ASIAN DEVELOPMENT

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CONTENTS

PREVIOUS ASIAN DEVELOPMENT OUTLOOK THEME CHAPTERS

1989	The Development of Human Capital
1990	Informal Finance in Asia
1991	Environment and Development In Asia
1992	Rural Poverty in Asia
1993	Asian Economies in Transition
1994	Urban Poverty in Asia
1995 and 1996	The Financial Sector and Asian Development: Historical Experiences and Prospects
1996 and 1997	Regional Cooperation
1997 and 1998	World Trading Environment and Asia
1998	Population and Human Resources
1999	Economic Openness: Growth and Recovery in Asia
2000	The Social Challenge in Asia
2001	Asia's Globalization Challenge

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Publication Highlights summarizes the *Asian Development Outlook 2002*, an annual publication of the Asian Development Bank. The Asian Development Outlook 2002 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 preferential trade agreements in Asia and the Pacific.

PART I
DEVELOPING ASIA AND THE WORLD

INTRODUCTION AND OVERVIEW

As external demand receded in 2001, economic growth of the developing member countries (DMCs or developing Asia) of the Asian Development Bank (ADB) slowed to half its 2000 pace (Table 1). East Asian economic growth, high in 2000, was much lower in 2001 because an erosion of external demand sharply affected Hong Kong, China; Republic of Korea (Korea); and Taipei,China; while growth eased somewhat in the People's Republic of China (PRC). Southeast Asia was similarly affected by falling external demand, resulting in a pronounced drop in growth in 2001. In contrast, South Asian growth accelerated as slowing export expansion was offset by improvement in agriculture. In Central Asia, growth was higher in 2001, in part because of heavy investment, particularly in the energy sector. The recession in Papua New Guinea, political instability, and fiscal difficulties continued to affect overall 2001 performance in the Pacific DMCs.

The United States (US) dollar value of merchandise exports of developing Asia fell by 6.8% in 2001, a stark reversal from the 21.2% expansion in 2000. The loss of momentum in external demand was less severe in the South Asian subregion, for which information and communications technology (ICT) and nonagricultural commodity exports are less important and for which less volatile products such as textiles are more prominent exports. For East Asia and Southeast Asia, generally, the severity of the turnaround in the momentum of external demand stemmed from the collapse in ICT trade. Central Asia was affected by the decline in commodity prices, which accelerated after the

TABLE 1 Summary of Aggregate Performance, Developing Asia, 1999–2003

	1999	2000	2001	2002	2003
Change in Real Gross Domestic Product					
Developing member countries	6.4	7.0	3.7	4.8	5.8
East Asia	7.6	8.3	3.9	5.2	6.2
Southeast Asia	3.8	5.9	1.9	3.4	4.3
South Asia	5.7	4.2	4.9	5.4	6.4
Central Asia	4.9	8.7	10.7	5.7	6.4
Pacific developing member countries	6.6	-1.0	-0.8	1.9	2.6
Consumer Price Index Inflation					
Developing member countries	0.8	2.3	3.0	3.1	3.3
East Asia	-0.7	0.7	1.4	1.5	2.3
Southeast Asia	1.0	2.5	5.2	5.7	4.4
South Asia	4.2	6.2	4.6	4.1	4.8
Central Asia	15.5	16.9	13.7	10.0	5.6
Pacific developing member countries	9.2	9.5	7.2	6.0	3.1
Current Account Balance					
Developing member countries	3.9	3.2	3.0	1.9	1.1
East Asia	3.2	2.3	2.7	1.8	1.0
Southeast Asia	9.9	8.5	6.9	5.0	4.0
South Asia	-1.6	-1.0	-0.8	-1.7	-1.9
Central Asia	-4.4	0.3	-2.9	-4.5	-4.9
Pacific developing member countries	1.8	4.3	2.2	0.2	3.0
Memorandum Items					
United States gross domestic product growth (%)	4.1	4.1	1.2	3.0	3.0
Japan gross domestic product growth (%)	0.7	2.2	-0.5	0.0	1.0
Euro area gross domestic product growth (%)	2.6	3.4	1.5	1.7	3.0
United States Federal Funds rate (%, end period)	5.5	6.4	1.8	3.0	—
Spot oil prices ($ per barrel, Brent crude, end period)	25.7	22.4	19.8	25.0	—

— Not available.

Sources: *Asian Development Outlook* database; CEIC Data Company Ltd.; staff estimates.

September 11th attacks on the US. Because the export decline was somewhat larger than the decline in imports, the 2001 current account surplus as a proportion of gross domestic product (GDP) for developing Asia as a whole shrank slightly in 2001, as it has done every year since peaking at 5.4% in 1998.

On the domestic demand side, the relatively stronger growth rates in some DMCs generally originated in the contribution of sustained or accelerating consumption growth, while investment growth tended to be somewhat weaker. In some cases, such as the PRC, this was partly the result of sustained fiscal deficit spending. In others, such as India and the Philippines, strengthening consumption arose from rising agricultural output and incomes. In those cases of weaker growth or contraction, DMCs often experienced both slowing consumption growth—despite fiscal stimulus—and falling investment. This, for example, included Malaysia; Singapore; and Taipei,China, for all of which the sharp deterioration in ICT exports fed through into investment in the ICT sector as a result of the deterioration in the outlook for sales. Some Central Asian countries are exceptions to this trend of relatively weak contributions to growth from investment in comparison to consumption. Fueled by rapid expansion of the oil and gas sector, Azerbaijan, Kazakhstan, and Turkmenistan experienced rapid growth of investment.

Despite generally weaker GDP growth, inflation edged up in developing Asia from just over 2% in 2000 to about 3% in 2001. However, this level of inflation was still low by historical standards, despite significant monetary loosening across the region, particularly in East Asia and Southeast Asia. The loosening had only a limited effect because of weak credit expansion. Moderate exchange rate depreciation against the US dollar in much of developing Asia also had a limited effect on inflation because import prices were generally falling. Indonesia's inflation rate, however, accelerated from under 4% to over 11% because of increases in administered prices for fuel. Inflation continued to decline in Central Asia.

EXTERNAL CONDITIONS

Macroeconomic Conditions in Major Markets for Asian Exports

The market for one fourth of DMC exports, the US economy, is strengthening after a sharp mid-2000 deceleration that evolved into a mild recession by April 2001 and culminated in a GDP contraction in the third quarter of 2001. With accelerating consumption and government expenditure growth more than offsetting double-digit contraction in private investment and exports, GDP growth reappeared in the fourth quarter of 2001. Despite heightened uncertainty about economic prospects that characterized late 2001 and early 2002, the US economy returned to growth after only one quarter of economic contraction. A key element of this rapid rebound from the shallow recession was the behavior of consumption. Contrary to the typical experience of past recessions, consumption continued to grow—by 3.1% in 2001—despite contracting investment, falling financial wealth, rising consumer debt, declining employment, the events of September 11th, and the Enron collapse.

There were indications in the first quarter of 2002 that the US economy was gathering momentum for further strengthening. The wholesale inventories-to-sales ratio fell to 1.3 months in January 2002, its lowest level since March 2000. Manufacturing output began to grow again in February 2002 after 18 months of contraction. Seasonally adjusted employment, which fell in 5 of the 6 previous months, rose by 0.6% in February 2002. However, 2002 economic growth in the US is expected to be moderate relative to past recoveries because the mild character of the recession and persistent weakness in fixed investment reduce the scope for a strong rebound. Elsewhere in North America, Latin America, and the Caribbean, most economies with important economic ties to the US experienced relatively sharp slowdowns in 2001. Those economies with no significant cyclical or structural imbalances should rebound with the US.

