Highlights—*ADO 2010 Update*

Developing Asia is rebounding solidly from the global economic downturn. Growth is expected to reach 8.2% in 2010, underpinned by a rapid turnaround in exports, healthy private demand, and the lingering effects of expansionary fiscal and monetary policy measures.

In contrast, the major industrial economies—the United States (US), eurozone, and Japan—seem to be losing steam and are forecast to grow by only 2.2% this year. Weakness in US housing markets, the specter of eurozone sovereign debt default, and risks of commodity price spikes are clouding global prospects. A second contraction in the major industrial economies is unlikely, but cannot be ruled out.

As developing Asia's recovery progresses, policy makers must turn their focus from managing short-term macroeconomic fluctuations to ensuring strong and sustained medium- and long-term growth. This will require policies that expand the region's productive capacity through both factor accumulation and rising productivity. Trade, human capital, infrastructure, and financial development will be key elements of that growth.

Key Messages

- The global economy has passed through its worst economic downturn since the Great Depression. Part 1 of this *Update* to the *Asian Development Outlook 2010* (*ADO 2010*), released in April, sees improved prospects for 2010 gross domestic product (GDP) growth in the major industrial economies on the back of better than expected results in the first quarter. However, the rising investor confidence, upbeat consumer sentiment, and continued fiscal and monetary support that led to robust first-quarter growth have not been sustained. These economies' growth momentum slowed in the second quarter, and is forecast to remain moderate for the rest of 2010.

- Still, the global recovery remains shaky, and downside risks lurk. The possibility of a double-dip recession in the major industrial economies has not receded completely. For example, the US housing market is showing lingering frailty, especially since the withdrawal of the homebuyers' tax credit in April 2010. In the eurozone, the risk of insolvency and default in one or more members of the bloc has not disappeared, as debt sustainability is imperiled by high borrowing costs and uncertain growth prospects. Commodity price spikes remain a concern, especially as weather aberrations adversely affect food supplies.

- For its part, developing Asia has recovered from the global crisis with remarkable speed and vigor. Strong export recovery, robust private demand, and the sustained effects of stimulus policies allowed regional economies to record solid growth in the first half of 2010. This improved performance is broad-based and is projected to carry on for the rest of the year. The *Update* thus upgrades GDP growth projections this year for developing Asia and for each of its subregions.

- As the region's recovery takes an increasingly firm hold, short-term aggregate demand management will give way to structural policies that augment developing Asia's productive capacity. Now is therefore a good time to take stock of developing Asia's medium- and long-term growth prospects and to reconsider its pathways to growth. This is because the postcrisis world is likely to present a less benign global environment for the region's precrisis export-led growth paradigm. More fundamentally, policies that were effective in earlier years' low-income, capital-scarce Asia are likely to be less effective in today's middle-income, capital-abundant Asia, as a whole.

- In particular, productivity growth, through more efficient allocation of productive resources and faster technological progress, will play a bigger role in the region's economic growth. Therefore, structural policies that promote productivity growth hold the key to sustaining the region's medium- and long-term growth and to allowing the region to make further progress in reducing poverty and spreading the benefits of growth to wider segments of the population. Part 2 of this *Update* presents concrete policy recommendations in four specific areas: trade, human capital, infrastructure, and financial development.

- Although the four areas are examined separately, much interdependence exists among them such that progress in one area will facilitate progress in another. For example, a major impediment to intraregional trade is inadequate transport infrastructure, which prevents the full exploitation of gains from trade with neighboring countries. Therefore, more and better transport infrastructure, domestic and regional, can stimulate both intraregional trade and trade in general.

- Good governance and institutions also have significant positive effects on growth. Efficient public services raise productivity of firms and industries. In addition, regional cooperation and integration expand markets and promote connectivity. These, together with improvements in the four areas mentioned above, will help expand the potential for developing Asia's future growth.

