Highlights—*ADO 2010*

Developing Asia can look ahead to a robust recovery in the next 2 years. Growth is forecast to rise to 7.5% in 2010 and moderate to 7.3% in 2011, marking a healthy rebound from the 2009 slowdown. Shifting the drivers of growth from the support of monetary and fiscal expansion to robust private sources is now the key challenge for sustaining the recovery, both globally and regionally. Inflation pressures are increasing but still manageable in most developing Asian economies. Beyond the crisis, developing Asia faces the challenge of adjusting its monetary, exchange rate, and fiscal policies to foster macroeconomic stability and sustained growth within the broader direction of a return to prudence and discipline.

Key messages

- Developing Asia weathered the harsh global environment in 2009 well. It was the first region to emerge from the global turmoil, helped by decisive policy responses. Supported by improving global prospects, the *Asian Development Outlook 2010* (*ADO 2010*) projects developing Asia's growth to rebound to 7.5% in 2010, a strong acceleration from 5.2% in 2009, though still well below the record 9.6% growth of 2007. The region faces the challenge nonetheless of maintaining momentum against the backdrop of a gradual unwinding of expansionary measures and a slow pickup in external demand. The projection for 2011 is a moderate 7.3%.

- As recovery takes hold, inflation pressures, particularly in asset prices, may well start to mount in the region. *ADO 2010* projects that inflation will increase, but to a still moderate 4.0% in 2010, conditional on the implementation of appropriate policy measures. Unusually easy monetary policy throughout the region cannot be kept for too long, and there is a need to revert to a normal stance. The surplus in developing Asia's current account balance narrowed for a second consecutive year to 4.9% of gross domestic product (GDP) in 2009 from a recent peak of 6.5% in 2007. It is forecast to narrow further to 4.1% in 2010 and 3.6% in 2011.

- Several downside risks to the global outlook—a slower global recovery, mistimed withdrawal of macroeconomic stimulus measures, a sharp increase in international commodity prices, deteriorating fiscal positions, and the persistence of global imbalances—could derail developing Asia's growth momentum. In addition, the region's stronger recovery and higher interest rates relative to those in the major industrial countries are already attracting potentially volatile capital flows, complicating macroeconomic management. Rising food prices, which disproportionately impact the poor, also pose a risk.

- Beyond the global crisis, the region's policy makers face the key challenge of adapting monetary, exchange rate, and fiscal policies to foster stable and sustainable growth. A long-standing tradition of fiscal and monetary prudence served the region well during the crisis. For example, ample fiscal space built up over years of sustained fiscal discipline enabled the unleashing of decisive and large fiscal stimulus programs. Part 2 of *ADO 2010* calls for the region to remain faithful to sound and responsible fiscal and monetary policy, while adapting those policies appropriately as recovery takes hold and the economic crisis recedes.

- There is plenty of scope for improving and strengthening Asia's monetary, exchange rate, and fiscal policy frameworks. As Part 2 lays out, such adjustments will enable the region to better adapt to the postcrisis world. For example, while price stability must remain the overriding objective of monetary policy, the global crisis highlights the need to prevent asset price bubbles, suggesting a need to improve coordination between financial regulation and monetary policy. In fiscal policy, while it is of paramount importance to safeguard sustainability with strong medium-term fiscal policy frameworks, a wide range of measures can contribute to more balanced growth by removing structural impediments to domestic demand. Finally, more flexible exchange rate systems are in the region's own interest, and carefully designed capital controls that mitigate disruptive capital inflows may be desirable during the transition to greater flexibility, at least in the short run

Performance in 2009

- At 5.2% in 2009, developing Asia's growth was its lowest in 8 years. Economies decelerated across the region, with only South Asia performing marginally better than in 2008. The larger economies, such as the People's Republic of China (PRC) and India, fared better. But for many economies, slower growth resulted from a sharp decline in exports to the industrialized world.

