1 Momentum for a sustained recovery?

Momentum for a sustained recovery?

The year 2009 opened with a global economic maelstrom in full fury. The questions put forth by pundits and policy makers alike at that time were how long the storm would last and how much wreckage would be left in its wake. Yet by midyear, it seemed that governments' rapid emergency responses had limited the damage, and that a tentative calm had returned.

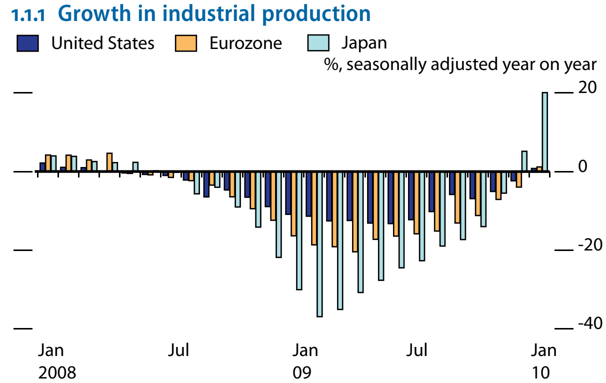
After the historic first-quarter contraction in gross domestic product (GDP), the global economy began to revive (Figure 1.1.1). Financial instability was contained, consumer sentiment brightened, businesses started restocking, and cross-border trade recovered. Taken together, these signs suggest a solid global recovery—and even optimism for 2010.

Yet clouds remain on the horizon. The upswing in consumer sentiment can be easily derailed if income prospects do not improve. The recovery must generate more jobs to eliminate the anxiety over eroded personal wealth and income, which is holding back spending. Consumer lending is inching up, but continued weakness in banks' mortgage portfolios makes them hesitant to offer new loans, and such hesitancy hinders the growth of private investment. Building inventories is itself a transient process, and firms will not restock for long if economic activity is sluggish. Robust recoveries in developing economies cannot serve as the sole engine of global recovery. Trade with the industrial world is still fuel for emerging economies' dynamism.

Underlying these concerns is the fact that the recovery was driven mainly by temporary forces—including huge government stimulus measures. Markets are closely scrutinizing the sustainability of these measures, and increasing sovereign risks could complicate the normalization process. In the end, a shift from public support to private forces is needed to maintain the momentum. Yet, because of the fragility of the recovery and the sheer size of the various stimuli, the winding down of public support must be carefully managed.

In place of the temporary emergency response measures, therefore, what robust sources of growth will come to the fore to sustain the recovery?

1.1.1 Growth in industrial production



Sources: Board of Governors of the Federal Reserve System. http://www.federalreserve.gov; Ministry of Economy, Trade and Industry. http://www.meti.go.jp; European Commission. http://ec.europa.eu (all accessed 23 March 2010).

Click here for figure data

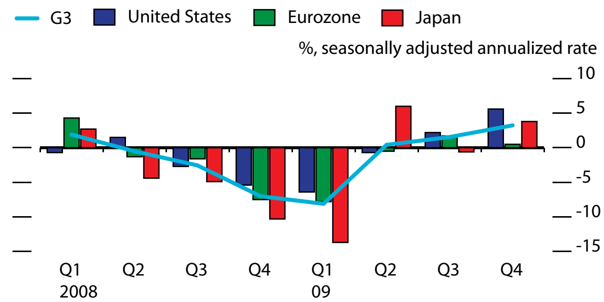
This chapter was written by Akiko Terada-Hagiwara, Benno Ferrarini, William James, Shikha Jha, Juthathip Jongwanich, Donghyun Park, Pilipinas Quising, Arief Ramayandi, and Joseph E. Zveglich, Jr., of the Economics and Research Department, ADB, Manila. The authors gratefully acknowledge the contribution of background materials prepared by Chee Sung Lee.

