1 Shifting global economic fortunes

Shifting global economic fortunes

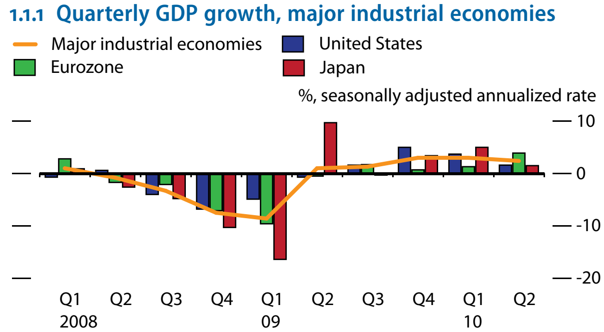
The world economy has passed through its worst economic downturn since the Great Depression. Yet many industrial economies are still struggling. Encouraging gross domestic product (GDP) growth rates in the first quarter of 2010 for the group of major industrial economies—the United States (US), eurozone, and Japan—decelerated in the second quarter (Figure 1.1.1). With signs of stagnant employment in the US, fiscal strains in parts of the eurozone, and pressures from currency appreciation in Japan, the gloom over the global recovery is mounting. Some analysts question the strength of recovery in these economies, even speculating that a "double dip" recession may be on the horizon.

The malaise of the industrial economies contrasts starkly with the dynamism in emerging markets. Brazil, the Russian Federation, India, and the People's Republic of China (PRC)—the so-called BRICs—had strong growth results through the first half of this year (Figure 1.1.2). The expansion in these economies is attracting foreign investors. These four economies attracted $194 billion in foreign direct investment (FDI) in 2009, or more than 17% of the global volume. Yet even here, the question remains how long this growth can be sustained without a firmer recovery of the major industrial economies.

In the continuing shift in the economic balance of power toward emerging economies, developing Asia stands out. The region's rise has become clearer in the wake of the global contraction. While the tremor of the global financial crisis jolted the US and Europe—with the aftershocks from the Greek debt crisis further shaking confidence—developing Asia withstood the worst of the downturn when its export markets dried up. Through the nascent recovery, the region has enjoyed strong investor confidence. Moreover, some large regional economies still have scope to support growth with fiscal and monetary measures, if necessary.

While the region's economies are still just a fraction of the combined economic strength of the US, eurozone, and Japan, the contrasting fortunes of developing Asia and the major industrial economies gives one pause for reflection. Is the region ready to lead the world on to a higher growth path? But before that question is discussed, an analysis of the industrial economies is made.

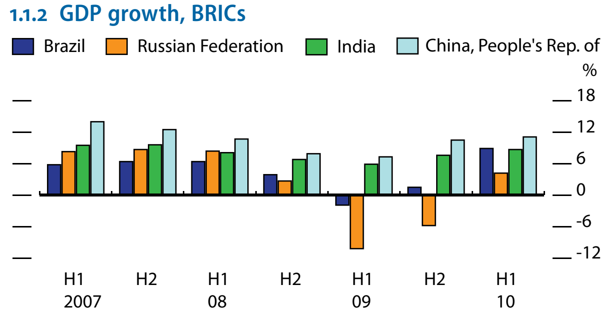
1.1.1 Quarterly GDP growth, major industrial economies



Sources: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov; Economic and Social Research Institute, Cabinet Office, Government of Japan. http://www.esri.cao.jp; CEIC Data Company (all accessed 15 September 2010).

Click here for figure data

1.1.2 GDP growth, BRICs



Note: All data in calendar years.

Source: CEIC Data Company (accessed 13 September 2010).

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This chapter was written by Shikha Jha, Benno Ferrarini, Donghyun Park, Pilipinas Quising, Akiko Terada-Hagiwara, and Joseph E. Zveglich, Jr., of the Economics and Research Department, ADB, Manila. The authors gratefully acknowledge the background materials contributed by Jeffrey Brown, Giovanni Capannelli, Peter Morgan, Kee-Yung Nam, Cyn-Young Park, Arief Ramayandi, and Guanghua Wan.

Wavering recovery in industrial economies

The major industrial economies began 2010 on an optimistic note. Rising investor confidence, upbeat consumer sentiment, and the support of fiscal and monetary stimulus led to a rapid expansion of consumption and investment in the first quarter of the year. The rebound in emerging economies meant a revival of export markets as well.

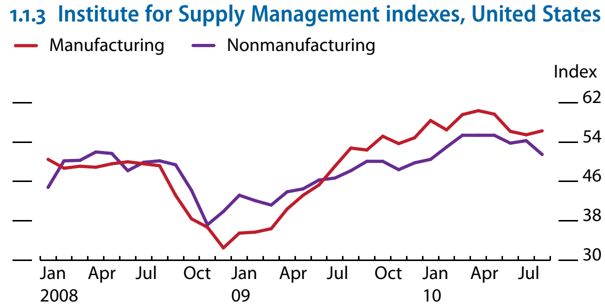
As the second quarter progressed, however, the major industrial economies moved in unexpected directions. Growth momentum slowed in the US and Japan, which was only somewhat counterbalanced by a brighter outcome in the eurozone. While the stronger than expected performance in the first quarter of 2010 may be enough to lift GDP beyond what the *Asian Development Outlook* (ADO) *2010* forecast in April, global growth prospects remain shrouded in uncertainty.

From optimism to pessimism

Signs of a weakening US recovery came early as growth decelerated from 3.7% in the first quarter of 2010 to 1.6% in the second quarter (quarter on quarter, seasonally adjusted annualized rate, or saar). The drop was led by a descent in net exports as export growth eased while growth of imports more than doubled, reflecting a greater degree of export deceleration than had been anticipated. This resulted in the largest quarterly drag from net exports in 6 decades. Similarly, weak performance of the service sector in recent quarters, eking out a measly 0.5% gain over the past year, has been atypical. On the positive side, manufacturing output grew strongly (8.5%, saar).

Looking ahead, the signals are mixed for the US. Institute for Supply Management index levels for August 2010 (though below their peaks of April 2010) suggest that moderate growth will continue (Figure 1.1.3).

1.1.3 Institute for Supply Management indexes, United States



Note: An index over 50% suggests economic expansion; an index below 50% indicates a decline.

Source: Institute for Supply Management. http://www.ism.ws (accessed 15 September 2010).

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Eurozone economic news has been dominated by the sovereign debt crisis that began when Greece's dire fiscal situation came to light in mid-2009 (Box 1.1.1). The impact of this loss of confidence spread to other countries in the eurozone's periphery, notably Portugal and Spain. The situation threatened to spread out of control, until interventions by the European Central Bank (ECB) and the International Monetary Fund (IMF) brought a measure of calm to the markets.

In an effort to reduce the lingering uncertainty about the health of the European banking sector since the onset of the global financial crisis, the Committee of European Banking Supervisors released the results of stress tests on 91 banks in July. These banks represent about 65% of total banking assets in the European Union. On the basis of macroeconomic and debt scenarios, only seven banks failed to reach the pass mark of a 6% Tier 1 capital ratio (the ratio

1.1.1 Eurozone sovereign debt crisis

The global crisis has exacerbated the fragile state of government finances in several eurozone economies. Greece has been worst hit, not just by the global slump and falling receipts in the country's vital tourism and shipping sectors, but by years of government overspending. Already on the monitor, in mid-2009 its dire fiscal position came under severe market scrutiny as evidence arose of deliberate misreporting of its public finance statistics.

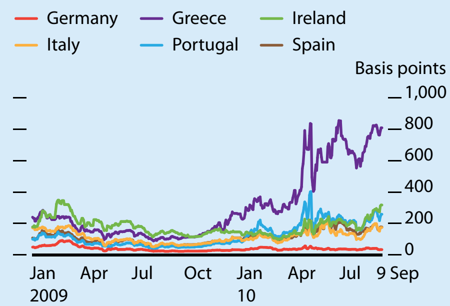
Investor nervousness and speculation—aggravated by eurozone governments' long hesitation to undertake concerted action—caused government bond spreads and borrowing costs to jump. These anxieties were quickly transformed into a crisis of confidence affecting some of the weaker, peripheral, eurozone countries. Rating agencies downgraded Portugal and Spain, and later Ireland, and countries took drastic fiscal retrenchment measures in an attempt to ensure continued access to capital markets.

In early May 2010, European Union finance ministers eventually agreed on a €110 billion rescue package for Greece after the country committed to a long and painful adjustment under the aegis of the International Monetary Fund (IMF). Against the backdrop of growing market nervousness over Ireland, Portugal, and Spain, the ministers also announced a €500 billion European Financial Stabilization Mechanism backed by an additional €250 billion IMF contribution.

On its side, the European Central Bank initiated a series of unprecedented measures of support, including a Covered Bond Purchase Program intended to buy up member countries' public and private debt in the primary and secondary markets. By June 2010, €60 billion had been purchased.

These interventions have averted an impending Greek default and contagion to other eurozone countries. However, they have not fully assuaged financial market nervousness. After coming down from their peak in May 2010, credit default swap spreads remain elevated and have been approaching a new peak in September, not just for peripheral eurozone countries, but for Italy as well (Box figure).

10-year euro-denominated government bond credit default swaps



Source: Datastream (accessed 10 September 2010).

Greece, in particular, has been making good progress in its adjustment program while drawing down emergency funds, but is yet to generate the structural basis of future growth rates high enough to avert possible insolvency further out. Financial markets also seem unconvinced about the future sustainability of countries like Ireland and Portugal in a context of high debt, steep borrowing costs, and low growth prospects. Unless creditors are willing to buy into their markets and premiums are not prohibitive, further eurozone bailouts or debt restructurings might, ultimately, be unavoidable.

of a bank's core equity to its total risk-weighted assets). The committee estimated the combined capital shortfall of the seven banks at €3.5 billion, a figure considerably lower than generally expected.

Despite concerns about the sovereign debt crisis, net exports from Germany proved a major boost to the second-quarter recovery in the eurozone, after detracting from first-quarter GDP growth. Driven mainly by external demand, industrial production and new orders continued to edge up in Germany during the first half of 2010. In response to the recovery in global activity and trade, first- and second-quarter growth in the eurozone was fueled by restocking of inventories. Eurozone GDP grew by 1.3% quarter on quarter, saar, in the first quarter, accelerating to 3.9% in the second.

Second-quarter data indicate that recovery is also slowly taking hold in the other core economies of the eurozone, including France (2.5%) and Italy (1.8%). Peripheral countries fared less well, with Greece's recession deepening (-6.8%), and subdued growth in Spain (0.7%) and Portugal

(1.1%). The scenario is one of widening differences between eurozone's core and peripheral economies.

After growth in the first quarter, GDP growth in Japan slowed more than expected in the second quarter—from 5.0% to 1.5% (quarter on quarter, saar)—due to weak domestic demand. Subsidies for certain environment-friendly durable goods (for example, energy-efficient flat-screen televisions) helped drive consumer spending through the first quarter, but their impact faded sharply in the second quarter once March's last-minute consumption surge—prompted by consumers' expectation that the subsidies would end—waned.

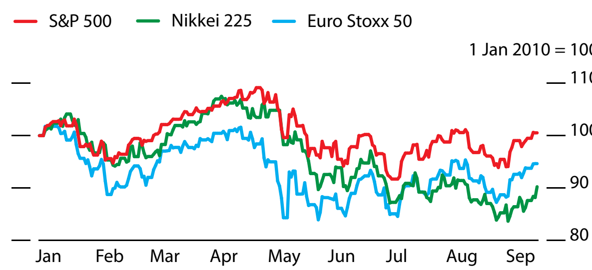
Deflation pressures in Japan are hurting business investment by weighing on firms' profits and increasing real borrowing costs. Weaker external demand in the second quarter dragged growth further down, a situation unlikely to be reversed soon.

Market response to the uncertainty

Stock markets reacted negatively to the slowing second-quarter growth in the US and Japan. The S&P 500, Nikkei 225, and Euro Stoxx 50 have all declined from their peaks reached in April 2010 (Figure 1.1.4). Many US stock indexes remain relatively low as fears of a double-dip recession there grow. Looking for a safer haven, investors flocked to buy US Treasury debt, pushing down yields. On 1 September 2010, benchmark 10-year Treasuries saw their largest monthly drop since the 2008 collapse of Lehman Brothers. In Japan, the Nikkei 225 fell to a 16-month low on 31 August, before regaining some lost ground.

Currency markets turned volatile as well. As eurozone fiscal difficulties became more pronounced, the dollar gained against the euro, while many emerging market and "commodity" currencies succumbed to concerns about the sustainability of global recovery. The dollar appreciated by around 15% against the euro from end-December 2009 to mid-June of this year. Stronger than expected growth in the eurozone (particularly in light of the sovereign debt crisis there) and solid demand for euro bonds issued by core countries subsequently helped the euro to gain back some of its value against the dollar.

1.1.4 Stock price indexes, 2010



Source: Bloomberg (accessed 15 September 2010).
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The publication of the European bank stress test results reduced uncertainty and helped calm financial markets. Although the assumptions underlying the stress tests were criticized for being insufficiently tough (notably, the sovereign risk shock scenario excluded sovereign bonds that banks will hold to maturity, hence effectively assuming away the possibility of sovereign default), the tests made the European banks' balance sheets more transparent.

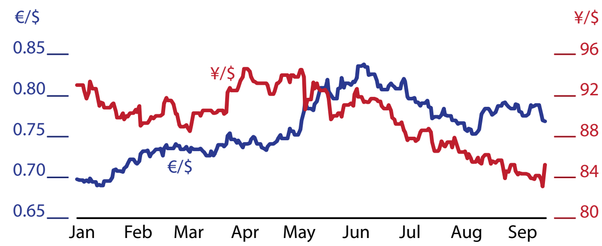
Markets reacted positively with a moderate decline of interbank lending rates, narrower credit-default swap spreads, and an increase in bank stock prices. Nevertheless, credit standards have tightened again and lending to the private sector is subdued. Facing heightened capital costs, eurozone banks continue to impose tighter conditions on loans to nonfinancial firms, hence passing on the costs to the real economy.

The yen had appreciated by 21% in real trade-weighted terms from the onset of the global slowdown in September 2008 to August 2010.

Because the currency hovered around 15-year highs against the US dollar and showed recent peaks against the euro, the Bank of Japan made massive purchases of dollars on 15 September. The nominal rate depreciated by 3% against the dollar in one day (Figure 1.1.5), and the stock market reacted positively. As the intervention was not sterilized, the expansion of the money supply will help to ease deflation.

