in investment will remain high. Consumption growth will be robust thanks to increased household incomes. GDP is forecast to rise by 8.8% in 2004, up from the *ADO 2004* figure of 8.3%, while growth in 2005 has been revised down slightly to 8.0% from 8.2%.

Investment spending in Hong Kong, China and Taipei, China is expected to remain robust, while consumption will be strong on the back of the continuing recovery of the labor and property markets. GDP growth for Hong Kong, China is revised up to 7.5% in 2004 and 6.0% in 2005, from 6.0% and 5.0% in *ADO 2004*. For Taipei, China, forecast growth is raised to 6.0% in 2004 and 4.8% in 2005, from the 5.4% and 4.7% in *ADO 2004*. Exports from all three economies

are likely to expand briskly, although import growth will surpass that of exports.

In Korea, a sluggish recovery in domestic demand and moderation of export growth have led to a downward revision in growth forecasts to 4.4% in 2004 and 3.6% in 2005, compared with the *ADO 2004* forecasts of 4.8% and 5.2%. Thus, expansionary macroeconomic policies are likely to continue in Korea, as will the effort to reduce the household debt problem. Policy makers should also refocus on reforms to promote economic efficiency and productivity, through greater flexibility in the labor market, a healthier credit culture, and improved governance in the corporate sector.

Macroeconomic policies will remain broadly neutral in the PRC; Hong Kong, China; and Taipei, China in the short term, although central bankers will be watching the return of inflation. In the subregion, inflation is expected to rise, averaging 3.8% in 2005, with this figure heavily influenced by a 2 percentage point increase in the projection for the PRC's price levels. So far, the central bank in the PRC has avoided using higher interest rates as a way to stem investment, though interest rates may well be raised if inflation exceeds 5% for an extended period.

Southeast Asia

The rebound of economic growth in Southeast Asia was impressive in the first half of 2004. The subregion's GDP growth for 2004 is now estimated to reach 6.2%, half a percentage point higher than in *ADO 2004*, and up from about 4.5% growth over the past 2 years. The economies of Malaysia and Singapore performed well above expectations while those of Thailand and Viet Nam continued to show healthy growth. In Indonesia, the largest economy in Southeast Asia, and the Philippines, growth in 2004 has also been improving, though at a more moderate pace.

A combination of domestic and external factors contributed to the better than projected performance of most Southeast Asian economies during the first 3 quarters of 2004. The same combination is expected to continue to drive growth for the rest of 2004 and well into 2005. First, with robust growth in most industrial countries, continued strong demand from the PRC, and the brisk revival of the electronics industry, exports from Southeast Asian countries

expanded substantially faster than forecast in *ADO 2004*. In nominal US dollar terms, exports are expected to jump by nearly 14% for the subregion, about 4 percentage points above the *ADO 2004* forecast. With the notable exception of Indonesia, exports grew well into double digits in most countries in the first half of 2004. Indonesia's net oil and gas exports declined by 26% in the first half, mainly due to declining production. Both agricultural and manufactured exports from Southeast Asia grew rapidly.

While net exports were a significant contributor to overall GDP growth in Indonesia, Malaysia, Singapore, and Thailand in 2003, data for the first 2 quarters of 2004 mostly show that net exports have subtracted from GDP growth in all countries except the Philippines. Indeed, strong domestic and external demand as well as the impact of higher oil prices led also to a sharp double-digit increase in imports in Southeast Asia. In the Philippines however, imports will expand moderately in 2004.

For the subregion, total imports in US dollar terms are forecast to rise by 16.8% in 2004, about 5 percentage points higher than projected in *ADO 2004*. With imports rising much faster than expected, the subregion's current account surplus will shrink to 7.2% of GDP, about 1 percentage point below the *ADO 2004* projections. For Malaysia, Singapore, and Thailand, the surplus remains substantial, while Cambodia is forecast to run a current account deficit of about 10% of GDP, about the same as in 2003.