Gauging the strength of industrial countries' recovery

The global economic turmoil that began in 2008 accelerated rapidly, as is evident from the quarterly GDP growth rates of the major industrial economies of the United States (US), Japan, and eurozone (Figure 1.1.2). Cumulatively, production in these economies plummeted by 8.1% in the first quarter of 2009 (annualized), but in a dramatic reversal of this trend, the contraction ended and industrial economies grew by 1.5% and 3.1% in the third and fourth quarters of the year. While the main driving forces varied—inventory restocking pushed the US revival while net exports helped Japan and parts of the eurozone (particularly Germany)—support from government spending was a common theme.

The recovery's momentum relies on the potency of the underlying sources of growth, since it is unclear how long government interventions can continue to buoy economic activity. Yet looking to the private sources of demand, signs that temporary factors have been replaced by a more robust foundation for future expansion are not yet obvious. Assessing the extent to which these shifts are under way—from public support to private demand and from transient factors to stable sources—is critical for setting the medium-term growth forecasts for the major industrial economies.

1.1.2 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 (both accessed 3 April 2010); CEIC Data Company (accessed 7 April 2010).

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Crisis response and normalization

Governments and monetary authorities responded quickly to the financial crisis and economic slump, stabilizing financial markets in the early stages and later shoring up flagging GDP. Central banks across the major industrial countries aggressively lowered interest rates, strengthened bank deposit guarantees, and adopted a raft of unconventional approaches to keep credit flowing. Governments also approved substantial multiyear fiscal measures, which began to be implemented in the first half of 2009. The fiscal support was meant to be considerably front loaded, such as the US 10-year fiscal package that was to disburse the bulk of its support within the first 3 years.

As the global recovery seemingly consolidates, policy makers have to tackle the dilemma of when to start reining in their stimuli. The recovery could falter if policy makers tighten too early. The 1937–38 US recession that came in the wake of the Great Depression is a frequently cited cautionary tale of the effect of pulling back policy support too soon. In the mid-1930s, signs of recovery prompted US policy makers to raise taxes, reduce spending, and tighten money supply—actions which quickly pushed the economy back into recession. Alternatively, normalizing too late may lead to higher inflation and unsustainable fiscal deficits in the longer term. Authorities are clearly concerned about repeating the

expansion of credit that created the conditions for the subprime crisis that ultimately sparked the latest global financial crisis.

In fact, while lacking the fanfare that surrounded the announcements of the stimulus packages, the normalization process has begun. Many temporary measures have finished or are set to end this year, particularly finance sector stabilization measures and nonrecurring fiscal expenditures. While other elements of the stimulus require direct interventions to reverse their effects—such as raising policy interest rates and reversing tax cuts—new support is unlikely as long as the recovery takes hold. With policy normalization under way, an issue is how much monetary and fiscal policy will continue to boost growth in the months ahead.

Concluding finance sector support

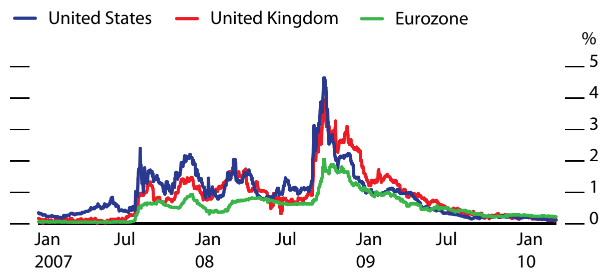
Uncertainty surrounding the health of the international financial system that began in mid-2007 was reflected in the elevated risk premiums on interbank lending (Figure 1.1.3). The spike in interest rates in the aftermath of the Lehman Brothers collapse jolted policy makers into action. Central banks took drastic steps to ensure the stability and liquidity of the finance sector.

Risk premiums have since returned to their precrisis levels, and monetary authorities have begun to roll back their emergency support to the finance sector. For example, the US Federal Reserve's support provided to money market mutual funds, commercial paper markets, and dollar swap lines with foreign central banks were closed in February 2010. In late 2009, the European Central Bank (ECB) began phasing out nonstandard operational measures, such as providing unlimited liquidity to the eurozone banks at longer than usual maturities (12 months), planning to gradually reach normal 3-month maturities by end-April 2010. As an exception to the trend, the Bank of Japan doubled the total amount of loans to be provided through an existing fund-supplying operation in March 2010 to encourage a further decline in long-term interest rates.