Yet the long-term impact of this intervention is seen limited. As long as Japan's real interest rates remain above those of the US and eurozone, unilateral intervention cannot stop flows into the yen for more than a brief period. Extended attempts to counteract these external inflows would be financially costly for the central bank.

1.1.5 Exchange rates, 2010



Source: Bloomberg (accessed 15 September 2010).

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Delayed return to normal policy stance

While recovery seemed to be taking shape, calls for fiscal consolidation were gaining ground in early 2010. Plans to withdraw stimulus measures were based on the expectation that private demand was strong enough to stand on its own, but private consumers have remained reluctant to spend, particularly in the US and Japan. In light of the wavering prospects of recovery, fiscal retrenchment measures are not yet under way there.

In the US, homebuyers' tax credit ended in April 2010. The government has proposed fresh stimulus to promote business investments and support infrastructure. A $50 billion stimulus plan to finance the renewing and expansion of the nation's roads, railways, and runways to help the economy grow and spur private sector hiring was announced on 6 September. It envisages leveraging private and public capital as against the current budgetary allocation for infrastructure. Two additional stimulus measures are targeted at businesses to encourage investment spending.

The budgeted amount for the subsidy for environment-friendly cars in Japan was fully spent by September 2010, though incentive schemes for other green goods such as consumer electronics and durable goods have been extended until March next year. In addition, a new child allowance program that started in June this year is aiming to encourage young families to have children and thus counteract the current trend of population aging in the country. The impact on consumption and GDP of all these schemes is, however, expected to be modest.

Only in the eurozone has the drive for fiscal consolidation been maintained. Fiscal austerity measures are planned across the eurozone even as the effects of crisis-related expenditure fade. Germany will cut the budget deficit by €80 billion over the next 5 years. The measures include a plan to slash €30 billion from the welfare budget, cuts in government jobs, and the abandonment of tax cuts scheduled earlier. France has announced plans to cut public spending by €45 billion over the next 2 years and raise its retirement age. Italy's cabinet approved an austerity package to cut the deficit by €25 billion in the 3 years to 2012. The package includes cuts in funding to city and regional governments, a 3-year freeze on public sector pay rises, and a crackdown on tax evasion and false benefit claims.

Greece, Ireland, Portugal, and Spain have already implemented tough austerity measures, drawing protests from the public. Greece is undergoing a severe IMF adjustment program, and rating agencies' downgrading of Portugal and Spain in May this year forced stringent fiscal retrenchment steps there.

Across much of the eurozone, austerity measures have angered workers and led to protests, signaling a limit to which tightening can be undertaken.

On the monetary front, policy is expected to remain expansive across the major industrial economies. The Federal Reserve is maintaining its target range of 0–25 basis points for the Federal Funds rate this year. Aside from the near zero interest-rate policy, it used nontraditional means to provide monetary stimulus, including direct purchases of mortgage-backed securities. In August, the Federal Reserve announced that it would continue to use its balance sheet to provide longer-term liquidity, using principal repayments from its holdings of mortgage-backed securities to purchase longer-term Treasury securities.

In early September, the ECB confirmed its 1% main policy interest rate, as well as its intention to continue meeting in full banks' demand for liquidity as long as it deemed it necessary. In Japan, the expansionary stance is expected to continue with nominal interest rates close to zero. In late August, the Bank of Japan introduced an additional stimulus measure in order to encourage a decline in market interest rates and further ease monetary conditions.

The global crisis has called for coordinated action on the global financial system so as to improve safeguard measures against risks that could jeopardize that system. Recently, leading international bank regulators agreed on new wide-ranging rules that would require banks to hold more ready capital and take fewer risks as part of an effort to make the world's banking system safer, while aiming to protect national economies from future financial crisis.

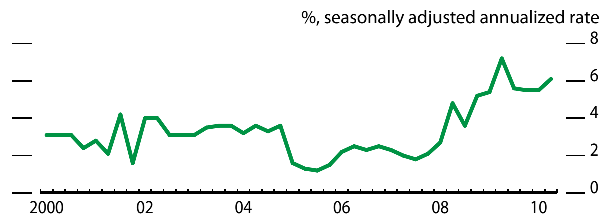
These "Basel III" regulations, which are about to be ratified by the G20, will gradually increase the ratio of reserve funds in a bank's assets from 2% to 7%. This stiffer ratio is expected to be phased in only from January 2013 and to be fully in effect from January 2018, partly in view of current global conditions.

The Basel III agreement is in line with the financial reform bill passed in the US in July. This landmark bill puts up new rules that govern how banks trade in (and protect consumers from) high-risk financial products, and imposes tighter scrutiny on large banks' cash reserves that are used to offset bad loans. The Basel agreement is also a significant step in global moves to reduce the incidence and severity of future financial crises in that it provides a more stable banking system that is both less prone to excessive risk taking and better able to absorb losses.

Revival of private demand

Given the uncertainties relating to the growth resurgence, until private demand takes a strong foothold, the implementation of exit policies in some countries is likely to be postponed.

1.1.6 Household saving rate, United States



Source: Bureau of Economic Analysis. http://www.bea.gov (accessed 30 August 2010).

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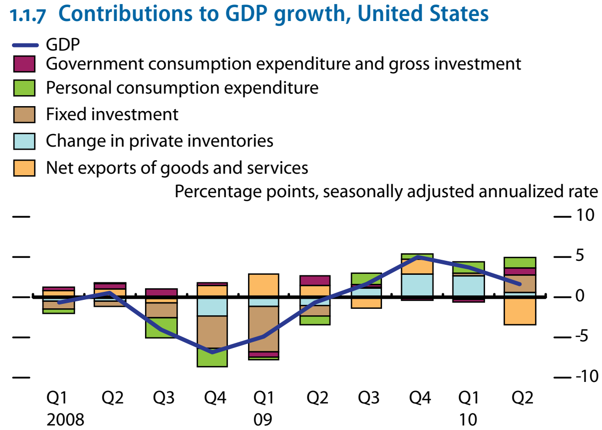
1.1.7 Contributions to GDP growth, United States



Source: Bureau of Economic Analysis. http://www.bea.gov (accessed 30 August 2010).

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Domestic demand

One effect of the crisis has been an upward adjustment of US households' average saving rate from about 1.9% in 2005–2007 to 5.7% from the third quarter of 2009 to the second quarter of 2010 (Figure 1.1.6, above). Private consumption expenditure contributed 0.8 percentage point in the second quarter from 1.3 percentage points in the first (Figure 1.1.7, above). New car and light truck sales, a major household discretionary expense, rose. There was also 27% growth in private residential investment, but it reflected the effects of the homebuyers' tax credit and low mortgage rates (Box 1.1.2).

As these policies are withdrawn and unemployment remains high, housing demand may not continue in the same line. Gross private domestic investment maintained its double-digit growth rate, however, rising by 25%. The inventory-to-sales ratio has returned to its prerecession level, indicating certain completeness in this adjustment process at least.

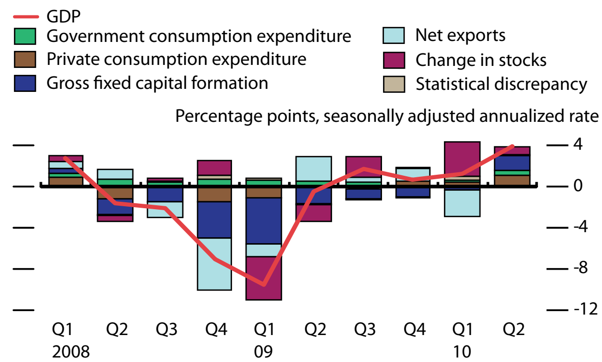
While jobless claims remain elevated in the US, the unemployment rate hovered at just under 10% from May to August 2010 (Box 1.1.3). In aggregate, over 100,000 jobs were lost in August and unemployment insurance claims declined. For the first time this year, manufacturing employment contracted (also in August). The latest jobs report does not paint a rosy picture on hiring, either. And though private sector salaries and wages grew by 0.5% in July, the personal saving rate declined to 5.9% from 6.2% in June.

In the eurozone, consumers stepped in to fill the void in consumption left by the retreat from fiscal expansion. Exports indirectly contributed to the rebound of the region by propelling gross capital formation and boosting confidence for consumption. Indeed, for the first time since the crisis hit, investment in the second quarter contributed substantially to GDP growth while household consumption recorded a large increase (Figure 1.1.8). Retail turnover, however, has yet to show a notable improvement (Figure 1.1.9). Driven mainly by external demand, new industrial orders in the eurozone continued to edge up during the first half of 2010, but are still far below precrisis levels.

Revamping private domestic demand continues to present a major policy challenge for the eurozone against a background of high unemployment. The eurozone unemployment rate appears to have peaked at 10% in March 2010, staying at that level until July 2010 (Figure 1.1.10). However, the disparities across labor markets of the eurozone are high and the challenges are country specific.

For example, in June 2010 Spain faced unemployment at 20.2%, with the prospect of further increases until the economy turns the corner. At the opposite spectrum within the eurozone, unemployment in Austria dropped to 3.9% in June (from 5.1% a year earlier), partly reflecting a 2.0% year-on-year rebound in economic activity during the second quarter.

1.1.8 Contributions to GDP growth, eurozone



Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 2 September 2010).
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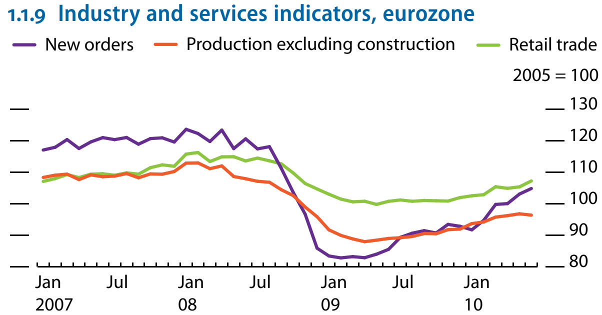
1.1.9 Industry and services indicators, eurozone



Note: May 2010 business surveys data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev. 2) causing a potential break in series at this date.
Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 2 September 2010).
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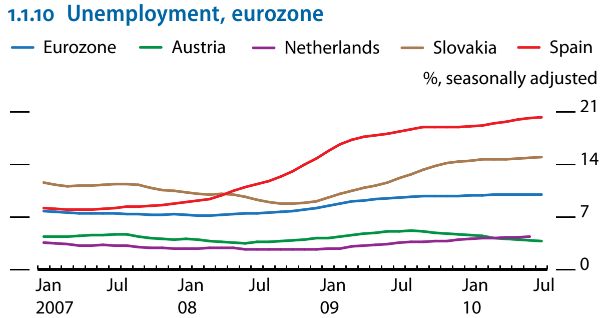
1.1.10 Unemployment, eurozone



Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 2 September 2010).
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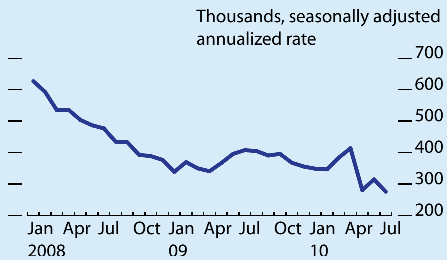
1.1.2 United States housing market

Poor labor market conditions in the United States reflect the current depression in the housing sector. Recent declines in mortgage rates (now around 4.5% for a 30-year fixed-rate mortgage) did little to revive housing demand, and increases in purchase applications from mid-August to early September are barely above the depressed June level.

Home sales increased in March and April, but this welcome break was driven mainly by home buyers advancing their purchases to benefit from the homebuyers' tax credit (a subsidy for first-time buyers worth $8,000), which expired at the end of April (Box figure 1).

1 New home sales



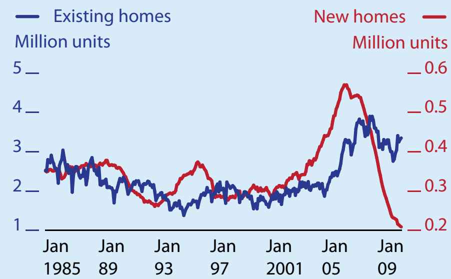
Source: CEIC Data Company (accessed 13 September 2010).

Click here for figure data

Despite the early months' strong sales of new homes, the stock of unsold existing homes is still high and above prior-year levels (Box figure 2). The July level is equivalent to about 12.5 months of supply, well above the 4–5 months seen in a healthy market. In contrast, the low level of housing construction activity has caused the inventory of new homes to plummet by 24.8% over the previous year, bringing new homes for sale inventories to unusually low levels.

The excess supply of homes continues to exert downward pressure on prices. There was a short respite in the decline in March and April as a result of the homebuyers' tax credit but in May and June the boost in prices started to wane. According to estimates from CoreLogic, an analytic research firm, 11 million (or 23%) of all residential properties with mortgages were in negative equity by end-June 2010.

2 Inventory of existing and new homes for sale



Source: CEIC Data Company (accessed 13 September 2010).

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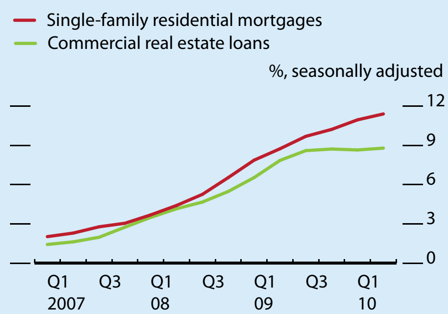
Delinquency rates for both commercial and residential real estate loans have been on a rising trend, and foreclosures remain at worryingly high levels, suggesting continued downward pressure on domestic banks' asset quality (Box figure 3).

3 Delinquency rates on real estate loans



Note: Loans are from all commercial banks; commercial real estate loans exclude farmland.

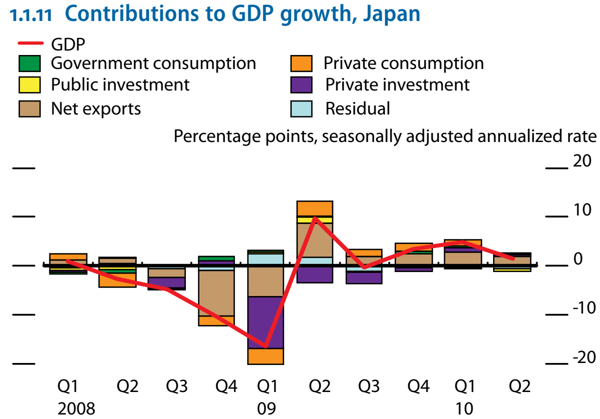
Source: Board of Governors of the Federal Reserve System. http://www.federalreserve.gov (accessed 15 September 2010).