Second, compared with the analysis in *ADO 2004*, a major emerging new feature of the economic developments in Southeast Asia during the first half of 2004 was, for the first time since the Asian financial crisis, a marked revival of business investment in most countries. Investment growth is projected to remain strong over the rest of 2004. Higher capacity utilization, good progress in the resolution of nonperforming loans, low interest rates, and a revival in construction have led a significant pickup in business investment in many countries. In Indonesia, Malaysia, Philippines, and Singapore, total investment contributed positively and substantially to growth after several quarters of negative contributions. In Malaysia, investment contributed 3.9 and 5.1 percentage points to GDP growth in the first and second

quarters, respectively. In Singapore, the contribution was 8.4 and 5.1 percentage points, respectively, after a negative contribution throughout 2003. In Thailand, capacity utilization surpassed precrisis levels for automobiles, electrical appliances, electronics, and steel. In Indonesia and the Philippines, investment recovered also but to a lesser extent. In both countries, there was a pickup in construction investment, but in the Philippines, investment in durables also rose. Complementing the strong performance of private consumption expenditures over the past few years, the revival of private business investment growth in Southeast Asia was a long-awaited and welcome development. It augurs well for longer-term subregional growth.

Sustained demand, combined with higher oil prices, nudged up inflation throughout Southeast Asia, with average inflation now projected at 4.2% for 2004, about half a percentage point higher than projected in *ADO 2004*. Inflation thus remains quite moderate in the subregion, particularly in Malaysia, Singapore, and Thailand. Monetary policies are thus projected to remain accommodative over the year, although as was the case in Thailand, some interest rate increases to align with those in the US will occur.

While a more positive growth environment could have led to some fiscal consolidation, this has not occurred so far. Fiscal deficits as a share of GDP are low in Indonesia and Thailand. Although it has a small and shrinking fiscal operating deficit, the overall budget of Singapore has a surplus of about 3.6% of GDP. However in other Southeast Asian countries, the deficits have been sizable for many years, in particular in Cambodia, Lao People's Democratic Republic (Lao PDR), Malaysia, Philippines, and Viet Nam. Public debt has also been accumulating. Policies to improve fiscal balances will need to be put in place and will affect the short- and medium-term outlook for Southeast Asia.

Projections for the subregion in 2005 indicate another year of robust growth, albeit at a slightly lower rate than in 2004. GDP is forecast to expand by 5.7%, with the fastest growth in Lao PDR, Malaysia, Thailand, and Viet Nam. Following elections in 2004, a return of confidence in the economy will also lift Indonesia's GDP growth to the highest level for at least 5 years, while growth

is projected to be higher than forecast in *ADO 2004* for the Philippines. Singapore's economy should return to more sustainable trend growth.

In line with the baseline assumption of lower world economic growth and a further slowdown in the PRC, exports will rise at a more moderate rate of about 8.5%. With domestic demand projected to remain strong, imports will continue to rise somewhat faster and as a result the subregion's current account surplus will shrink further to a still comfortable 6.6% of GDP.

The major contribution to sustained growth in the subregion will come from domestic demand, both consumption and investment. Strong consumer sentiment will support further increases in private consumption spending. At the same time, the current improvements in investor sentiment are expected to continue underpinning robust growth in fixed investment over 2005.

A marked increase in capacity utilization in 2005, a more stable political environment in several Southeast Asian countries following peaceful elections in 2004 (notably Indonesia and the Philippines), as well as some improvement in the investment climate will spur business investment in 2005. In spite of relatively high oil prices, inflation is not forecast to accelerate significantly in 2005, and, as a result, monetary policies will remain generally neutral. Some fiscal consolidation will be effected notably in the Philippines and Malaysia, but this would have only a small impact on the outlook for 2005.

