Publication Highlights *summarizes the* Asian Development Outlook 2001, *an annual publication of the Asian Development Bank. The* Asian Development Outlook 2001 *contains three parts. In the first section, performance and prospects for the world economy with particular reference to Asia are reviewed. The second section deals with recent developments and prospects for Asian and Pacific economies from a subregional perspective. The third section discusses the globalization challenge facing Asia.*

Part I
Developing Asia and the World

INTRODUCTION AND OVERVIEW

Growth in the world economy accelerated to an impressive 4.8 percent in 2000, the fastest in over a decade. The very strong performance for the year as a whole, however, masks a significant downshift in the second half as the United States (US), in particular, reached a cyclical peak and began to slow. As a result, the world economy entered the current year with considerably less growth momentum.

The US slowdown occurred as domestic demand growth began to shift to a much more moderate pace following several years of high growth. Japan's economy grew more rapidly than in 1999 but showed some signs of weakness after midyear. Growth also began moderating in several of the developing member countries (DMCs) of the Asian Development Bank (ADB) with close trading links to the US. Growth, however, held up or accelerated in much of western and eastern Europe.

Notwithstanding considerable uncertainty about near-term prospects, the *Asian Development Outlook (ADO) 2001* is cautiously optimistic that the world economy will experience only a relatively shallow and short-term

slowdown in 2001 before returning to trend growth in 2002. On the other hand, there are some significant downside risks in the near-term outlook.

Despite resource use rising to high levels in several major industrial countries, inflation generally remained subdued in 2000. Average inflation in the major industrial countries continued at its lowest rate for several decades before rising modestly in the second half of the year in response to a run-up in world oil prices. Among developing countries, inflation was also generally moderate.

Through most of the year, the dollar strengthened further in foreign exchange markets as the large and growing US current account deficit continued to be more than adequately financed by large capital inflows. This prompted the major central banks to undertake a coordinated intervention in September to slow the decline of the euro. In the fourth quarter, the dollar began to weaken somewhat, especially against the euro, as clear evidence appeared that the US economy was slowing.

Major equity markets remained at high levels in early 2000 with technology stocks, in particular, beginning the year with significant further advances. However, volatility in international financial markets began to increase later in the year as equity valuations, especially in the technology sector, collapsed. Within Asia, those DMCs that had benefited from the technology boom saw sharp further downward movements in their equity markets, in some cases reversing much of the gains made in 1999.

Looking forward, the outlook is for more moderate growth in 2001 and 2002 compared with the first half of 2000. *ADO* projections are that, following a cyclical slowing to around 3.5 percent in 2001, world growth will pick up to almost 4 percent in 2002, broadly in line with longer-term trends. As regards the major industrial countries, this strongly reflects a temporary sharp slowing of the US economy to a shade below 2 percent in 2001 followed by a recovery to around 3 percent in 2002. Growth in the euro area should moderate to 2.5–3.0 percent in both 2001 and 2002, from 3.4 percent in 2000. After some weakness in early 2001, growth in Japan is expected to pick up modestly to 1–2 percent in 2002.

The DMCs as a group are expected to experience a sharp slowdown as aggregate growth declines from over 7 percent in 2000 to 5.3 percent in 2001, before rebounding somewhat in 2002. This would reflect the effects of the slowing US economy and the moderation of the technology boom on many DMCs' recent dynamic export performance. Even then, the DMCs would still be one of the fastest-growing regions in the world. Parts of Latin America are also expected to slow quite sharply in 2001, given close trade linkages with the US, but the region as a whole is expected to hold up quite well. Eastern Europe and Africa are expected to be less affected by the US slowdown, provided that growth is reasonably well maintained in the euro area.

The projected slowdown for the DMCs as a whole in 2001 masks variations across subregions. Among DMCs, those expected to see fairly

sharp slowdowns are the newly industrialized economies (NIEs)—namely Hong Kong, China; Korea; Singapore; and Taipei,China—and the countries of Southeast Asia depending heavily on technology exports and their linkages with the US market. Some of these economies began to slow in 2000 as their recoveries matured and the technology boom cooled. Conversely, growth in the PRC and India is expected to hold up quite well, if domestic demand can be maintained.

Industrial Countries

GDP growth in the industrial countries accelerated to 3.8 percent in 2000, led by US growth of 5.0 percent. The euro area picked up to 3.4 percent as buoyant domestic demand was reinforced by export strength. Japan recorded growth of 1.7 percent, up from the 1999 rate, led by private nonresidential investment and exports.

Inflation in industrial countries picked up somewhat to a little over 2 percent in 2000, from 1.5 percent in 1999, primarily because of higher oil prices. Inflation was 2.4 percent in the euro area, a shade higher than in the previous year but generally subdued. Prices fell at a faster rate in Japan even as its economy recovered early in the year.

Stock markets were volatile in 2000. In the US, technology stocks weakened after reaching a peak in March as investors began to reevaluate earnings prospects and due to the outlook for further interest rate increases. Europe's bourses also showed some weakness but this was less severe. In Japan, stock prices were under downward pressure for most of the year, in part due to weakness in the technology sector.

In foreign exchange markets, the euro depreciated against the dollar up until late October before strengthening somewhat through the end of the year. Both the yen and the dollar experienced slight real effective appreciation.

Unemployment rates either fell or remained stable in 2000 in most industrial countries. In the euro area, unemployment fell by nearly a full percentage point to 9.0 percent against the background of increased labor market flexibility and the pickup in growth. In the US, the rate fell to 4.0 percent, a rate not seen in over 30 years, reflecting the growth improvement early in the year. The unemployment rate remained steady in Japan.

Short-term interest rates rose slightly in most industrial countries over the year. The US Federal Reserve raised short-term rates in the first half of 2000, as did the European Central Bank. Long-term interest rates remained relatively low, reflecting a benign view of long-run inflation and, in some countries, strong budgetary positions.

Helped by continued strong revenue performance in the last few years, fiscal positions in most industrial countries improved further in 2000. The US federal surplus grew to around 2 percent of GDP in 2000 from about 1 percent in 1999, while the euro area also had a small surplus compared

with a deficit of more than 1 percent of GDP in 1999. Conversely, the central government deficit widened further in Japan.

International imbalances increased further in 2000 as the US continued to grow more rapidly than other major industrial countries. In particular, the US current account deficit widened to almost 4.4 percent of GDP but was easily financed by strong capital inflows from the rest of the world. Interest rate differentials between the relatively high rates in the US and the lower rates in other industrial countries persisted and even widened slightly over the year.

The near-term outlook for industrial countries is dominated by the anticipated slowdown in US growth to less than 2 percent in 2001, followed by an upturn in 2002. In the euro area, growth is expected to moderate slightly in 2001 and 2002 but to remain relatively strong. In Japan, the outlook is for continued growth of 1–2 percent, with the momentum sustained by restructuring—intended to increase efficiency and improve resource allocation—and by fiscal and monetary support. Reflecting the global slowdown, industrial countries' inflation is expected to generally remain subdued or to further soften.

Transition Economies

The transition economies of central and eastern Europe in 2000 continued the economic recovery that began in the preceding year. Output growth was strong, accelerating to 5–6 percent, this is due partly to faster growth in the euro area and the revival in domestic demand in some of the transition economies. Supportive macroeconomic policies, including lower interest rates, some fiscal stimulus, and strong export performance, fueled growth of over 7 percent in the Russian Federation, 4–6 percent in Hungary and Poland, and almost 3 percent in the Czech Republic. Inflation was moderate in the Czech Republic but reached double-digit rates in Hungary, Poland, and particularly the Russian Federation, where it was just over 20 percent.

Growth in the transition economies is expected to remain relatively strong in 2001–2002 but more muted than in 2000. Much will depend on the progress in domestic economic reform and the external environment. Somewhat slower growth in the euro area, the major trading partner of these economies, will have a mild negative effect as will expected slower growth in the Russian Federation and a leveling off or slight decline in oil prices. Throughout this region, inflation should generally moderate as growth slows.

DEVELOPING ECONOMIES

Growth in the developing regions of the world improved to 5–6 percent in 2000 from less than 4 percent in 1999 and 3.5 percent in 1998. The DMCs as a group continued to be among the strongest performers. After

many countries in Latin America experienced weak or negative economic growth in 1999, the region saw revived growth of over 4 percent in 2000, led by strong performance in Mexico, Chile, and Brazil. In Africa, growth also accelerated as economic performance in South Africa strengthened, as did that of the oil exporters in the region—Algeria and Nigeria. In the Middle East, income rose more rapidly in 2000 than in 1999 on the back of higher oil prices in the second half of the year.

Growth in developing countries in 2001 is likely to depend on several factors. Commodity prices continue to be a critical external factor for many countries in Africa and the Middle East and to a lesser extent for Latin American countries and DMCs. The pace of growth in industrial countries will also be a critical factor that will impact on developing countries, especially exporters of manufactured goods. Domestic macroeconomic and structural policies will be important, particularly where countries have deep-seated weaknesses.

Africa and the Middle East

In 2000, buoyant oil markets gave a strong boost to oil producing countries in these two regions. Conversely, many of the non-oil producing countries suffered from adverse terms of trade as the price of their exports failed to keep up with the cost of imported oil and manufactured goods. Those countries where government policies have been weaker and/or where the adverse terms-of-trade effect has been compounded by civil disturbance or drought performed poorly. Economic growth resumed in Saudi Arabia and other Gulf and Middle East oil exporting countries in 2000. These countries have also begun to benefit from structural reforms undertaken, when petroleum prices were much lower, to stimulate the non-oil private sector.

Within Africa, output growth accelerated to about 3 percent, from around 2 percent in 1999, as a result both of more buoyant markets for some commodities, particularly petroleum, and the effects of implementation of better macroeconomic polices and structural reforms. The two largest economies in the region—Nigeria and South Africa—recorded growth of about 3 percent, the former aided by higher oil prices and the latter by greater external demand and growing international competitiveness. Several other African countries also grew more rapidly as they effectively implemented macroeconomic and restructuring policies. However, some countries suffered from a range of constraints including weak commodity prices, drought, and civil conflict.

Latin America

Growth in Latin America rebounded strongly to around 4 percent in 2000, from negligible growth in 1999. The region benefited from a combination of strong growth in the US, higher prices for some commodities, and generally sounder macroeconomic policies and

performance, particularly with respect to inflation. The two largest economies in the region—Mexico and Brazil—grew at about 7 percent and 4 percent, respectively. Mexico's buoyant economy was led by soaring exports, primarily of oil, to the US and by strong investment growth. Brazil benefited from greater export competitiveness following its currency depreciation in early 1999. Argentina began to recover from a severe recession in 2000 but growth was slower than expected. This resulted in severe financial pressures toward the end of the year. Venezuela benefited from higher oil prices, while the economies of Chile and Peru continued to perform well. Inflation in the region abated somewhat in 2000 as many countries have adopted either inflation targeting or policies with a strong inflation containment component.

Asian and Pacific Developing Member Countries

The DMCs' recovery from the financial crisis of 1997/98 strengthened in 2000 (see Table on page 7). The strong performance reflected the favorable external environment through most of 2000; expansive macroeconomic policies; competitive exchange rates; and, in varying degrees, progress in financial and corporate restructuring. Higher oil prices toward the end of the year had different effects on oil exporters and importers, but on balance were a negative factor for growth, and in some countries, it has pushed up inflation slightly.