Click here for figure data

As public investment in Japan contracted in the second quarter this year, private investment showed only modest growth; private consumption was virtually flat. With export volumes close to precrisis levels—driven largely by exports to neighboring economies, particularly to the PRC—net exports contributed strongly to Japan's growth in the first and second quarters (Figure 1.1.11).

Japan's wage growth has picked up in recent months but unemployment has gone up, too. With deflationary tendencies in place, consumers are postponing purchases in anticipation of further price falls. Residential investment turned to contraction in the second quarter after growing in the first. Housing starts declined by more than 9% in the second quarter. The

1.1.11 Contributions to GDP growth, Japan



Source: Economics and Social Research Institute, Cabinet Office, Government of Japan. http://www.esri.cao.go.jp/en (accessed 15 September 2010).

Click here for figure data

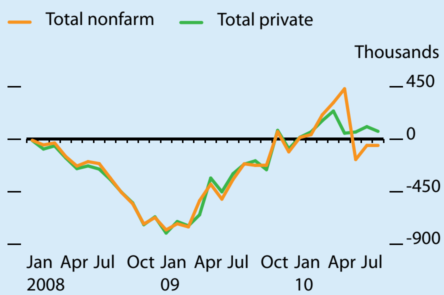
1.1.3 United States labor market

The labor market in the United States remains weak, but at least recent reports point to continued sluggish growth rather than further worsening.

While the August unemployment rate inched up to 9.6% from the 9.5% of the prior 2 months, the increase was due to more people entering the labor force—a turnaround from the post-May trend of a declining civilian participation rate.

More important, private sector employment rose by 67,000 in August (Box figure 1). Still, given the pace of the gains this year, it may well be a long time before the total number of jobs in the economy surpasses December 2007's level.

1 Monthly employment changes



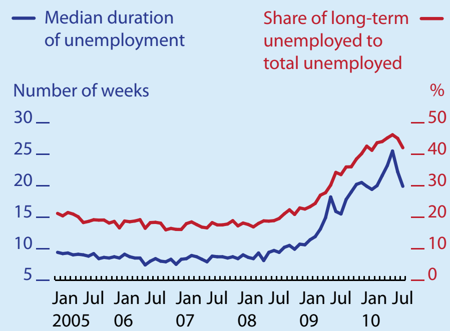
Source: CEIC Data Company (accessed 13 September 2010).
Click here for figure data

Employment gains in the private services sector present a nugget of hope. Of particular interest is the increase in temporary service workers of 16,800 in August. This figure is a good leading indicator of future employment trends. In a downturn, when firms see an uptick in demand, they will first assess if it is just a blip or a real recovery.

Wary, firms will first maximize their existing human resources instead of hiring new people to meet increasing demand for labor. Indeed, average workweek remained at 34.2 hours, up from 33.8 a year ago. The second thing that firms will do is use temporary services—which is what they seem to have started to do. Only when firms are confident that business is on a solid footing do they make employees permanent.

Another glimmer comes from the median duration of unemployment (Box figure 2). That continued to fall in August, from a record high of 25.5 weeks in June, down to 19.9 weeks. Further, the percentage of workers unemployed for more than 27 weeks continued the downward trend that started in May, from 46% that month to 42% in August.

2 Unemployment



Source: CEIC Data Company (accessed 13 September 2010).
Click here for figure data

Still, the duration of unemployment remains at a worrying level compared to the 1997–2007 average of 8 weeks. It is pernicious because most people in their sixth month of joblessness have exhausted their savings. Also this time around, given the dire straits in the housing market, unemployed homeowners are less likely to be able to draw on their home equity to cope with their predicament.

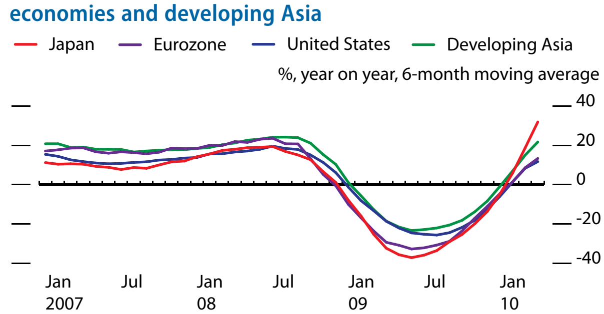
expected virtuous circle—more exports leading to investment and employment, and hence improved income conditions and private consumption—has not yet materialized. This trend may continue a while, and the speed of recovery may further slow.

External demand

Despite the recovery, world trade growth is far below the peak years of globalization in 2003–2007, but the level of trade is back to about what it was in 2008. Trade growth in industrial economies is recovering relatively strongly, but the pace is likely to remain well below the rate of growth seen in developing Asia (Figure 1.1.12).

In the US, for example, the goods and services trade deficit eased back in July to $42.8 billion, the first narrowing

1.1.12 Growth in exports to the world, from major industrial economies and developing Asia



Source: International Monetary Fund. Direction of Trade Statistics online database (accessed 16 September 2010).
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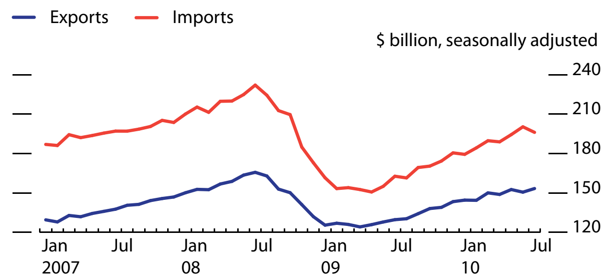
in the trade deficit after 3 consecutive months of widening (Figure 1.1.13). Net exports had sharply deteriorated in the second quarter of 2010, likely limited by the dollar's appreciation, subtracting 3.4% from GDP growth in their largest quarterly drag on growth since 1947. (Exports had begun picking up in the second half of 2009.) The inventory restocking cycle has caused imports to accelerate faster than exports in the first half of 2010. But with the inventory cycle phasing out in the second half and with consumer spending still anemic, the upward pressure on imports may be limited.

Eurozone external trade rose along with a strong rebound in global trade (Figure 1.1.14). A weakening of the euro against the dollar and the yen—on the back of European debt woes and fears about possible repositioning by major holders of euro-denominated foreign reserves—helped this performance. Germany, in particular, benefited from its diversified export structure and strong competitiveness, and saw its exports surging, manufacturing capacity on the rise, and business sentiment upbeat.

Japan's exports in July were 23% higher than a year earlier but slower than the 27% growth registered the previous month, continuing the declining growth trend since February (as the previous year's low base moves out of the frame) (Figure 1.1.15). Although rapid currency appreciation is further straining export growth (Figure 1.1.5, above), the trade surplus is expanding with slower import growth.

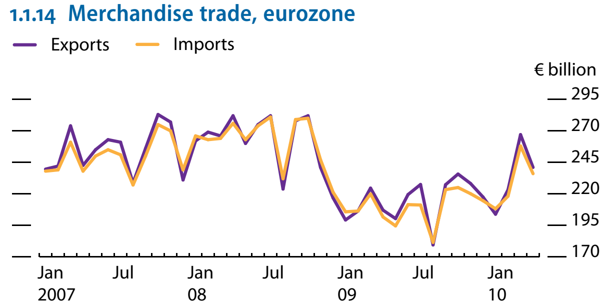
1.1.13 Trade in goods and services, United States



Source: Bureau of Economic Analysis. http://www.bea.gov (accessed 15 September 2010).

Click here for figure data

1.1.14 Merchandise trade, eurozone



Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 2 September 2010).

Click here for figure data

Slow progress in rebalancing

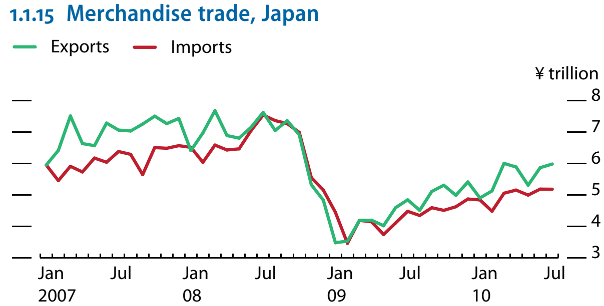
Global current account imbalances, which helped set the conditions that led to the recent global turmoil, showed some signs of abating during the depths of the contraction in international trade. The US current account deficit averaged 1.6% of world GDP in 2004–2006, the years immediately prior to the onset of the financial crisis. As trade volumes fell, global imbalances collapsed as well. By 2009, the US current account deficit was less than half its precrisis level (0.7% of world GDP) (Figure 1.1.16).

On the surplus-country side, much of the reduction in imbalances came from the oil-exporting countries (from a precrisis average of 0.4% of world GDP to less than 0.1% in 2009) and Japan (from an average of 0.4% to 0.2%).

Are the reversals in imbalances likely to hold? The rise in the US household saving rate is a positive sign. Quarterly household saving rates that had been at or below 2.5% of GDP during 2005–2007 (and as low as a paltry 1.2% of GDP), have been above 5% for the 7 quarters ending midyear 2010 (Figure 1.1.6, above). However, this will be partly offset by continued high fiscal deficits. If the recovery holds, surpluses for the oil-exporting countries in the Middle East will also likely expand.

The dollar value of the PRC's surplus dropped during the crisis, from its peak of $371.8 billion (11% of GDP) in 2007 to $297.1 billion in 2009 (6% of GDP), as trade slowed and domestic demand was boosted by huge

1.1.15 Merchandise trade, Japan



Source: CEIC Data Company (accessed 15 September 2010).

Click here for figure data

fiscal stimulus packages. Yet this surplus has remained high as a share of world GDP (about 0.5%).

The rest of developing Asia also continued to run strong surpluses relative to global GDP. As the region maintains its growth lead (Figure 1.1.17), it should continue to attract significant capital flows. On the whole, progress in unwinding the unsustainable global current account imbalances looks fragile.

Global economic outlook

GDP growth rates

Output in the major industrial economies continues to expand, suggesting the world may have passed the worst of the global turmoil. But the steep drop in growth rates between the first and second quarters of 2010 exposed the fragility of the recovery. This *Update* forecasts somewhat stronger growth overall for the year when compared to the April *ADO 2010* forecasts (Table 1.1.1).

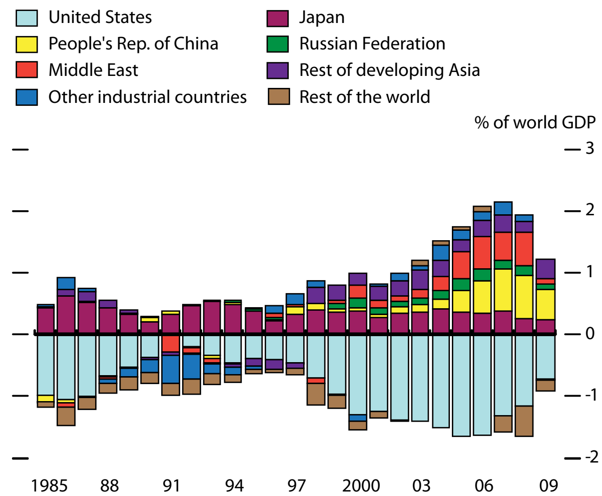
But while for the second half of 2010 and into 2011 there is considerable uncertainty, not all of the news is gloomy. The expansion in international trade seems to be more robust than earlier anticipated. Inflation remains subdued, which will give policy makers some flexibility in returning to normal monetary policy.

Fresh stimulus for businesses and infrastructure development in the US may temporarily boost domestic demand a bit longer. This prop may be aided by foreign demand for US exports, which are expected to be stronger in the second half of 2010, supported by growth in emerging market economies in Asia and Latin America. The surge in import growth is unlikely to be sustained against a backdrop of slowing US consumer spending and moderating industrial production growth. Together, these trends should result in a positive contribution of net exports in the second half.

The 2010 US growth forecast has been revised up to 2.8%, from 2.4% in *ADO 2010*, largely because of the relatively strong start to the year. Over the next year, the growth in consumer spending, which accounts for around 70% of the US economy, is likely to be restrained by slow growth in wages, weak gains in household wealth, and continuing credit restraint. High joblessness rates are likely to persist, despite some improvement in employment.

As the stimulus measures are withdrawn and incomes fail to rise significantly, private consumption will grow at only a subdued rate. Housing sales that were kept high through stimulus policies for first-time home buyers may see a decline even as delinquency rates remain high. A large excess supply of residential and commercial property will stymie the recovery of investment. Slow revival in external demand will

1.1.16 World current account balance



Source: International Monetary Fund. 2010. World Economic Outlook database. April. www.imf.org (accessed 7 September 2010).

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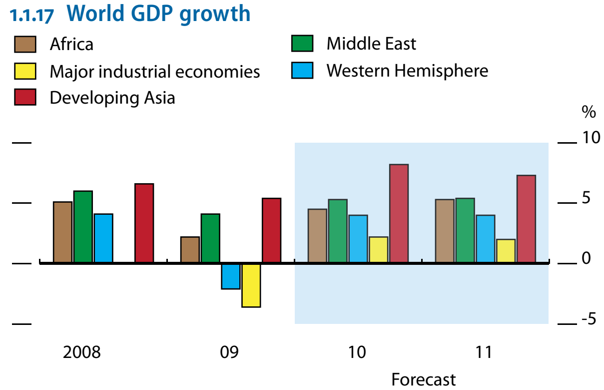
1.1.17 World GDP growth



Africa: Composed of 50 countries: Algeria; Angola; Benin; Botswana; Burkina Faso; Burundi; Cameroon; Cape Verde; Central African Republic; Chad; Comoros; Congo, Democratic Republic of; Congo, Republic of; Côte d'Ivoire; Djibouti; Equatorial Guinea; Eritrea; Ethiopia; Gabon; Gambia; Ghana; Guinea; Guinea-Bissau; Kenya; Lesotho; Liberia; Madagascar; Malawi; Mali; Mauritania; Mauritius; Morocco; Mozambique; Namibia; Niger; Nigeria; Rwanda; São Tomé and Príncipe; Senegal; Seychelles; Sierra Leone; South Africa; Sudan; Swaziland; Tanzania, United Republic of; Togo; Tunisia; Uganda; Zambia; and Zimbabwe.

Middle East: Composed of 14 countries: Bahrain; Egypt; Iran, Islamic Republic of; Iraq; Jordan; Kuwait; Lebanon; Libya; Oman; Qatar; Saudi Arabia; Syrian Arab Republic; United Arab Emirates; and Rep. of Yemen.