- Inflation in developing Asia was subdued at 1.5%, held down by depressed economic activity and lower international commodity prices. In some economies, such as the PRC; Taipei,China; and Thailand, consumer prices even declined on average during the year as deflation pressures persisted. Current account surpluses fell marginally. Although demand for the region's exports slowed sharply, imports also weakened, leaving the surplus in developing Asia at 4.9% of GDP, down from 5.4% the previous year. Surpluses in East Asia, Central Asia, and the Pacific declined substantially in 2009.

- Though most economies in East Asia contracted in 2009, solid growth in the PRC buoyed the aggregate performance. Overall GDP expanded 5.9%, almost entirely a result of 8.7% growth in the PRC, which was based heavily on exceptional fiscal and monetary stimulus adopted to combat the impact of the global recession. The Republic of Korea grew marginally, also helped by fiscal stimulus, but global headwinds battered Hong Kong, China; Mongolia; and Taipei,China, all of which contracted in 2009. Consumer prices fell slightly in the PRC and Taipei,China, and were flat on a subregional basis.

- Southeast Asia's growth slowed sharply to just 1.2% in 2009, the weakest outcome since the 1997–98 Asian financial crisis. Aggregate GDP would have declined if it had not been for relatively high growth of 4.5% in Indonesia, the subregion's biggest economy. Indeed, half the 10 economies contracted (Brunei Darussalam, Cambodia, Malaysia, Singapore, and Thailand), as the global recession cut into exports and investment flows. In many economies, imports fell even more steeply than exports, such that the subregional current account surplus rose. Aggregate inflation decelerated to 2.7%.

- South Asian growth edged up to 6.5% in 2009 from 6.4% in 2008, but only India and Afghanistan saw gains. India experienced a strong rebound to an estimated 7.2% for the year, despite the impact of a drought on crops. Continued fiscal stimulus and monetary easing in India over the year, alongside an improving global environment, prompted large capital inflows as investor and consumer confidence strengthened. Afghanistan recovered from a drought, posting 15.1% growth. But the Pakistani economy again slowed, though macroeconomic imbalances narrowed, as worsening security and power shortages obstructed any meaningful improvement in economic performance. GDP growth also slipped in Bangladesh, Bhutan, Maldives, and Sri Lanka, although Sri Lanka revived markedly from May, after the end of its long civil conflict. Inflation in the region was back to around pre-crisis levels, at 5.6%.

- In Central Asia, growth fell by half for a second year, to 2.7% from 6.1% in 2008, with all countries putting in a weaker performance. Armenia and Georgia were jolted by contractions in GDP. Kazakhstan eked out a 1.2% expansion, despite major bank failures and depressed non-oil activity. And growth in the Kyrgyz Republic and Tajikistan was clipped sharply, in part by reduced inflows of workers' remittances and economic difficulties in Central Asia and the Russian Federation. Among the four oil and gas producers, Azerbaijan, Turkmenistan, and Uzbekistan experienced only moderate slowing in growth. Across the subregion, inflation slowed to an average of about 6%, down from double-digit rates of the past 2 years.

- Aggregate growth in the Pacific decelerated to 2.3% in 2009, from 5.4% a year earlier. In Papua New Guinea, the biggest subregional economy, GDP grew by 4.5% (slowing from 2008), supported by fiscal spending and expectations of a large new natural gas export project. However, seven of the 14 Pacific economies contracted in 2009, with Fiji Islands' GDP declining for a third consecutive year. GDP in three others was estimated to be flat. Inflation slowed from high rates in the previous year, to 5.2% on a subregional basis in 2009.

Global outlook

- After the historic first-quarter contraction in GDP, the global economy began to revive in the second quarter of 2009. But uncertainty still clouds the global outlook, particularly beyond the first half of 2010. Emergency policy measures are gradually being unwound, but the strength of broader demand components is not robust enough to take over from these temporary forces. On aggregate, GDP in the United States (US), eurozone, and Japan is expected to show a mild recovery in 2010, and grow by 1.7%. Growth in 2011 will rise only slightly to 2.0%, still below potential. Inflation is forecast to pick up to 1.4% this year and 1.3% in 2011.