Some unconventional measures will take more time to unwind, but as calm has been restored to financial markets, further expansion of this support is unlikely. For example, the Federal Reserve ended its purchases of publicly guaranteed mortgage-backed securities in March 2010 after accumulating $1.1 trillion in these securities (Figure 1.1.4). Its purchases of such securities have helped hold mortgage rates to near-record lows to foster recovery in the housing market. For such unconventional measures, policy makers are faced with the challenge of managing the assets they have acquired, to maximize recovery value at the time of disposal. But they will need to be careful not to disrupt recovering asset markets, where trading may still be thin and price discovery mechanisms not yet well anchored.

Weak spots remain, and difficult tasks lie ahead, despite overall stabilization of financial markets (Box 1.1.1). While lending conditions remain tight and inflation is still low, policy makers should stay watchful of financial market developments and be ready to intervene as necessary. Timing, though, is of the essence.

1.1.3 TED spread, selected economies



Note: The TED spread is the difference between 3-month LIBOR and the yield on 3-month Treasuries.

Source: Bloomberg (accessed 22 March 2010).

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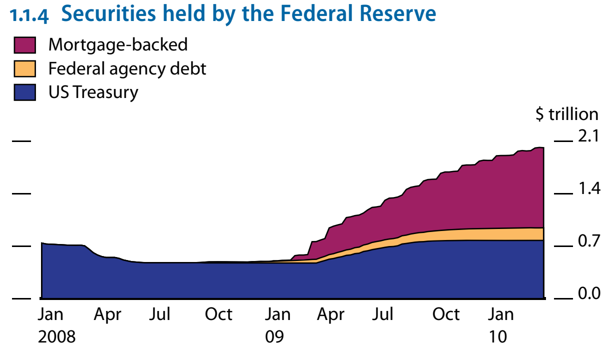
1.1.4 Securities held by the Federal Reserve



Source: Board of Governors of the Federal Reserve System. http://www.federalreserve.gov (accessed 4 April 2010).

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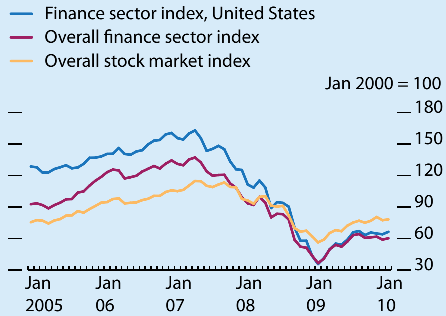
1.1.1 Financial systems stabilized for now

With tight global credit conditions persisting, many industrial economies' financial institutions are still fragile, especially banks. Finance sector equity prices have recovered from their trough of March 2009, but they remain weaker than the market as a whole (Box figure 1), largely reflecting banks' need to rebuild their balance sheets.

1 Finance sector development



Note: Overall index averages are averages of Dow Jones Industrial Average Composite index (US), Nikkei300 (Japan), FTSE100 index (UK), Dax index (Germany), and SBF250 index (France).

Source: Bloomberg (accessed 23 March 2010).

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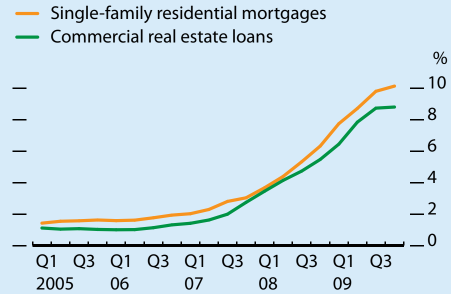
The weakness in the finance sector has its origins in the meltdown of the United States (US) subprime mortgage market. Several countries—not just the US—experienced property bubbles. The housing sector in the US and United Kingdom have stabilized since then, albeit in part due to special measures. However, the picture is still wobbly for commercial and industrial property prices in the US, reflecting the sluggish recovery of business activity. Low real estate prices depress the resale value of the property relative to the unpaid mortgage balance, raising the risk of default. Delinquency rates on residential mortgages and commercial real estate loans are on the rise (Box figure 2), and bank balance sheets are suffering as a consequence.