Western Hemisphere: Composed of 32 countries: Antigua and Barbuda; Argentina; Bahamas; Barbados; Belize; Bolivia; Brazil; Chile; Colombia; Costa Rica; Dominica; Dominican Republic; Ecuador; El Salvador; Grenada; Guatemala; Guyana; Haiti; Honduras; Jamaica; Mexico; Nicaragua; Panama; Paraguay; Peru; St. Kitts and Nevis; St. Lucia; St. Vincent and the Grenadines; Suriname; Trinidad and Tobago; Uruguay; and Venezuela.

Sources: ADB calculations based on data from: International Monetary Fund. 2010. *World Economic Outlook*. April; World Development Indicators online database (accessed 15 September 2010); *Asian Development Outlook* database.

Click here for figure data

1.1.1 Baseline assumptions for external conditions

	2008	2009	2010		2011	
	Actual	Actual	*ADO 2010*	*Update*	*ADO 2010*	*Update*
GDP growth (%)						
Major industrial economies[a]	0.0	-3.6	1.7	2.2	2.0	2.0
United States	0.0	-2.6	2.4	2.8	2.6	2.6
Eurozone	0.4	-4.0	1.1	1.3	1.6	1.4
Japan	-1.2	-5.2	1.3	2.5	1.4	1.4
World trade (% change)						
Merchandise exports volume	2.2	-12.2	7.1	9.5	8.1	8.1
Prices and inflation						
Brent crude spot prices (average, $ per barrel)	97.3	61.7	80.2	80.2	84.6	82.5
Energy price index (% change)	40.1	-36.9	28.0	25.0	8.1	-0.3
Food and beverage price index (% change)	23.3	-13.1	4.7	0.9	2.9	-1.0
CPI inflation (G3 average, %)	3.2	-0.2	1.4	1.2	1.3	1.3
Interest rates						
US Federal Funds rate (average, %)	1.9	0.2	0.3	0.2	1.3	0.5
EU refinancing rate (average, %)	3.9	1.3	1.1	1.1	1.5	1.5
Japan interest rate (average, %)	0.5	0.1	0.1	0.1	0.2	0.2
US$ Libor[b] (%)	2.7	0.3	0.3	0.3	1.3	0.8

[a] Average growth rates are weighed by GNI, Atlas method (current US dollars). [b] Average interbank quotations on 1-month loans.

Sources: US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp; World Trade Organization, http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary Fund. Primary Commodity Prices, http://www.imf.org; World Bank. Global Commodity Markets, http://www.worldbank.org; ADB estimates.

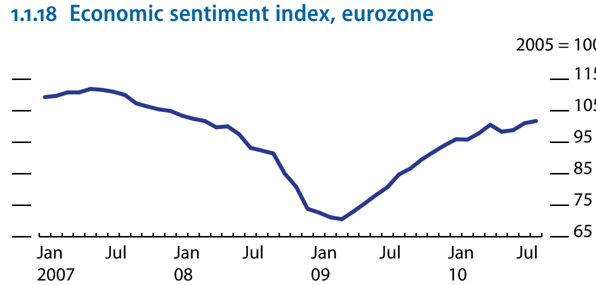
also pull down growth. In 2011, the pace of economic expansion is seen slackening to 2.6%.

Forward-looking indicators for the eurozone suggest that its momentum will be maintained through the second half of 2010. Unemployment is expected to come down slowly toward the end of this year, as the recent upswing in GDP growth starts to be reflected in the labor markets with the usual lag of 6 months or more. The economic sentiment index shows continued signs of improvement, mainly on account of the services sector, despite some signs of flattening since May (Figure 1.1.18).

GDP growth in 2010 is revised to 1.3%, up from the 1.1% anticipated in *ADO 2010*. However, fiscal consolidation announced across all eurozone countries will heavily dent 2010 growth during the second half, both through actual cuts and expectations. The effects will be felt more in 2011 if the policy announcements are carried through.

Against the prospects of a subdued demand for exports from the US and Japan during much of 2011, as recovery in both the regions itself hinges on external demand, sharply lower government spending and tax hikes in the eurozone risk suffocating the nascent domestic momentum needed for a sustained recovery. Moreover, by stifling growth excessively, widespread retrenchment could eventually undermine its purpose of achieving a

1.1.18 Economic sentiment index, eurozone



Note: May 2010 business survey data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev. 2) causing a potential break in series at this date.

Source: European Commission, Directorate General for Economic and Financial Affairs. http://epp.eurostat.ec.europa.eu (accessed 2 September 2010).

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significant improvement of debt and fiscal deficit ratios, hence debt servicing capacity and market confidence.

The medium-term eurozone outlook for employment creation is likely to be of a slow and gradual recovery, largely due to the medium-term effects of some countries adopting "short work" practices, notably Germany and Italy. Such policies have prevented excessive labor shedding in the face of the downturn, but typically cause delays further out, for example in terms of the structural adjustments necessary for labor adjustment to occur across sectors and firms.

GDP growth in 2011 is now expected to be 1.4%, down from 1.6% projected in *ADO 2010*, reflecting continuing weakness in the global economy and fiscal austerity across the eurozone.

Japan's economy has benefited from strong exports to the PRC and other regional economies during the recovery process so far, but domestic demand growth remains sluggish. Near-term prospects thus heavily rely on exports and the impact on business sentiment and incentives to invest. Private consumption is likely to stay weak unless labor market conditions improve substantially.

Given wobbly economic prospects both domestically and globally, expansionary policies are being continued to support Japan's recovery. An increase in the consumption tax is unlikely soon, with any rise being preceded by cuts in corporate taxes. The current expansionary monetary stance is expected to continue because output remains below potential and inflation pressures are low.

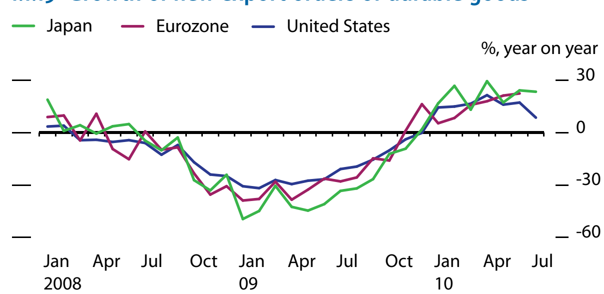
Real GDP in Japan is projected to grow at 2.5% in 2010—an upward revision from the *ADO 2010* projection of 1.3%—as private consumption had a boost in the first quarter backed by the changing subsidy scheme. However, fiscal policy can only play a limited role in supporting the recovery process as large fiscal deficits have pushed public debt to approaching 200% of GDP. A slowdown in export demand from the US combined with a rapidly appreciating currency pose a strain on exporting industries. As expansionary policies end, GDP growth in 2011 is expected to moderate to 1.4% as projected in *ADO 2010*.

In the aggregate, growth of major industrial economies in the second half of 2010 is likely to be weaker than in the first half. Still, the strong first quarter is expected to lift average annual growth in 2010 to 2.2%, a slight upward adjustment from the 1.7% growth projected in *ADO 2010*. As the slowing from the second quarter shows, however, the ability to sustain growth as economic stimulus packages are unwound remains uncertain. Growth in 2011 is expected to be more anemic than in 2010, at 2.0%. Given the policy compulsions, interest rates are likely to remain low in these economies this year and next.

International trade

World merchandise exports have begun to bounce back in 2010 boosted by the pickup in global economic activity. The JP Morgan Global manufacturing measure of new export orders increased from an average of 56.1% in the third quarter of 2009 to 60.3% in April (despite concerns of slow growth in major markets such as Europe). The index has tapered off from its April

1.1.19 Growth of new export orders of durable goods



Sources: US Census Bureau. http://www.census.gov; Ministry of Economy Trade and Industry. http://www.meti.go.jp; Eurostat. http://epp.eurostat.ec.europa.eu; CEIC Data Company (all accessed 15 September 2010).

Click here for figure data

peak. This is reflected in the continued but slowing rise in export orders of durable goods for the major industrial economies (Figure 1.1.19, above).

Accordingly, merchandise exports should grow by 9.5% in 2010 as against the *ADO 2010* projection of 7.1%. The projection for 2011 remains the same at 8.1% due to the uncertainty surrounding the continued strength of industrial economies' recovery.

Commodity prices

The OECD-FAO *Agricultural Outlook 2010–2019*, published in mid-2010, foresees higher global agricultural prices in the next decade relative to the decade before the 2007–2008 price spike (Figure 1.1.20). Recent rises in global wheat prices due to natural calamities and temporary export bans by, for example, the Russian Federation are unlikely to persist for long, given strong global production on average and comfortable world food stocks (Box 1.1.4).

Nonfuel commodity price developments in the near future will largely depend on supply conditions in major exporting countries. According to estimates from the US Department of Agriculture and the Food and Agriculture Organization of the United Nations, global wheat production in 2010/11 is expected to be only marginally lower than in 2009/10. For rice, all the top 10 producing countries are expected to reap larger harvests in 2010/11. This will support higher consumption even as global stocks are reduced.

Oil prices are likely to continue fluctuating within a narrow band, for reasons outlined in Box 1.1.5. The projected oil price for 2010 is retained at $80.20 a barrel and slightly downgraded for 2011 at $82.50 a barrel.

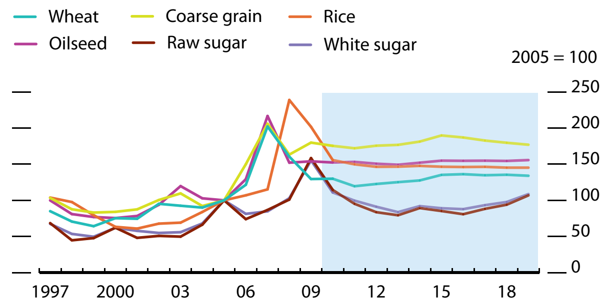
Nonfuel commodity prices (except fertilizers) have moved in unison with energy prices since early 2009 (Figure 1.1.21). On the back of significant declines in 2009, energy and nonenergy commodity prices have rebounded, and are expected to moderate again in 2011. The energy price index is projected to show an increase of 25% in 2010 and a minor contraction of 0.3% in 2011.

The food and beverages price index is expected to have risen by 0.9% in 2010 due to the resumption of economic growth (especially in developing countries), increased demand due to rising biofuel production, and anticipated higher costs of energy-related inputs. However, it will slacken by 1.0% in 2011 as global growth moderates.

Industrial-country inflation

Consumer price inflation in the major industrial economies is now very low, to the extent that Japan has deflation (Figure 1.1.22). The average for this group is 1.2% in 2010 and 1.3% in 2011 (the latter unchanged from *ADO 2010*), as demand remains low and an expansionary monetary policy stance is likely to be continued. External shocks may arise from food and oil price rises. But unlike developing economies, the food

1.1.20 Agricultural commodity price forecasts



Source: OECD-FAO Agricultural Output 2010–2019 database. http://www.agri-outlook.org (accessed 15 September 2010).
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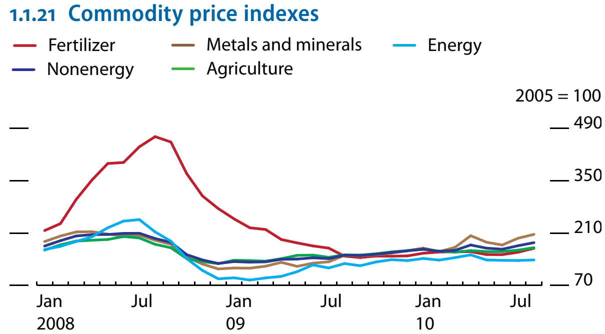
1.1.21 Commodity price indexes



Source: World Bank. Commodity Price data (Pink Sheet). http://www.worldbank.org (accessed 15 September 2010).
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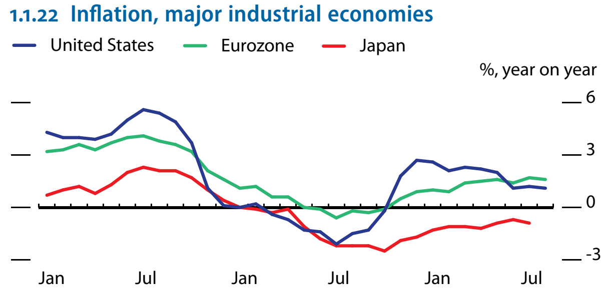
1.1.22 Inflation, major industrial economies

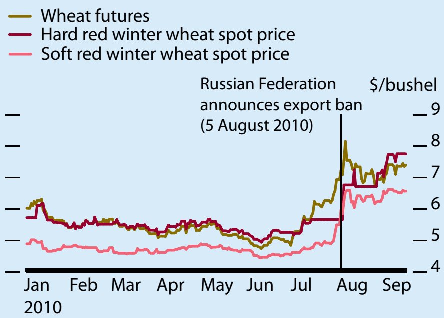


Source: CEIC Data Company (accessed 15 September 2010).
Click here for figure data

1.1.4 Natural disasters and high food prices

In early August 2010, wildfires fueled by high temperatures and the most severe drought in 130 years destroyed wheat and other crops throughout many parts of the Russian Federation. Amid fears of a 35% drop in wheat production, its government announced a temporary export ban to curtail inflation pressures. Given that the country accounts for about 13%–14% of global exports, the global wheat price reached a 23-month high. In addition, wheat futures gained and the December delivery wheat rose on the Chicago Board of Trade, touching a peak of $8.41 a bushel and almost doubling since early June (Box figure 1).

1 Global wheat prices



Source: Bloomberg (accessed 15 September 2010).

Click here for figure data

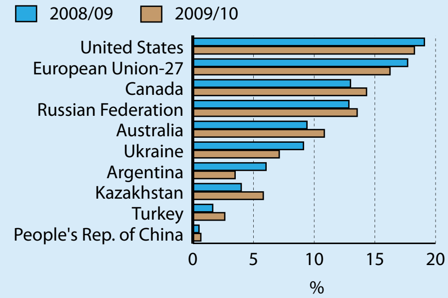
The international wheat price turned volatile as major producers lowered production estimates on weather aberrations. Due to dry weather, the wheat crop may suffer in Australia, which accounts for about 10% of global exports, while prolonged wet weather has reduced acreage in Canada, which supplies about 15% of world demand.