South Asia

A return of favorable weather in 2003 in South Asia led to a remarkable agricultural recovery and a surge in GDP growth to 7.6%. *ADO 2004* projected more moderate but still high growth for the subregion at 7.0% in 2004 and 7.2% in 2005. These forecasts are now revised downward to 6.4% in 2004 and 5.9% in 2005. Less favorable weather conditions in 2004, price pressures (mainly in oil and metals), and a less buoyant outlook for global growth in 2005 are the main factors underlying the downward adjustments. In addition, inflation in the subregion has been repegged at somewhat higher rates—at 5.5% in 2004 and 6.5% in 2005. Estimates for the balance-of-payments outlook continue to show strength with trade expanding at double-digit rates in most countries. South Asia

as a whole is expected to continue to record a current account surplus.

In India (accounting for about four fifths of the subregion's GDP), developments through August suggest that a weak and erratic monsoon will lower agriculture sector growth not only to below that of the sharp rebound expansion in FY2003 (ended 31 March 2004) but also below its trend rate of growth. This would markedly lower growth in personal income and consumption from the robust expansion in that year. Moreover, wholesale price index (WPI) inflation accelerated sharply to just over 8% by end-August, largely reflecting rising prices of oil, iron and steel, and coal. To temper price pressures, the Government responded in August by cutting excise and import duties on selected commodities and fuels. Subsequently, in September the Reserve Bank of India, which had intended to continue an accommodative monetary policy for FY2004, announced an increase in the reserve requirement ratio to 5%, effective 2 October, an action that will likely raise interest rates, limit bank lending, and restrain growth.

Taking these developments into account, FY2004 estimated agricultural growth in India has been downgraded to 2% while expansion in industry and services has been reduced to 7.8%, to yield revised GDP growth of 6.5%. For FY2005, GDP growth of 6.0% is now expected. This projection is based on a normal monsoon but a slowing expansion in industry and services, reflecting expected developments in the Indian business cycle. For FY2004, average WPI inflation is estimated at 5.7% and is projected to rise to 6.8% in FY2005 due to a full pass-through of the previous year's price increases.

The new United Progressive Alliance Government that took office in May has announced its National Common Minimum Program that emphasizes economic reform with a "human face." The main goals include generating employment and stimulating pro-poor growth, increasing rural credit and social spending, and stepping up investment in physical infrastructure. The (full-year) federal government budget for FY2004 released in July 2004 sought to implement some of these goals while reducing the revenue and overall budget deficits. Nevertheless, weaknesses in state government finances are expected

to keep the consolidated government budget deficit at about 10% of GDP. Comprehensive steps toward much-needed fiscal deficit reduction are expected to be taken in FY2005.

In Bangladesh, GDP growth is estimated at 5.5% for FY2004 (ended 30 June 2004), driven by steady growth in export-oriented industrial production and the services sector. Macroeconomic policies kept to a cautious tack; inflation that had been on the rise during the year was checked and held to 5.6%. Export growth rebounded sharply (15.9%) and, while imports also rose, growth in worker remittances and official transfers kept the current account in surplus. Policy reforms adopted with the FY2005 budget included the following: measures to expand income tax and value-added tax coverage; rationalization of customs duties to moderate tariff protection and promote efficiency of domestic industry; and adjustment of interest rates on National Savings Certificates to foster greater flexibility and market orientation.

The outlook for Bangladesh GDP growth in FY2005 has been revised downward to 4.8% (from 6.0% in *ADO 2004*) due to the devastating floods in July and August that severely damaged agricultural activities, infrastructure, and industry. Inflation is now projected to be 6.0% while the current account balance is likely to be pushed to a deficit of 1.5% of GDP as a result of the calamity. Macroeconomic management will be challenged, especially if recovery in food and other production takes an extended time. Since Bangladesh relies heavily on Multifibre Arrangement (MFA) quota-restrained markets, the abolition of quotas at year-end seriously threatens to undermine the country's textile and garment exports (75% of total exports) and consequently employment levels. This is because effective competition by the industry in the global market is hobbled by low productivity, inadequate infrastructure, and policy constraints.

Nepal's economy grew by only 3.6% in FY2004 (ended 15 July 2004), mainly due to the breakdown of the cease-fire with the insurgents in August 2003. Industry underperformed, expanding by only 1.8% with minimal growth in construction. Agricultural output strengthened, with paddy production up 7.8%, while some improvement in tourism lifted the services sector.