The process of absorbing bad credit losses is set to run a long while yet. After the huge provisioning for nonperforming residential mortgages, losses from commercial real estate exposure to falling prices are now on the rise (Box figure 3). Finance sector writedowns on securities and loans will continue in the quarters ahead. Banks may need substantial additional capital before they fully recover. For example, at end-2009, the European Central Bank estimated that total eurozone bank writedowns for 2007–2010 would reach €553 billion, 13% higher than its €488 billion estimate made 6 months earlier. The expected writedowns are concentrated in countries that experienced the largest runups in prices and subsequent corrections.

2 Delinquency rates on real estate loans, United States



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 March 2010).

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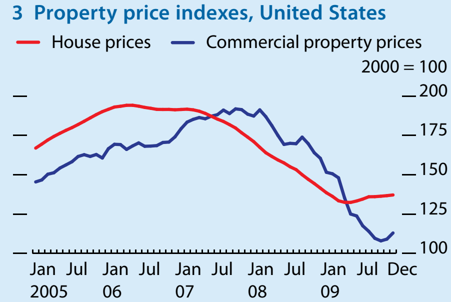
Given that banks in the US and Europe are still weak, the withdrawal of central bank liquidity facilities and government guarantees for their debt is a concern. While the use of both types of programs has fallen as money markets and funding markets have stabilized, some banks remain more dependent than others on such support, and unless these more fragile banks' weaknesses are addressed, renewed distress is a risk. Longer term, uncertainty about more stringent regulatory frameworks may also constrain banks in their lending, as banks will surely need additional capital if these frameworks are adopted.

3 Property price indexes, United States



Sources: MIT Center for Real Estate. http://mit.edu/cre; Standard and Poor's. http://www.standardandpoors.com (both accessed 26 March 2010).

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Bank credit growth has yet to recover in the major industrial economies. Bank lending officer surveys show that lending conditions remain tight in the US and eurozone, though the severity has eased greatly. While the improving economic outlook should shore up both the demand for credit and banks' ability to lend, considerable work lies ahead before the system fully recovers.

Timing monetary tightening

In setting monetary policy, authorities must choose the right timing to withdraw the exceptionally accommodative monetary stance as the economy gets to a firm recovery. If the economy is susceptible to overheating, authorities should further tighten monetary policy. One indicator is the output gap. This is the difference between what is currently being produced (actual GDP) and the theoretical production level that the economy can sustain without accelerating inflation (potential GDP). Various estimates suggest that economic activities in the major industrial countries are currently far below their potential (Figure 1.1.5), implying that central banks can maintain accommodative monetary policy until recovery becomes firm without undermining price stability.

However, it is difficult to measure potential output precisely. In addition, the global slowdown may have had permanent effects, lowering these economies' potential output. The point where monetary policy needs to be tightened may, therefore, be closer than the figure suggests.

Inflation expectations are another important indicator of an economy's susceptibility to overheating. Economic agents' assessments of future price movements will affect their behavior today in ways that tend to reinforce the anticipated price movements. For example, if workers feel that prices will be higher next year, they will incorporate this into their wage negotiations, which will create inflation pressures through higher costs of production.

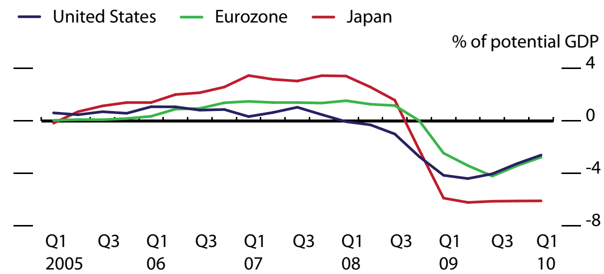
Central banks need, consequently, to consider expectations of future inflation as well as current inflation when setting the monetary stance. One of the measures is based on the yield differential between nominal and inflation-indexed bonds. This yield spread is also called the "breakeven inflation rate." An increase in the breakeven rate can be viewed as a sign that market inflation expectations may be on the rise (Figure 1.1.6).