These developments have sparked fears that major importing countries may suffer from price increases as wheat-exporting firms apply force majeure clauses in their supply contracts for events beyond their control, freeing them from their obligations without penalty. The concern is mounting because Australia, Canada, Kazakhstan, the Russian Federation, and Ukraine account for about half of world wheat exports (Box figure 2).

Like the Russian Federation, the People's Republic of China has been severely affected by adverse weather conditions, namely, the worst flooding there since 1998. It produces one-third of the world's rice, an amount that might be reduced by 10%. However, sluggish demand and ample global supply have been tempering any upward movement of prices.

Against this backdrop, grain prices, including those for rice and corn (maize), remain well below their spikes in 2008. At the time of the highs of the 2008 price rally, wheat futures prices spiked to over $13 per bushel amid fears of a global food crisis. In the current situation, the upward movement of the prices is a result more of market expectations than of demand and supply conditions. Despite the drought in the

2 Share in world wheat exports



Source: US Department of Agriculture. http://www.fas.usda.gov (accessed 10 August 2010).

Click here for figure data

Russian Federation and other Black Sea states, crop conditions elsewhere are favorable.

The overall global supply remains stable, providing enough cushion so that the natural disasters do not present an immediate threat of world grain shortage. Global grain stockpiles are about 50% higher than they were in 2008, following record harvests in 2008 and 2009. The wheat crop in the US, the world's largest exporter, has been strong this year. Next year, worldwide wheat production is expected to be only slightly lower than this year. Global production of rice in 2011 is projected to increase marginally relative to 2010.

Moreover, different production cycles worldwide are providing significant stability to world trade and prices. Sowing and harvesting at different times allow exporting countries to take action swiftly in response to changing market conditions. Most of the world's wheat is grown in winter in the northern hemisphere, but Canada, Kazakhstan, the Russian Federation, and the US have large spring wheat production, which is planted much later. This is followed by sowing in Australia and Argentina in the southern hemisphere.

The situation presents an opportunity for other countries to augment their exports as well, which should cool down global prices. Currently, Argentina plans to increase its wheat production by 20%. Additionally, India is considering removing the ban on its grain exports following the huge accumulation of about 60 million tons of rice and wheat in public storage.

The majority of rice production is not traded, and Asia controls over 90% of the world stock. Given the dominance of Asia for production, consumption, and stocks of rice, there is scope for Asian countries to collectively manage available rice at the regional level, instead of resorting to trade restrictions individually, in order to prevent potential price hikes.

High food prices have a negative short-run effect on poor households, as witnessed during the 2007–2008 food price crisis. That crisis showed that panic buying and protectionist policies only exacerbate the supply problems and artificially raise prices.

1.1.5 Recent global oil price trends and short-term and medium-term prospects

Introduction

One major determinant of developing Asia's growth and inflation performance in the short run is the trajectory of global oil prices, which is influenced by a wide range of supply and demand drivers.

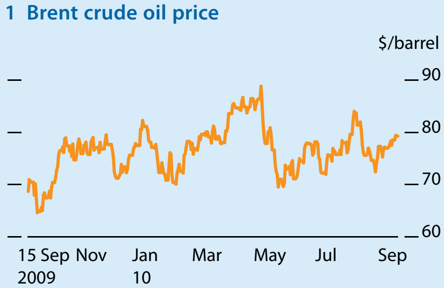
On the demand side, the speed and strength of global recovery will play a dominant role. On the supply side, persistently high levels of inventories and strong output growth provide the primary context. This box analyzes the recent pattern of global oil prices, along with the main drivers of their likely evolution in the short and medium term.

Stability of oil prices due to balance of upsides and downsides

After bottoming at around $40 toward the end of 2008 during the trough of the global crisis, oil prices have gradually recovered along with the world economy. In particular, the robust and speedy turnaround of nonmembers of the Organisation for Economic Co-operation and Development (OECD) has driven the rebound in prices. Demand from OECD countries remains subdued, reflecting the fitful, fragile, and uncertain nature of their recovery.

During the past year, prices have remained fairly stable in the $65–$85 range (Box figure 1). This stability mirrors a fine balance between upside and downside pressures in the global oil market.

1 Brent crude oil price



Source: Bloomberg (accessed 15 September 2010).

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On the upside, discipline among members of the Organization of the Petroleum Exporting Countries (OPEC) on output quotas has been fairly tight, even though OPEC's current collective spare capacity is fairly large at around 7 million barrels per day (mb/d). This discipline has been maintained because the main holders of the spare capacity are Kuwait, Saudi Arabia, and the United Arab Emirates, which all adhere closely to their quotas.

Furthermore, if prices fall toward $65, production from important but high-cost sources such as Canadian tar sands typically begins to slow. Demand from non-OECD countries, in particular the People's Republic of China (PRC), also helps to set a price floor.

Conversely, ample global spare capacity exerts a significant downside pressure on prices. Significantly, the spare capacity is large enough to cushion even major geopolitical events, such as an embargo on the Islamic Republic of Iran, as well as natural shocks, such as hurricanes in the Gulf of Mexico. In addition, inventories remain exceptionally high in historical terms and uncertainty lingers about the global recovery.

Moderate oil price rise seen in 2011 amid limited volatility

The broad equilibrium between supply and demand, which limited volatility during the past year, is expected to continue through the rest of 2010 and into 2011. Oil prices averaged $75–$80 per barrel in the first 2 quarters of 2010 and this is likely to continue into the third and fourth quarters. For 2010 as a whole, the price is projected at $80.20. In 2011, the range of prices is expected to shift up slightly. The average price will also rise moderately to $82.50 in 2011.

On the demand side, robust growth from non-OECD economies will continue to be counterbalanced by subdued demand from the OECD, again reflecting stronger momentum in the former group. More specifically, total OECD demand in 2010 is likely to be almost identical to its 2009 level and about 2 mb/d lower than its 2008 level, although the gap is expected to narrow to around 1 mb/d in 2011.

In contrast, non-OECD demand has continued to grow despite the global crisis. After rising marginally in 2009, in 2010 it is expected to surpass its 2008 level by about 2 mb/d in 2010 and rise by a further 1 mb/d in 2011.

The big picture is that global oil supply will moderately exceed demand in both 2010 and 2011, leading to a slight inventory buildup. The supply and demand forecasts of various organizations are closely in line with each other and all point to a limited price increase combined with muted price volatility (Box table).

The broader contours of the global oil market make sharp price movements in either direction highly unlikely. Rising production, ample spare capacity, and high and climbing inventories militate against the type of spike witnessed during 2007–2008. On the other hand, the gathering pace of global recovery, combined with relatively high discipline within OPEC, render a price collapse equally implausible.

While price volatility has been limited, the market did experience $5–$10 price swings during the course of 2010. Those oscillations probably reflect the ups and downs of expectations about the prospects for a sustained recovery,

1.1.5 Recent global oil price trends and short-term and medium-term prospects (*continued*)

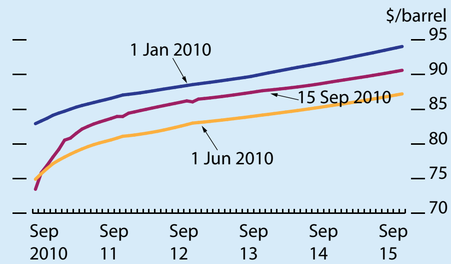
OPEC output and changes in global oil demand, 2009–2011

	2009	2010	2011
Actual and projected OPEC output			
FGE	28.2	28.5	29.1
IEA	28.4	29.1	29.4
EIA	29.1	29.4	30.3
OPEC	28.9	28.7	28.8
World oil demand, year-on-year growth			
FGE	-1.5	1.7	1.7
IEA	-1.3	1.8	1.3
EIA	-1.5	1.6	1.5
OPEC	-1.3	1.0	1.0

FGE = FACTS Global Energy; IEA = International Energy Agency; EIA = Energy Information Administration, US Department of Energy; OPEC = Organization of the Petroleum Exporting Countries.

Source: FACTS Global Energy (2010).

3 NYMEX forward price, West Texas Intermediate



Source: Bloomberg (accessed 15 September 2010).

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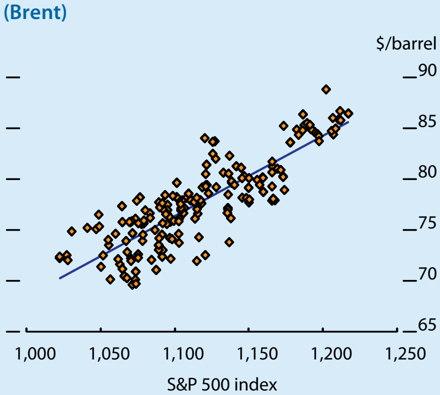
especially in the United States. Good news based on one indicator has been followed the next week by bad news based on another indicator, and so forth.

The very high correlation between the S&P 500 index and global oil prices during 2010 supports this conjecture about the source of volatility (Box figure 2).

2 Correlation between S&P 500 and oil price (Brent)



Source: Bloomberg (accessed 15 September 2010).

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Iraqi production a medium-term wild card

The basic assessment for the medium term remains largely unchanged from *ADO 2010*. Beyond the short term, strong demand from fast-growing non-OECD countries such as the PRC and India will overshadow OPEC's high spare production capacity as the dominant driver of price. NYMEX crude futures for 2015 are about $10 above current spot prices and mirror the futures markets' expectation of higher prices in the medium term (Box figure 3).

Against this baseline assumption, Iraqi production remains a wild card with big implications. It currently stands at about 2.5 mb/d but has a huge upside potential due to plans to develop new production capacity.

Iraq has recently entered into oil field development contracts with several major oil companies, including BP, ExxonMobil, and Shell. Those new developments can lift its potential output to as much as 10 mb/d by 2015–2020. A great deal of uncertainty hangs over Iraqi expansion since there are serious political and security risks as well as logistical constraints, even though Iraq has large proven reserves that are cheap to extract.

The exact impact of additional Iraqi output on OPEC will depend on when the country will be brought back into the quota system and at what level. However, more broadly, higher Iraqi output will substantially raise OPEC's spare capacity and constrain the scope for upward price pressures.

Benign short-term and more challenging medium-term environment

A further source of medium-term uncertainty is the evolution of global growth, in particular whether or not the world economy is able to fully recover the robust momentum that preceded the global crisis. Still, even allowing for various supply and demand shocks, the overall assessment of the global oil market remains the same as in *ADO 2010*. The scope for higher prices will be limited by ample OPEC spare capacity, which makes a sharp surge highly unlikely in the medium term, whereby the baseline forecast is still that of reemerging upward price pressures.

Asian governments should take advantage of the benign short term to prepare their economies for the more challenging medium term, for example, by removing policies that disconnect the price of oil products from their true, underlying marginal cost.

share of household consumption is relatively low in industrial economies, implying that any food-inflation impact is limited. The transmission of high global oil prices to domestic markets depends on government policy of regulating domestic prices.

Headline inflation for the US increased by 0.3% in August from the previous month. Consumer prices were boosted by a 2.3% increase in energy prices, a reversal of the situation in the April–June period when declining energy prices pulled headline inflation down. The core consumer price index (CPI), excluding food and energy, increased by less than 0.1%. Core CPI inflation has averaged only 1.1% year on year during the first 8 months of 2010.

Inflation pressure across the eurozone remains low, reflecting considerable slack in the economy. Headline consumer price inflation was estimated at 1.6% in August 2010, down from 1.7% a month earlier. Inflation is expected to hover at around 1.6% for the rest of 2010, and to fall to 1.3% in 2011 as the strength of recovery relents.

Deflation continues in Japan as the large output gap as well as structural factors put downward pressure on prices. There are signs of stabilization, however. Although core CPI inflation (excluding fresh food) fell to a negative 1.5% (year on year) in April 2010 as a result of a one-time administrative price change related to the introduction of high school tuition waiver, month-on-month inflation was virtually flat during the first half of this year.

Risks to the global outlook

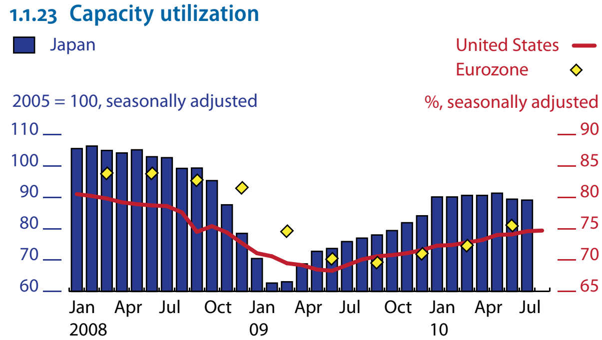
Financial constraints eased and leading indicators turned broadly positive in 2009 and early 2010. Since then, the recovery momentum in the major industrial economies has lost some steam (though new stimulus measures may revive the momentum for a time). Moreover, some critical downside risks further threaten this fragile outlook.

Double-dip recession

Although the more buoyant second quarter growth in the eurozone was encouraging, signs of weakness continue to dominate the global macroeconomic landscape. The unexpectedly slower second-quarter growth in the US and Japan means that the specter of a double dip recession cannot be fully discounted. As the recovery is still fragile, weak demand (both private domestic demand and export demand) continues to present a major policy challenge and the foremost risk to businesses over the coming months. With continuing excess capacity in major industrial economies (Figure 1.1.23), commodity prices remain low while asset prices have fallen back.

The decline in confidence and the continued market uncertainty have resulted in a postponement of the normalization of monetary policies in industrial economies and a slowing of the pace of policy tightening in other countries. Shifting too quickly to fiscal and monetary tightening could heighten the risk of a double-dip recession.

1.1.23 Capacity utilization



Note: Manufacturing operating ratio index is used for Japan.

Sources: Board of Governors of the Federal Reserve System. http://www.federalreserve.gov; Bloomberg; CEIC Data Company (all accessed 15 September 2010).

Click here for figure data

Continued weakness in US mortgage markets

The US housing market remains weak though signs of life have emerged in recent months, mostly as a reaction to the homebuyers' tax credit that ended in April 2010. Home sales and mortgage applications have been weaker than expected lately. The rebound in home sales seen in June was replaced by July's all-time low.

Mortgage purchase applications, though increasing, are still below their last year's average. Last year's surge in unemployment indicates the inability of many households to service their debt, and although the government has implemented programs to restructure mortgages to provide a respite, the problem is still not yet fully resolved.

Sudden rises in commodity prices

Agricultural markets, especially for rice and wheat, are prone to sudden weather changes or natural calamities, as the recent experiences from flooding in Pakistan, natural disasters in the PRC, and wildfires in the Russian Federation demonstrate. Such episodes may create rapid rises in domestic prices leading to export restrictions and even social unrest. They could also create an upward spike in global prices and exacerbate the situation of artificial scarcity, as seen during the food price rise of 2008.