- Several substantial short-term downside risks remain for the global outlook. Continued weakness in the US housing market is worrisome, as the uncertainty may impede the resumption of new lending there. Mistimed macroeconomic policy responses by authorities in the major industrial economies could squelch recovery, but any weakening of fiscal sustainability would undermine financial stability. Globally, a sharp rise in commodity prices cannot be ruled out.

- Among the medium-term risks is the failure of countries with current account deficits and surpluses to take measures to reduce those imbalances. Any reignition of the growth of global imbalances could lead to another bout of global instability. Moreover, poor international policy coordination could delay global financial regulatory reform. Failure to tackle the unfinished reform agenda will leave financial markets vulnerable to future shocks. Multilateral cooperation is equally important to avoid bilateral conflicts over exchange rate and trade issues.

Outlook for developing Asia

- Prospects for developing Asia in the next 2 years have improved after better than expected growth in the second half of 2009. GDP is projected to grow by 7.5% in 2010 as a moderate global recovery supports a modest revival in global trade. Investment is expected to remain strong as the stimulus measures of last year continue to have a positive impact. Private consumption is projected to improve as income prospects pick up and unemployment continues to decline. In 2011, GDP growth will edge back to 7.3%, as the effects of the emergency policy measures begin to fade.

- Robust regional growth in the next 2 years will lift domestic demand, boosting consumer price inflation to about 4% in each year. The overall current account surplus is predicted to decline further this year and next as external demand only slowly picks up and domestic demand strengthens.

- Growth in East Asia is forecast to accelerate to 8.3% in 2010, with strong recoveries in the three economies that shrank last year (Hong Kong, China; Mongolia; and Taipei,China). GDP growth will remain buoyant in the PRC, while the Republic of Korea is expected to rebound to a 5.2% expansion, driven by stronger private investment and consumption and the pick up in global trade. Similar factors will benefit both Hong Kong, China and Taipei,China. In 2011, the five subregional economies are likely to see a slight easing in the pace of expansion, partly a result of a phasing out of stimulative policies and because this year's rebound will set a higher base.

- The PRC economy is forecast to grow by 9.6% in 2010. Aggressive fiscal and monetary stimulus is being adjusted, but will continue to contribute to strong growth, and firmer external demand will back buoyant domestic demand. The trade surplus will resume its upward trend. Economic growth is forecast to ease to about 9.1% in 2011, as the stimulus policies are phased out. Inflation is seen picking up to 3.6% this year and moderating to 3.2% next year as the highly stimulatory monetary policy is reined in.

- In Southeast Asia, aggregate growth is forecast to rebound to 5.1% in 2010, based in large part on the recovery in global trade and a rebound in investment. The five contracting economies of 2009 will return to growth in 2010. Next year, the pace of growth in most of the subregion will likely quicken a bit. Inflation is seen averaging a moderate 4.5% in 2010. Viet Nam is the outlier, where consumer prices might rise by 10%, partly on account of last year's rapid growth in money supply and local currency devaluation.

- Growth is expected to pick up in most of South Asia in 2010. India will lead the group with a projected 8.2% performance. Its rebound a year earlier and continued strong expansion stem largely from domestic demand—a revival of exuberance of the years prior to 2008. For its part, Sri Lanka is expected to see an uptick of 6.0%, boosted by the peace dividend of stronger investor confidence. Improved domestic economic fundamentals should allow Pakistan to attain higher growth of 3.0%. Bangladesh and Nepal are projected to see growth ease slightly.