The breakeven inflation rates for the US and eurozone are in a positive range. The inflation expectation for the US rebounded sharply from its low in March and, although the yield spread is a slightly downward trend in the eurozone, the timing for normalizing the policy rates seems to be in sight for these two economies. In Japan, though, deflation is expected, implying the need to continue with the accommodative policy.

Entering 2010, the Federal Reserve, ECB, and the Bank of Japan all held their main policy rates close to zero. With output below potential and low inflation expectations, this accommodative monetary stance is likely to remain in place at least through the first half of 2010, and possibly longer for Japan given the lingering threat of deflation there.

However, in February 2010 the Federal Reserve raised its discount rate by 25 basis points to 0.75%. While the differential between this rate and the Federal Funds rate, which is the main monetary policy instrument in the US, is still below its precrisis level of 100 basis points, the move is indicative of the Federal Reserve's intentions.

1.1.5 Output gap, major industrial economies



Sources: International Monetary Fund. 2009. World Economic Outlook database. October. http://www.imf.org (accessed 6 April 2010); Bloomberg (accessed 22 March 2010).

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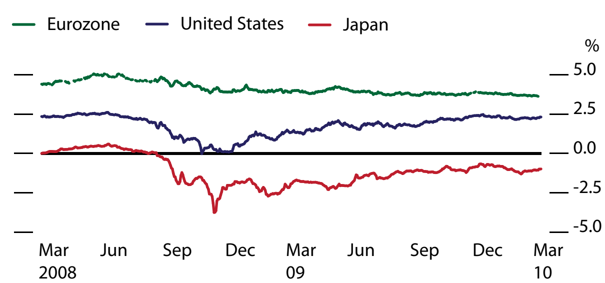
1.1.6 Breakeven inflation



Notes: Breakeven inflation is calculated by subtracting the real yield of the inflation-linked maturity curve from the yield of the closest nominal Treasury maturity. Ten-year bond is used for US; 15-year bond for eurozone; and for Japan, 10-year bond for March 2008–15 June 2009 and 5-year bond thereafter.

Source: Bloomberg (accessed 6 April 2010).

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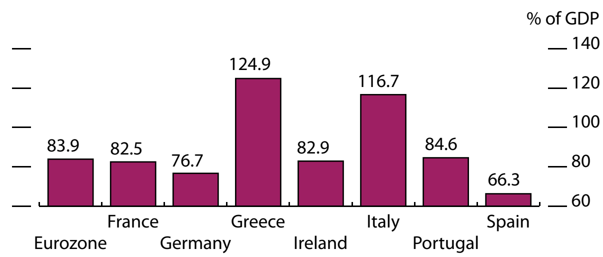
Monetary policy, of course, was only one weapon in the authorities' armory. Fiscal policy was also aggressively used in aid of economic recovery.

Completing fiscal stimulus measures

The multiyear fiscal packages approved in most industrial economies will likely be fully implemented. However, as mentioned, this support was intended to be heavily front loaded, and the vast majority will have been spent by the end of this year. Of the $787 billion (5.5% of GDP) 10-year US fiscal package, about one-third of the total was disbursed last year and about half is to be spent this year. The four largest eurozone economies—France, Germany, Italy, and Spain—spent about 43% of their collective €225 billion fiscal package (3.2% of their 2008 GDP). In Japan, the fiscal stimulus approved last year has been mostly spent, yet the government has approved a new budget for 2010, which includes extensions of some packages.

While it is likely that these stimuli will bring about some impacts this year, additional significant fiscal stimulus for 2011 appears unlikely in a context of mounting sovereign risks for 2011 (Box 1.1.2). Indeed, pressures are already mounting on eurozone countries to rein in large deficits and growing public debt ratios, which are expected to surge to average 84.0% of GDP in 2010 (Figure 1.1.7). The European Commission has increased pressure on governments to take firmer action toward reaching the Stability and Growth Pact 3% deficit target by fiscal year 2014/15. For most eurozone countries, this will require structural consolidation efforts starting in 2011.