GDP growth for the region was over 7 percent for the whole of 2000, up from just over 6.5 percent in 1999, though the pace slowed during the second half of the year. Domestic demand began to strengthen in a number of economies relative to the preceding two years. Hong Kong, China; and Singapore led the continued strong performance of the region, with economic growth in 2000 of about 10 percent. In Indonesia, Philippines, and Thailand, recovery continued but remained somewhat fragile due to incomplete structural reforms, political uncertainty, and generally weak private investment. Growth in the PRC and India, where the impact of the Asian crisis was more limited, continued at a rapid pace, primarily due to strong domestic demand and buoyant export performance.

Inflation was benign in 2000 for most DMCs. In the NIEs, except Hong Kong, China, prices rose slightly faster than in 1999 as a result of higher oil prices but, even so, inflation remained at less than 1.5 percent. In Hong Kong, China, the consumer price index continued its deflationary trend due to weakness in property rental prices. In the PRC, a strengthening of private consumption reversed the 1998–99 deflationary trend; the consumer price index rose by 0.4 percent. In Southeast Asia (except the Lao PDR and Myanmar), overall inflation remained low and relatively stable. In the Central Asian republics, Azerbaijan, and Mongolia; and Myanmar, inflation remained high, primarily due to the effect of currency depreciation on import prices and accommodative monetary policies. In South Asia,

Selected Economic Indicators, Developing Member Countries 1998–2002

	1998	1999	2000	2001	2002
Gross domestic product (annual percent change)					
DMCs	0.2	6.6	7.1	5.3	6.1
Newly industrialized economies	-2.9	7.9	8.4	4.3	5.6
PRC	7.8	7.1	8.0	7.3	7.5
Central Asian republics, Azerbaijan, and Mongolia	1.5	4.7	7.8	3.3	4.8
Southeast Asia	-9.0	3.1	5.1	4.0	4.8
South Asia	6.1	5.8	5.8	5.8	6.5
India	6.6	6.4	6.0	6.2	7.0
Pacific DMCs	-2.0	4.1	-1.8	3.4	5.0
Crisis-affected economies	-8.3	6.8	6.8	3.9	5.1
Inflation (percent change in consumer price index)					
DMCs	8.0	2.3	2.1	3.4	3.3
Newly industrialized economies	4.6	-0.1	1.1	2.2	2.5
PRC	-0.8	-1.4	0.4	2.0	2.5
Central Asian republics, Azerbaijan, and Mongolia	9.7	20.2	15.2	10.6	10.0
Southeast Asia	26.5	9.4	2.7	5.4	4.4
South Asia	6.3	4.2	6.2	5.4	4.8
India	5.9	3.3	7.0	5.5	4.8
Pacific DMCs	10.1	10.0	11.5	8.3	5.0
Crisis-affected economies	17.8	5.4	2.6	4.3	3.5
Current account balance (percent of GDP)					
DMCs	4.1	3.7	2.8	2.5	2.4
Newly industrialized economies	7.4	6.3	4.7	4.6	5.0
PRC	3.1	1.6	1.5	1.2	1.0
Central Asian republics, Azerbaijan, and Mongolia	-5.5	-1.3	2.5	2.6	3.6
Southeast Asia	4.7	6.6	5.2	3.6	3.0
South Asia	-1.4	-1.6	-1.9	-1.7	-1.5
India	-1.0	-0.9	-1.3	-1.2	-1.0
Pacific DMCs	1.2	3.0	6.4	—	—
Crisis-affected economies	6.5	5.9	3.8	2.8	2.3

— Not available.

Source: Staff estimates.

India experienced somewhat higher inflation due to deregulation of fuel prices and the depreciation of the rupee.

Several DMCs recorded double-digit export growth in 2000. The continuing global demand for goods related to information and communications technology (ICT) led to a surge in exports from India; Korea; Malaysia; Singapore; Taipei,China; and Thailand. Rising international oil prices stimulated exports from Indonesia and many of the Central Asian republics and Azerbaijan, while the PRC benefited from higher demand for its labor-intensive manufactured goods. Notwithstanding strong exports, more rapid growth of imports in 2000 led to a narrowing of current account surpluses in many DMCs. These surpluses were in some cases used to finance both external debt repayments and a further buildup in reserves, albeit generally at a much slower pace than in 1999.

Equity and currency markets declined significantly in 2000 in many DMCs. Externally, rising interest rates, slower growth in the US in the second half of the year, and the popping of the technology bubble triggered downward adjustments in equity markets. Domestic considerations also, in some cases, dampened investor enthusiasm and confidence in the region. These included incomplete restructuring of banks and corporations, limited progress in structural reforms, and perceived heightening of political risks in some countries. Domestic currencies weakened in the region due to concerns over an international growth slowdown and any resultant impact on regional growth through the export sector.

Prospects for 2001 and 2002

Compared with GDP growth of over 7 percent in 2000, growth in the DMCs is expected to slow to 5.3 percent in 2001 before picking up to just over 6 percent in 2002. The anticipated slowdown reflects primarily a sharp deceleration of export growth to single-digit levels in 2001. Private consumption is expected to moderate in 2001 as the income effects from the export sector spread during the year. Monetary policy is generally expected to be accommodative. Fiscal policy will be constrained by the need to reduce fiscal deficits in some countries, but it can provide support for domestic demand in others.

The projections for 2001 have been revised from the *ADO 2000 Update* to incorporate the effects of the sharper than expected slowdown in the global economy that is under way, as well as the stronger outturn for 2000.

The *ADO 2001* projections are based on a number of assumptions about the external environment. First, the US economic slowdown will only be brief with the US recovering to close to its long-term trend growth in 2002. Growth in the euro area and Japan is expected to slow marginally, though still maintain momentum in 2001 and 2002. Second, growth in world trade volume is expected to drop quite sharply in 2001 and then level off in 2002, while oil prices are assumed to remain in the $23–$28 per barrel range in 2001 and 2002. Third, macroeconomic

policies in industrial countries are assumed to be supportive of the recovery to stronger growth in 2002 through an accommodative monetary and fiscal stance.

RISKS AND UNCERTAINTIES

The main external risks for DMCs in 2001 and 2002 relate to the prospects for the US economy. This was central during 1998 and 1999 when the US economy was the main locomotive of global growth, given weakness in much of Europe, Japan, and the developing world. A sharp US slowdown at that time risked plunging the world into recession with adverse implications for many countries, including DMCs struggling to grow out of the 1997/98 financial crisis. In view of the broadening of the global recovery in 2000, the risks in this area have clearly receded, but have not entirely disappeared given the size and importance of the US economy and some fragilities in the rest of the world.

Key assumptions underlying the projections are that the current slowdown in the US will not be very severe and that the other major industrial economies have sufficient momentum to keep the world economy growing at a satisfactory pace in 2001 and 2002 as the US recovers from its current weakness. Each of these assumptions can be considered in turn.

The expectation that the US slowdown will not be very severe or long-lived is based on strong macroeconomic fundamentals, flexible product and factor markets, and the possibility that recent investments in high technology have permanently and significantly boosted the economy's potential growth rate.

But there is considerable uncertainty about the size of the "new economy" effects and the extent to which US productivity growth has been permanently raised. In addition, questions remain about high US stock market valuations and the prospects for the dollar (in light of the large US current account deficit). It is possible that imbalances in these areas are small and could be reduced gradually, especially if new economy effects are very important. But the argument might also be plausibly made, based on historical experience, that the necessary adjustments could be large and disorderly with significant adverse effects on growth.

The projections for the near-term outlook for the US economy have been made from the middle ground. On the one hand, it is assumed that the slowdown will be sharper and longer-lived than the hiccup assumed by new economy advocates. On the other hand, the projections assume no deep or long recession, such as might occur if the US economy faced a significant further stock market correction or if the dollar came under severe pressure.

The other key assumption—that the other major industrial economies have sufficient momentum to keep the world economy growing—is based on the judgment that growth in Europe, and especially the euro area, has become sufficiently self-sustaining to withstand a slowdown in US imports.

An important concern for the euro area, however, would be a sharp correction in the euro/dollar exchange rate due, for example, to unwillingness of investors to continue to finance the US current account deficit. Were the resulting appreciation of the euro to be very large and rapid, this could harm export competitiveness and growth. Although this is an important risk, it should not be exaggerated as some of the funds that previously financed the US deficit would no doubt move to the euro area and would help boost European financial markets, offsetting somewhat the adverse implications of euro strength for external competitiveness.

Although recent data for Japan suggest some faltering of the recovery in 2000, it is premature to conclude that the economy will slip back into recession. Indeed, the projections suggest that the recovery will remain largely on track in 2001—albeit at a slightly lower rate than in 2000—before picking up momentum again in 2002. There are, however, risks if the US economy makes a hard landing.

Turning to the DMCs, the main external risks relate to the effects of slower growth in the US. Although the projections already take account of a US slowdown, the size of its effect is uncertain, given both the key role that the strong recent expansion in the US played in helping DMCs grow out of the 1997/98 financial crisis and the fragility of some of the recoveries in DMCs. In addition, there is uncertainty about the implications of the US slowdown for the terms and conditions of DMCs' access to international capital markets. The possibility of an increase in risk aversion and tighter terms for external financing cannot be excluded, especially if major stock markets remain volatile.

As background, the 1997/98 financial crisis gave an important lesson to many DMCs on the risks of financial integration. Not surprisingly, therefore, concerns have been raised as to whether such a crisis could happen again in the event of a sharp deterioration in the external environment. As currencies and stock markets in a number of DMCs tumbled in the latter half of 2000, many commentators wondered whether the region was seeing a repeat of the earlier crisis.

There are several reasons for believing that the current situation is fundamentally different from that of 1997/98, and that another crisis is, therefore, extremely unlikely.

- First, and most important, the external shock that the region faces this year is primarily a real rather than a financial shock, related to the slowing in one of the region's major export markets.
- Second, reflecting policy reforms and adjustments since the financial crisis, many DMCs have considerably stronger external situations than a few years ago.
- Third, the structure of capital flows to many DMCs has changed since the mid-1990s with portfolio flows and relatively stable foreign direct investment (FDI) largely replacing volatile short-term bank loans.

- Fourth, many DMCs—including several with relatively open external capital accounts—have adopted more flexible exchange rate arrangements.
- Fifth, many DMCs have embarked on comprehensive reform programs to enhance the safety and soundness of their financial systems and strengthen corporate sectors.
- Sixth, transparency has been improved considerably in many DMCs, making the reappearance of the kind of regionwide negative surprises that figured prominently in the 1997/98 crisis unlikely.
- Finally, the degree of leverage and the activities of investment hedge funds have been cut back in the last few years, making the intense speculative pressure that was evident in the earlier crisis less likely.