The pace of 2001 economic growth in the euro area, which absorbs about 16% of DMC exports, slackened, and turned into a contraction in the fourth quarter. The contraction resulted from weak consumption growth and deeper contractions in fixed investment and exports. For 2001 as a whole, economic growth was relatively balanced across demand components—private and government consumption each grew at just under 2% but the drag from declines in both fixed and inventory investment more than offset the positive contribution from net exports.

The euro area economy was showing evidence in early 2002 of growth momentum. The purchasing managers' index for the euro area strengthened and business confidence rose for the second consecutive month in January 2002. However, the seasonally adjusted rate of unemployment remained at 8.5% in December 2001, unchanged since September 2001. In addition, consumer confidence declined in January 2002. As a result, consumption growth is expected to be subdued in the early part of the year. Overall, euro area economic growth is expected to strengthen modestly in 2002 relative to 2001.

The United Kingdom expanded at a relatively strong 2.4% in 2001 as sustained consumption and government spending growth more than offset weak investment and export demand. This robust performance, especially in the context of a weak global economy, is expected to continue in 2002 because of continued strength in domestic demand and improvement in external conditions.

Japan, which is the destination for over 12% of DMC exports, slipped into an economic recession in the second quarter of 2001. For the year, GDP declined because of a contraction in exports combined with shrinking public and private residential investment. This more than offset modest growth in business investment and government consumption, while private consumption stagnated.

In early 2002, there were some signs of a nascent Japanese recovery. Low business inventories and a strengthening US economy indicated an improving outlook. Further, consumer confidence in January 2002 rose relative to December 2001, after weakening for 3 consecutive months. Overall, domestic demand is forecast to contract in 2002 with, perhaps, sufficient offsetting improvement in the external sector to bring about zero growth over the year. However, private sector-led corporate mergers and acquisitions are increasingly restructuring the manufacturing and finance sectors, which should provide some scope for increased efficiency and productivity growth. This, together with sustained strength in external demand, should result in an improvement in the investment outlook, contributing to a return to growth in Japan in 2003.

In the US, despite the surge in energy prices early in the year, average annual consumer price index (CPI) inflation fell in 2001 to 2.9%, from an already relatively low 3.4% in 2000 (especially in the context of rapid growth and very low unemployment), while it edged up by 0.3 percentage points to 2.7% in the euro area. In Japan, deflationary conditions persisted as average prices fell by 0.7%, compared with a drop of 0.8% in 2000. Overall, subdued inflation in industrial economies was matched in developing economies as the prices for most commodities and some manufactured goods fell. The outlook is for global inflationary pressures to increase somewhat relative to 2001 but to remain relatively low in 2002–2003 by historical standards.

World Trade in Goods and Services

The US, euro area, and Japan together account for over 50% of DMC exports (when total DMC exports are adjusted for reexports from Hong Kong, China and Singapore). It was largely double-digit growth in imports by these three economies that fueled high rates of economic growth in many DMCs in 2000 and it was the rapid reversal of that trend that led to sharply slower growth rates in the same DMCs in 2001. Although the most extreme swing from strong growth to steep contraction occurred in the ICT sector, the trend was generally evident, though to a lesser extent, across most merchandise products.

Because of the relatively modest nature of the projected economic recovery in the US, euro area, and Japan, and because the trade-dominating ICT sector will revive only slowly, trade is expected to rebuild to rapid growth only gradually. Single-digit growth is expected in industrial economies' import volumes of goods and services in the first half 2002, as domestic demand expansion will be somewhat subdued because of lingering excess capacity and profit weakness in manufacturing, which will limit investment growth. Thus, in general, DMCs may experience slowly improving external demand, with growth of merchandise exports expected to be less than 6% in 2002, but conditions may vary by subregion and by sector.

Commodity exports are important to several DMCs, such as Indonesia, Viet Nam, and several economies in South Asia and Central Asia. Because of weaker world demand, commodity prices fell sharply in 2001, particularly in September 2001, reducing the value of such exports. Commodity prices experienced the beginning of a recovery later in the year, and these are generally expected to continue to rebound with the pace of global economic activity.

Of particular importance, as a key barometer of energy market conditions and of business costs, the spot price of crude oil softened over the course of 2001. This was despite announced production cuts by the Organization of Petroleum Exporting Countries, totaling 5 million barrels or 20% of its daily output, during the course of 2001. However, oil prices began to climb in early March 2002 because of renewed concerns about the stability of supply in the Middle East and because of a stronger outlook for global recovery. Prices are expected to continue to firm in 2002 but to stay within OPEC's target range of $22–$28 per barrel.

The value of commercial services exports, about 20% of world exports of goods and services, grew by 6% in 2000 but is expected to have expanded at a slower pace in 2001, or perhaps even contracted. This is because of generally slowing economic activity throughout the year and disruptions to trade and travel from mid-September 2001. DMCs account for about 15% of the value of total commercial services exports. Of special importance to many DMCs is the tourism industry. International tourist arrivals fell by 1.3% in 2001, compared with 7% growth in 2000, primarily because of a sharp worldwide drop in tourism in the last 4 months of the year. However, the outlook for the industry is considerably less bleak than predicted in late September 2001. While global travel is expected to remain subdued in the first half of 2002, it should recover in the second half of the year as expanding global economic activity increases business travel and aggressive marketing campaigns (emphasizing enhanced security measures and lower prices) begin to have a positive impact on leisure travel.

Financial Markets

Global financial developments are of concern to DMCs both because international investors, banks, and corporations are sources of financial capital and because DMC financial market trends are heavily influenced by trends in major markets. Global financial markets in 2001 were characterized by weakness in equity markets, lower interest rates, steeper yield curves, and increased risk premiums for low-grade investments. They were also remarkably resilient: they suffered severe disruption in mid-September 2001, after which financial market turbulence dissipated rapidly. Moreover, while the global slowdown and the events of September 11th generally reduced portfolio flows to emerging markets, rising risk premiums on Argentina sovereign bonds in late 2001 did not lead to a global increase in sovereign risk spreads, as similar episodes had in the past.

Worldwide equity markets were volatile in 2001 as sentiment about the expected duration of the economic downturn fluctuated between optimism and pessimism. Ultimately, markets worldwide lost value for the second year in a row, their worst performance since 1991, as the glowing corporate earnings outlook of the late 1990s faded amid a constant stream of announcements of downward earnings revisions. With substantial liquidity support from monetary authorities, coordinated efforts by market makers to avoid runaway sell-offs, and extensive corporate stock repurchases, stock markets in industrial countries (though not in emerging markets) returned to pre-attack levels by mid-October 2001. Because of evidence of improving conditions emerging in early 2002, most major stock markets had posted gains from the beginning of the year through 15 March 2002; the Morgan Stanley Capital International World Index was up by 0.6%.

Despite across-the-board declines in debt issuance, particularly in the second half of 2001, as corporate financing needs fell, credit spreads—generally falling in early 2001—began to rise in the third quarter for both lower-grade corporate issues and the sovereign debt of more vulnerable emerging markets. Whereas investment grade borrowers enjoyed more favorable rates, speculative grade issuers were increasingly confronted with higher spreads and more difficulty in placing issues. These tendencies, present in all markets, were more pronounced in emerging markets. There are several factors that may account for this tendency for investors to focus on certain emerging markets, especially those with generally stronger fundamentals in some areas—including lower levels of short-term external debt, more flexible exchange rates, and, in many cases, current account surpluses.