Outlook for 2010 and 2011

- Encouraging macroeconomic developments in the first quarter of 2010 for the major industrial economies will boost the annual growth rate beyond what was projected in *ADO 2010*, and this *Update* revises the 2010 GDP growth projection for these economies to 2.2% from April's 1.7%. However, the recovery that looked promising early this year is starting to run out of steam, and moderation in growth is now seen for the remainder of this year. As the effects of the economic stimulus packages fade, uncertainty about the ability to sustain growth picks up. Growth in 2011 in the major industrial economies is thus expected to be more anemic than in 2010 and the forecast is maintained at 2.0%.

- Inflation remains subdued in the major industrial economies as restrained growth in oil prices and muted domestic demand keep inflation in check. Consumer price inflation in these economies is expected to average 1.2% in 2010 and 1.3% in 2011.

- Oil prices are expected to be less volatile in the next 2 years. Demand for oil from countries in the Organisation for Economic Co-operation and Development (OECD) is forecast to decline somewhat, but this will be tempered by a rise in oil demand from non-OECD countries, particularly the People's Republic of China (PRC). Given the countervailing oil demand trends and the strengthening of the US dollar, oil prices are seen fluctuating within a narrow band.

- Food and beverage prices are expected to be fairly stable in 2010. Recent rises in global wheat prices due to natural calamities and the export ban by the Russian Federation are unlikely to persist for long because overall global production and stockpiles provide enough cushion. With generally well-supplied markets, good crop prospects, and slow global growth, commodity prices are expected to be relatively steady in 2011.

- Downside risks to the wobbly industrial-country recovery remain. Slower second-quarter growth and signs of continued weaknesses in the US and Japan mean that their economic recovery is still frail. Shifting too quickly to fiscal and monetary tightening could heighten the risk of another contraction. There is also the danger that the eurozone will be unable to avoid eventual default or debt restructuring by one or more of its member economies. The lingering sovereign debt concerns have seen bond spreads widening in the bloc's peripheral economies. Spikes in commodity prices remain a downside risk.

- Developing Asia continues to benefit from growth momentum. Driven by buoyant exports, strong private demand, and the sustained effects of stimulus policy, economies in the region performed better than expected in the first half. GDP growth is now projected to rebound to 8.2% in 2010, revised up from the earlier forecast of 7.5%. The improved outlook is broad-based with projections lifted in all subregions. However, with growing concerns over the strength of the global economy, the sustainability of private domestic demand, and the challenge of managing capital inflows and exchange rates, the 2011 growth forecast is maintained, at a still robust 7.3%.

- Despite recent upward movements in food prices, inflation in developing Asia is generally within central banks' "comfort zones." It is expected to be subdued at 4.1% and 3.9% in 2010 and 2011, respectively. But monetary authorities will need to guard against spikes in global oil or food prices. The continued strength of domestic demand will keep the overall current account surplus in the next 2 years to an average of around 4%.

- Aggregate growth in the five economies of East Asia is now projected to rise to 8.6% in 2010, largely owing to recoveries that came in more strongly than forecast in April in the open economies of Hong Kong, China; the Republic of Korea; and Taipei,China. They were hit hard by the slump in world trade in 2009, and have shown a healthy bounceback in tandem with the recovery in trade. The PRC, as expected, grew at a double-digit rate in the first half of 2010. While that pace will ease in the second half, the PRC is still forecast to expand by 9.6% over the full year. In 2011, the impact of the phasing out of economic stimulus policies, slower growth in world trade, and the end of the low-base effect due to the slump indicate that East Asian GDP will increase at a more moderate 7.7%.

- East Asia's inflation forecast is lowered a touch to 3.0% this year, as price pressures in the PRC have been milder than anticipated. It is maintained at this rate for 2011. Current account surpluses equivalent to about 5% of East Asian GDP are still expected for this year and next.