Against this background, the current situation appears quite different from that of 1997/98. Yet, this does not imply that DMCs should be complacent about the outlook for 2001. In this connection, some vulnerabilities are:

- high dependence of recoveries in some DMCs on export growth (despite recent pickups in domestic demand);
- concentration of some DMCs' exports in a relatively few product groups, such as technology goods that are currently slowing sharply as the US weakens;
- incomplete progress in financial sector restructuring as reflected in either continued relatively high levels of NPLs and/or inadequate provisioning for bad loans;
- inadequate progress in corporate restructuring as reflected in poor profitability and/or continued high leverage ratios;
- unbalanced recoveries in which some domestic sectors (such as construction) and certain demand components (such as investment spending) have remained relatively weak, even with rapid GDP growth; and
- political difficulties and uncertainties that may impair DMCs' ability to deal effectively with the problems created by a growth slowdown, and that may hinder the pace of economic recovery and reform.

The extent of these vulnerabilities as well as their implications vary significantly across and within country groups in the region. Perhaps the most vulnerable countries are among the five most severely affected by the 1997/98 crisis. To varying degrees, these five countries have been undergoing a sharp "V-shaped" rebound in the last three years and recording, in many cases, very impressive growth. Initially, the recovery was driven mainly by exports. However, domestic demand has in some cases been largely driven by spillovers from the export sector, rather than by autonomous factors.

The other DMCs likely to be significantly affected by the US slowdown are Hong Kong, China; Singapore; and Taipei,China. These three NIEs were less severely affected by the Asian financial crisis and thus are not undertaking the kinds of broad recovery programs adopted by the other five. Like the five countries, however, recent growth has generally been

heavily dependent on exports, including technology items, and their exports are generally expected to slow sharply in 2001, contributing to lower GDP growth that year before a rebound in 2002.

Finally, the PRC and India will obviously be affected by the US slowdown given the importance of exports in their recent expansions. In addition, each economy, to varying degrees, has benefited from the technology boom. At the same time, however, each country has a substantial nontraded sector and domestic demand has been driven significantly by the implementation of economic reforms and supportive domestic macroeconomic policies. If exports slow rapidly, growth could be sustained in these countries through the implementation of domestic structural reforms and, to the extent that medium-term sustainability is not compromised, through continued supportive fiscal policies. In general, the ability of these two countries to sustain growth is likely to be much greater than in the case of the five crisis-affected countries. And indeed, by maintaining domestic demand growth, the PRC and India can help provide economic stability to the region.

The effects of the US slowdown on DMCs will depend heavily on the behavior of intraregional trade. This has grown significantly over the last decade and can play a role in reducing the region's vulnerability to external factors, such as a slowdown in the US. Whether intraregional trade will, in practice, play such a role will depend on its composition and the factors driving its growth. Hence, for example, if it has been driven mainly by autonomous demand in the region, it might be expected to provide a significant buffer to an external slowdown. Conversely, if outsourcing of production for the region's exports has driven its growth, then it may be less resilient. Based on available data, a sizable share of intraregional trade seems to involve intermediate inputs. Even though this implies that, if such trade will not necessarily be a major buffer to a US slowdown, it does not rule out a stabilizing influence, especially if the PRC and India show continued strong domestic demand growth.

Part II
Economic Trends and Prospects in Developing Asia

NEWLY INDUSTRIALIZED ECONOMIES

Growth in the newly industrialized economies (NIEs) accelerated to 8.4 percent in 2000 from 7.9 percent in 1999 as the subregion further recovered from the Asian financial crisis. Rapid export growth led the expansion, supported by strong investment spending and a moderate increase in consumption. The economic performance of the four economies was more consistently broad based relative to 1999 as Hong Kong, China; Korea; and Singapore all recorded similar growth rates of about 9–10 percent.

Exports were boosted by robust demand from the US. For the subregion, the rate of growth in shipments increased to 19.5 percent in 2000 from 5.5 percent in the previous year. The rapid increase in demand for exports triggered a surge in domestic investment, especially in the electronics sector. Gross capital spending was particularly strong in Korea; Singapore; and Taipei,China. Private consumption spending rose as consumer confidence increased, labor markets tightened, and property prices firmed.

On the supply side, the industry sector performed well in Korea; Singapore; and Taipei,China, buoyed by production in the high-technology sector, particularly electronics. In Hong Kong, China supply-side growth was led by the services sector, while the relocation of manufacturing to nearby mainland provinces continued.

Despite a rise in interest rates in industrial countries in the first half of 2000, monetary policy was basically neutral and there was little interest rate volatility. Korea and Singapore maintained relatively flat rates throughout the year, while Hong Kong, China generally kept pace with interest rate developments in the US. Fiscal policy was tightened during the year, partly because rapid growth brought in more taxes than anticipated. The fiscal surplus increased in Singapore; the deficit fell in Taipei,China; and the deficit turned into a surplus in Korea.

Inflation remained subdued in the subregion, though some upward movement toward the end of the year was seen in response to higher world oil prices. However, capacity utilization rates remained comparatively low in contrast to the years before the financial crisis and had a moderating effect

on inflation, as did generally tighter fiscal policy. In Korea, for example, the rate of capacity utilization was around 70 percent. In Hong Kong, China, fierce competition in the retail sector led to price deflation.

Although net exports made a positive contribution to growth in the NIEs, the size of this contribution diminished, from a peak of around 7 percentage points on average in 1998, to about 2 percentage points in 2000. This is primarily because imports also grew quite rapidly, reflecting a combination of restocking of intermediate inputs and, increasingly, of rising demand for consumer goods, as domestic demand conditions improved.

As the NIEs are small open economies with a substantial international trade share of GDP, their prospects depend largely on external developments in industrial countries. In 2001, GDP growth is likely to fall back to just over 4 percent for the group. Slower export growth will be the main cause of this: from 19.6 percent in 2000, it is projected to fall to 7.5 percent. Slower export growth translates into a slowdown in domestic consumption and investment. The inventory cycle will also play a role in taking investment lower as firms work off excess inventories as external demand softens. Nevertheless, some additional investment in the high-technology sector is expected as the NIEs invest in new equipment and processes to enhance productivity and to take advantage of developments in the new economy. Furthermore, the strong performance of the People's Republic of China and its strong trade linkages with Hong Kong, China and with Taipei,China should provide a partial buffer for these two economies.

Governments are also likely to adopt appropriate macroeconomic policies to soften the downturn. Across the NIEs, monetary policy is expected to ease more and interest rates may fall further, while a further weakening of exchange rates in Korea; Singapore; and Taipei,China is also likely. Fiscal stimulus is more likely in Korea and Singapore than in Hong Kong, China and Taipei,China. Economic restructuring will continue in the NIEs as they make the transition toward higher value-added and technology-intensive products and services. This will involve additional investment in new plant and equipment and in research and development. Sophisticated services-based activities and broadened diffusion of ICT pose challenges to those workers with fewer skills and lower education. Further upgrading of the workforce will be needed, particularly at the post-secondary level. Greater investment in physical infrastructure, particularly in the ICT sector, will also be required.

In the financial sector, especially banking, the NIEs face a variety of challenges, from overcrowding, low profitability, and growth of nonperforming loans in Taipei,China; to the continued problem of restructuring of financial and corporate institutions in Korea; to the development of domestic capital markets in Singapore; and to the strengthening of the regulatory framework and increasing efficiency through greater competition in securities and futures markets in Hong Kong, China. To meet these challenges, flexible policies will have to be developed to deal with a rapidly changing and potentially volatile external environment.

CENTRAL ASIAN REPUBLICS, AZERBAIJAN, AND MONGOLIA

This group of countries face challenging geographic and economic circumstances. These include the relatively small size of their economies; remoteness from world markets; long-term isolation from global technology and capital flows; heavy dependence on primary production of energy, minerals, and other commodities; continuing vulnerability to external shocks arising from volatility in international oil and commodity prices; dependence on the Russian economy (which is still the single largest market for their exports); and an industrial structure from the Soviet era that is hardly compatible with an open economy.

Problems of systemic transition and the severance of Soviet fiscal subsidies further exacerbate these formidable economic challenges. This has resulted in a sharp decline in human development indicators and emergence of widespread poverty. Recently, the appearance in some of these countries of social, religious, and ethnic strife, which perhaps lay dormant under the strictures of the earlier centrally controlled regime, has added to the uncertainty, affecting the investment climate and growth prospects of these economies.

Faced with such adverse circumstances, the various governments have implemented a large-scale and wide-ranging program of structural reforms, though with significant variations across countries. On the basis of these reforms and with external circumstances finally turning favorable in 1999, most of these economies—with the exception of Mongolia—are now recovering from the economic downturn that lasted, for most of them, from the breakup of the former Soviet Union until the mid-1990s when the decline in GDP was arrested and positive growth was achieved. This recovery was nearly derailed as a result of the Russian crisis of August 1998 that followed in the wake of the Asian financial crisis.

The improvement in the Russian economy since 1999 and the rise in international energy prices have helped generate strong aggregate GDP growth of nearly 5 percent in 1999 for these countries as a whole; this growth improved further to almost 8 percent in 2000. The growth performance would have been better if the agriculture sector had not suffered a severe drought that affected the cotton crop, a major export item, and food grain production in some countries.

More creditably, the improved growth performance has been achieved along with overall macroeconomic stability. The aggregate level of inflation in these seven countries remained high at around 15 percent in 2000. This reflected the positive effects of exchange rate stability and tighter monetary policies. Higher revenues from the oil sector and efforts at improving public expenditure management and tax administration have seen the countries' fiscal balances improve.

Taking advantage of high international oil and gas prices and greater access to pipelines and other supply outlets, the export earnings of the group increased from virtually zero to about 25 percent in 2000 (excluding Azerbaijan and Turkmenistan). This enabled some of these countries to improve their external account balances as reflected in the buildup of international reserves and the significant improvement in external debt-service ability. The Kyrgyz Republic and Tajikistan, though, face an unsustainable external debt-service burden in the short term. This has prompted a multilateral review of their external debt liability and bilateral negotiations for rescheduling their debt-service flows.

Although the positive aggregate economic performance hides wide variations across countries, the economic outlook for this group is upbeat. Economic growth will remain positive, though lower than in 2000 as oil prices are expected to soften and demand from the Russian Federation and other countries in the Commonwealth of Independent States slackens as a result of a slowing of these economies. Agricultural performance is expected to remain weak if the adverse weather forecasts for the next two years are proved right. Even with strong and sustained GDP growth as achieved in the last two years, per capita income levels in these countries are not expected to return to the levels of the late 1980s for the next few years. Determined policy efforts will be needed to ensure that market-based economic growth does not cause equity disparities to rise further and that growth is inclusive.

For generating sustained growth in per capita incomes and for reducing poverty levels, the countries, to greater or lesser degrees, need to vigorously pursue their structural reform programs. The focus has to be on generating pro-poor growth while maintaining macroeconomic stability. This will require liberalizing the economies further, in keeping with individual country conditions; removing any significant price distortions and controls on the current account; privatizing state enterprises and setting up a regulatory mechanism to ensure fair competition and consumer protection; establishing the institutional framework for private sector-led growth; ensuring that the poorer segments of society participate in the growth process; and putting in place a social safety net that will protect the poor and vulnerable from the adverse impact of cyclical economic downturns.