While oil prices are expected to remain stable, much uncertainty hangs over expansion of oil production in Iraq, which has huge, proven reserves that are cheap to extract. However, there are serious political and security risks. The exact impact of additional Iraqi output on OPEC will depend on when the country is brought back into the quota system and at what level.

Insolvency and default in the eurozone

There is a risk that one or more eurozone members may be unable to avoid eventual default or debt restructuring. This possibility is most clear for Greece, which, despite undergoing a stringent adjustment program and drawing down emergency funds, is yet to generate the structural basis for future growth rates high enough to avert a situation of insolvency further out.

This possibility exists also for Ireland and Portugal, whose debt sustainability is being undermined by a combination of high debt, elevated borrowing costs, and low growth prospects. Unless creditors are willing to buy into these markets, even a further bailout by the European Union and emergency lending might ultimately prove insufficient to avoid default.

Ascent of emerging markets

The year began on an optimistic note for the major industrial economies. But with the pace of recovery slowing drastically in the second quarter, indicators are turning more somber. Labor markets remain weak and high unemployment persists. Low wage growth and poor incomes are keeping household savings and asset creation at bay. This is impacting households' spending decisions and firms' investment plans, putting a damper on growth. Despite recovering since the global crisis, external demand remains relatively subdued. Moreover, recent trends in current

account balances suggest limited progress in resolving the global imbalances that persisted before—and contributed to—the global economic downturn.

Government policies are being tailored to address the issues, which results in postponement of the exit from fiscal and monetary support in some economies. This is most evident in the US and Japan, which have announced new stimulus measures. Financial markets remain wary and have the potential to disrupt the recovery process.

In contrast, emerging markets seem to have maintained their buoyancy this year. Among emerging markets, the resilience of developing Asia stands out. A perceptive shift in global economic power toward developing Asia has been under way for decades. Yet the region's strength through the recent global crisis and its aftermath has helped establish the region as an important voice in international policy discussions. With the rebound of the industrial world still uncertain, the burden of carrying global growth forward may fall on developing Asia. The question is whether the region is prepared to take on this role.

Solid recovery in developing Asia

Driven by buoyant exports, strong private demand, and effects of stimulus policy, economies in the region performed better than expected in the first half of the year. The push given by expansionary fiscal and monetary policies propelled growth by raising consumer and business confidence, which in turn strengthened domestic demand.

Despite the sluggish global recovery, the region's growth momentum has sustained itself in 2010, and prospects are bright for most regional economies. GDP growth is now projected to rebound to 8.2% in 2010, revised up from the April forecast of 7.5% in *ADO 2010* (Figure 1.2.1). The improved outlook is broad-based with projections lifted in all subregions.

While the strengthening of the recovery is being felt across the region, the driving forces differ among economies (Figure 1.2.2). In the PRC, strong rebound in exports and resilient domestic demand has been lifting growth. In India, growth has continued to benefit from forceful expansion of domestic demand, corporate profits, and favorable financing conditions that have stimulated investment.

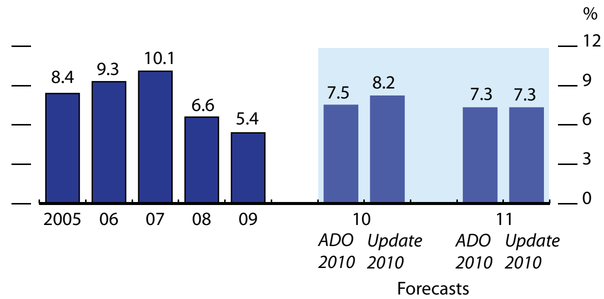
In tandem with the recovery in global trade, a sharp upturn in exports sparked growth in the larger ASEAN economies (Indonesia, Malaysia, the Philippines, and Thailand) and the newly industrialized economies (Hong Kong, China; Republic of Korea; Singapore; and Taipei,China), fueling recoveries in consumption and private investment. Central Asian economies have benefited from buoyant oil and metal prices and recovery in remittance inflows.

However, country-specific circumstances, such as devastating floods in Pakistan, the ongoing political impasse in Nepal, and political unrest in the Kyrgyz Republic will weigh on future growth. In the PRC, the impact of the phasing out of economic stimulus policies and a deceleration in the expansion of world trade will act to moderate growth somewhat. The opposite is the case with India where private consumption and investment demand will continue to be strong.

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 the *ADO 2010* level, at a still robust 7.3%.

The trend of strong growth in 2010 followed by a slowdown in 2011 is projected for all subregions with two exceptions (Figure 1.2.3). Growth is expected to continue to revive in Central Asia because of higher oil prices and sustained growth in the Russian Federation, the region's major trade and financial partner. Similarly, the resource-driven economies of Solomon

1.2.1 Growth rates for developing Asia, %



Source: Asian Development Outlook database.

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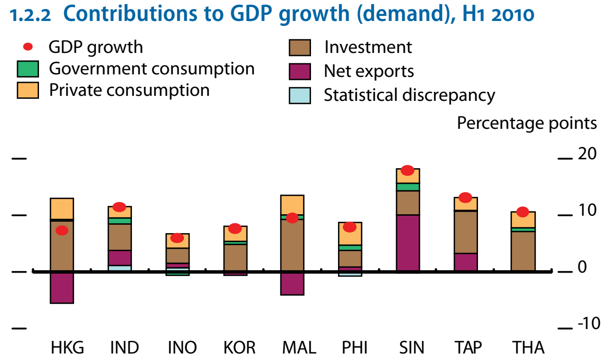
1.2.2 Contributions to GDP growth (demand), H1 2010



HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; SIN = Singapore; TAP = Taipei,China; THA = Thailand.

Note: India is based on GDP at constant market prices.

Source: CEIC Data Company (accessed 22 September 2010).

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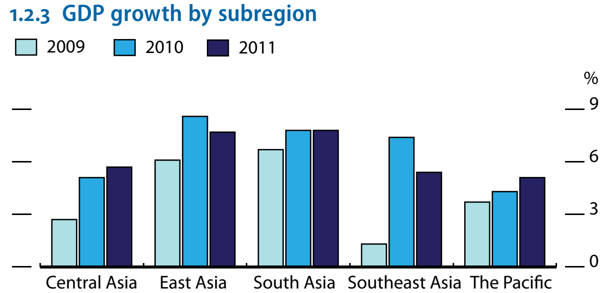
1.2.3 GDP growth by subregion



Source: Asian Development Outlook database.

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Islands and Democratic Republic of Timor-Leste are likely to raise aggregate growth in the Pacific even as low growth is experienced in most of the remaining subregional economies.

The rebound in private demand is allowing some governments to wean their economies off the emergency measures introduced to counteract the effects of the global turmoil. India is gradually reducing the federal fiscal deficit to avoid an unsustainable buildup of public debt. Monetary authorities in the PRC increased bank reserve requirements to rein in private credit expansion. A few countries—including India, the Republic of Korea, Malaysia, Pakistan, and Thailand—have also increased policy rates to keep inflation in check (Figure 1.2.4).

Price pressures in the PRC this year have been milder than anticipated. However, India has faced very high inflation, largely because food inflation soared due to poor monsoon rains in 2009 and difficulties in food management. As part of policy reforms, India, Indonesia, and Pakistan have increased fuel prices while Bangladesh is expected to follow suit. Inflation in developing Asia on the whole is generally within central banks' "comfort zones."

In the aggregate, mild inflation is expected in the region, averaging about 4.0% in both 2010 and 2011 (Figure 1.2.5). However, monetary authorities still need to keep an eye on potential spikes in global oil and food prices.

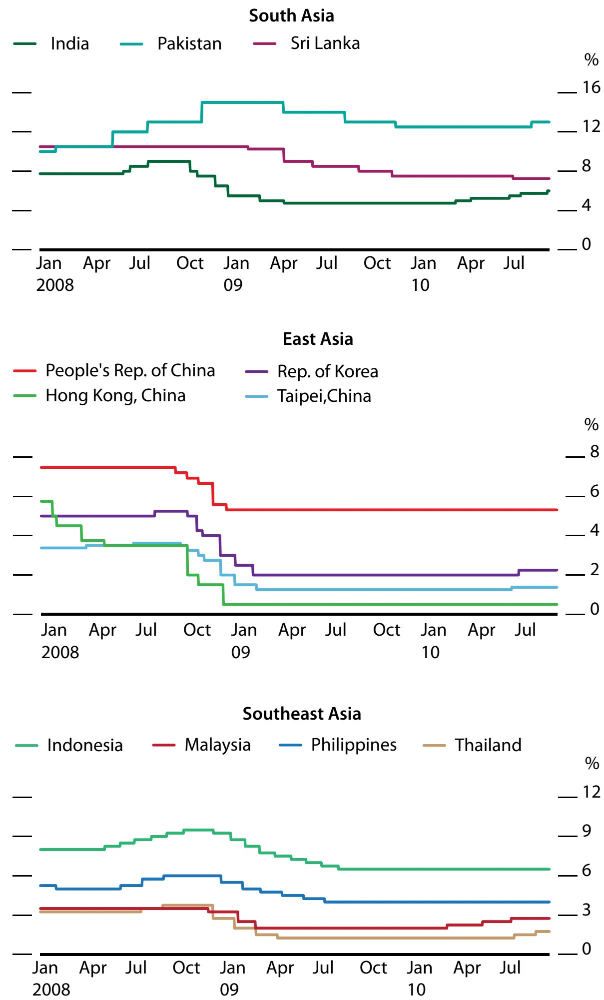
Continued strong domestic demand will limit the region's overall current account surplus to around 4.0% in the next 2 years (Figure 1.2.6). The surplus will be relatively high in East Asia, equivalent to about 5% of GDP both years. Likewise, current account surpluses of 5.7% are projected for Southeast Asia in both years. The overall Central Asian current account position is forecast to strengthen to a surplus of 8.4% of GDP in 2010 and 8.3% in 2011, mainly due to better outcomes for oil and gas exporters.

At the other end of the spectrum, the projection of the 2010 current account deficit in South Asia is increased to 2.2% of GDP, due mainly to India's strengthened growth and investment. The current account deficit will further widen to 2.5% of GDP in 2011, due in part to India as faster economic expansion draws in imports, but also Pakistan's flood-related relief and reconstruction.

Unlike the industrial world, strong revival in developing Asia's private consumption and investment suggests that the private sector is holding its own in the recovery. Even the slower growth expected in 2011 is in line with the average growth of 8.6% in 2003–2007, the 5 years immediately preceding the onset of the recent crisis.

Having withstood the worst of the global turmoil, the region must now face the challenge of playing a bigger part in the global recovery. The region can rely on the sound policy foundation that helped it survive the recent turmoil to provide a basis for its expanded role in the global recovery.

1.2.4 Policy rate movements, developing Asia



Source: Bloomberg (accessed 15 September 2010).

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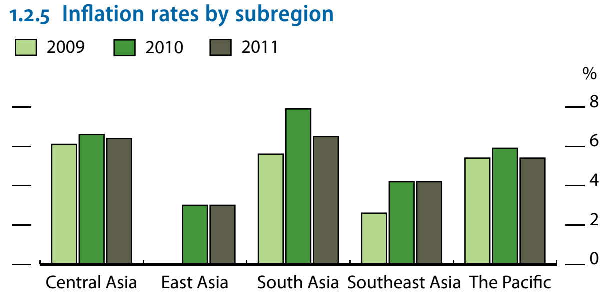
1.2.5 Inflation rates by subregion



Source: Asian Development Outlook database.

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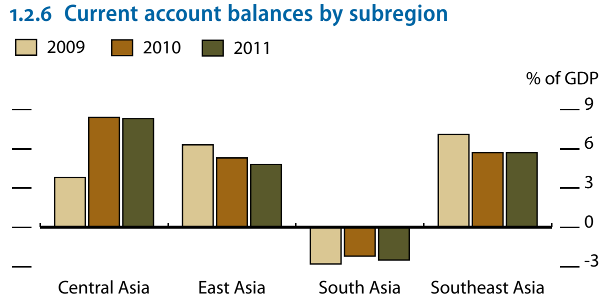
1.2.6 Current account balances by subregion



Source: Asian Development Outlook database.

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Policy foundation for growth

The evidence of developing Asia's rising economic power covers many facets, allowing it to assert itself on the global stage through greater economic presence. One facet is seen in increasingly sophisticated production networks, which provide a platform for low-cost production. At the other end of the scale, developing Asia is also an acknowledged leader in production of high-end information technology (IT) goods and services.

Among individual economies, the PRC and Taipei,China have established themselves as worldwide suppliers of toys and electronics. The Republic of Korea is making its presence felt as an exporter of high-tech products such as phone handsets, automobiles, and IT products. India and the Philippines are among the most sought-after destinations for business-process outsourcing, computer software, and other IT services.

Those countries in Asia with large domestic markets are exploiting economies of scale to create home-grown multinational corporations, an evolution supported by the spending power of the region's expanding middle class. With its ability and willingness to pay a premium for higher-quality products, this burgeoning segment is becoming an important force to reckon with in global demand for goods and services. Yet even amid this rising affluence, the challenge of ensuring that the benefits of growth are broadly shared remains (Box 1.3.1).

These positive developments were not mere accidents but were supported by policy imperatives. The monetary and fiscal policies—in particular, fiscal restraint, anchored exchange rates, and stable prices—not only enabled the region's rapid growth but also gave it the space for fiscal and monetary expansion needed to fight the global crisis.

Financial sector reforms, particularly prudential norms for the banking sector—the backbone of Asia's financial system—helped the region to develop a resilient financial sector that is capable of better absorbing volatile capital flows and providing alternative sources of financing for domestic firms.

Policy reforms to strengthen intraregional ties in production, trade, and investment by reducing barriers to trade and cutting trade costs helped developing Asia to emerge relatively easily from the steep drop in global trade during the recent crisis.

Improved macroeconomic policies

The recent slowdown in the region's economic activity due to the sharp fall in demand for its goods from major industrial-country consumers required a bold response from authorities in the region. Most countries reacted by easing both monetary and fiscal policy to bolster demand. The policy reaction stands in sharp contrast to the Asian crisis when governments were obliged to tighten monetary policy and rein in public spending. The reactions were made possible by the marked strengthening in the fundamental position of Asian countries after the late 1990s, including strong financial sectors, better institutions, more anchored

1.3.1 Including the poor in the growth process

Growth is inclusive when coupled with equality of opportunity. A development strategy based on this approach will need to have high growth to create productive jobs and economic opportunities, but will also need social inclusion measures to ensure equal access to these opportunities. Even with sustained growth, social safety nets are needed to prevent people from falling into extreme poverty.