The increased occurrence of current account surpluses in several economies, notably emerging markets in Asia, was accompanied, naturally enough, by capital outflows. Generally, the trend after the Asian financial crisis of weak private capital flows to emerging markets continued in 2001. As a rule, net private capital flows to emerging markets have been weak since 1998 at frequently less than half the size experienced in the preceding 3 years. However, equity markets, particularly in East Asia and Southeast Asia, made some gains in the first quarter of 2002 as the global economic outlook improved. This trend should generally continue for all capital inflows (bank lending, portfolio flows, foreign direct investment) into emerging markets in Asia so that, overall, capital inflows into Asia are expected to increase in 2002 with the rebounding global economy.

The US dollar strengthened almost steadily throughout the first 6 months of 2001 against most major currencies. It began to soften in the third quarter, weighed down by evidence of a weakening economy, but recovered in the fourth quarter as investor flight to safe havens moved it higher against other major currencies. The US dollar ended the year slightly higher against the euro and significantly higher against the yen.

As inflationary pressure dissipated and economic activity slowed rapidly in the US (and more gradually in the euro area over the course of 2001) monetary authorities took countercyclical action—aggressively so in the US. As the year wore on, and the global nature of the slowdown became more apparent, official interest rates fell worldwide. In the US, although this had limited effect on investment, as plummeting profits and excess capacity led corporations to slash investment budgets, it lowered mortgage rates. The ensuing wave of refinancing bolstered household disposable incomes and provided support to consumption.

With clear indications of economic recovery, particularly in the US, and some evidence of inflationary pressure, particularly in the euro area, further easing in official interest rates is unlikely in 2002. However, with unemployment likely to remain relatively high, especially in the European Union (EU), in most of 2002, large increases in official interest rates are not anticipated during the year but some tightening of monetary policies is possible, perhaps as early as mid-year.

Countercyclical fiscal policy measures were also undertaken in 2001, although less aggressively and less uniformly. Under current policies, there will be considerable fiscal stimulus over the next 3 years, in particular in the US, where the combined effects of a June 2001 tax cut package and an emergency spending authority enacted after September 11th, totaling $375 billion over fiscal 2002 (ending September 2002) to fiscal 2004, are projected to further reduce the fiscal surplus in 2002.

OUTLOOK AND RISKS FOR DEVELOPING ASIA

Growth in developing Asia is expected to strengthen moderately in 2002, picking up further in 2003, as the region slowly returns to a more balanced and sustainable pace of development—which may be below historical long-run growth rates—after a turbulent 1997–2001 period. A critical question for these DMCs is whether, and how soon, they can return to rates of growth approaching that long-run trend. Over the next few years the answer rests, in part, on the strength of external demand. Ultimately, however, DMC growth performance will depend on domestic conditions. For those countries most affected by the financial crisis, weak financial and corporate fundamentals caused by high levels of nonperforming loans will inhibit long-run growth.

The projections for 2002–2003 are contingent upon a sustained improvement in the global environment, although DMC export growth rates are not expected to return to the over 20% rate seen in 2000. The US recovery that began in the fourth quarter of 2001 is expected to continue to build, although slowly by the standards of past recoveries. It should be accompanied by an improvement in economic conditions in the EU and Japan. Other external conditions key to a sustained and robust revival of economic expansion in developing Asia include relatively low and stable oil prices and interest rates throughout 2002. Further, it is assumed that the major currencies will experience no major realignments in 2002. Moreover, a continuing trend of generally falling bond spreads in developing Asia will be important. Under these conditions, a gradual recovery in global trade and a moderate improvement in capital flows to DMCs should provide favorable conditions for economic growth to all the subregions of developing Asia.

Increased uncertainty over economic conditions has complicated the task of forecasting in recent years. Thus, a careful assessment of risk factors is critical to an understanding of the complete picture of possible economic performance in developing Asia. The major short- to medium-term external risks to the moderate recovery forecast for the region are that (i) export demand will be weaker than anticipated and that (ii) disruptive global events or temporary bottlenecks will cause inflationary pressure for key commodities—particularly oil. The primary medium- to long-term internal risk to the ability of a large number of DMCs to generate stronger growth rates is that slow progress in structural reform will inhibit domestic demand and productivity growth.

TABLE 2 Comparison of Outlook to Past Performance, Selected Developing Member Countries (GDP growth in %)

	1951 –2000	1981 –1990	1991 –1996	1997 –2001	2001	2002	2003
12 Selected DMCs	6.6	7.7	8.1	4.6	3.8	4.9	5.8
East Asia (3 economies)	7.5	9.2	9.1	5.8	4.3	5.5	6.3
China, People's Rep. of	6.9	9.4	11.4	7.3	7.3	7.0	7.4
Korea, Rep. of	7.9	9.4	6.9	4.8	3.0	4.8	6.0
Taipei,China	8.2	8.0	6.6	3.8	-1.9	2.8	4.0
Southeast Asia (5 economies)	6.2	6.1	7.5	1.2	1.8	3.1	4.2
Indonesia	5.9	5.3	7.4	0.0	3.3	3.0	3.6
Malaysia	6.5	5.1	9.1	1.5	0.4	4.2	5.8
Philippines	4.1	1.0	3.5	2.6	3.4	4.0	4.5
Singapore	8.0	6.1	9.2	4.0	-2.0	3.7	6.5
Thailand	6.8	7.6	8.0	0.0	1.8	2.5	3.0
South Asia (4 economies)	4.3	5.4	5.7	5.4	4.8	5.4	6.4
Bangladesh	3.5	4.0	4.5	5.2	5.2	4.5	5.7
India	4.2	5.5	6.1	5.7	5.4	6.0	6.8
Pakistan	5.3	6.1	3.9	3.7	2.6	3.0	5.0
Sri Lanka	4.0	3.7	5.2	3.9	-1.3	3.5	5.5

Sources: *Asian Development Outlook* database; staff estimates.

External Risks

A major risk that could result in slower regionwide economic growth in 2002–2003 than expected in the *Asian Development Outlook 2002* forecast is that the recovery in external demand could be weaker than expected. This could occur for two reasons. First, the global trend of strengthening economic activity and trade could be slowed by prolonged weakness in investment. Second, a current account correction or increased transaction costs on international trade could reduce the US propensity to import goods for a given level of aggregate demand. Consequences for DMCs include (i) continued weakness in export markets; (ii) further erosion of corporate and finance sector health resulting from a prolonged period of weak earnings; and (iii) high unemployment or underemployment with continued fiscal constraint, implying slowing progress in poverty reduction.

A possible source of a faltering global rebound is the inability of the US economy to sustain its emerging recovery because consumption might slow and exports remain lethargic. This would likely result in generally weak earnings projections, which, in turn, would prevent a recovery of investment demand. However, as evidence of US economic strengthening continued to mount in late March 2002, this risk appeared to recede.

An adjustment to the US current account balance is a second reason for lower external demand that could affect the economic recovery in developing Asia by reducing export demand even in the event of a US recovery. Such an adjustment is of increasing concern because of the sheer magnitude of the US deficit in recent years. There is a fair possibility that, with the US poised to emerge from the global economic slowdown ahead of both the EU and Japan, the US current account deficit will widen further before it begins to shrink, increasing the chance of a sharp adjustment being precipitated by an event (or series of events) that erodes the global appetite for US financial assets. Although a current account correction would likely be gradual, it would tend to reduce the US propensity to import. A second factor that might reinforce this tendency is an increase in trade costs associated with heightened security concerns.