PEOPLE'S REPUBLIC OF CHINA

GDP growth in the PRC accelerated to 8.0 percent in 2000 from 7.1 percent in 1999. Growth in 2000 was driven mainly by industry and by domestic consumption and investment. Industrial growth accelerated to 9.6 percent from 8.1 percent. The profitability of both private and state-owned enterprises (SOEs) improved as a result of increased consumption demand, and reform measures such as debt-equity swaps. The services sector likewise improved, posting 7.8 percent growth in 2000, compared

with 7.5 percent expansion in 1999. The agriculture sector, on the other hand, suffered from a severe drought and a decline in retail food prices. Grain output fell by about 9 percent in 2000.

After slowing for five consecutive years, retail sales grew by 9.7 percent, up from 6.8 percent growth in 1999. A combination of fiscal stimulus packages and a recovery in private investment led to 9.3 percent expansion in 2000 in domestic fixed investment. An accommodative monetary policy boosted domestic demand: the prime lending rate was 5.9 percent from June 1999, compared with 11 percent in mid-1996. Since June 1999, the domestic bank lending rate has been lower than the comparable rate on dollar-denominated assets in the international market.

The deflationary trend of the previous two years was largely arrested in 2000: the consumer price index increased by 0.4 percent. However, excluding oil-related goods and one-time price adjustments for some service products, the index declined slightly in 2000, mainly because of lower prices for agricultural products.

The official estimate of urban unemployment in 2000 was about 3.1 percent of the urban labor force, the same level as in the previous year. However, this estimate covers only those registered with the Ministry of Labor and Social Security. It does not include about 7 million *xiagang* workers (i.e., those who were laid off as part of ongoing SOE reforms) who have not found alternative employment. When *xiagang* workers are included, urban unemployment rises to about 7 percent.

Fiscal policy in 2000 remained expansionary. An additional Y50 billion stimulus package was announced in August 2000. Revenue collection was 16.9 percent higher than in 1999 because of improved performance in industry, recent fiscal reform measures including those against smuggling, and strong growth of external trade. Despite this, the fiscal deficit in 2000 widened to 2.8 percent of GDP compared with 2.1 percent in 1999. Broad money supply grew by 12.3 percent in 2000, slightly lower than in 1999.

To prepare the economy for membership of the World Trade Organization (WTO), the People's Bank of China, the central bank, is considering mechanisms to gradually allow a greater role for market forces in determining interest rates. As a first step, interest rates on foreign currency loans and foreign currency deposits of more than $1 million were liberalized in the third quarter of 2000.

With the recovery of the countries affected by the Asian financial crisis and strong growth in the US economy, exports from the PRC surged in 2000 by 27.8 percent while imports rose by 36.8 percent. The current account surplus in 2000 amounted to $14 billion or 1.5 percent of GDP. Actual foreign direct investment increased by 4 percent in 2000, while contracted foreign investment rose by 51 percent. With foreign exchange reserves of $165 billion and an external debt of $156 billion, the external payments situation remained comfortable.

Driven by domestic consumption growth, the economy is forecast to maintain annual GDP growth of 7.3 percent and 7.5 percent in 2001–2002, respectively. Both the industry and services sectors should grow at about 8 percent in this period, and the agriculture sector at about 3 percent. Domestic consumption is projected to remain strong as the general domestic economic environment improves. With the pickup in domestic consumption and economic growth, the deflationary trend in prices will be reversed. Furthermore, the impact of rising world oil prices will push up production costs. Given significant excess capacity in many industries, including several consumer industries, the net result is that inflation is likely to be about 2–2.5 percent in 2001–2002. Urban unemployment could further rise as more workers are laid off as SOE reforms continue.

Export growth is forecast to decline to about 10–15 percent in 2001–2002, reflecting a slower global economy and the high base of 2000. With the PRC's entry into WTO and the liberalization of trade policies, including fewer tariff and nontariff barriers, imports will continue to grow faster than exports in the next few years. As a result, the current account surplus will gradually decline. However, the fall in the current account surplus will be offset by larger inflows of foreign investment and the level of foreign exchange reserves will increase further, providing import cover of about eight months of imports. The exchange rate is expected to remain stable.

Issues that the Government must resolve in the coming years include strengthening the financial system, addressing urban poverty, adjusting the economy to WTO rules, and reducing income disparities between regions. The establishment of four asset management companies (AMCs) to resolve the problem of NPLs in the banking system in 1999 was a major milestone in financial sector reform. Many of the problems in the financial sector are related to ailing SOEs, which account for a large portion of bank NPLs. While the transfer of a significant proportion of NPLs to AMCs will improve the financial position of the banks, the ultimate success of the AMCs will depend on the rate of recovery from NPLs.

SOUTHEAST ASIA

GDP growth in Southeast Asia improved to 5.1 percent in 2000, from 3.1 percent in 1999 as the economic recovery that began in 1999 continued to broaden and deepen. The driving force behind the momentum was robust external demand for the subregion's products and a slight increase in domestic demand. These overall trends, however, masked significant variations among countries, with GDP growth ranging from 8.5 percent in Malaysia to 3.9 percent in the Philippines. Moreover, toward the end of the year, economic growth seemed to lose some of its momentum with export growth, particularly of electronic products, declining sharply.

While exports across the subregion received a boost in 2000 from strong US growth and recovery elsewhere in Asia, domestic demand growth

has been underpinned in a majority of countries by expansionary fiscal and monetary policies. While public consumption and investment have substantially increased since the Asian financial crisis, private consumption remains relatively subdued despite rises in public sector wages and tax breaks. However, the distinction between cyclically advanced and less advanced economies is important. In Malaysia, private consumption has grown strongly on the back of greater consumer confidence resulting from higher export revenues, employment levels, and real wages, and low interest rates. On the other hand, in Indonesia, Philippines, and Thailand, consumer sentiment remained downbeat in 2000, due to weakening currencies and uncertainty over the sustainability of recovery.

Although renewed investment in export-oriented industries has led to a recovery in private capital formation from the crisis-induced contractions of 1998 and 1999, the overall level of gross fixed capital formation in 2000 remained considerably below precrisis levels. Private investment activity (especially foreign direct investment) remained slack owing to a combination of factors that included excess capacity in non-export industries, weak corporate sector profitability, and incomplete corporate and financial sector restructuring. Moreover, in Indonesia and the Philippines, this has been compounded by political uncertainty, civil unrest, and a perceived lack of transparency in business practices. These factors, together with a lack of market orientation, have also hindered private capital formation in Cambodia, Lao PDR, and Viet Nam.

Low interest rates, made possible by subdued inflation, helped balance sheet restructuring in the corporate and banking sectors and limited the growth of public debt-service payments. However, weak loan growth across the subregion due to concerns by banks over their asset quality has tended to reduce the effectiveness of an accommodative monetary stance. Moreover, in Indonesia and the Philippines, the authorities pushed up interest rates during 2000 to defend weakening currencies in the face of persistent doubts over their resolve to implement needed structural reforms.

Despite a pickup in subregional inflation during the last quarter of 2000 as a result of higher oil prices, overall inflation during the year remained low and relatively stable due to moderate food price inflation and continued excess capacity in certain production sectors.

Current account surpluses throughout the subregion narrowed during the year due to a recovery in imports, in spite of robust export growth. This owed much to higher domestic economic activity, the import-dependent nature of manufactured exports, and (except for Indonesia, Malaysia, and Viet Nam) higher oil prices.

Immediate prospects for the subregion have been clouded considerably by less hospitable external and domestic environments. Subregional economic growth is expected to slow to 4.0 percent in 2001 before picking up to 4.8 percent in 2002. The outlook for the US economy has deteriorated: a relatively sharp slowdown in GDP growth is expected in the

first half of 2001 before activity picks up in the second half of the year. This is likely to have a significant negative impact on Southeast Asia's exports in general and electronic products in particular, as the US remains the subregion's largest export market, accounting for some 20 percent of total exports. Individual country exposure to electronics exports varies from 14 percent of total exports for Indonesia to around 60 percent of total exports for Malaysia and the Philippines. The slowdown in the US is also likely to adversely affect exports within the subregion, given that a large proportion of these exports form part of linked production sites that ultimately feed final demand for goods from industrial countries. Slower export growth will also hold back domestic consumption and investment in the subregion. Moreover, investment activity in 2001 is likely to remain subdued owing to incomplete corporate sector restructuring in Indonesia, Malaysia, and Thailand. A perceived nontransparent investment environment in Indonesia, Philippines, and Viet Nam, and ongoing political uncertainty and civil unrest in Indonesia are other factors that are likely to hinder inward investment into the subregion. In Cambodia and Viet Nam, which are less dependent than most other countries in the subregion on electronics exports, GDP growth is likely to remain stable or even increase in 2001 due to a recovery in agricultural production, after the effects of severe droughts in 2000.

In the medium term, high growth in Southeast Asia can only be sustained if governments step up the pace of structural reforms. In the countries worst affected by the financial crisis, although substantial progress has been made in corporate and financial sector restructuring, some items on the reform agenda remain: nonperforming loans are unacceptably high, and the pace of restructuring of heavily indebted companies is slow. In the Lao PDR and Viet Nam, as well as pursuing banking sector reform, the governments should play a less active role in the economy while enhancing their regulatory and supervisory capabilities to promote greater competition. These governments also need to expedite trade liberalization by dismantling existing quantitative restrictions. In addition, throughout the subregion, governments need to enhance human resources development to provide greater flexibility to take full advantage of the opportunities that globalization presents.

SOUTH ASIA

In 2000, the seven South Asian economies achieved generally healthy growth by virtue of a combination of factors, the most noteworthy of which were a strong recovery in agricultural production, rejuvenated export activities, an increase in private sector dynamism, and substantial price stability. India's economy grew at a rate of 6.0 percent in 2000, one of the best performances among developing member countries, led by the service sector which grew at over 8 percent. India continued to make rapid progress

in developing the information and communications technology sector, which has played a major role in recent robust growth performance. Pakistan's GDP growth of 4.8 percent in 2000 was the highest since 1997, and was the result of a strong agriculture sector and an increase in exports. The year's outcome was quite encouraging in view of poor performance in recent years. Bangladesh also recovered well from moderate growth in 1999 when floods devastated the country. The pickup was mainly the result of a bumper crop, helping the country achieve self-sufficiency in food grain production for the first time in many years. Other countries in the subregion showed generally strong signs of recovery during the year, attributed largely to higher agricultural growth.

Large fiscal deficits remained a concern in the majority of South Asian countries. The fiscal position of central as well as local governments generally showed no improvement despite continued efforts to stabilize annual budgetary shortfalls and restructure overall revenue and expenditure programs. Pakistan and Sri Lanka saw an increase in the fiscal deficit, mainly due to an overrun in defense expenditures. India's fiscal deficit contracted from 5.5 percent of GDP in 1999 to 5.1 percent.

Inflation was generally kept under control in the subregion, although in India the wholesale price index rose to 7.0 percent in 2000 from 3.3 percent in 1999. Higher world oil prices were the primary cause of this spike. Bangladesh did well in controlling consumer price inflation to only 3.4 percent, compared with substantially higher levels in previous years, thanks largely to greater availability of food items from the bumper harvest. Nepal also exhibited noteworthy stabilization in inflation for the same reason. In Bhutan, price developments were highly dependent on inflationary trends in India, while in the Maldives lower inflation resulted from better fiscal and monetary management.