- South Asia's growth prospects for 2010 have been lifted to 7.8% from April's forecast, mainly owing to stronger domestic demand conditions as consumer and business confidence is on the rise. India is experiencing a surge in economic activity, prompting the central bank to tighten its monetary stance in a series of policy rate adjustments starting in January to forestall overheating. India's growth projection is raised to 8.5%. All other economies but Nepal are seeing greater growth momentum than earlier expected, with *Update* revisions for economies generally in the range of 0.5–1 percentage points for 2010.

- For 2011, South Asia's growth forecast has been cut to 7.8%. The markdown is due to reductions in the outlook for Pakistan and Nepal: the former because of the devastating floods in August; the latter by an ongoing political impasse that has left government policy direction largely rudderless.

- South Asia's inflation forecast has been increased to 7.9% for 2010. This adjustment is entirely due to very high inflation in India, where food inflation soared after poor monsoon rains in 2009 stunted agricultural output. For 2011, this *Update* retains the earlier projections for relative price stability to prevail in most economies, though the subregional projection has been raised to 6.5%, owing to upward adjustments in Nepal and Pakistan.

- The projection of the 2010 current account deficit in South Asia is increased to 2.2% of GDP. The change is mainly due to a revision for India to 2.7% of GDP, reflecting strengthened growth and investment. Maldives, Pakistan, and Sri Lanka continue economic adjustment programs with the International Monetary Fund to reduce fiscal and external imbalances. The projection of South Asia's current account deficit in 2011 has been increased to 2.5% of GDP. Again, the change mostly reflects reworked estimates for India.

- Southeast Asia's bigger economies—Indonesia, Malaysia, Philippines, Singapore, and Thailand—have rebounded from last year's weakness at a much stronger pace than was foreseen in April. The growth spurt was sparked by a sharp upturn in exports, which fueled recoveries in consumption and private investment. Aggregate growth for the 10 subregional economies this year is now forecast at 7.4%.

- The pace of growth in several Southeast Asian economies will decelerate in 2011, due in part to the end of the low-base effect and moderation in the expansion of world trade. Aggregate growth is forecast at 5.4%, slightly better than foreseen earlier.

- Forecasts for subregional inflation are edged down to just over 4% for both 2010 and 2011, given moderate price pressures so far this year. Current account surpluses of 5.7% are projected for Southeast Asia in both years.

- Growth across Central Asia has revived—largely as anticipated in *ADO 2010*—because of higher oil prices and economic recovery in the Russian Federation, the region's major trade and financial partner. Macroeconomic policies and reform efforts have generally been both effective and sustained. Forecasts are now edged up or maintained for all but two economies in the subregion (Azerbaijan and the Kyrgyz Republic). Subregional growth is now nudged up to 5.1% in 2010. At 5.7%, the forecast for Central Asia in 2011 is essentially unchanged from that made in April.

- Inflation pressures in the subregion have been kept in check by a strengthened watch on the part of policy makers as well as by adequate food supplies. As a result, this *Update* marginally lowers the inflation forecast to 6.6% in 2010 and 6.4% in 2011.

- The overall Central Asian current account position is now forecast to strengthen to a surplus of 8.4% of GDP in 2010 from the earlier estimate of 7.0%, mainly due to a better outcome for oil exporters Azerbaijan and Kazakhstan. For 2011, an 8.3% of GDP current account surplus is forecast.

- Upgrades to 2010 growth forecasts for Solomon Islands and the Democratic Republic of Timor-Leste have raised the Pacific aggregate growth projection to 4.3% for 2010. However, the better performances by these resource-driven economies mask low levels of growth in most of the 14 subregional economies. Forecasts for several are revised down and two economies—Fiji Islands and Tonga—are expected to contract.

- Aggregate growth in the Pacific is seen picking up to 5.1% in 2011, slightly above the earlier forecast, largely owing to an upward revision for Timor-Leste, return to growth by Fiji Islands, and a vigorous expansion by Papua New Guinea spurred by a ramping up of construction for a large new gas project. The subregional inflation forecast is raised to 5.9% for this year, with price pressures expected to ease a bit in 2011.