A significant risk to the recovery that was of increasing concern in late March 2002 involved a reemergence of inflation. There are two possible scenarios. First, disruptive events in the Middle East could cause skittish oil markets to send prices higher. The price of Brent crude oil shot up by over 15% in about a week to $22.85 by 7 March 2002. Second, the lagged effects of large doses of macroeconomic stimulus—combined with aggressive inventory corrections and large numbers of layoffs—could create a scenario in which bottlenecks occur, fueling inflationary conditions that lead to premature tightening by monetary authorities.

Domestic Risks

Because the outlook for external demand recovery remains relatively moderate, achieving and sustaining higher rates of poverty-reducing economic growth over the medium term rests, more than ever, on the strength and character of domestic demand expansion. DMCs, particularly those in East Asia and Southeast Asia (which have historically encouraged high savings rates and favored investment in export industries) are increasingly recognizing the critical contribution that a vibrant domestic market can make to a stable and balanced growth path in which all the major sectors of the economy experience dynamic progress. In South Asia, the risk is that the pace of the reform agenda will falter, resulting in slower improvements in economic efficiency and resource allocation.

Thus, a significant risk on the domestic front for many DMCs is that they may fail to take the opportunity to use the stronger growth performance of the next 2 years to move aggressively on structural reform. Renewed focus on domestic demand policies, including progress on corporate and financial restructuring, as well as competition policy and labor market reform, could provide the impetus for continued high rates of long-run growth. With slow progress on reform, DMCs risk a prolonged period of low growth because of increased global competition in traditional export markets and the likelihood of reduced industrial country import growth over the medium term.

Part II

REGIONAL TRENDS AND PROSPECTS IN DEVELOPING ASIA

EAST ASIA

East Asia, with a 58% weight in aggregate DMC economic activity, experienced a significantly slower pace of economic growth in 2001 than in the previous year (Table 3). Growth moderated in the PRC, decelerated rapidly in Korea and Hong Kong, China, and reversed into recession in Taipei,China. Mongolia continued to struggle with low growth performance because of severe weather conditions and low commodity prices. The ability of the PRC to sustain a relatively high growth rate resulted primarily from strengthening consumption and, to a smaller degree, the momentum of optimism surrounding World Trade Organization (WTO) accession. This drove foreign direct investment 15% higher than in 2000 to $46.8 billion, which, together with stronger domestic debt-financed public investment, lifted fixed investment by over 11% to nearly 39% of GDP in 2001 from 37% in 2000. In contrast, Korea and Taipei,China suffered fixed investment contractions of 1.7% and 18.2%, respectively, partly because of the global correction in the ICT sector. Taipei,China's investment contraction was more severe because of a trend toward shifting production to the mainland in some industries. Hong Kong, China managed a 2.1% increase in fixed investment, based, in part, on an improvement in equipment purchases.

The growth in value of the PRC's merchandise exports decelerated from 27.9% in 2000 to 6.8% in 2001. In 2001, the value of merchandise exports from

Korea fell by 14%, from Taipei,China by 17.3%, and from Hong Kong, China by 5.9%, reflecting the varying degrees of concentration of ICT products in their export mixes. Hong Kong, China suffered the further blow of a steep drop in demand for commercial port services as world trade activity, and particularly the PRC's, slumped.

TABLE 3 Growth Rate of GDP, East Asia, 1999–2003

	1999	2000	2001	2002	2003
East Asia	7.6	8.3	3.9	5.2	6.2
China, People's Rep. of	7.1	8.0	7.3	7.0	7.4
Hong Kong, China	3.0	10.5	0.1	2.1	4.8
Korea, Rep. of	10.9	9.3	3.0	4.8	6.0
Mongolia	3.2	1.1	1.5	3.0	4.9
Taipei,China	5.4	5.9	-1.9	2.8	4.0

Sources: Asian Development Outlook database; staff estimates.

Finance sector performance also showed a divergence in 2001 among the East Asian economies. Korea's stock market performance was among the best in the world, with the Korean Stock Price Index surging by 32% in US dollar terms. In part, this was a consequence of the perceived long-run strength of the economy. Because of sharply decelerating growth and uncertainty about future prospects, Hong Kong, China's Hang Seng Index lost 25% of its value in 2001. Taipei,China's Taiwan Stock Exchange Index, which had fallen by about 27% in US dollar terms through the third quarter of 2001, bounced back in the fourth quarter to improve by over 11% during the year largely as a result of some government interventions.

With the pace of economic activity ebbing, inflation, at 1.4%, was slightly higher in East Asia in 2001 than in 1999 or 2000, but still very low. Labor market conditions generally deteriorated in the subregion. Unemployment reached a record 5.3% in Taipei,China. However, in Korea, the unemployment rate fell over the course of the year as strong domestic demand propelled services sector job creation and opposition to corporate restructuring retarded job cuts in manufacturing. In Hong Kong, China the unemployment rate rose from 4.4% in 2000 to 6.1% in 2001. This was nearly as high as the record level experienced in 1999, when the economy grew slowly as it struggled to recover from a sharp, financial crisis-related contraction in 1998. Uniquely among DMCs, Hong Kong, China recorded price deflation in 2001, for the third year in a row, as property prices continued to decline and retailers offered large discounts to reduce inventories.

Under these conditions of low inflation and rising unemployment, there was moderate macroeconomic stimulus in East Asia. The PRC sustained a policy of deficit spending, but did not widen the deficit as increased revenues allowed increased public expenditures. Korea adopted a more expansionary fiscal policy with tax cuts and a supplementary spending package in the third quarter. Hong Kong, China's fiscal deficit ballooned from less than 1% of GDP in 2000 to over 5% in 2001 as rapidly decelerating economic activity eroded revenues while expenditures rose by over 10%. Taipei,China also significantly increased its fiscal deficit in 2001 with a combination of lower revenues and increased spending.

Monetary policy was accommodative in 2001 in Korea and Taipei,China, which made official interest rate cuts of 125 basis points and 250 basis points, respectively. But this had limited impact on credit expansion through much of the year, although retail lending began to pick up in the fourth quarter of 2001 in Korea. Both economies experienced relatively mild exchange rate depreciation. In the PRC, interest rates on US dollar deposits were cut more or less in line with US official target cuts, leaving them lower than local currency deposit rates at the end of 2001. Similarly, Hong Kong, China lowered interest rates in parallel with the US cuts. The PRC maintained its de facto exchange rate peg to the US dollar and Hong Kong, China maintained its currency board arrangement.

In terms of structural changes, the PRC and Taipei,China joined the WTO, thereby committing to a wide range of reforms. The benefits of these reforms will be felt over the medium to long term.

Over the next 2 years, economic performance is expected to strengthen in East Asia, with GDP growth rising to over 5% in 2002 and to over 6% in 2003. In part, this will come about because of an improvement in the external environment. The value of merchandise exports, which contracted in 2001, will grow moderately in 2002 before rebounding to nearly 9% growth in 2003. This should allow the PRC to boost growth moderately in 2003 after some slowing in 2002 as it begins to adjust to WTO membership. GDP growth in Korea should strengthen in 2002 as the US recovers, with further improvement in 2003 as its other important market, Japan, strengthens. Economic growth in Hong Kong, China will improve moderately but it will be limited by continued weakness in domestic markets—particularly real estate. Taipei,China will revive slowly from recession as a weak global recovery and uncertain investor and consumer confidence combine to limit the strength of the rebound. Mongolia, while still suffering from the devastating effects of severe winter weather on agriculture, should benefit from a recovery in commodity demand.