The export sector played a key role in the subregion's economic recovery. Following moderate growth of about 11.6 percent in 1999, India's exports improved further by about 17 percent in 2000, helped by faster global trade expansion and by depreciation of the rupee. Exports from Bangladesh recovered significantly due to improved foreign demand for ready-made garments and knitwear, its two key products. Sri Lanka's exports increased by 19.8 percent and the growth of exports in Pakistan was also strong at 8.4 percent. Because exports were buoyant in all the countries of the subregion, the majority of them held their current account deficits to around 2 percent of GDP or less.

Macroeconomic forecasts for the next two years are cautiously optimistic, although the slowdown in the US economy will have an adverse impact on both economic growth and export performance. Nevertheless, the impact of the US slowdown will probably be less pronounced in this subregion than elsewhere in Asia, simply because it is less dependent on the US market. India is likely to show GDP growth of 6–7 percent in 2001 and 2002, and Bangladesh, Pakistan, and Sri Lanka of about 4–6 percent over the same

period. Inflation is forecast to be modest, barring another steep rise in international oil prices and assuming that weather patterns are normal, contributing to solid agricultural performance. Exports from the subregion, except Bhutan and Sri Lanka are likely to show double-digit growth while imports will also be boosted by the import demand of export industries. This should lead to current account positions similar to those of 2000.

The subregion faces many formidable challenges that could have serious repercussions for socioeconomic development if they are not addressed promptly. It has had persistently large fiscal imbalances that are a concern as they are the main reason for the crowding out of financial resources for the private sector, underdevelopment of the financial sector, and high credit costs. It is, therefore, crucial that governments ensure prudent fiscal management by reforming expenditure programs, broadening and modernizing the tax base, and reforming their tax administrations. All these measures have to be accomplished within a rigorously planned medium-term target aimed at a rapid reduction of the fiscal deficits.

Another major issue is pervasive poverty. The subregion is home to more than half Asia's poor people. Poverty reduction efforts have not been successful in the past largely because of high population growth, insufficient GDP growth, low human development, and improper social assistance for the poor. Sustained vigorous reforms to address macroeconomic and social sector impediments are, therefore, critical if the subregion is to improve the people's welfare and accelerate socioeconomic progress. More rapid, equitable, and sustained economic growth should be pursued, since only this can increase the level of per capita income. However, certain microlevel antipoverty programs need to be simultaneously implemented for both rural and urban poor, with recognition of the large differences in underlying circumstances of the two groups.

THE PACIFIC

The momentum of economic recovery in the Pacific, begun in 1999, was not sustained in 2000 due to political instability and social unrest in the Fiji Islands and Solomon Islands. Further, growth in the largest economy in the subregion, Papua New Guinea, slowed significantly. Aggregate real GDP of the 12 Pacific developing member countries (DMCs) declined by 1.8 percent in 2000 compared with 4.1 percent growth in the previous year. However, this masks improved growth for some Pacific DMCs, led largely by tourism and construction.

Fiji Islands, Kiribati, Marshall Islands, and Solomon Islands saw their economies contract. While the contraction in Solomon Islands was broad based and affected the entire formal sector of the economy, the nonagriculture sectors, including tourism and garments, were the worst affected in the Fiji Islands. Declines in real GDP in Kiribati and the Marshall Islands were largely due to contractions in the industry sector and weaker

domestic demand. Papua New Guinea's growth slowed largely due to a contraction in mining. Cook Islands, Federated States of Micronesia, Papua New Guinea, Samoa, Tonga, Tuvalu, and Vanuatu saw growth in real GDP. While Cook Islands, Tonga, and Vanuatu experienced buoyant growth in visitor numbers due to their weak currencies, promotion activities, and unrest in the Fiji Islands, GDP growth was led by construction activity in Samoa, Tuvalu, and Vanuatu.

Inflation in Cook Islands, Kiribati, Federated States of Micronesia, Nauru, Papua New Guinea, Tonga, Tuvalu, and Vanuatu rose in 2000 as a result of weakening currencies and increasing world oil prices. In contrast, the Marshall Islands—which uses the US dollar as its medium of exchange—experienced deflation of about 2 percent, caused by US dollar strength. Inflation in the Fiji Islands and Solomon Islands declined slightly, largely due to a fall in demand, although it still remained high in Solomon Islands at 6.6 percent due to shortages of local food supplies.

Except for Cook Islands, Marshall Islands, Papua New Guinea, and Vanuatu, Pacific DMCs' overall balance-of-payments positions deteriorated, mainly due to higher oil costs in 2000. The balance-of-payments positions improved markedly due to a stronger US dollar in the Marshall Islands, improved exports in Papua New Guinea, and increased transfers from international aid agencies in Vanuatu.

Government deficits in 2000 widened in Fiji Islands, Kiribati, Solomon Islands, and Vanuatu; in Samoa the budget surplus switched to a deficit, while the surplus in the Marshall Islands fell. In the Fiji Islands and Solomon Islands, the higher deficit was caused by the disruption to economic activities stemming from political instability and social unrest. In Samoa and Vanuatu, the main cause of the increase in the deficit was the launching of large development projects.

The external debt position improved in 2000 in most Pacific DMCs. However, a few of them, including the Federated States of Micronesia and Nauru, still have very high debt-service ratios.

With a gradual return toward normalcy in the Fiji Islands and Solomon Islands, and the expected response of the Papua New Guinea economy to the reforms currently under way, the medium-term growth prospects are solid for Pacific DMCs. The outlook is for inflation to fall in most Pacific DMCs during 2001 and 2002 in response to a slowing world economy, rebounding currencies, and lower oil prices. The exceptions to this outlook are Fiji Islands, Marshall Islands, and Samoa, with a buildup of some inflationary pressure in Samoa due to strong economic growth being a concern. However, subregional macroeconomic stability is fragile, and is vulnerable to internal and external economic developments. Securing and maintaining both macroeconomic and political stability remain crucial for ensuring a strong economic future.

The small Pacific DMCs are subject to high variability in government revenue due to their vulnerability to external economic developments, and

their heavy reliance on aid, royalties from natural resources, and other irregular or windfall forms of revenue. Some Pacific DMCs have introduced trust funds, or some form of revenue equalization reserve fund, to assist in smoothing government revenues. Success varies: Kiribati, Tonga, and Tuvalu have managed to develop quite substantial funds, though the size of the Marshall Islands fund is still modest.

Many Pacific DMCs, particularly Papua New Guinea, Solomon Islands, and Vanuatu, have low human development and high poverty indices. The cost of living in Pacific DMCs is high because of steep transportation costs. Pacific DMCs also face issues related to vulnerability to natural disasters and access to basic services, particularly in the more remote islands. In addition, social and economic inequalities are growing, as are inter-island and rural-urban disparities. In this regard, greater poverty and rapid environmental degradation, due to increasing populations and overexploitation of natural resources, are issues requiring urgent resolution.

Part III
Asia's Globalization Challenge

This part of the *Asian Development Outlook 2001* deals with globalization and the interface of Asian economies with this ongoing dynamic process. Globalization can be defined as the ongoing economic, technological, social, and political integration of the world that began after the Second World War. There are several dimensions to this process, including the increased internationalization of economic markets as reflected, for example, in trade and financial capital flows. However, there are also institutional and social changes that are taking place within the geographic borders of states, though these are much more difficult to quantify. Globalization is impacting the institutional framework in both developing and industrial countries; it is changing the way in which governments view their developmental role in society.

THE ASIAN GROWTH EXPERIENCE AND GLOBALIZATION

Two major themes are developed in this section. The first is that an increasing number of DMCs have capitalized on globalization to achieve rapid growth and poverty reduction. Participation in the global economy strengthened through growth in international trade and movement of capital and labor. The second theme is that policies and institutions were tailored to facilitate growth based on factor accumulation, particularly in the early stages of the growth process.

The rapid growth of Asia in the last three decades, particularly of the NIEs of Hong Kong, China; Korea; Singapore; and Taipei,China, as well as the economies of Southeast Asia, has been widely documented. This rapid progress in economic development occurred through export-led growth accompanied by high savings and investment rates, competitive pricing, a supportive macroeconomic framework, inflows of new technology, and a dynamic response to the changing pattern of overseas demand.

International Trade Trends

As more DMCs adopted an export-oriented growth strategy, world trade accelerated as did trade among DMCs. In both Taipei,China and

Hong Kong, China, trade with the PRC increased while the PRC's trade with the region fell as OECD markets became more important. Korea began to export more manufactured goods such as automobiles to the rest of Asia. For Singapore, trade with Indonesia and Malaysia, particularly in electrical products became increasingly important. In India, the opening up of the economy in the 1990s helped the country integrate more with its Asian neighbors. In Indonesia, some of the increased trade within the region has been in oil exports but also in other primary materials and labor-intensive manufactures.

Capital Movements

As they adopted more liberal trade policies, many DMCs opened their economies to financial capital flows. Inflows accelerated throughout the first part of the 1990s, nearly tripling between 1990 and 1997. Between 1997 and 1999, however, there was a sharp reversal in capital inflows to Asia as a result of the financial crisis. Portfolio and other investment inflows turned sharply negative. Only FDI inflows remained positive in 1998, continuing to grow, particularly to the NIEs.

Until the financial crisis, the PRC managed to attract the bulk of FDI to the Asian region. However, other countries were also able to build up FDI quite rapidly. FDI inflows nearly doubled in the NIEs and more than doubled in Southeast Asia between 1990 and 1997. FDI inflows increased quite rapidly in South Asia, albeit from a low base. Portfolio and other investment was much more volatile than FDI, reacting more dramatically to the financial crisis. Other investment, mostly bank loans, reversed from an inflow in 1996 in Southeast Asia to an outflow in 1997 and in 1998. In the NIEs, the reversal came a year later. In the PRC, the reversal was more modest.

Labor Movements

DMCs have experienced a trend toward integration on many levels, including labor markets. Richer Asian countries that grew rapidly in the 1980s and 1990s now have low levels of unemployment and are experiencing a growing need for a variety of skills that are in short supply among the domestic labor force. While the movement of unskilled labor has received wide publicity, there is also a strong flow of immigrants in some skilled and professional occupations.

Recently, with the advent and spread of the Internet and the new economy, it is jobs that are beginning to move in search of labor rather than the reverse. Using advanced telecommunications technology, many tasks can be easily and efficiently outsourced to developing countries. Some examples include data entry, software programming and development, Internet website development, computer help lines, and some accounting functions.

Globalization and Poverty

Globalization, when accompanied by appropriate domestic policies, can promote poverty reduction. This is because countries that are more open to trade tend to enjoy higher rates of growth. A reduction of barriers to trade tends to increase the demand for relatively abundant factors of production. In the case of Asia, these have been initially unskilled and semiskilled laborers, i.e., those most likely to be poor. Moreover, there is a strong negative relationship between growth in the incidence of poverty and the rate of long-run economic growth. The NIEs and Southeast Asian countries, where the development of outward-looking, export-oriented industries resulted in rapid income growth and a reduction in poverty during the 1980s and 1990s, exemplify this relationship.