1.1.7 Forecasts of gross government debt for 2010, eurozone



Source: European Commission. http://ec.europa.eu (accessed 31 March 2010).

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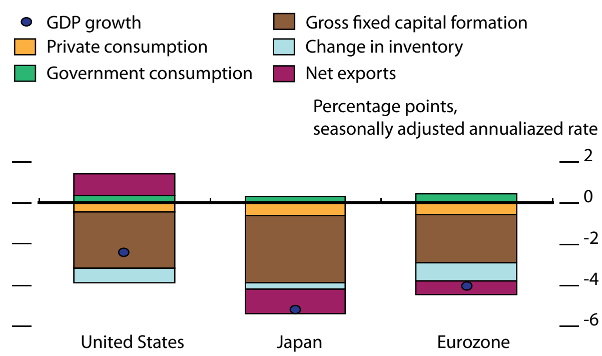
Winding down policy support

Looking back on 2009, emergency finance sector stabilization measures as well as the monetary and fiscal support that the major industrial economies employed have generally been effective. Finance sector support managed to assure liquidity, and monetary policy provided an accommodative environment. Fiscal measures played a large role in the immediate economic recovery, such that public spending solidly contributed to GDP growth throughout 2009 (Figure 1.1.8).

Nonetheless, these policy measures are temporary and will be withdrawn in time. Authorities are beginning to remove finance sector support, though the winding down of some of the unconventional support to less liquid segments (such as purchases of mortgage-backed securities) will need to be managed carefully to avoid disrupting these markets. Industrial economies' central banks will likely maintain an accommodative monetary policy through the first half of 2010 (possibly longer in Japan).

Relatively high levels of fiscal support are likely to continue in 2010 as commitments under approved fiscal packages are fulfilled in the US and some eurozone economies. Japan will also continue with fiscal support with the new 2010 budget. However, not all economies have the fiscal space to continue their spending given rising concerns on sovereign risk,

1.1.8 Contributions to 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 (both accessed 3 April 2010); CEIC Data Company (accessed 7 April 2010).

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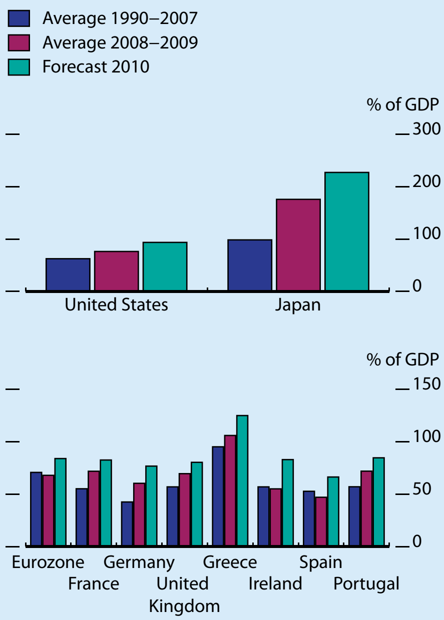
1.1.2 Mounting sovereign debt and constraints on policy

Fiscal instability is becoming a major concern in some industrial economies. The expansionary macroeconomic policies—fiscal stimuli in particular—cannot be sustained indefinitely as they add to the preexisting sustainability concerns related to, for example, public pension funding.

Crisis-related stimulus and lower tax revenue have put public debt on a sharply steeper trajectory (Box figure 1). This has emphasized the need for structural reform in the medium and long run and, given worrisome unemployment levels, has complicated near-term exit strategies.

1 Public debt



Note: For the eurozone, the average is from 1995 to 2007.

Sources: The Office of Management and Budget. http://www.whitehouse.gov/omb; Bank of Japan. http://www.boj.or.jp/en; European Commission. http://ec.europa.eu (all accessed 30 March 2010).