- Inflation is expected to pick up but remain moderate in South Asia, provided that monetary policy makers remain alert. The countries are not highly open to trade, but are vulnerable to abrupt changes in commodity prices, especially oil. Bangladesh, Nepal, Pakistan, and Sri Lanka all rely heavily on workers' remittances to offset large trade deficits; but these earnings have held up quite well over the past 2 years. Maldives, Pakistan, and Sri Lanka have all experienced large losses in foreign exchange reserves in the past 2 years and have turned to the International Monetary Fund (IMF) for adjustment assistance. All three countries are in the process of working down the macroeconomic imbalances that have caused their difficulties.

- Growth in all of Central Asia's economies should edge up in 2010, underpinned by higher oil prices and recovery in the Russian Federation, the major trade and financial partner. Ongoing weakness in Kazakhstan's non-oil economy will hold its overall growth down to 2.5%, while the Armenian and Georgian economies are projected to turn around but record anemic growth (about 2%). In the Kyrgyz Republic and Tajikistan, expansion is expected to accelerate slightly, to about 4%–6%.

- Inflation is expected to pick up to 6.7% this year in the subregion, but not to be a major issue in any country. Stronger oil prices will bring higher current account surpluses for the hydrocarbon exporters. But Armenia, Georgia, the Kyrgyz Republic, and Tajikistan will continue to face relatively large deficits of 8%–15% of GDP, little changed from 2009: these four countries will continue their adjustment programs with the IMF.

- Aggregate growth in the Pacific is forecast to rise to 3.7% in 2010, buoyed mainly by stronger growth in Papua New Guinea and Timor-Leste, both of which benefit from higher export demand and prices for natural resources. However, GDP in the Fiji Islands is expected to contract again, and most of the smaller economies will grow by less than 1%. In Papua New Guinea, a large new gas project is likely to spur growth in 2011. Inflation in the Pacific is expected to remain around an average of 5.3% in the next 2 years.

Macroeconomic policy for postcrisis developing Asia

- Governments across developing Asia quickly rolled out large fiscal and monetary stimulus packages to fight the sharp slowdown of economic activity stemming from the global financial crisis. The crisis highlights the potential usefulness of countercyclical fiscal and monetary policies for coping with the impact of large shocks. This positive experience has sparked debate on whether the region should pursue fiscal and monetary activism in the postcrisis period.

- As the global crisis recedes and normalcy returns, developing Asia should revert to the sound and responsible fiscal and monetary policies that fostered macroeconomic stability and sustained growth. There is, however, plenty of scope to improve and strengthen monetary, exchange rate, and fiscal policies to better prepare the region for the postcrisis world.

- In the area of monetary policy, the global crisis highlights the potentially huge risks of an excessively narrow focus on consumer price inflation. After all, the combination of lax monetary policy and inadequate financial regulation contributed to inflating the US housing market bubble that was the immediate catalyst of the global financial crisis. For developing Asian policy makers, this means that asset price trends must be watched and preventive action taken before disruptive asset bubbles materialize. More effective financial supervision and regulation, and its closer coordination with monetary policy, will help avert a homegrown financial crisis.

- Developing Asia would also benefit from a shift toward more flexible exchange rates. Reducing the excessive rigidity imposed by heavy foreign exchange market intervention would allow exchange rates to move more in line with their fundamentals, and help economies rebalance demand toward domestic sources. Intraregional exchange rate policy coordination among developing Asian countries can help promote greater exchange rate flexibility in the region, with less concern over losing export competitiveness vis-à-vis neighboring economies. Carefully designed capital controls can help guard against disruptive short-term capital flows and prevent extreme volatility in exchange rates.

- Developing Asia should maintain the fiscal discipline that served it well in the past and enabled it to aggressively boost public spending and cut taxes during the global crisis. The potentially more challenging postcrisis global environment strengthens the case for setting up strong and credible medium-term fiscal frameworks that can withstand even large negative shocks. Well-designed and well-implemented automatic stabilizers can be core components of such frameworks. A wide range of fiscal measures can also promote the rebalancing process by easing the structural distortions that constrain domestic demand.