POLICIES FOR ADAPTING TO GLOBALIZATION

Policymakers must continue to be alert and responsive to both the opportunities and the challenges of globalization if DMCs are to continue to capitalize on this process. This section has two major themes. The first is that development strategies should be modified both to adapt to a changing global economic environment and to take advantage of the opportunities that come with globalization. Moreover, the revolution in information and communications technology (ICT) will continue to create opportunities in goods and services export markets, but those countries with the appropriate ICT infrastructure and personnel will best be able to exploit these opportunities. The second theme is that there are also risks to a globalization strategy and policies must be formulated to minimize them. Greater volatility is probably the biggest risk that accompanies globalization. The section discusses ways to reduce the volatility in economic performance that has been associated with globalization and to mitigate its impact on the poor. These include policies to monitor and regulate capital flows, develop an appropriate exchange rate regime, minimize fluctuations in productivity and investment, and strengthen social safety nets.

MAXIMIZING BENEFITS

Managing Economic Learning

Each country, either implicitly or explicitly, has a network of policies and institutions in place to manage innovation or economic learning. This network is the public and private institutional framework used to support R&D-led and market-mediated efforts to create, absorb, and adapt new technology for commercial use. International comparisons emphasize the diversity of such networks even within Asia. There are, however, sufficient similarities among the systems within the region to justify considering an “Asian approach” to development, innovation, and economic learning.

This Asian approach, in its early stages of development, was designed to bring in technologies from outside the region (emulation or imitation) rather than develop new technologies (innovation). This made sense for Asian economies that were relatively late to develop and could take rapid strides simply by importing and assimilating foreign technologies. But the longer the Asian rates of growth have continued to outstrip those in the US, Europe, and Japan, the closer DMCs have drawn to the technological frontier. As the frontier is approached, the opportunities for rapid progress through emulation diminish and the ability to innovate becomes increasingly important.

Channels. Channels for the acquisition of technology include capital goods imports, licensing arrangements, joint ventures, FDI, and outsourcing. Of these, capital goods imports, licensing, and joint ventures have long been the staples of the Asian approach. New technologies are usually embodied in new capital goods, and importing such equipment allows a country to immediately benefit from foreign technological advances and also opens up opportunities for learning through reverse engineering. The use of this mode of technology acquisition is evident from the fact that the NIEs have historically had a higher propensity to import capital goods in comparison to other developing economies.

Policies. Asian governments have pursued policies designed to maximize the knowledge spillovers associated with licensing, FDI, capital goods imports, and outsourcing. They have often required licensing agreements as a condition for foreign multinationals to establish operations locally.

Macroeconomic, financial, and trade policies can also be regarded as an important part of the Asian approach. Stable monetary and fiscal policies supported high and rising savings rates. Much of these savings were channeled through government-controlled banking systems that provided credit to exporting firms in technologically progressive sectors. Export promotion thus provided the dual benefits of allowing firms to overcome the constraints imposed by limited domestic markets, while exposing them to the discipline of foreign competition.

Adapting to Globalization. Adapting to globalization is an ongoing process. The policies of bureaucratic direction that worked well at an earlier stage of Asia's technological development will work less well today. In their early stages of industrial development, Asian economies, particularly the NIEs, relied heavily on arm's-length transactions—technology licensing and purchase of foreign capital goods—and less on FDI, joint ventures, and outsourcing.

Adopting licensed technologies arguably requires more limited adaptations of domestic economic structure than FDI and joint ventures, which will be attractive to foreign firms only if the economy is comprehensively restructured. However, licensing tends to be a source of less sophisticated technologies. Thus, as economies approach the technological frontier, they increasingly rely on FDI as a source of foreign technology.

Although economic systems tend to evolve as economies mature, the policies and institutions developed for and appropriate to earlier stages of economic development tend to get locked in, posing obstacles to further development. Thus, if small firms are disproportionately responsible for the development of new technologies, industrial policies conducive to the growth of large firms will eventually become obstacles to innovation. If the development of new technologies requires venture capital allocated through securities markets, then the earlier forms of capital allocation—through intimate banking relationships that extend funding in large chunks to preferred customers with established technologies—will inhibit innovation.

Moreover, as globalization proceeds, economic learning and evolution as described may no longer be available to latecomers. The multinational corporations that are the sources of advanced technologies are inclined to license latecomers only when prevented from setting up their own operations in foreign markets. As more developing-country markets are thrown open to FDI, it becomes harder for individual governments to insist on licensing as an alternative.

The Asian approach has to be reoriented and those who do this quickly will be the first to reap the benefits. This will require the same concerted efforts that Asian economies employed to initiate industrialization and technology transfer from the West after the Second World War. The role of government in this process also needs to be reconsidered, given the desirability of a flexible and responsive private sector: this role will likely be to support the development of human resources, including engineers, scientists, and ICT and financial sector professionals.

Exploiting the New Economy

In the past 20 years, as the Asian approach allowed economic convergence of DMCs toward the economic structures prevailing in industrial countries, these industrial economies—and, indeed, the world economy—underwent a rapid transformation. An indication of the scope of this transformation is that economists estimate that more than half the world's total output of goods and services is now contestable (meaning that producers must keep prices competitive to avoid losing market share to potential entrants). This process of globalization, itself unleashed by policies of economic liberalization and technological breakthroughs in ICT, is reinforcing the huge impact of those ICT forces reshaping the economic landscape into the new economy.

ICT Revolution. The ICT revolution is multifaceted. One aspect is the rapid development of computing hardware and software, including much greater power, smaller size, and lower prices. This triggered the rapid spread of powerful computers to offices and to nonpoor households around the world. A second aspect is the development of high-speed transmission of information by relay stations, satellite, and fiber optic cables. A third aspect is the digitization of information—not only words and data but sound and

video as well, generating new business applications such as computer-aided design (CAD) or practices such as teleworking.

ICT is a technology that transcends its own particular industry, spilling over into the entire economy, increasing productivity, and changing the way businesses operate. The new economy has brought with it a dramatic acceleration in innovation, an explosion of new products, shorter product cycles, greater competition, and improved business efficiency.

ICT and Economic Performance. The impact of the ICT revolution on economic performance is difficult to quantify. Measuring the impact of ICT, computers, and the Internet is complicated because these three components are interrelated and because long time series to analyze the data are lacking. Historically, labor productivity tends to fall in recession and accelerate in the initial stages of recovery. The current surge in productivity is the first in the postwar period that has come when the economy has been in a sustained upswing in output growth. Some experts have suggested that the ICT revolution is responsible for this although there is some controversy about these results. Nevertheless, it is clear that the ICT revolution is having a significant impact on the pace and character of world development, creating a new economic development paradigm for DMCs.

DMCs and the New Economy. The extent to which DMCs are integrated into the new economy varies across countries. Some DMCs are at par with the US and Europe in certain areas, such as Singapore and Hong Kong, China; and perhaps Taipei,China; and Korea. Many DMCs have experience in production of electronics exports in which the new economy best business practices of outsourcing and flexible production systems are already highly developed. These economies might be relatively well placed to take advantage of unfolding opportunities in the new economy, provided they can adapt their economic systems.

Growth of trade will create additional opportunities to develop export markets. More openness in trade and the flow of capital should facilitate the spread of the new economy to DMCs. In addition, the ICT revolution could create opportunities for DMCs to export skill-intensive services. India, Philippines, and Singapore have already developed substantial software and data entry platforms in the past decade. Furthermore, growth of the Internet may create a more level playing field. The capacity of poorer countries to market retail products and to bid for subcontracting jobs in industrial countries may be enhanced by the spread of the Internet. Finally, DMCs will receive greater payoffs from improving education and skills. The ICT revolution might reduce the tendency for highly skilled labor to emigrate. Since many ICT applications are not bound geographically, labor services can be provided from separate locations.

ICT Infrastructure. ICT infrastructure will be increasingly critical, in all the DMCs, to an economy's ability to capitalize on globalization. The sector is growing rapidly, provides an important linkage to the global economy

and, from the experience of the US, has the potential to be a source of rapid productivity gains.

For the ICT sector in DMCs to flourish, several prerequisites must be met. First, ICT has to be supported by a vibrant telecommunications sector. This will require large expenditures in Southeast Asia and South Asia, to bring these subregions to par with the NIEs. It will also need a partnership between the public and private sectors as well as appropriate technological transfer from industrial countries and perhaps the NIEs. The growth of the private sector is necessary to provide easy and economical access for students and others to ICT as well as to computer education. Policy support for private sector ICT development, including standards for assuring the compatibility of systems (hardware and software), is justified by the positive spillovers of ICT to the rest of the economy. Finally, intellectual property rights have to be safeguarded by strengthened laws on copyright and patent rights.

MINIMIZING THE RISKS

Volatility in a Globalizing World

Recent Asian experience suggests that globalization can be a source of macroeconomic volatility, which generally reduces economic welfare. This is not to suggest that the costs of globalization swamp the benefits, but to emphasize the importance of developing institutions and pursuing policies aimed at limiting volatility and minimizing its adverse social consequences.

Effects of Volatility on Productivity and Investment. The negative association of volatility with growth reflects adverse impacts on productivity and investment. Productivity will suffer if unpredictable changes in relative prices lead firms to choose sub-optimal technologies. Countries where volatility is high also display relatively low investment rates, reflecting the reluctance of entrepreneurs to commit to projects when prices and macroeconomic conditions change unpredictably.

The most damaging forms of volatility are financial crises. These crises are incompatible with growth: they lead to stop-go policies, interfere with the operation of the domestic financial system, cause distress to the corporate sector, and force governments to curtail public investment.

Crises have multiple causes, but one unquestionably important cause is financial fragility, which becomes increasingly important as capital flows increase. One sign of financial sector fragility is a “double mismatch problem”. The balance sheets of domestic financial and nonfinancial firms display either a maturity mismatch (a combination of long-term assets and short-term liabilities) or a currency mismatch (a combination of assets denominated in domestic currency and liabilities denominated in foreign currency). This leaves domestic markets vulnerable to destabilization by sudden changes in financial conditions, such as the loss of investor confidence (as seen in the Asian financial crisis).

Effects of Volatility on Poverty and Social Indicators. Ample evidence now shows that volatility has undesirable consequences for the distribution of income, poverty, and educational attainment. The poor, unskilled, and uneducated are least able to protect themselves by hedging their incomes and diversifying their investments; it is not surprising that they should suffer disproportionately from volatility. Moreover, some evidence suggests that crises and the policy adjustments they entail are particularly bad for income distribution and that their unequalizing effects are especially pronounced in middle-income countries. Similar results are found for poverty rates. The poor and near poor tend to be employed in sectors and activities that suffer from volatility; and cuts in social spending in times of crisis fall disproportionately on their shoulders.

Households near the poverty line have the least savings, the worst collateral, and the most tenuous access to credit and insurance. Moreover, volatility aggravates poverty through its negative impact on growth. It also tends to worsen health outcomes and result in increased labor force participation rates, longer hours worked and lower rates of pay in some countries.

Finally, volatility is associated with low levels of educational attainment. It affects education partly through its impact on inequality. In economies that are volatile, the poor, who are already on the margin of subsistence, may be forced periodically to withdraw their children from school so that they can contribute to household income, and this interruption of attendance hinders educational attainment.