- Overall, developing Asia's recovery seems to have taken firm hold. As the global crisis recedes, medium- and long-run growth will reassert itself as the region's top macroeconomic priority. Aggressive fiscal and monetary expansion limited the depth of the slowdown, and laid the foundation for a V-shaped recovery. The central challenge now facing the region is to transform this foundation into sustained medium- and long-run growth.

The future of growth in Asia

- Medium- and long-term growth matters hugely to developing Asia. Despite its rapid precrisis growth and resilience during the crisis, the region lags far behind the industrial economies in per capita income and remains home to two-thirds of the world's poor. Therefore, sustaining growth matters both for lifting the region's general living standards and making a further dent on its poverty.

- The return of long-run growth means that the region's policy makers must give higher priority to structural supply-side policies that improve the economy's productive capacity by fostering factor accumulation and productivity growth. While countercyclical fiscal and monetary policies can smooth temporary output fluctuations, they cannot sustain growth over a longer time horizon.

- Above all, developing Asia's continued transformation from a low-income capital-scarce region to a middle-income capital-abundant region may significantly affect the profile of its future growth. This growth is likely to be more balanced, where both factor accumulation and productivity growth are major contributors. Elements such as trade, human capital, infrastructure, and financial development are likely to be especially important for growth.

- Trade has been a core ingredient of the region's past success and will remain beneficial for both factor accumulation and productivity growth. Given their different levels of development and integration into the world economy, various parts of developing Asia need to pursue a range of strategies in order to leverage trade for growth.

- For East and Southeast Asia, the key challenge is for production and trade networks to take full advantage of potentially large domestic consumption and intraregional trade. For South Asia, the top priorities are trade facilitation and regional integration. For Asia's weaker economies, the urgent need is to expand the base of domestic production and diversify exports.

- Human capital promotes growth through improving labor productivity and facilitating technology adoption and innovation. Developing Asia has made significant progress in educational outcomes. The regional average, however, still falls below that of the industrial economies and masks considerable variations. Therefore, the region should continue to prioritize investments in human capital.

- However, simply raising average educational outcomes may not automatically translate into higher growth rates. For investments to be effective, the design of the education reform agenda will need to take account of how the educational system is able to produce outcomes that meet the standards and skill sets required by the labor market.

- Overall, physical infrastructure stocks in developing Asia have been growing fast. However, they remain well below world-class standards in both quantity and quality. But as the substantial infrastructure investments needed may be beyond the financial capacity of governments alone, facilitating arrangements, such as public–private partnerships, are likely to be required.

- Demand for infrastructure services is expected to soar in developing Asia's cities due to rapid urbanization. In order to keep cities competitive, investments in infrastructure need to be designed to address congestion, environmental degradation, and other costs associated with urban agglomeration. In addition, closing the wide urban–rural infrastructure divide requires improving access to basic infrastructure services, such as the provision of potable water and sanitation, in rural areas.

- As the relative weight of productivity growth in developing Asia's growth gradually rises, its financial systems will have to evolve accordingly. The role of these systems must no longer be limited to boosting the quantity of investment but must enhance the efficiency of investment and thus contribute to productivity growth. Such an evolution requires deeper, broader, and more liquid financial systems.

- As the global crisis showed, financial instability can have huge consequences for growth. Therefore, it is critical that the region safeguard financial stability through strong prudential regulation and bond market development. Another priority is to make financial services more accessible to small- and medium-sized enterprises and poorer households, so as to promote entrepreneurship and equality of opportunity.

- Good governance and institutions matter for growth as well. Competent and honest governments that efficiently deliver basic public services, such as administration, education, and health care, raise the productivity of all firms and industries. Such governments are also more conducive for political stability and a more benign overall investment climate. In addition, greater regional integration and cooperation expand markets and promote connectivity. A policy package that combines all these elements will help push developing Asia's future growth potential.