Developing Asia has made huge gains in terms of economic growth and poverty reduction. Between 1990 and 2008, average per capita gross domestic product in constant 2005 purchasing power parity terms increased from $1,631 to $4,430, for growth of 5.7% a year. This has led to huge reductions in the number of extremely poor (those living on less than $1.25 a day), with more than 850 million fewer poor in 2005 than in 1990.

Yet progress has been uneven across the region. Countries such as the People's Republic of China and Indonesia reduced poverty by more than 30 percentage points in this period, while poverty incidence in four former Soviet countries (Georgia, the Kyrgyz Republic, Tajikistan, and Uzbekistan) rose. In Bangladesh and Nepal, more than half the population still survives on less than $1.25 a day.

Beyond the poverty incidence numbers lies deprivation in terms of basic social services—more than half of Asians live without basic sanitation, for example. Access to health services remains an issue, with women and children most vulnerable. In South Asia, malnutrition among children under 5 years old is a staggering 45%.

Such human impacts are a stark reminder of the need to ensure that the benefits of rapid economic growth are shared more widely within society.

Source:

Zhuang and Ali (2010).

exchange rates, lower inflation, strong fiscal positions, modest short-term foreign debt, and bigger foreign exchange reserves, without which a loss of confidence might have been triggered. These policies brought about the stable macroeconomic environment needed for countries to grow, and provided the capacity for authorities to respond to the massive external shock.

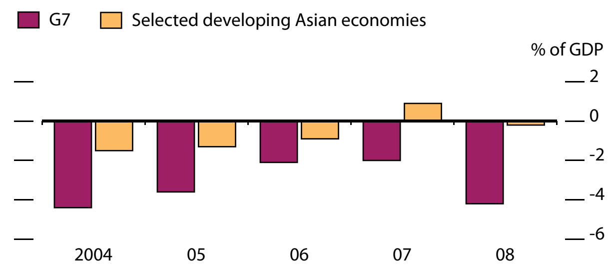
Fiscal policy

Most regional governments have, as a matter of policy, maintained healthy finances by keeping budget deficits at manageable levels or even running surpluses, allowing a high degree of fiscal freedom. In 2004–2008, fiscal balances in 10 major regional economies averaged -0.6% of GDP in contrast to -3.2% in the G7 economies (Figure 1.3.1). In line with this, the average debt-output ratio of these regional economies in 2007 was 24.7%, well below the G7 average of 79.5% (Figure 1.3.2).

As a widely watched indicator of the fiscal vulnerability a country faces, a high ratio of government deficit to GDP implies that the government must allocate a larger part of its expenditures on paying interest on its debt rather than on goods and services. By raising concerns about its debt sustainability, a high deficit also increases the risk premium and the cost of servicing the debt. In turn this could dent business confidence, crowd out private investment, and create adverse reactions in financial markets, thereby deterring foreign investors and leading to capital outflows.

One reason for developing Asia's recent resilience was that when the global crisis hit, its strong fiscal position allowed regional economies to accommodate costly fiscal expansions and support domestic demand to cope with the crisis (as noted, a markedly different response from that in the late 1990s).

1.3.1 Fiscal balance of selected economic groups



Note: Selected developing Asian economies comprise People's Rep. of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

Canada, France, Germany, Italy, Japan, United Kingdom, and United States constitute G7.

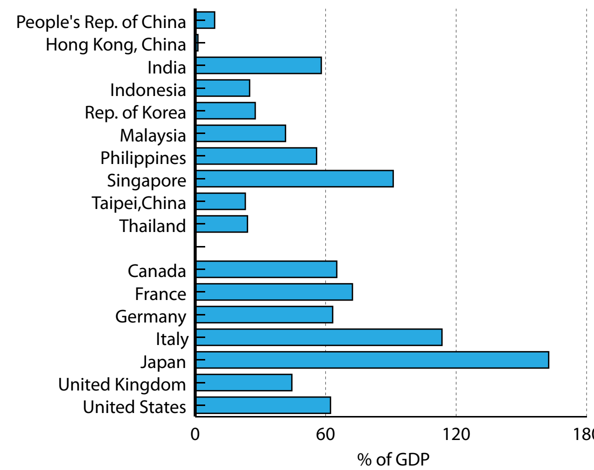
Source: ADB calculations using data from Oxford Economic Forecasting Model, September 2010.

Click here for figure data

In 2010, only a handful of regional economies are pursuing fiscal stimulus, representing a significant unwinding. Larger countries showing strong economic recovery, such as the PRC and India, are already on the way to normalizing their macroeconomic policies.

The region's experience during the global crisis highlights the fact that fiscal responsibility during normal times provides governments with the resources they need to support the economy during extraordinary times. Still, the current low level of public indebtedness in developing Asia should not lull the region into complacency about debt sustainability. Rather, the region's governments should closely monitor their public debt positions and implement a credible medium-term fiscal framework for maintaining or achieving debt sustainability.

1.3.2 Public debt of selected economies, 2007



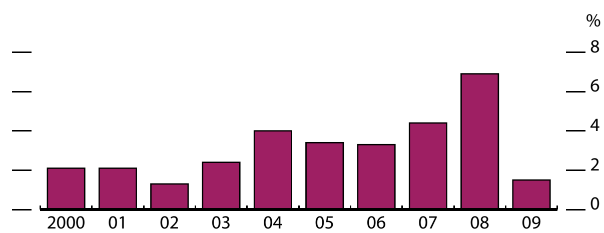
Sources: Oxford Economic Forecasting Model, September 2010; ADB calculations using data from CEIC Data Company (accessed 16 September 2010).

Monetary and exchange rate policy

Given that high and volatile inflation is detrimental to growth, the most significant shift after the Asian crisis was the adoption of the inflation targeting framework in many developing Asian economies as their monetary policy tool. Particularly, losing a de facto dollar peg during the crisis was the motivation for the inflation targeting as a new anchor. Indonesia, the Republic of Korea, the Philippines, and Thailand adopted flexible inflation targeting, which gives the central bank a more stable target and induces inflation expectations to converge. Average inflation in the region declined significantly in the last decade, accompanied by high growth.

From 2000 to 2007, inflation rates in the region were reasonably low and stable (Figure 1.3.3), providing room for the easing of monetary policy when prompted by external shocks. When the global crisis struck, monetary authorities across the region proactively cut policy rates and boosted bank reserves to ensure adequate liquidity in the economies.

1.3.3 Inflation rate, developing Asia



Source: Asian Development Outlook database.

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The region's accumulated foreign exchange reserves acted as an important buffer against the financial impacts of the crisis. Countries with higher reserves experienced smaller reductions in demand during the global crisis, and only a small portion of foreign exchange reserves were used to defend currencies. No speculative attacks occurred. As a result of the more muted foreign exchange outflows in the recent crisis, exchange rate movements were generally not a factor.

With the exception of Indonesia and the Republic of Korea, no countries in the region saw sharp exchange rate movements. But, as large economies, they are significant exceptions. Despite running current account surpluses, avoiding obvious overvaluation, and having quite large foreign exchange reserves and healthy financial sectors, both Indonesia and the Republic of Korea experienced large depreciations during the recent crisis (in the latter's case, the fall in 2008 was of similar magnitude to that in 1997).

These two countries' experience adds another dimension to the use of reserves for intervention. In both cases, the starting level of reserves was comfortable in terms of the ability to repay foreign debt and to defend the

currency. But as soon as these reserves began to be used, financial markets focused on the fall in the reserves rather than the absolute level. In this context, swap lines with other central banks seemed to be effective in combating adverse market sentiment, and government backing for bank foreign borrowing appeared effective in countering market misperceptions. The effectiveness of this combination of swap arrangements and government backing in defending currencies therefore strengthens the case for the multilateralization of the Chiang Mai Initiative.

Beyond the crisis, more flexible exchange rates are desirable to reduce the region's current account imbalances. But unilaterally allowing exchange rate to appreciate will create the fear of losing export competitiveness. Developing Asia would benefit from a shift toward intraregional exchange rate policy coordination to promote greater exchange rate flexibility in the region, resulting in less concern over a loss of export competitiveness to neighboring economies. While price stability must remain the overriding objective of monetary policy, the global crisis highlights the need to prevent asset price bubbles through improved coordination between financial regulation and monetary policy.

Prudent financial management

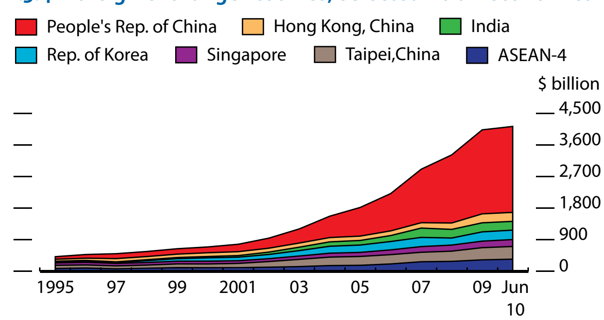
Following the Asian crisis, wide-ranging financial regulatory and supervisory reforms were implemented across developing Asia. Some Asian economies introduced prudential measures on their banking sectors to control short-term overseas borrowing in a precautionary move to guard against speculative capital inflows and associated currency volatility. Such resilience helped financial systems in Asia to absorb the impact of the global crisis more easily. No major banks failed in Asia during the recent crisis.

Foreign exchange reserves surged in the aftermath of the recovery from the Asian financial crisis, primarily as a result of large and persistent current account surpluses, coupled in some cases with strong net capital inflows (Figure 1.3.4). To some extent, the unprecedented reserves buildup reflected a precautionary self-insurance demand for international liquidity to prevent another Asian crisis.

The region's sizable foreign exchange reserves holdings were more than adequate to cover the rollover of short-term foreign currency debt as developing Asia headed into the recent crisis. These reserves have helped to maintain investor confidence and enhance regional economies' capacity to respond to external shocks. They also provided alternative policy options to stabilize currency and financial markets in the face of large swings in exchange rates.

Capital flows, particularly of short-term duration, have in the past disrupted the functioning of monetary policy and created financial instability with adverse consequences for growth. The experience of capital flight during the Asian crisis made governments wary of surges in capital inflows. Authorities are often concerned that these surges may exert undue pressure on the exchange rate to appreciate excessively. Sharp appreciation and high volatility in the exchange rate may cause longer-term damage to the competitiveness of the economy. For emerging Asian economies

1.3.4 Foreign exchange reserves, selected Asian economies



Note: ASEAN-4 comprises Indonesia, Malaysia, Philippines, and Thailand.

Source: International Monetary Fund. International Financial Statistics online database (accessed 22 September 2010).

Click here for figure data

where exports remain an important driver of growth, this consideration is particularly relevant. Capital inflows could also fuel a domestic lending boom, leading to asset price bubbles that eventually burst and instigate financial instability.

Private capital flows to emerging countries fell dramatically during the recent global crisis. However, flows to the Asian region were less affected than those to other emerging markets such as Eastern Europe. Although equity markets and borrowing costs were affected, relatively stable financial systems and a negligible exposure to the toxic assets emanating from the industrial world contributed to developing Asia's hardiness.

Following a dip in late 2008 and early 2009, capital inflows to the region have recovered (Figure 1.3.5). The return of investors' risk appetite for emerging market assets and the strong economic recovery have combined to bring a surge in capital flows to developing Asia.

The strong rebound in capital inflows has been driven by portfolio equity flows spurred by strong economic fundamentals. The region continues to attract sizable FDI on the back of its long-term growth potential, improved business environment, and commitment to economic reforms and macroeconomic discipline.

Availability of relatively cheap and skilled labor, good economic infrastructure, and extensive supply networks have also facilitated rapid growth in the share of FDI. These flows are, in general, more stable than portfolio flows since physical investments are not as easy to withdraw.

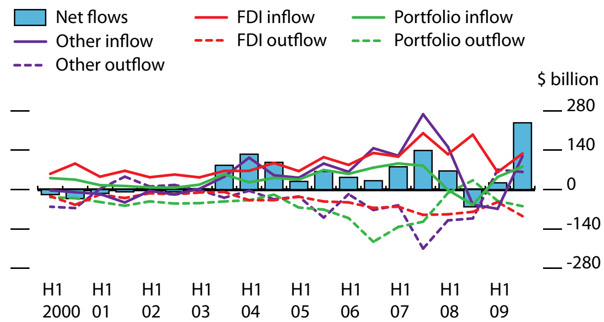
Other flows have been consistently more volatile and tend to be more susceptible to external shocks and currency instability compared to FDI and foreign portfolio investment flows. With ample local funding available, banks and nonbank corporations have shied away from foreign borrowing, thereby limiting net debt inflows.

While capital inflows bring benefits to recipient economies, spurring investment and economic growth, a gush can also carry significant challenges by posing a threat to financial market stability and undermining long-term strategies to strengthen economic fundamentals. By adding to reserves, significant flows to developing Asia are creating excessive liquidity and putting pressure on exchange rates to appreciate (Figure 1.3.6).

All this is complicating macroeconomic management by exacerbating trade and current account imbalances. Given developing Asia's rapidly growing reserves, attention has now shifted from reserve management to reform of the global reserve system (Box 1.3.2), in which developing Asia's policy makers need to take their part.

The prospect of reversal of inflows remains a possibility in the medium term as monetary tightening in the US and the eurozone narrow the interest rate differentials with developing Asia (Figure 1.3.7). Asian authorities should therefore consider

1.3.5 Capital flows in selected Asian economies



Note: Data used in this chart are for People's Rep. of China; Hong Kong, China; Indonesia; Rep. of Korea; Philippines; Singapore; Taipei,China; and Thailand.

Sources: ADB calculations using data from CEIC Data Company (accessed 22 September 2010); International Monetary Fund. International Financial Statistics online database (accessed 22 September 2010).