Managing Volatility in a Globalizing World

If globalization can increase volatility and volatility—particularly in the case of crises—can slow growth and exacerbate poverty, then it is important to adopt policies and develop institutions to limit such volatility.

Although the positive impact on growth of trade and FDI flows is now widely recognized, the benefits of portfolio capital flows continue to be questioned.

However, as globalization proceeds, statutory restrictions on transactions on the capital account will become increasingly difficult to operate without disrupting other forms of economic activity. This heightens the importance of coordinating international financial liberalization with the elimination of distortions that would otherwise cause such liberalization to heighten volatility and crisis risk. In concrete terms, this means that the following actions should be taken.

Strengthening the Financial Sector. Capital account liberalization should follow rather than precede recapitalization of the banking sector, the reinforcement of prudential supervision and regulation, and the removal of blanket guarantees. If bank capitalization is inadequate, managers will be inclined to excessive risk taking. If bank liabilities are guaranteed on the grounds that widespread bank failures would be devastating to a financial

system dominated by banks, foreign investors will not hesitate to provide the requisite funding. The lesson from the Asian financial crisis is that the process of financial sector reform should proceed quickly, yet prudently.

Liberalizing FDI. FDI is the form of foreign investment that is most likely to come packaged with managerial and technological expertise. It is also the form least likely to aggravate weaknesses in the domestic banking system, or be associated with capital flight and creditor panic. This suggests liberalizing inward foreign investment as the first stage of financial-side opening.

Internationalizing the Banking System. Entry by foreign banks is a low-cost way of upgrading the banking sector's risk-management capacity. The knowledge spillovers that figure prominently in discussions of other forms of FDI apply also to the financial sector. Moreover, insofar as their home-country regulators oversee foreign banks, opening the banking sector to foreign investment should raise the average quality of prudential supervision. And insofar as foreign banks are better capitalized, they are less likely to engage in excessive risk taking. For all these reasons, entry by foreign banks can accelerate the upgrading of domestic financial arrangements that is a prerequisite for further capital account liberalization.

Developing Stock and Bond Markets. Stock and bond markets tend to develop only after bank finance is well established. In part, this is due to the additional information requirements of these markets. Moreover, bond markets tend to develop only once a reliable market has arisen in a benchmark asset, typically treasury bonds, which in turn requires a government with a record of sound and stable macroeconomic and financial policies.

In the absence of financial disclosure following recognized auditing and accounting practices, firms will find outsiders reluctant to purchase their securities for fear of market manipulation by insiders; hence, stock market capitalization and turnover will be low. With inadequate contract enforcement and equitable bankruptcy procedures, investors will be reluctant to invest for fear that issuers will walk away from their obligations. This is why significant stock market capitalization and turnover tend to be observed relatively late in the process of financial development. It is why many countries, and developing countries in particular, rely on banks for intermediation services—banks having a comparative advantage through long-term relationships with their clients in assembling information and enforcing contracts.

Creating active stock and bond markets thus requires putting in place a regulatory framework mandating the disclosure of accurate and up-to-date financial information, the use of recognized auditing and accounting standards, penalties for insider trading and market manipulation, and statutes protecting the rights of minority shareholders.

Yet, firms in countries where equity finance is available are likely to enjoy additional advantages in a globalized world. In terms of managing volatility, firms in countries with well-developed equity markets will be less

dependent on short-term finance and less susceptible to liquidity crises. Such firms will also be less highly leveraged than those in countries (such as in Asia) where debt finance is the norm, which makes their balance sheets less sensitive to the changes in interest rates that exposure to globalized financial markets can bring. Compared with countries where debt is denominated in foreign currency, they will suffer less damage from exchange rate changes. And in a technologically dynamic world, where firms are forced to choose between as yet unproven competing technologies, equity finance has advantages in terms of competitiveness and innovation.

Accumulating Reserves. The response of many Asian countries to the volatility of 1997/98 has been to accumulate a cushion of international reserves. It is true that the larger the reserves are, the more confident investors will be that they will be able to take out their investment without suffering losses when sentiment turns and the banking system comes under pressure. However, because bank-to-bank lending will be greater when reserves are large the costs of a banking crisis will be higher. Moreover, holding reserves against short-term external liabilities is expensive, since US treasury bonds ordinarily bear lower interest rates than deposits in Asian banks. The implication is straightforward: if short-term foreign borrowing comes with risks that are expensive to insure against, is it not better to avoid it in the first place? Clearly, countries seeking protection from volatility should accumulate a cushion of reserves. But this must be balanced against the costs.

Strengthening Monetary and Fiscal Institutions. Limiting volatility in a financially globalized world requires building credible policy-making institutions. The greater the credibility of the individuals and institutions responsible for monetary policy, the less the danger that a shock will incite an investor panic and a self-fulfilling crisis. As a matter of fact, if policymakers have accumulated sufficient credibility, the markets will do much of the stabilizing work for them. If inflation accelerates, for example, pushing up interest rates and depressing the prices of short-term interest-bearing assets, investors anticipating that the acceleration of inflation is only temporary will buy into temporarily depressed fixed-income markets, thereby stabilizing asset prices and interest rates.

Similarly, the more credible fiscal policy is, the greater will be the fiscal authorities' capacity to pursue counter cyclically stabilizing budgetary policies. If they are committed to running budgets that are balanced over the cycle, they will be able to borrow and run deficits in recessions. If, on the other hand, their intentions are suspect, they will have to cut spending and/or raise taxes in recessions, rendering fiscal policy pro-cyclical and aggravating rather than limiting volatility. One possible option that enhances credibility and provides a degree of flexibility for dealing with volatility is to give the authorities a mandate and the independence to pursue it. For monetary policy this is the well-known formula of independence for the central bank and a mandate to pursue price stability. For fiscal policy there

is an analogous argument for creating an independent fiscal authority responsible for setting a ceiling for the budget deficit and a set of rules for cutting expenditure in the event that the fiscal authorities overrun it.

Managing Exchange Rates. One of the most difficult challenges posed by globalization, recent experience suggests, is how to manage the national currency in a financially interlinked world. There are three possibilities. First is the hard peg where a currency is fixed using a currency board or where the currency of another country has been adopted. Second is a "soft peg" where the currency is tied to another currency or a basket of currencies either through a peg, a crawling peg, or bands around a reference rate. Finally is the free float, where the value of the currency is either allowed to fluctuate freely or where there is a managed float—no central rate is specified but the central bank may intervene to influence the exchange rate.

Each of the major financial crises in the past few years has involved countries with a soft peg. Large and liquid international capital markets make it more difficult for national authorities to support a shaky currency peg. Effective defense of the exchange rate requires raising interest rates and restricting domestic credit, something that will have significant costs unless the economy is strong. If the markets detect a chink in the country's armor—high unemployment, a heavy load of short-term debt, or a weak banking system—that could render the authorities reluctant to raise interest rates to defend the currency, then they will pounce, exposing the authorities' weakness.

For which extreme should Asian economies opt—a hard peg along Hong Kong, China lines or a free float in the Korean style? The choice is typically framed in terms of the trade-off between credibility and flexibility. With the adoption of a hard peg, domestic monetary policy is dictated by the central bank of the country whose currency provides the external anchor, and the peg automatically acquires all the credibility accumulated by the issuer of the anchor currency. By ensuring greater exchange rate stability, the economy's access to foreign capital is enhanced. Floating rates, in contrast, maximize the flexibility with which the authorities can use monetary policy for economic stabilization. They leave the central bank free to intervene as a lender of last resort to financial markets.

Which approach will be more attractive to most DMCs? Insofar as most DMCs are quite open, standard arguments on optimum currency areas favor hard pegs. At the same time, the diversification of DMC exports across markets—and the tendency of exporters in the region to sell to the Japanese and US markets simultaneously—makes a hard peg to any single currency less attractive. Because DMCs have relatively underdeveloped domestic bond markets, they borrow long term mainly in foreign currency, and sharp exchange rate changes can then wreak havoc with the domestic currency cost of external debt servicing. In other words, a flexible exchange rate will make obtaining foreign funding difficult. But because savings rates in Asia are so high, foreign funding is less essential: banks and firms seeking

external finance can obtain it at home via the banking system and supplier credits. The existence of so many cross-cutting considerations suggests that not all DMCs will prefer the same exchange rate arrangement.

Policies to Minimize Risks to the Poor

Globalization will be accepted most readily if its benefits are widely shared. The fact that economies that are more deeply integrated into global markets tend to have larger public sectors can be understood as providing social protection for those who cannot protect themselves from the volatility and pressures of globalization. Such protection helps support the broad-based political coalition needed to sustain a commitment to openness. In addition, it facilitates the quick policy adjustments needed to absorb globalization-related shocks, since people will see that the immediate costs of adjustment, like the benefits, are being equitably shared.

For countries seeking to capitalize on globalization, two policies may help in minimizing the risks to the poor of globalization. For the short term, insurance against shocks is needed. For the long term, measures are required to foster the accumulation of forms of human capital that are useful in an economically globalized world, specifically among socioeconomic groups that have not traditionally possessed them.

In the context of globalization, risks can range from sharp changes in relative prices on world markets to full-blown economic and financial crises. Building an effective social safety net and ramping up programs in response to a crisis can be inefficient and time-consuming, and is therefore difficult. This makes it important to put in place lasting social infrastructure protection. Whereas general principles underlying social safety nets are well documented, specific programs need to be designed in the light of particular financial and country-specific conditions.

The short-term safety net should provide employment for those able to work. Public works programs providing jobs for the poor, often referred to as workfare, have been shown to be a relatively efficient way of providing immediate relief, especially where local input is used in selecting projects and where the workers are the beneficiaries of the public works. Workers can be offered public employment at a wage equal to, say, 90 percent of the wage for unskilled agricultural labor. Workfare designed in this way will protect the poorest workers against the loss of income without drawing other workers away from private employment or encouraging welfare dependency.

Because globalization exposes national economies to external shocks, it requires workers as well as firms to act quickly. The implication is that educational spending should impart general knowledge rather than technical training and sector-specific skills. The literature on this subject shows that such general knowledge is imparted most efficiently in the early stages of the education process. This suggests targeting educational subsidies at primary education and ensuring that the poorest (especially females) are included.

Insofar as openness leads poor countries to specialize in the production and export of labor-intensive goods, there is the danger that globalization may draw poor children out of school. Targeted subsidies for school attendance are the obvious policy response and such programs has been successful in increasing school enrollment in some DMCs.

INSTITUTIONAL OPTIONS IN A GLOBALIZING ENVIRONMENT

In the absence of a crisis, institutional changes are slow to take root because they are often subject to strong forces of inertia. In this section emphasis is placed on reforming institutions at different levels of government. Economies must choose a proper mix of institutions to effect policy change. These may be national, regional, or global. It is argued that many policy issues relating to globalization can still be addressed at the national level even though regional and global institutions have greater importance as the world's economies become more integrated.

As Asian economies integrate further into the global economic system they face a number of challenges and opportunities. In many cases these can be addressed by the private sector. However, in some instances governments will have to be involved. Because of the nature of the globalization process, they will have to adopt new approaches and be willing to develop new institutions and policies to address the issues presented by continued globalization. Governments will no longer be able to rely solely on national initiatives, although these will still be important. They must go further in developing relationships and participate with other countries in institution building to deal with global issues at both the regional and global levels.