The continued insurgency hit government activity, causing a 16% shortfall in development expenditures. An ongoing deterioration in the investment climate was reflected in weak growth in credit to the private sector and a fall in interest rates for the second consecutive year.

A new prime minister, appointed in June, has formed a coalition Government that enjoys support from some political parties, despite the fact that Nepal's Parliament remains suspended. The FY2005 budget announced in July aims to implement the Government's poverty reduction strategy and to raise expenditure allocations to local-level, community-led projects as part of its effort to boost development expenditures and reform. Apart from this stimulus, monetary policy is to be accommodative so as to support a stronger economic expansion. Assuming no substantial deterioration in the security situation, GDP is forecast to grow by 3.7% in FY2005, underpinned by a favorable monsoon, and by some pickup in construction and manufacturing.

Pakistan's economic reforms of the past 4 years have made a major contribution to a stronger economy. GDP growth accelerated to 6.4% in FY2004 (ended 30 June 2004), with manufacturing accounting for half of the expansion. The current account of the balance of payments remained in surplus for the fourth straight year, though at a lower level. With macroeconomic reforms and policies on a sound footing, the FY2005 budget and the trade policy continued the structural adjustment process and moved on to "second generation reforms." Measures were taken to accelerate growth in agriculture, industry, housing and construction, and business activities—and to further improve tax administration. The measures largely involved tax and tariff rate cuts and new financial incentives, but also included steps to reduce the harassment of business by government regulators.

With private investment in Pakistan picking up and a sizable increase in the public sector development program, GDP is estimated to grow by 6.5% in FY2005, up from 5.8% projected in *ADO 2004*. Notwithstanding an expected gradual tightening of monetary policy that will raise interest rates, inflation is now estimated at 5.5% for the year, reflecting a buildup in domestic liquidity in recent years and the fact

that industries are approaching full capacity utilization. Rapid economic growth and continued high oil prices will widen the trade deficit, and the current account is now expected to switch to a deficit of about 1.3% of GDP in FY2005. Over the longer term, restructuring and modernization of the textile and garment industries have helped prepare the country to be competitive in the post-MFA quota era.

Central Asian Republics

In the six Central Asian republics (CARs), developments through midyear confirm that 2004 will be a year of continued rapid growth, as projected in *ADO 2004*. Economic performance remains driven by large investments in the oil and gas sector as well as by higher oil prices and gas sales in some countries. Additionally, higher prices for non-oil export commodities, especially for cotton and for gold and other metals, have, to varying degrees, boosted economic expansion in all countries in the subregion.

Economic growth for 2004 in the CARs as a whole is now estimated to be 7.9%, marginally lower than in *ADO 2004* with all countries but one expected to meet or exceed the original growth forecast. In summary: growth fueled by the oil and gas sector has supported rapid GDP expansion in Azerbaijan (10.0%), Kazakhstan (9.5%), and Turkmenistan (10.0%) while export commodity-led growth prevails in the Kyrgyz Republic (4.5%), Tajikistan (8.5%), and Uzbekistan (3.0%). The Kyrgyz Republic and Tajikistan are implementing poverty reduction growth strategies supported by international financial institutions and other aid partners. Despite achieving current account convertibility in 2003, economic growth in Uzbekistan remained low and well below potential as implementation of its policies for market-based structural reforms has been slow. Prospects may be enhanced following announcements that, over the next 5 years, the PRC and the Russian Federation aim to invest a combined total of about \$3 billion in Uzbekistan in various sectors, which could be the catalyst for a growth breakthrough.

Most countries have experienced a modest uptick in inflation from 2003 actual and *ADO 2004*-projected levels, mainly because of robust expansion in investment and consumer demand. Nevertheless, the revised estimate for subregional

average inflation in 2004 remains moderate at 6.4%, with individual country performance narrowly bunched around this average. This average is somewhat lower than the *ADO 2004* projection largely because inflation in Uzbekistan is now estimated at about 10%, well below the earlier projection, though inflationary imbalances there are still to be unwound. Growth in employment continues to be limited, in some countries by the capital-intensive nature of oil and gas sector-led development and in all countries by difficulties in achieving structural adjustments necessary to achieve broad-based rapid growth.