- In general, addressing this wide range of structural challenges will require authorities to coordinate monetary, exchange rate, and fiscal policies more closely and systematically. During the global crisis, the coordinated easing of fiscal and monetary policies magnified the countercyclical impact of the macroeconomic expansion. Exiting current expansionary policies, likewise, calls for a closer coordination of fiscal and monetary policies within an economy and among regional economies. Monitoring asset price trends to prevent bubbles also requires coordination between monetary policy and financial regulation. Fiscal measures—such as strengthening social protection—in tandem with more flexible exchange rates, can boost domestic consumption and demand and maximize the impact of macroeconomic policy on developing Asia's rebalancing process.

	Table 1 Growth rate of GDP (% per year)					Table 2 Inflation (% per year)				
Subregion/economy	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Central Asia	**12.0**	**6.1**	**2.7**	**4.7**	**5.9**	**11.2**	**16.5**	**5.9**	**6.7**	**6.6**
Azerbaijan	25.1	10.8	9.3	9.5	9.7	16.7	20.8	1.5	5.8	6.0
Kazakhstan	8.9	3.3	1.2	2.5	3.5	10.8	17.3	7.3	6.8	6.5
East Asia	**10.4**	**7.3**	**5.9**	**8.3**	**7.7**	**3.9**	**5.4**	**0.0**	**3.3**	**3.0**
China, People's Rep. of	13.0	9.6	8.7	9.6	9.1	4.8	5.9	-0.7	3.6	3.2
Hong Kong, China	6.4	2.1	-2.7	5.2	4.3	2.0	4.3	0.5	2.2	2.8
Korea, Rep. of	5.1	2.3	0.2	5.2	4.6	2.5	4.7	2.8	3.0	3.0
Taipei,China	6.0	0.7	-1.9	4.9	4.0	1.8	3.5	-0.9	1.5	1.6
South Asia	**8.7**	**6.4**	**6.5**	**7.4**	**8.0**	**5.6**	**9.3**	**5.6**	**6.0**	**6.0**
Bangladesh	6.4	6.2	5.9	5.5	6.3	7.2	9.9	6.7	7.5	7.8
India	9.2	6.7	7.2	8.2	8.7	4.8	8.3	3.6	5.0	5.5
Pakistan	6.8	4.1	2.0	3.0	4.0	7.8	12.0	20.8	12.0	8.0
Sri Lanka	6.8	6.0	3.5	6.0	7.0	15.8	22.6	3.5	6.5	8.0
Southeast Asia	**6.5**	**4.3**	**1.2**	**5.1**	**5.3**	**4.1**	**8.8**	**2.7**	**4.5**	**4.5**
Indonesia	6.3	6.0	4.5	5.5	6.0	6.4	9.8	5.0	5.6	6.2
Malaysia	6.2	4.6	-1.7	5.3	5.0	2.0	5.4	0.6	2.4	3.0
Philippines	7.1	3.8	0.9	3.8	4.6	2.8	9.3	3.2	4.7	4.5
Singapore	8.2	1.4	-2.0	6.3	5.0	2.1	6.6	0.6	2.3	2.0
Thailand	4.9	2.5	-2.3	4.0	4.5	2.2	5.4	-0.9	3.5	3.0
Viet Nam	8.5	6.2	5.3	6.5	6.8	8.3	23.0	6.9	10.0	8.0
The Pacific	**5.0**	**5.4**	**2.3**	**3.7**	**5.0**	**3.6**	**9.5**	**5.2**	**5.1**	**5.4**
Fiji Islands	-0.5	-0.1	-2.5	-0.5	0.5	4.8	7.7	3.7	3.4	3.1
Papua New Guinea	7.2	6.7	4.5	5.5	7.7	0.9	10.6	7.6	7.1	7.7
Developing Asia	**9.6**	**6.6**	**5.2**	**7.5**	**7.3**	**4.4**	**6.9**	**1.5**	**4.0**	**3.9**

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

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