SOUTHEAST ASIA

With nine members of the Association of Southeast Asian Nations (except Brunei), this subregion, representing just under a quarter of DMC economic activity, slowed from nearly 6% growth in 2000 to below 2% growth in 2001. However, there was a marked contrast between the performance of Singapore and four former crisis countries of Indonesia, Malaysia, Philippines, and Thailand on the one hand, and of the Mekong countries of Cambodia, Lao People's Democratic Republic (PDR), and Viet Nam on the other. The former group generally suffered more severely from exposure to the global economy.

TABLE 4 Growth Rate of GDP, Southeast Asia, 1999–2003

	1999	2000	2001	2002	2003
Southeast Asia	3.8	5.9	1.9	3.4	4.3
Cambodia	6.9	5.4	5.3	4.5	6.1
Indonesia	0.9	4.8	3.3	3.0	3.6
Lao People's Dem. Rep.	7.3	5.9	5.5	5.8	6.1
Malaysia	6.1	8.3	0.4	4.2	5.8
Myanmar	10.9	6.2	—	—	—
Philippines	3.4	4.0	3.4	4.0	4.5
Singapore	6.9	10.3	-2.0	3.7	6.5
Thailand	4.4	4.6	1.8	2.5	3.0
Viet Nam	4.7	6.1	5.8	6.2	6.8

— Not available.
Sources: Asian Development Outlook database; staff estimates.

Heavily dependent on ICT trade, Singapore's economy, after booming with 10.3% growth in 2000, contracted by 2.0% in 2001 as the value of merchandise exports shrank by 11.9%. Malaysia's economy, similarly ICT trade-dependent but with a smaller drop in domestic demand, decelerated from over 8% growth in 2000 to less than 1% in 2001. In Thailand, with a somewhat smaller export contraction, economic growth slowed from 4.6% in 2000 to 1.8% in 2001. In contrast, the Philippines, which suffered a 16.2% decline in exports, experienced only a modest slowdown in economic growth because of stronger domestic demand. With a relatively diversified export base, Indonesia's 2001 economic performance lagged behind only that of the Philippines in this group, because of less strength in domestic demand.

In contrast, Cambodia, Lao PDR, and Viet Nam all sustained GDP growth rates of over 5% in 2001 with merchandise export value growth rates of 6–8%. This is, in part, because these economies have preferential (Cambodia) or improved (Viet Nam) access to markets in industrial economies, allowing strong growth of textile and clothing exports. Additionally, Viet Nam benefited from robust expansion in fisheries exports. Moreover, the agriculture sector, which is still large in these economies relative to the four former crisis countries, had a reasonably good 2001 in Cambodia and the Lao PDR. Viet Nam had healthy investment growth because of investor optimism generated by a bilateral trade agreement signed with the US in 2000.

The relatively slow growth rates of Southeast Asia in 2001 meant further delays in meaningful improvement of the welfare of the poor, particularly in

Indonesia and Thailand but also in the Philippines. In Cambodia, Lao PDR, and Viet Nam, steady growth performance and job-creating expansion of export manufacturing sectors in 2001 allowed poverty reduction progress to be sustained.

The direction of macroeconomic policy in 2001 was mixed in Southeast Asia, with Malaysia and Singapore adopting aggressive stimulus measures similar to those of the East Asian economies while other governments pursued less active countercyclical policies, in part because of limited capacity to do so. Indonesia, Malaysia, and Singapore all adopted more expansionary fiscal policies—Malaysia and Singapore by enacting supplementary stimulus budgets in the face of rapidly slowing economies. Indonesia's wider deficit arose from debt-servicing and project-funding requirements. This wider deficit was thus planned and Indonesia met its deficit target under an International Monetary Fund (IMF) agreement and was able to sign a new letter of intent with IMF in November 2001. The fiscal deficit in the Philippines remained at 3.8% of GDP in 2001. Thailand's deficit fell by a full percentage point to 2.1% of GDP because of lower capital spending. In the three Mekong countries, the size of the fiscal deficits relative to GDP, which are mostly financed by official development assistance, was broadly stable in 2001.

Monetary policy across the subregion was mixed as monetary authorities, with varying tools, straddled competing objectives. In the Philippines, interest rates have been lowered by more than 750 basis points since December 2000, at which time they were at high levels, having been raised to prevent capital flight. In contrast, Indonesia and Thailand have followed relatively tight monetary policies. In Indonesia, with inflation at a double-digit level, the exchange rate still weak, and the need to attract financing for public debt, interest rates remained high. In Thailand, official interest rates were raised in mid-2001 because of concern about a weakening baht and capital outflows. In Malaysia, which pegs the ringgit to the US dollar, the central bank made only one official interest rate cut, of 50 basis points in late September 2001. In Singapore, which does not directly influence interest rates but maintains an exchange rate band, this band was widened to allow the Singapore dollar more flexibility to adjust to external conditions.

The outlook for Southeast Asia is for gradual strengthening of economic growth that will, nevertheless, stay well below past performance over the medium term. For Indonesia, Philippines, and Thailand, this is because external demand will only slowly recover and because domestic demand will remain weak over the medium term. To varying degrees, high levels of public debt, incomplete corporate and finance sector restructuring, investor caution, and weak political will to reform hamper each of these countries. Thus, each is expected to continue to make only very limited progress in reducing poverty. In contrast, Cambodia, Lao PDR, and Viet Nam are expected to continue to improve both economic performance and capacity to significantly reduce poverty over the medium term.

SOUTH ASIA

South Asia accounts for about 17% of the DMCs' GDP, of which India represents 75%. In India, with fiscal year 2001 closing at end-March 2002, substantially improved agriculture sector performance is projected to offset slowing industrial growth. Bangladesh, Nepal, and Pakistan, for which the fiscal year ended in mid-2001, experienced moderately slowing economic growth, primarily because of slowing agricultural growth in Bangladesh and Nepal—after bumper crops in the previous year—and because of a drought-related agricultural contraction in Pakistan. In the first half of fiscal year 2002 (the second half of calendar year 2001), these countries experienced further weakening in the pace of economic activity, in part because of slowing external demand and the disruptions of military operations in Afghanistan. For the economies reporting on a calendar year basis, Bhutan maintained strong economic growth based on expansion of the hydropower sector; performance in the Maldives deteriorated because of a severe drop in tourism in the fourth quarter; and Sri Lanka experienced a contraction because of slowing external demand and drought, exacerbated by security problems.

TABLE 5 Growth Rate of GDP, South Asia, 1999–2003

	1999	2000	2001	2002	2003
South Asia	5.7	4.2	4.9	5.4	6.4
Bangladesh	4.9	5.9	5.2	4.5	5.7
Bhutan	7.3	5.7	6.5	6.5	6.5
India	6.1	4.0	5.4	6.0	6.8
Maldives	7.4	4.6	2.1	2.0	0.0
Nepal	4.4	6.1	5.0	3.5	5.0
Pakistan	4.2	3.9	2.6	3.0	5.0
Sri Lanka	4.3	6.0	-1.3	3.5	5.5

Sources: Asian Development Outlook database; staff estimates.