With higher than expected oil and commodity prices so far in 2004, export earnings in the CARs have expanded more rapidly than projected in *ADO 2004*. Increased earnings, however, have been offset by higher imports and larger net deficits on invisibles, especially larger oil sector payments for services, outflows of repatriated profits, and foreign labor remittances.

For the subregion, the current account deficit for 2004 is now estimated at 3.9% of GDP, slightly above the *ADO 2004* projection. Current account deficits are covered by foreign direct investment in Azerbaijan and Kazakhstan where large oil and gas development projects are under way, and by development aid and other capital flows in the other CARs. Azerbaijan's current account deficit in 2004, estimated at about 35% of GDP, is an extreme outlier among the CARs, reflecting heavy expenditure on four major oil and gas projects near completion in a relatively small economy.

The outlook projected for the CARs in 2005 is for a continuation of rapid GDP growth of about 8%. The pace of growth in individual countries is expected to be largely similar to that estimated for 2004, though in the Kyrgyz Republic and Tajikistan a modest improvement over the *ADO 2004* forecast is now expected as structural reform takes hold. Both these countries face intrinsically difficult economic circumstances and weak resource bases.

Governments are likely to maintain their generally cautious monetary and fiscal policies, and inflation is expected to moderate to an average of 6.4% for the subregion with essentially all countries improving on the 2004 projected outcome. Despite moderation in oil and commodity prices and slower growth in exports

and imports, the current account deficit for the subregion is forecast to be about 2% of GDP in 2005, about half the 2004 projected outcome. This mainly reflects some moderation in oil and gas sector investment activity.

A major issue facing the CARs is to diversify from their heavy dependence on oil and gas or a few non-oil sector commodities. Further structural reform and a broadened economic base will be necessary to maintain the sustainable, high growth necessary to generate the needed employment opportunities and reduce poverty.

Risks to the Outlook for Developing Asia

ADO 2004 identified various risks to the economic outlook, including global and regional economic risks, as well as terrorist outrages. In addition, the threat of various epidemics, most recently avian flu, appears to have become a recurrent concern. In short, the risks analyzed in *ADO 2004* are still relevant in September 2004, with perhaps, some adjustments required to the likelihood and dates of the economic risks occurring.

Global Economic Risks

At the time of writing *ADO 2004*, the quality and breadth of the recovery in industrial countries remained unclear, mainly due to weak employment generation, the prospects of rising inflation (associated with upward movements in oil and commodity prices), and the uncertainty of the timing and impact of the projected rise in interest rates from historically low levels. Over the medium to longer term, the ballooning US fiscal and current account deficits were seen as exacerbating the risks to the world recovery.

By the third quarter of 2004, growth in industrial countries—the US and Japan in particular, but also increasingly in the EU—has gained momentum and remains quite solid, while in developing Asia, growth is healthier than forecast earlier in the year.

In spite of higher oil prices for most of 2004, core inflation in major industrial countries remains little affected and, as a result, inflationary pressures are generally subdued. Although employment generation has been much softer than usual in this cyclical recovery in the US, the apparent strength of the growth momentum has

persuaded the Federal Reserve to start raising interest rates earlier than previously expected. Despite this, and contrary to the fears expressed in *ADO 2004*, no significant disruptions have occurred in financial markets. Although policy rates in all industrial countries are still extremely low, the cycle of progressive monetary tightening will continue and will likely accelerate at least in the US in 2005, especially if inflation picks up. Similarly, ECB could raise rates earlier than previously expected. With major industrial countries forecast to continue growing above trend over the rest of 2004 and the first half of 2005, an acceleration of monetary tightening will depend significantly on changes in inflation rates.