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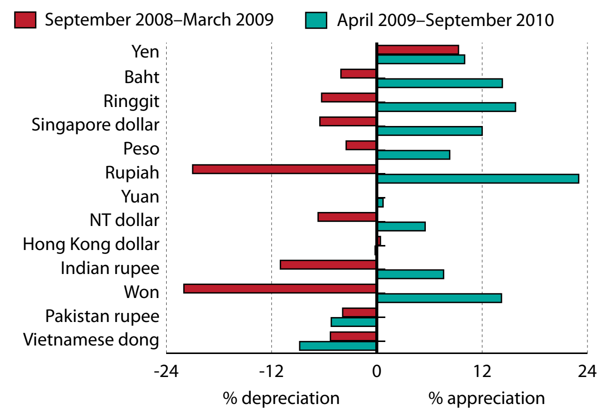
1.3.6 Change in exchange rates vs United States dollar

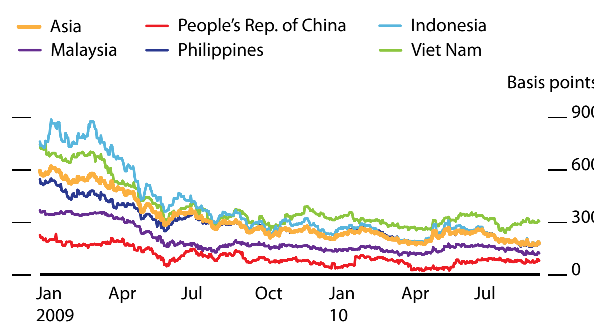


Note: Based on monthly average of $ value of local currency as of 15 September 2010.

Source: ADB calculations using Bloomberg data.

Click here for figure data

1.3.7 Bond spreads



Note: Data for "Asia" refer to JP Morgan Emerging Markets Bond Index sovereign stripped spreads.

Source: Bloomberg (accessed 15 September 2010).

Click here for figure data

appropriate policy measures to manage a surge in capital inflows and to encourage stable long-term capital flows. Economies such as Indonesia and the Republic of Korea have already responded by imposing capital controls. As investors from industrial economies still account for about half of the FDI inflows to developing Asia, prospects of global economic recovery are important for determining these movements. Nevertheless, should those investment flows become weak, a stronger base of intraregional trade and investment provides a cushion to developing Asia.

1.3.2 Reform of the global reserve system

The recent global crisis highlighted critical weaknesses in the current global reserve currency system. The crux of the problem is that the current system is dominated by a single currency: the United States (US) dollar. Despite the advent of the euro and its increasing use as a reserve currency, the dollar continues to dominate reserve holdings (Box figure). The dollar's preeminence is even more pronounced for developing Asian economies, which have stronger economic linkages with the US than with the European Union.

The main risk from relying on a single currency is the absence of binding mechanisms to ensure the soundness of the issuing country's macroeconomic and regulatory policies. It was concerns about the role of the dollar as a store of value that precipitated recent debate for an overhaul of the global reserve system and an expanded use of the special drawing rights (SDR) of the International Monetary Fund as a reserve currency.

The underlying fear was that unsound US policy would undermine the purchasing power of the dollar and thus impose large losses on Asia's huge holdings of dollar-denominated reserve assets. The fear was accentuated by large US fiscal deficits and growing public debt.

The global dominance of the US dollar inevitably creates a tension between US monetary policy and global monetary policy. The dollar would be strengthened if the US shifted from a balance-of-payments deficit to a surplus, but the rest of the world would lose its main source of reserves. The resulting shortage of international liquidity would jeopardize global trade, investment, and growth.

On the other hand, continuing US deficits would benefit the world economy through the expansion of international liquidity, but excessive deficits and debt would undermine confidence in the dollar and thus its role as the reserve currency. The dilemma here is that the US cannot simultaneously run a balance-of-payments surplus and deficit.

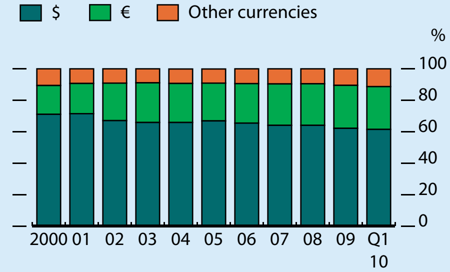
Shortcomings in the global reserve system that impede cross-border trade and investment would have serious repercussions for developing Asia's growth and stability. As a region that depends heavily on these international flows for its prosperity, developing Asia has a huge stake in a well-functioning global reserve system that provides international liquidity in a smooth, stable, and efficient manner, and is thus conducive for trade and investment.

The region holds close to half the world's total reserves. Yet despite being one of the three centers of gravity of the world economy, no currency from developing Asia is widely held as a reserve currency. It is, therefore, imperative for the region's policy makers to participate actively and constructively in the evolving dialogue on the reform of the global reserve system, which will impinge heavily on developing Asia's growth and stability.

A comprehensive reform agenda of the system would entail regional and global policy actions. Regional policy recommendations include the use of the region's reserves in stabilizing the global financial system, exchange rate coordination, temporary capital controls and their coordination across vulnerable countries, and country-specific economic surveillance and adjustment conditionality.

Proposals for global-level policy actions include strengthening prudential capital market regulations by standardizing regulatory frameworks across regions and countries; and convening a "brain trust" of independent international monetary experts to mitigate tension (such as that over exchange rate manipulation) among countries.

Share of major currencies in allocated global reserves



Source: Currency Composition of Official Foreign Exchange Reserves (COFER) database. International Monetary Fund. http://www.imf.org (accessed 21 September 2010).

Click here for figure data

Strengthened regional economic ties

After the Asian crisis, countries in developing Asia followed deliberate policy measures to strengthen economic ties within the region by reducing barriers to trade. Trade costs have declined as a consequence (Figure 1.3.8).

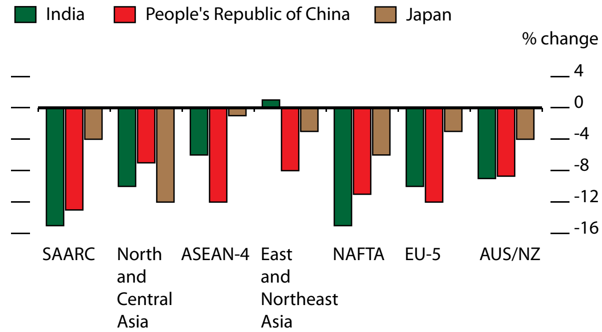
There is also increased macroeconomic interdependence among Asian economies as reflected in considerably higher comovement of GDP across Asia and more synchronized business cycles of the region's economies since that crisis. Output correlation among Asian economies, for example, has turned from being negative in the early 1990s to average 0.5–0.75 since 1997 (which is now comparable to that of European Union economies). In particular, interdependence between the fast-growing Asian economies has risen and is now similar to that between Asia and the European Union and US (Figure 1.3.9).

Better regional integration allows countries to pool their resources, produce on a larger platform according to their comparative advantage, and supply larger markets beyond their borders. The possibility of exploiting increasing returns to scale in large markets promotes expansion of intraregional trade. By lowering trade barriers and shifting the industrial structure of many economies from labor-intensive products such as textiles to more capital-intensive ones such as steel, electronics, and machinery, the region has witnessed enhanced trade, investment, and technology transfers across its borders. Particularly, East Asia has taken the lead (Table 1.3.1).

Apart from the intensification of trade in intermediate goods, dispersion of the production process across different countries strongly contributed to regional economic integration by stimulating FDI (Table 1.3.2). For instance, direct investment of Hong Kong, China and Taipei,China remains heavily focused on the PRC. Foreign investment has indeed been an important driver of trade in developing Asia, associated with the growth of efficient production networks. Along with the investment, FDI flows also bring the associated know-how, giving the recipient countries a chance to enhance their technical knowledge and skills and improve productivity.

The region's competitiveness has been further reinforced

1.3.8 Changes in trade costs between subregions and the People's Republic of China, India, and Japan, 2003–2007



Notes:

SAARC (South Asian Association for Regional Cooperation) comprises Bangladesh, India, Pakistan, and Sri Lanka.

North and Central Asia comprise Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgz Republic, and Russian Federation.

ASEAN-4 comprises Indonesia, Malaysia, Philippines, and Thailand.

East and Northeast Asia comprise People's Rep. of China; Japan; Rep. of Korea; Macao, China; and Mongolia.

NAFTA (North American Free Trade Area) comprises Canada, Mexico, and United States.

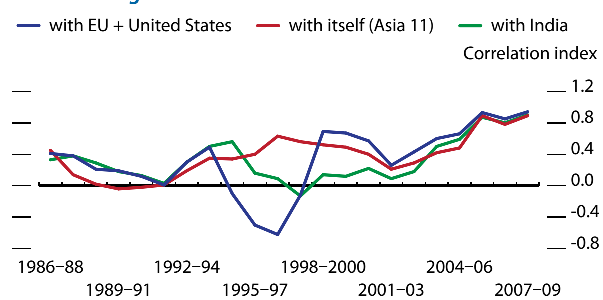
EU-5 comprises France, Germany, Italy, Spain, and United Kingdom.

AUS/NZ = Australia and New Zealand.

Source: UNESCAP (2010).

Click here for figure data

1.3.9 Output correlation of East Asia and India with selected countries/regions



Notes:

Asia 11 comprises People's Rep. of China; Hong Kong, China; India; Indonesia; Japan; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

EU (European Union) here comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Source: ADB (forthcoming).

Click here for figure data

1.3.1 Uneven economic integration in Asia and the Pacific

Subregion	Intermediate goods	Final goods	Services
East Asia	High	Moderate	Moderate
Central Asia	Low	Low	Low
South Asia	Low	Low	Low
The Pacific	Low	Low	Low

Notes: Intermediate goods refer to trade in parts and components. The assessment is classified as "high" if intraregional trade share is more than 50%; "moderate" if 20%–50%; and "low" if less than 20%. East Asia comprises the PRC; Hong Kong, China; Japan; Rep. of Korea; Mongolia; Taipei,China; Brunei Darussalam; Cambodia; Indonesia; Lao PDR; Malaysia; Myanmar; Philippines; Singapore; Thailand; and Viet Nam.

Source: Asian Development Bank (forthcoming).

1.3.2 Outward investment flows (net) by destination region, $ billion

	Period	North America	Europe	China, People's Rep. of	Other Asia	Latin America	Others	Total
Hong Kong, China								
Direct investment	2008	1.9	-1.8	27.6	-0.9	19.1	4.7	50.5
Malaysia								
Portfolio investment	2008	9.6	23.6	0.0	37.7	0.0	7.7	78.6
	2009	5.9	15.0	0.0	14.3	0.0	4.7	39.9
Loans	2008	0.1	0.7	0.0	3.9	0.0	51.6	56.4
	2009	0.3	0.5	0.0	1.8	0.0	71.7	74.4
Taipei,China								
Direct investment	2008	0.4	0.0	9.8	1.7	-	0.0	12.0
	2009	1.1	1.0	6.1	0.7	-	-1.0	7.9

Source: Morgan (2010).

through cooperation on developing cross-border infrastructure, which supports development opportunities by improving market access and reducing losses of perishable goods. Regional connectivity provides access to regional populations who constitute a larger market for goods and services than markets within national boundaries.

Greater trade within developing Asia is perhaps a reason why the region managed to cope well with the sharp decline in global trade in 2008–2009. Compared to the 23% fall in world export volume (in current US$) in 2009, exports from the PRC fell by 16% and ASEAN by 15%. Exports from these two economies combined account for more than half of all developing Asia's exports. Intraregional trade has rebounded quickly, which is notable since trade impacts of the recent global crisis in major Asian economies were more severe than in either Europe or North America in the 1930s or during the Asian crisis.

While relevant policy choices have enabled developing Asia to ride the storm of the global crisis with relative ease, the region cannot afford to rest on its laurels. A rapidly changing world requires developing Asia to move beyond its current policies.

Building on the foundations

The Asian financial crisis proved to be an eye opener for regional economies to the disastrous implications of external shocks and forced them to prepare for such future eventualities. Decisive policy actions undertaken in the aftermath of that crisis to lay strong and stable foundations for macroeconomic fundamentals have allowed developing Asia to emerge quickly with a robust recovery from the global recession. Indeed, riding on the strong base of the fundamentals, some economies are reaching close to the high-growth path they enjoyed in the pre–global crisis era.

Developing Asia has built solid policy foundations that have served it well in its development. Yet looking ahead, the region must reform its institutions and overcome critical structural impediments to unlock its long-term growth potential. Can the region build on its foundations to sustain rapid growth in the future?

Constraints to long-term growth

The growing economic size and financial power of Asian economies has changed the international economic and financial landscape. A few large Asian economies in particular are making their voices heard in global economic circles as part of the G20. The PRC, India, Indonesia, and the Republic of Korea join seven other developing country representatives in a group that has become the premier forum for international dialogue on economic and financial policy, replacing the exclusively industrial-country G7 in this role.

Yet the region will face many hurdles to sustain growth over the long term. The crisis has slowed the region's progress in raising the living standards of its people and put at risk its achievements in poverty reduction. Deeply embedded structural constraints prevent it from reaching its full production potential and attaining the maximum possible outputs that its vast resources are capable of producing. To accelerate growth and reduce poverty, the region must address the limitations it faces both in terms of resource use efficiency and raising productivity.

Continued reliance on expanding the factors of production—that is, a growing labor force and capital stock—is essential for increasing long-term supply. But more than simple accumulation of factors, using these resources more efficiently and spurring innovation hold the key to sustain high growth over the longer term.

The region's successful reliance on trade for its development will need to be seen in a new light as the region strives toward more balanced growth. With domestic demand emerging as a vital driver of growth alongside exports, Asian economies must become increasingly important markets for each other's final products. Expanding intraregional trade would also allow many of them to transition away from labor-intensive to capital- and knowledge-intensive manufacturing and put them on a higher growth profile.

Developing Asia supplies cheap labor to industrial economies but its poor educational systems and archaic labor laws are hurdles to further progress. Overhauling the educational system would contribute to the quality and quantity of its rich resource base of highly skilled professional and educated workforce.

Poor infrastructure—within nations and across borders—and high infrastructure costs present key binding constraints to sustained regional growth. By creating and strengthening economic corridors, regional infrastructure reduces trade costs, attracts FDI, and has a direct impact on productivity and trade.

Notwithstanding the region's strong performance in financial markets during the global crisis, decades of bank-dominated financial intermediation and government-directed lending have left domestic financial systems underdeveloped. Complex institutional and regulatory frameworks have limited the scope further for expanding growth continually. Modernizing their financial systems would take developing

Asian economies far in their quest for a higher-growth path as the future unfolds.

As the crisis recedes and recovery gathers momentum, these challenges present developing Asia with a daunting task. The next section analyzes the extent of the region's capacity and preparedness in four critical areas: improving human and physical capital through better education systems and infrastructure facilities, enhancing regional trade, and developing the financial sector.

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