Although not so heavily dependent on the ICT sector, the subregion experienced a drop in merchandise exports that was nearly as severe as that in East Asia and Southeast Asia. India is expected to experience a contraction in merchandise exports in fiscal year 2001, in part because of a drop in demand for its computer and ICT-related services. In Bangladesh and Pakistan, export growth in 2001 strengthened relative to 2000. During 2001, exports of textiles and garments were relatively robust, benefiting in part from strong US consumption growth. Nepal's exports growth settled back to 4% in 2001 from rapid growth in 2000 because of expansion of carpet and garment exports that year. Sri Lanka suffered a sharp reversal in export performance, from double-digit growth to double-digit contraction, because of deterioration in external markets and internal disruptions, which raised shipping costs. In addition to weakness in merchandise exports, tourism suffered in South Asia. International tourist arrivals to the subregion are estimated by the World Tourism Organization to have fallen by over 6% in calendar year 2001 with Maldives, Nepal, and Sri Lanka, where tourism is more important, the hardest hit.

With rapid labor force growth in South Asia of 2% a year and significant underemployment or disguised unemployment, real GDP growth of less than 5% for the subregion is probably insufficient to generate adequate jobs and wages growth to meaningfully reduce poverty. Although strong agricultural performance in Bangladesh and India likely helped the rural poor subsist, weak industrial growth did not generate the higher incomes and lower-risk employment that can provide more secure graduation from poverty.

Fiscal policy was variable. India's fiscal deficit is likely to have widened because of a combination of contracting imports, and hence lower import-based revenues, and increased defense spending. Pakistan, in contrast, cut its fiscal deficit by more than 1 percentage point of GDP to 5.3% under an IMF standby arrangement, although this was accomplished primarily through expenditure cuts. Bangladesh and Sri Lanka both had small increases in their fiscal deficits as a proportion of GDP. Despite this progress, South Asia continues to be characterized by relatively high fiscal deficits and large government debt burdens.

Against a backdrop of generally low or falling inflation, monetary policy in South Asia was moderately accommodative—India reduced the official bank rate from 7.0% to 6.5%, Pakistan from 12.0% to 9.0%—but with limited impact because of conditions of excess liquidity. Both Pakistan and Sri Lanka moved to more liberal exchange rate regimes. Pakistan moved from a managed float to a free float exchange rate system at the start of fiscal year 2001. Sri Lanka moved from a fixed rate to a float in January 2001 as reserves dwindled, and the currency depreciated. Bhutan and Nepal retained exchange rate pegs to the Indian rupee.

Perhaps the key constraint on development in the subregion is that structural reforms are either slowing or stagnant. In India, a combination of factors complicates the related issue of privatization. Pakistan is having similar trouble finding buyers for some of its state-owned enterprises, given the current economic climate. In Bangladesh, the new Government intends to broaden market-friendly reforms, but concrete progress has yet to be made. Nepal's efforts to reform its troubled banking sector are moving ahead slowly, amid political and economic turbulence.

The outlook for South Asia is for further strengthening of growth over the medium term. In part, this is a result of an improvement in external demand both because of a generally improving global economy and because of more stability in the subregion. Merchandise export growth should accelerate significantly. Tourist arrivals should rebound somewhat in the second half of calendar year 2002, although the subregion's tourism industry is expected to recover only slowly from the impact of September 11th and its aftermath. A general improvement in domestic demand is also forecast for the subregion. Based on the improvements in global economic conditions, internal security, and political stability, investment growth should improve. In Afghanistan and Pakistan, substantial inflows of official development assistance should support increases in public investment.

CENTRAL ASIA

Central Asia, benefiting from strong commodity demand in late 2000 and early 2001, and from rising investment in energy and minerals, enjoyed rapid growth in 2001. Growth accelerated in 2001 despite slowing commodity demand and low commodity prices in the fourth quarter of the year. In Azerbaijan, Kazakhstan, and Turkmenistan, where oil and gas accounted for over 80%, over 50%, and over 60%, respectively, of the value of exports in 2000, the volume of oil and gas exports continued to rise in 2001. Further, investment in the development of oil and gas fields continued to expand. In the Kyrgyz Republic, where gold mining dominates industrial activity, economic growth was sustained in 2001 largely by increased gold production and strong agricultural growth, particularly grain production. In Tajikistan, aluminum, accounting for 50% of the value of exports, sustained industrial growth in 2001, which together with very strong agricultural performance, primarily in cotton, boosted economic growth. The performance of Uzbekistan, with the largest population among the Central Asian republics (CARs), has lagged behind that of the other CARs because of structural problems, lack of resources, and weak exports.

TABLE 6 Growth Rate of GDP, Central Asia, 1999–2003

	1999	2000	2001	2002	2003
Central Asia	4.9	8.7	10.7	5.7	6.4
Azerbaijan	7.4	11.1	9.9	10.0	11.0
Kazakhstan	2.7	9.8	13.2	7.0	6.0
Kyrgyz Republic	3.7	5.4	5.3	4.5	4.5
Tajikistan	3.7	8.3	10.0	6.0	5.0
Turkmenistan	16.0	17.6	20.5	11.0	11.0
Uzbekistan	4.4	4.0	4.5	4.0	5.0

Sources: Asian Development Outlook database; staff estimates.

Large structural distortions, off-budget spending, and inaccurate statistics make it difficult to interpret or compare developments in macroeconomic policies in the CARs. Nevertheless, some common features are apparent. Many CARs are dependent on taxes from commodity exports for revenues but otherwise have weak tax administration. Azerbaijan and Kazakhstan have set up national funds with oil sector receipts that can help cushion the budget in lean times. Both appear to have allowed fiscal deficits to widen somewhat in 2001, with increased expenditures on state payrolls in Azerbaijan and on defense in Kazakhstan. The Kyrgyz Republic recorded a sharp drop in revenues as a proportion of GDP in 2001 because revenue collection efforts failed to keep pace with economic growth. Uzbekistan, with low revenues and extensive off-budget subsidies to state-owned enterprises and favored sectors under import-substitution schemes, financed the deficit through borrowing from the central bank.

The outlook for the CARs is for economic growth to moderate somewhat from the rapid pace set in 2000 and 2001. Nevertheless, growth will still be in the double digits in Azerbaijan and Turkmenistan, and 5–7% in Kazakhstan and Tajikistan, as they continue to rebuild their economies on the basis of continued expansion of their export sectors. However, the Kyrgyz Republic and Uzbekistan will likely experience slower growth than the other CARs over the next 2 years, reflecting weak export markets. Sustaining or improving performance in the subregion will depend primarily on structural reforms that address the weaknesses discussed above and that allow diversification away from overdependence on commodity exports.

PACIFIC DEVELOPING MEMBER COUNTRIES

The Pacific DMCs manifested a mixed performance in 2001. Papua New Guinea underwent a second year of economic contraction, in part because of a strong decline in mining and in part because commodity exports fell with weakening world demand. The Fiji Islands recovered from a political crisis-induced contraction of economic activity in 2000 to record growth of about 1.5% because of rebounding tourism. Samoa and East Timor experienced double-digit growth, the former because of reforms introduced in the 1990s and the latter as conditions normalized and the country began to recover from substantial deterioration in 1999. The economies of Solomon Islands and Vanuatu both contracted, the former for the third straight year as a consequence of ethnic unrest and the latter because of cyclone damage to agricultural production. The Cook Islands sustained moderate growth based on strength in tourism while Tuvalu did so with higher public spending. While Kiribati emerged from recession based on expansionary fiscal policies, the Marshall Islands and the Federated States of Micronesia struggled, with growth of less than 1%.