The impact of high oil prices, possibly sustained well into 2005, needs to be evaluated. Faster oil-induced inflation would require a sharper tightening of monetary policy in major industrial countries. The danger inherent in such tightening is partly that it could affect a recovery still rather uncertain in its self-sustainability. The outcome for the world economy, and industrial countries in particular, would then depend on a continued domestic consumption recovery and strengthening of business investment. The risks of a faster deceleration in growth in major industrial countries in the latter part of 2005 remain a distinct possibility.

The huge macroeconomic imbalances in the world economy—mainly the twin US deficits but also imbalances in Japan and the EU—have been left unresolved during the 2003–2004 recovery cycle. As 2005 advances and in 2006, these imbalances that are characterizing the current recovery cycle could start dragging down world growth, due both to sharply higher interest rates and to a substantial depreciation of the dollar. They could impact on growth as renewed inflationary pressures, stemming from sustained high oil prices, trigger policy tightening. Moreover, an extended period of slow growth in output and employment, especially if accompanied by inflationary pressures, would risk a rise in trade protectionism that would throttle what has been a main impetus to global expansion. Taken together, these elements hold significant risks for the world economy over the medium term.

As noted in *ADO 2004*, it will be important for developing Asia to evaluate the impact of

these possible negative outcomes, since they could well spell a return to a period of stagflation in the second half of the decade. Domestic policy adjustment and reforms need to be carried out now while growth is robust. One policy shift to consider is to increase domestic consumption demand in supporting growth in the context of making economies more open. As the experience in some countries of the region has shown in recent years, this requires a continuation of economic reforms, particularly in the financial sector.

Regional Risks

ADO 2004 identified a set of risks specific to the region. All are still in place. However, many of these risks also represent opportunities, such as the surge in intraregional trade, the increasing importance of domestic consumption demand as a driver of growth, and the accumulation of large amounts of foreign reserves by many Asian governments.

Intraregional trade dynamism continued as a major feature of the outlook in the first 3 quarters of 2004. It is likely to remain so over the forecast period under the current baseline projection that the PRC economy will achieve a soft landing. While the PRC is projected to expand robustly at least in 2004, a steeper slowdown in 2005 is possible. Investment is still growing fast in many sectors, and at the same time inflation has been rising substantially to about the central bank's intervention point of around 5%. A greater tightening of policy, including monetary policy, might be needed in late 2004 or 2005. However, an interest rate rise and a deterioration of the growth environment could lead again to a substantial surge in nonperforming loans, possibly affecting the medium-term economic outlook.

As discussed in Part 3, a slowdown in the PRC's growth rate by 2 percentage points would cut GDP growth in East and Southeast Asia by about 0.2–0.5 percentage points. Hong Kong, China would feel the impact more, at close to 1 percentage point. However, combined with a simultaneous slowdown in the US and Japan, the impact on East and Southeast Asia would be in the range of 0.5–1.0 percentage points (again, except Hong Kong, China where the impact could be about 1.4 percentage points). These possible scenarios highlight the need for many governments

in developing Asia to consider medium-term policies aimed at expanding the role of domestic consumption demand in sustaining growth.

However, the experience of Korea over the past 2 years shows that weaknesses in some areas of financial sector regulation and supervision can easily result in a sharp increase in household debt, and, possibly, in a consumer debt crisis. The Bank of Thailand, for instance, in 2004 tightened its credit card regulations in seeking to preclude a Korean-type crisis. As mentioned in *ADO 2004*, the importance of deepening financial sector reforms, including the development of nonbanking financial institutions in developing Asia, is highlighted. In an environment of rising international interest rates—even if rates remain low in a historical perspective—and mounting household debt in some countries, the urgency to accelerate such reforms is evident.

Looking at possible scenarios for the world economy over the medium term, many regional governments should use the current opportunity of robust economic growth projected in 2004–2005 to undertake reforms to consolidate their fiscal situation and reduce public sector indebtedness. Following the 2001 world recession, many Asian countries have indeed pursued expansionary fiscal policies to support economic growth. Outside these countries, mainly in South Asia, the Pacific, as well as the Philippines, large budget deficits have been common for many years. As a result, public debt-to-GDP ratios have been rising and have reached worrisome levels in several countries. As interest rates rise and economic growth slows over the medium term, the public sector's debt-servicing burdens will increase, leaving little room for possible fiscal support. Also, if robust growth is to be maintained in the region, business investment needs to expand substantially over the next few years. However, in a higher interest rate context, large fiscal deficits will crowd out private investment.