Global Initiatives

The case for global initiatives is straightforward. If markets are global, so must be their regulation and the institutions through which that regulation takes place. In a world of systemic risk, economic and financial institutions take on the character of a global public good. Institutional arrangements affecting, among other things, prudential supervision and the conduct of monetary-cum-exchange-rate policies are of critical interest not just to the initiating country but also to the rest of the world. Global initiatives to influence national practices are justified as a way of internalizing these externalities.

The danger is that these global initiatives will subject countries to blueprint formulas, denying them the opportunity to design regulatory institutions responsive to their distinctive traditions. Standards, which define criteria that all countries should meet but allow them to meet them in different ways, offer a way of reconciling the common imperatives created by participation in international markets with the diversity of economic systems.

Reservations have been voiced about how much can be accomplished through the promulgation of international standards. The definition of acceptable standards causes disagreement. The danger is that an international standard broad enough to encompass these variations will tend toward a lowest common denominator.

The Regional Option

To some extent, the external shocks associated with the forces of globalization can be moderated by regional initiatives. Insofar as the cross-border externalities associated with national policies (e.g., exchange rate and R&D policies) are felt mainly by countries within a region, this creates an argument for coordination at the regional level.

Frameworks for addressing such problems at the regional level have developed in other parts of the world, providing precedents that DMCs could follow. Interest in the regional option has attracted new attention in Asia in the wake of the 1997/98 financial crisis and has given rise to discussions for the establishment of an Asian Monetary Fund. Similarly the Chiang Mai initiative can be seen as a way of addressing regional financial pressures.

Discussions of the case for a common basket peg for Asian countries are seen as responding to the dilemma of having to choose between a hard peg and a floating exchange rate. Asian countries can avoid this difficult choice by agreeing to a collective peg and supporting one another in its maintenance. A similar style of institution building in Europe created a zone of monetary and financial stability and led to a measure of political integration.

In Asia, however, the motivations for regional cooperation are different from Europe's. DMCs have less interest in a regional trade arrangement since much of their trade is with the US. Moreover, Asia has shown virtually no desire for political integration, given the various political tensions since the Second World War, often exacerbated by outside influences.

Rather, the impetus for monetary cooperation reflects the desire to create a zone of financial stability. The fear created by the financial crisis is that small currencies and large financial markets are incompatible. Asian central banks, on their own, lack the resources to cope with global financial flows, even with the position-taking ability of a few highly leveraged institutions. Confronted with the vast liquidity of global capital markets, unilateral floats and unilateral pegs are subject, in this view, to speculative manipulation, and both are therefore equally uncomfortable for the government attempting to operate them. The solution is the pooling of reserves designed to marshal sufficient resources for the authorities to counter speculative pressures and, ideally, maintain the stability of intra-Asian rates.

Multilateral trade liberalization is another area where a regional focus may be an appropriate catalyzing force. DMCs need to concentrate on their own priorities during the next round of World Trade Organization (WTO) multilateral trade negotiations, the so-called Millennium Round.

Coordination among DMCs could be effective in putting forward an agenda of proposals that would benefit the entire region.

National Initiatives

If one accepts the argument for diversity of national practices, a uniform mode of governance across countries cannot be optimal. Nonetheless, scholars distinguish three forms of governance: the strong state, the decentralized state, and the participatory state. The strong state model vests responsibility for designing and implementing institutional arrangements with an authoritarian government and its bureaucratic arm. The decentralized state encourages experimentalism and competition among local jurisdictions, on the same grounds that the national approach encourages experimentation and competition among countries. Thus, federal systems generally encourage competition among their states and this has led to some successes.

The participatory approach, in a world of globalized markets, may have advantages. Democracies empower a wider range of decision makers and argues that this diversification implies less risk in an environment of imperfect information; hence, democracy should be positively associated with short-term stability. There is evidence that participatory systems pay higher wages and are characterized by less income inequality, since participation leads to the development of more elaborate social insurance and transfer mechanisms.

CONCLUSIONS—TOWARD A FRAMEWORK FOR GLOBALIZATION

In this final section, the policies suggested in the previous sections are synthesized against a background of the potential for globalization and the remaining impediments to further globalization

What is the Future of Globalization?

Since the Second World War, the decline in the cost of international transportation and communications, the spread of global production networks, and the progress in drawing countries and regions more deeply into the global system, has been quite substantial. Yet, the extent of participation in international trade and capital flows varies enormously across countries.

This is in part due to the existence of a number of barriers to further integration of countries with global markets. Foremost among these are barriers to trade. Despite significant reductions brought about by eight rounds of multilateral trade negotiations since 1949, widespread restrictions on trade, especially nontariff barriers, exist in most developing countries. These serve to artificially raise the cost of imported goods and services, inhibiting the efficient allocation of resources in each country.

For DMCs, late 20th and early 21st century globalization is also coinciding with an important change in the sources of economic growth. For the last four decades, DMCs have recorded rapid rates of growth by maintaining high rates of factor accumulation—capital accumulation in traded-goods sectors in particular—and by selling their products in world markets. But as Asia's high-growth economies mature, the source of their growth will progressively shift from factor accumulation to factor-productivity growth. This will require changes in policies and institutions. In addition, low-income DMCs that wish to follow their high-income predecessors down the path of labor-intensive, export-oriented manufacturing using imported technologies will find their task complicated by globalization.

That the need for stable macroeconomic policies, sound regulatory arrangements, and good governance is obvious does not make them unimportant. Appropriate policies are easier to prescribe than to implement and their specifics are likely to vary over time as an economy evolves. A brief set of policy recommendations that arise from the review of Asia's globalization challenge is presented below.

Trade Policies

Trade liberalization played a major role in stimulating development in many DMCs. Further progress in this area will reinforce the trend towards globalization that has been so beneficial:

- In order to minimize the efficiency losses and economic distortions brought about by trade barriers, trade policy instruments need be modified. The first step of a liberalization strategy is replacing nontariff barriers by tariffs.
- A second set of policies toward openness and greater neutrality of trade regimes consist of (i) lowering the average level of protection and (ii) reducing the average dispersion, or variance of protection. If the dispersion is not reduced, as the average tariff declines, the tariff structure may become less neutral and more discriminatory, and therefore, highly distorting.

Human Resources Development, Technology, and Infrastructure Issues

While it is recommended that the role of Government in coordinating resource allocation be generally diminished, public investment in human and physical capital can still play a critical role in stimulating economic development. Specifically, in the current context:

- On the one hand, more emphasis on basic education, rather than vocational training, will provide semi-skilled workers with the solid but flexible foundation necessary to adapt to a rapidly changing environment. On the other hand, DMCs need a core of highly trained engineers, scientists, financial sector personnel and technicians that can facilitate the

absorption of new technology and innovation and transfer it to domestic firms. Which of these concerns is more critical will depend on local conditions, but significant investments in education are clearly warranted.

• Among the economies at the lower end of the technological ladder, it is still possible to achieve effective and productive integration into the global system by importing capital goods, attracting FDI, and licensing foreign technology. It will also be important to maintain competitiveness in the new economy environment through selected investments in telecommunications infrastructure and computer literacy programs.

Institutional Factors

The optimal role of Government is increasingly a dynamic concept. To remain successful, institutions must adapt. Specifically:

• As DMCs approach the technological frontier, they will have to rely more on innovation than capital accumulation. This may necessitate radical changes to the policies and institutions supporting the Asian approach as they can pose a barrier to technical change. Generally, an environment conducive to innovation will involve less Government command over resources.

• The process of adapting institutions to the imperatives of globalization takes place at the global, regional, and national levels. Actions at these levels should be seen as complementary to each other. At the global level, institutional arrangements that define standards to be met by all countries but that permit individual countries to meet them in different ways offer the best chance of success. Insofar as cross-border externalities associated with national policies are felt mainly by countries within a region, coordination at the regional level is considered to offer better outcomes than global initiatives.

Macroeconomic Stabilization

Stable, credible macroeconomic policies are critical to efforts to limit volatility in capital markets. Specifically:

• Monetary and financial institutions have to be strengthened if volatility is to be reduced. The hallmark of these policies should be credibility and prudence. Inflation targeting has much to recommend it. On the fiscal side, rigid rules are probably not as acceptable. Nevertheless, large deficits should be avoided to minimize the buildup of public sector debt and the crowding out of private sector activity.

• In the aftermath of the crisis, most countries have adopted floating rate regimes. This has been the preferred solution, except in Hong Kong, China; Malaysia; and the PRC, where policies and financial resources are sufficient to hold a peg to the US dollar. It is not generally recommended that countries return to a soft peg as that would require frequent interventions by the central bank to maintain the peg.

Strengthening the Financial System and Capital Account Liberalization

Capital account liberalization is likely to become increasingly difficult to resist as economic and financial globalization proceeds. This point heightens the importance of coordinating domestic financial liberalization with the elimination of distortions that would otherwise cause such liberalization to heighten volatility.

- FDI is the form of foreign investment that comes packaged with managerial and technological expertise. It is also least likely to aggravate weaknesses in the domestic banking system or to be associated with panic. For these reasons liberalization of FDI should be the first step in liberalizing the capital account.
- Greater competition should be selectively introduced to strengthen the banking system, increase efficiency, and enhance the quality of banking services. Foreign competition should perhaps be phased in so that the domestic banks have time to adjust. It must also be recognized that opening the financial market to foreign banks might increase the flow of portfolio investment. Thus, banks should be allowed to fund themselves offshore only after other policies to strengthen the financial system have been put in place.
- Using market-based initiatives to regulate capital flows (thus mitigating the volatility of portfolio and other investment flows) is preferable to administrative measures.
- Bond and stock markets should be developed to provide greater stability to the financial system. The development of bond markets helps diversify sources of corporate debt, while that of stock markets avoids excessive reliance on debt in general. However, developing deep and liquid bond and stock markets is likely to take time given the need to put in place regulatory requirements mandating the disclosure of up-to-date financial information, the use of recognized auditing and accounting standards, penalties for insider trading, and statutes protecting minority shareholders.

Poverty Measures

Globalization will be accepted most readily if its benefits are widely shared. Two sets of policies can help to achieve this:

- For the short term, insurance against shocks is needed. These include short-term safety nets for those who cannot work, and public works programs for those who can. These safety net programs should be targeted to maximize efficiency, although experience in India, Bangladesh, and the Philippines demonstrates that this is difficult. Microcredit programs are an important element of these programs to avoid distress asset sales. Moreover, these social safety nets need to be in place prior to a crisis if they are to be effective.
- In the long term, policies are required to foster the accumulation of forms of human capital that are useful in a globalized world. The ability to respond quickly to global changes will be more important. This means less

focus on vocational training and more on basic education, particularly for women, who because of their family obligations, are least able to reeducate themselves as adults.

In closing, it may be put forward that DMCs experienced the economic and financial crisis of 1997/98 because they failed to recognize the risks that came with large portfolio inflows that were ultimately linked with liberalization of financial markets and globalization. The challenge for DMCs now is how to capitalize on the opportunities for growth and development afforded by globalization while at the same time minimizing the risks of volatility, dealing with possible crises and managing other issues that may arise as the process continues.

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