Subregion/Economy	Table 1 Growth rate of GDP (% per year) 2009	2010 ADO 2010	2010 Update	2011 ADO 2010	2011 Update	Table 2 Inflation (% per year) 2009	2010 ADO 2010	2010 Update	2011 ADO 2010	2011 Update
Central Asia	**2.7**	**4.7**	**5.1**	**5.9**	**5.7**	**6.1**	**6.7**	**6.6**	**6.6**	**6.4**
Azerbaijan	9.3	9.5	3.8	9.7	3.5	1.5	5.8	5.0	6.0	4.0
Kazakhstan	1.2	2.5	4.8	3.5	5.2	7.3	6.8	6.8	6.5	6.5
East Asia	**6.1**	**8.3**	**8.6**	**7.7**	**7.7**	**0.0**	**3.3**	**3.0**	**3.0**	**3.0**
China, People's Rep. of	9.1	9.6	9.6	9.1	9.1	-0.7	3.6	3.2	3.2	3.2
Hong Kong, China	-2.8	5.2	5.8	4.3	4.3	0.5	2.2	2.6	2.8	2.8
Korea, Rep. of	0.2	5.2	6.0	4.6	4.6	2.8	3.0	3.0	3.0	3.0
Taipei,China	-1.9	4.9	7.7	4.0	4.0	-0.9	1.5	1.5	1.6	1.6
South Asia	**6.7**	**7.4**	**7.8**	**8.0**	**7.8**	**5.6**	**6.0**	**7.9**	**6.0**	**6.5**
Bangladesh	5.7	5.5	6.0	6.3	6.3	6.7	7.5	7.3	7.8	7.5
India	7.4	8.2	8.5	8.7	8.7	3.6	5.0	7.5	5.5	5.5
Pakistan[a]	1.2	-	4.1	-	2.5	20.8	12.0	11.7	8.0	13.0
Sri Lanka	3.5	6.0	6.5	7.0	7.0	3.5	6.5	6.5	8.0	8.0
Southeast Asia	**1.3**	**5.1**	**7.4**	**5.3**	**5.4**	**2.6**	**4.5**	**4.2**	**4.5**	**4.2**
Indonesia	4.5	5.5	6.1	6.0	6.3	4.8	5.6	5.2	6.2	5.7
Malaysia	-1.7	5.3	6.8	5.0	5.0	0.6	2.4	1.8	3.0	2.4
Philippines	1.1	3.8	6.2	4.6	4.6	3.2	4.7	4.5	4.5	4.4
Singapore	-1.3	6.3	14.0	5.0	5.0	0.6	2.3	3.0	2.0	2.0
Thailand	-2.2	4.0	7.0	4.5	4.5	-0.9	3.5	3.2	3.0	3.0
Viet Nam	5.3	6.5	6.7	6.8	7.0	6.9	10.0	8.5	8.0	7.5
The Pacific	**3.7**	**3.7**	**4.3**	**5.0**	**5.1**	**5.4**	**5.1**	**5.9**	**5.4**	**5.4**
Fiji Islands	-2.5	-0.5	-0.5	0.5	0.5	3.7	3.4	6.0	3.1	3.5
Papua New Guinea	4.5	5.5	5.5	7.7	7.7	7.6	7.1	7.1	7.7	7.7
Developing Asia	**5.4**	**7.5**	**8.2**	**7.3**	**7.3**	**1.5**	**4.0**	**4.1**	**3.9**	**3.9**

Notes: Developing Asia refers to 44 developing member economies of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Republic of Palau, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India and Pakistan are recorded on a fiscal year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

[a] In light of Pakistan's revisions to the GDP series in June 2010, *ADO 2010* GDP growth forecasts are not comparable with current estimates and have been omitted.