ADO 2004 also warned of the need to translate growth into employment generation and to address widening income inequalities. Developments in the first half of 2004 have confirmed the need to address these concerns, and, in many countries of the region, they are rapidly becoming a priority in public policy. In several countries, the robust growth rates observed during the first half

of 2004 did not generate sufficient employment for the expanding labor force. Significantly, in the many elections that have taken place so far in the region in 2004, employment and income inequality issues were major election themes that had a strong bearing on the election results.

Finally, in recent years, and increasingly so, outbreaks of various epidemics have become an integral part of regional risks. As the outbreak of the SARS epidemic in 2003 showed, if such epidemics are not detected early and dealt with promptly and openly at a regional level, they can cause considerable damage to regional economies. Had the SARS virus been more contagious, its economic impact would have been dire. Earlier in 2004, a widespread regional outbreak of avian flu also decimated the poultry industry in the region. The recent occurrence of new avian flu cases in several countries and subsequent reports that the H5N1 virus was found in pigs have further heightened concerns about diseases that may jump from one species to another, their possible impact on human health, and their potential economic consequences.

The impact of an avian flu outbreak obviously depends on the scale, duration, and spread of the disease. The macroeconomic impact will be limited if the outbreak is confined to poultry as this industry accounts for below 2% of GDP in most economies. Model simulations show that, among the countries concerned, Thailand will be the most hurt as poultry is an important export sector. But even with a half-year ban on poultry exports, the impact on Thailand's GDP would be in the order of 0.5 percentage points, and the impact on other Asian economies minimal, in this model. Despite the relatively low macroeconomic impact, some particular segments of society would be severely affected though. Until any effective vaccination or other control method becomes available, mass culling of poultry will remain the major means of controlling the disease, which will hit farming incomes and rural consumption hard in areas where poultry farming is concentrated. Government compensation packages will be necessary both to offset the income loss to farmers and to encourage early reporting.

Clearly, such measures will put pressure on government budget positions in the short term. One element cannot be calculated at the moment

and that is the effect of the virus mutating and becoming transmissible among humans. The health, economic, and social impacts would be extremely severe as flu viruses are much more contagious, and possibly more lethal, than the virus responsible for SARS. A pandemic could then occur. Enhanced regional cooperation and openness in dealing with possible large-scale epidemics, and significant improvements in regional and national early warning systems and preparedness plans, would then be of paramount importance to contain these multiple impacts.

In conclusion, the risks are not negligible. However, the underlying strong regional growth momentum could also create tremendous opportunities if it can be channeled into improving regional competitiveness. To this end, with regard to their long-term growth strategy, regional governments should focus on enhancing resilience to external shocks and on fostering domestic growth for greater sustainability. The following considerations are germane in this respect.

First, broadening intraregional trade has enabled the regional dynamics to allow more efficient resource allocation, thus helping developing Asia's economies achieve more balanced growth. Second, the emergence of strong regional domestic demand could provide extra resilience to adverse shocks from the rest of the world. Third, developing Asia's economies should continue structural reforms to foster the investment climate through improving competitiveness and productivity. These reforms include the successful implementation of ongoing financial sector transformations—strengthening bank balance sheets, broadening financial markets, establishing a sound credit culture, and enhancing governance—and they remain key to promoting domestic investment and attracting foreign investment. These structural reforms remain particularly important, as sustained progress in economic reforms would ensure resilient and balanced growth in developing Asia to counterbalance an adverse external environment. Fourth, the high oil prices that are likely to persist, largely as a result of rising global demand, make it imperative for developing Asia's economies to significantly improve their energy efficiency levels. Indeed, their continued competitiveness may ultimately hinge on this.