A common theme among the Pacific DMCs is difficulty in fiscal management because of the small size of the economies, exposure to external shocks, inexperienced civil services, dependence on external funding, and frequent episodes of political instability. In Papua New Guinea, with tax revenues declining in the face of a weakening economy, the Government was forced to shave expenditures because of a delay in accessing external funding that depended on the privatization of a public sector bank. The Fiji Islands ran a fiscal deficit of 4.9% of GDP, financed by an increase in government debt to 43% of GDP, excluding contingent liabilities. Kiribati was able to draw on resources from its Revenue Equalization Reserve Fund to replace a shortfall in revenues while Nauru has virtually depleted a similar fund, built on revenues from now exhausted phosphate mines. The Marshall Islands and the Federated States of Micronesia each relies on US transfers under a Compact of Free Association, extensions to which are currently under negotiation. The Cook Islands made progress in reducing its large public debt through improved revenue mobilization. Solomon Islands and Tonga have deteriorating fiscal positions, leading to high debt and balance-of-payments pressures in both countries.

TABLE 7 Growth Rate of GDP, Pacific DMCs, 1999–2003

	1999	2000	2001	2002	2003
Pacific Developing Member Countries	6.6	-1.0	-0.8	1.9	2.6
Cook Islands	2.7	4.1	3.0	2.5	3.3
Fiji Islands	9.7	-2.8	1.5	3.5	4.7
Kiribati	2.1	-1.7	1.5	2.8	2.5
Marshall Islands	-0.2	0.7	0.6	0.7	—
Micronesia, Federated States of	1.1	2.5	0.9	3.3	0.7
Papua New Guinea	7.6	-0.8	-3.3	1.2	1.8
Samoa	3.1	7.3	10.0	5.0	5.0
Solomon Islands	-1.3	-14.0	-5.0	-5.0	0.0
Tonga	3.1	6.2	3.0	2.9	2.6
Tuvalu	3.0	3.0	4.0	3.0	3.0
Vanuatu	-2.5	3.7	-0.5	0.7	1.9

— Not available.
Sources: Asian Development Outlook database; staff estimates.

The Pacific DMCs are forecast to return to growth in 2002, with further strengthening in 2003, as Papua New Guinea emerges from recession into low growth because of a combination of modest improvements in agriculture and structural changes in the economy. Economic growth is expected to strengthen in the Fiji Islands, with generally broad-based growth led by improvements in tourism. In general, prospects for economic growth in the Pacific DMCs are clouded by a host of structural problems, including factor market rigidities, depletion of natural resources, the continued potential for civil unrest, and the domination of economic activity by the public sector.

Part III

PREFERENTIAL TRADE AGREEMENTS IN ASIA AND THE PACIFIC

INTRODUCTION

Trade openness is widely recognized as a cornerstone of economic development and growth, and through these, poverty reduction. Open borders have been linked with stimulation of economic growth, microeconomic improvements in the efficiency of resource allocation, and increasing the level of competition in industries. Trade increases the variety of intermediate products and capital goods that are available, and opens up communications channels for exchange of production methods and business practices. Economic integration has also been shown to have an important impact in reducing corruption, increasing government responsiveness, and improving the quality of economic policies. Although there is substantial debate about the extent of the short-term adjustment costs of reducing barriers to trade, there is widespread agreement that increased trade openness has a significant long-term positive impact on economic development. In this context, developments in preferential trade agreements (PTAs) and multilateral trading arrangements carry important implications for future economic growth and prospects for reducing poverty in the developing world.

There are many reasons to be optimistic about increasing global trade and the trend among economies in the Asia and Pacific region toward greater integration, including expansion of regional PTAs. The volume of trade globally has risen steadily in recent decades and the increase was particularly sharp in the 1990s. This growth has enabled Asian economies to increase the per capita income of their populations and to achieve significant reductions in the incidence and severity of poverty. Simultaneous with the strong growth, there has been a rapid increase in the number of international trading arrangements, including PTAs. The growth in international trade and the increasing importance of trade in determining the level of economic growth that countries can achieve have been leading nations to devote greater energies to develop PTAs while they negotiate global trade agreements under the auspices of the World Trade Organization (WTO), though the Asian financial crisis had a stifling effect on aggregate growth rates and the expansion of PTAs in the region.

The debate over the relative merits of PTAs is pertinent for DMCs for several reasons. First, the number of PTAs in the region is growing. The Association of Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC) have formed PTAs—the ASEAN Free Trade Area (AFTA) and the SAARC Preferential Trading Arrangement (SAPTA). Australia and New Zealand have deepened the Closer Economic Relations Trade Agreement (CER) and extended preferential trade to their Pacific island neighbors via the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA). In addition, several Pacific island nations have joined the Melanesian Spearhead Group (MSG). The Asia-Pacific Economic Cooperation (APEC) arrangement continues to evolve. Bilateral agreements in Central Asia have multiplied and a Japan-Singapore trade agreement was signed in January 2002. Other PTAs are also on the agenda. For example, an East Asian Free Trade Agreement, an expansion of ASEAN, and bilateral agreements between Japan and Korea are currently being discussed.

Most theoretical work in economics suggests that PTA-enhanced trade is not as beneficial to welfare as more general trade liberalization. Although inferior to a multilateral trading arrangement in reducing the barriers to trade on a global scale, PTAs receive support as a second-best means of promoting trade liberalization in a context where multilateral negotiations proceed slowly. PTAs generate increases in market size and result in increases in the variety and availability of new products. Nevertheless, when compared with multilateral trade liberalization, PTAs are more limited vehicles for compelling economic efficiency and enhancing welfare. First, the product variety among PTA members is lower than the product variety in the world. Second, a PTA-created market, as the product of an agreement among a few countries, is obviously smaller than the world market.

Opinions vary regarding how effective PTAs are for creating incentives for efficient allocation of resources. Opponents of PTAs point out that patterns of specialization in PTAs are not necessarily those that would occur if the country had opened its borders to the world economy. They also stress the potential that PTAs create for a complicated network of overlapping rules and trade restrictions that will suffocate trade across PTAs. From the critics' perspective, the political attractiveness of PTAs is cause for fear that trade agreements negotiated outside of the WTO forum could lead to a reduced importance for WTO and preclude global free trade.

The difference between the effects of PTA-enhanced trade and more general liberalization varies with the institutional design of the PTA. The size of the tariff differential for members relative to the rest of the world determines the extent of distortion, primarily trade diversion, which the PTA can create. The greater the advantage accorded to members, the more the agreement isolates members from competition by firms in countries outside of the PTA. The incentives for inefficient specialization is determined by the difference in member countries' external tariffs and the necessity for developing and implementing rules of origin to prevent nonmembers' goods from entering the group via the member country with the lowest level of trade protection. The adoption and enforcement of rules of origin can lead to distortions in production and location decisions, create incentives for unproductive lobbying activity, and open up wide scope for rent seeking. The extent of the market created by a PTA depends heavily on the trade facilitation and nontrade measures that are incorporated into the agreement. PTAs can potentially lower border costs more than general liberalization because the smaller number of member countries are more likely to reach agreement on regulatory policies, customs procedures, and infrastructure priorities to promote trade.

There are diverse opinions within the economics profession regarding the welfare effects of PTAs when these are considered in terms of their efforts to foster economic cooperation and integration rather than their narrower effects on trade liberalization. This is particularly relevant to the effects of PTAs as institutional trading arrangements for broader regional economic corporation and integration, an area to which economic analysis has devoted less attention than the narrower effects on international trade. Many of the positive effects of PTAs arise in this area.

On nontrade grounds, PTAs have several potentially beneficial effects as instruments for structural change. The institutional design of the PTA can have an important impact on how much the gains from PTA trade approximate the gains from more general liberalization as well as the degree to which nontrade benefits are realized. For example, the limited market size of a PTA can be mitigated by deep integration, such as harmonization of regulations and streamlining of customs procedures, that reduces border costs by more than simple tariff changes. Further, PTAs, as internationally negotiated pledges to leave unchanged trade reforms made in the past or to implement trade liberalization in the future, demonstrate greater commitment to reform than unilateral declarations of intent. This is particularly true when the PTA includes procedures for identifying and sanctioning countries that renege on the agreements. PTAs also provide forums for interaction between leaders as well as technical officials in member countries. This interaction can have positive spillovers for resolving other conflicts, enhancing regional cooperation in larger multinational negotiations, and generally ensuring a higher level of international communication.

PREFERENTIAL TRADE AGREEMENTS AND THE WORLD TRADE ORGANIZATION

Clearly, there is a need to reform the regulations governing the relations between PTAs and WTO, and to improve the institutional architecture guiding the interaction between PTAs and WTO. The future economic growth of the Asia and Pacific region is clearly linked to the health of the multilateral trading system.

The WTO rules-based multilateral trading system was strengthened and made even more global with the accession to WTO of the PRC in late 2001 and Taipei,China in early 2002. The trade growth that will emerge from the PRC over the next few years will present an adjustment challenge in the short term for other DMCs in the region. Nonetheless, the medium- to longer-term prospect is for a more efficient location of production in industry in general and thus for accelerated economic growth.

Several DMCs are still in the midst of negotiations to join WTO, including Cambodia, Lao PDR, Nepal, Viet Nam, several Central Asian countries, and some Pacific DMCs. The recent commitment by WTO members at Doha to accelerate the pace of accession negotiations for developing and, especially, for least-developed countries provides an opportunity for these economies to speed up their reform process and thereby begin reaping the various benefits of WTO membership earlier.

POLICIES FOR THE ASIA AND PACIFIC REGION AND FUTURE DEVELOPMENTS

The operational question now facing policymakers is how to achieve fuller benefits of increased openness to trade. Although they involve a measure of controversy—particularly within the economics profession—PTAs are, at the moment, a popular means of liberalization in the face of domestic and international constraints. There are several issues, however, that need to be addressed.

The first issue is that PTAs in the Asia and Pacific region appear to be a suboptimal route to free trade, but hold potential benefits to both members and nonmembers as international arrangements in the wider sense. The extent of trade facilitation and nontrade cooperation embedded in PTAs has been increasing, but this remains the first important area for further reform. The second issue is that agreements in the region remain preferential trade agreements with only incremental progress toward becoming free trade areas. Furthermore, the exclusion of sectors from PTAs substantially reduces their potential welfare benefits, as it allows sectors in need of reform to continue inefficient production. Progress toward free trade is needed, particularly in agriculture—the second major area of reform. Third, all PTA agreements in the region have relatively complex rules of origin. This makes it profitable to alter production patterns simply to fulfill the rules for market access rather than to reduce costs and improve efficiency. Processes for certification of origin also create opportunities for rent seeking. Policies to reduce the differences between PTAs members' external policies and thus decrease the importance of rules of origin are the third major area for reform.

As institutions for international cooperation, PTAs in the region are relatively advanced. Two of the region's PTAs, AFTA and SAPTA, are embedded in larger regional cooperation organizations. Generally, PTAs' agendas could, however, be focused further on discussing regional priorities and preparing for negotiations in larger forums such as WTO. The potential role of PTAs as enhancing commitment to policy reforms in member countries could also be strengthened. Many of the PTAs in the region resolve disputes via bilateral negotiations and have no real provisions for sanctioning members that violate the provisions of the PTA.

The Asia and Pacific region should continue its historical efforts to further multilateral trading arrangements, while continuing to pursue limited PTAs focusing on broader aspects of regional cooperation. However, exceptions are warranted in particular sectors or on issues where the multilateral arrangements either have not addressed an important area where liberalization would be beneficial, or where the region's interests need to be better represented in the international arrangements.

There is great variation in the efforts undertaken by different PTAs throughout the world. Considering PTAs in their broader sense, they address concerns beyond narrow issues of trade liberalization between members and serve as vehicles for fostering regional cooperation in other economic and non-economic issues. This makes it unproductive to discuss PTAs in general terms. Instead, greater nuance in the portrayal of PTAs can aid understanding of the types of PTAs that can serve as useful complements in a multitiered international trading system.

PTAs have considerable merit in contributing to the improved welfare of members, as well as that of nonmembers, in some areas. These areas include improving communication between regional neighbors and reducing the chances of conflict, pursuing reform in areas not addressed or difficult to address in broader multilateral arrangements, providing commitment mechanisms to support or reinforce domestic policy reform, and areas for experimentation and learning in trade liberalization. On the other hand, there are characteristics in existing PTAs that are detrimental to these goals and should be avoided in future PTAs and reformed in the current ones. These include rules of origin that distort comparative advantage, and overlapping jurisdictions and rules of the various PTAs.

New export market opportunities are emerging for least-developed countries as a result of the EU's "Everything But Arms" initiative, which, in providing duty- and quota-free access for least-developed country exports, helps producers in the poorest DMCs. It does so, however, at the expense of other DMCs who have to compete in the EU market without the benefit of such preferential access. Whether the gains will exceed the costs to some DMCs within the Asia and Pacific region is not yet clear. What is clear, however, is that any such trade diversion will be lower, the more the EU and others lower their most-favored nation barriers to trade.

The proliferation of PTAs outside of the Asia and Pacific region is a source of concern for DMCs that fear that they may lose as a result of trade and investment diversion. In response, the region has seen numerous initiatives aimed at bolstering trade growth. It remains to be seen whether those responses within the region to developments elsewhere are ultimately welfare enhancing to the region and to the world.

Within the region, Japan has recently expressed interest in possible regional arrangements (e.g., a Japan-ASEAN partnership). The proposed ASEAN-PRC Free Trade Area, and the moves toward economic partnership between ASEAN and Australia and New Zealand have the potential to make similar contributions to boosting trade growth and increasing competition and economic efficiency. The ASEAN-PRC Free Trade Area, proposed by China and endorsed by ASEAN's 10 leaders in Brunei in October 2001, represents a limited but concrete proposal. It envisages evolution to become a full-fledged free trade area within 10 years, even though ASEAN's own free trade area has yet to be fully implemented.

Bilateral agreements currently being negotiated or discussed are somewhat limited. Japan, for example, has signed and is currently implementing a Japan-Singapore Economic Partnership Agreement; and is exploring arrangements with Korea and Mexico. Singapore, which is already nearly completely open, can negotiate new arrangements at little cost. The country has added bilateral trade agreements to its portfolio of trade policy measures. In addition to the agreement with Japan, it signed a free trade area with New Zealand in 2001, is negotiating one with Australia, and is also exploring arrangements with Chile and the countries of the European Free Trade Association as well as the US. In South Asia, bilateral PTAs have been signed (or are planned) between India and several other countries including Bhutan, Nepal, and Sri Lanka. Sri Lanka is currently seeking a bilateral arrangement with Pakistan.

The growth in bilateral trade deals is, however, likely to have only a small direct impact on goods trade within the region. It has to be remembered, though, that goods trade is not the only focus of such agreements. Those agreements that can also lower barriers to services trade, and to investment flows, may well be WTO-plus agreements, which pave the way for further liberalization in those areas and thereby deepen integration through regional forums and WTO.