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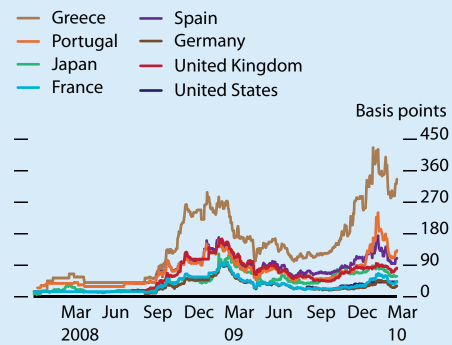
Financial markets are increasingly reacting to fiscal stability issues in industrial economies, especially as substantially more public sector debt is to be issued in the next 2 or 3 years. Such concerns (coupled with political uncertainties) have led to a surge in sovereign credit default swap spreads in some industrial economies, such as Japan and the United Kingdom, in early 2010. European issuers—most notably Greece, but also Portugal and Spain—have come under greater pressure after their ratings were downgraded or as uncertainty heightened over their fiscal imbalances and consolidation plans (Box figure 2).

2 Credit default spread, senior 5-year



Source: Bloomberg (accessed 24 March 2010).

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These increasingly heavy deficits and debts impose fundamental challenges to policy makers and present risks to financial stability. One risk is that issuance of new public debt could crowd out private sector credit growth through higher interest rates and therefore undermine economic growth. Another risk is from a rapid increase in interest rates on public debt valuations. With a steepening of the yield curve, this would hit both financial institutions and growth, as sovereign debt is repriced.

particularly in 2011. Hence, the effects of these public support measures are likely to gradually fade next year.

How well, therefore, will sources of private demand take up the baton?

Potential private demand sources

With the normalization of monetary and fiscal policy set to come on stage, sustained recovery must be led by private demand sources. So far, there are no obvious candidates among consumption, investment, and external demand. There have been some signs of private demand returning since the second half of 2009, but whether they have enough strength to support continued growth in the medium term is not yet clear.

Gradual return of private consumption

In the initial stages of the global downturn, the deterioration of personal wealth from falling stock and property prices inhibited consumption spending across the major industrial countries, especially in countries that experienced a burst property bubble. Tightening credit further reinforced the declines in asset values, as well as lowering consumption directly as consumer credit evaporated. Uncertain labor market conditions served to further depress spending.

The US experienced the worst of all of these elements, but a gradual recovery is under way. The slide in residential property prices eased in the second quarter of 2009 but they are only picking up slowly. Government subsidies to promote vehicle trade-ins for new more fuel-efficient models provided a boost in the third and fourth quarters. However, consumer credit only finally started to grow in January 2010, following 17 consecutive months of decline. Even though private consumption picked up in the second half of 2009, it dropped by 0.6% overall for the year—the second consecutive year of contraction and the first multiyear contraction in consumption in the US since the 1930s.

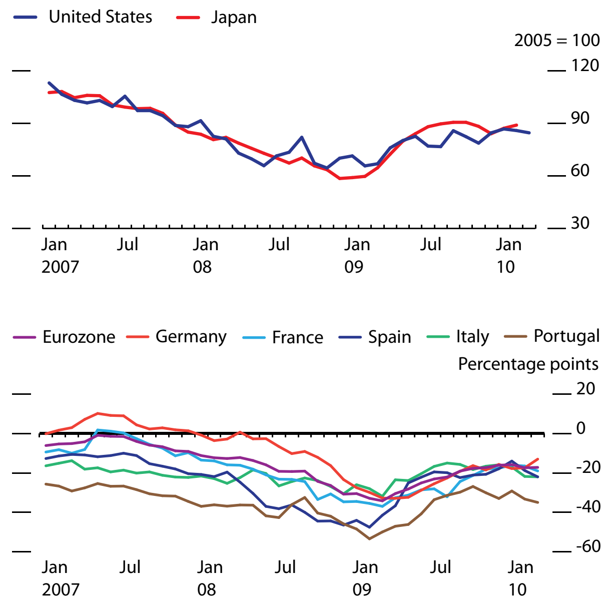
Private consumption plummeted in the eurozone as the global turmoil set in, but the recovery in consumption that began in the second quarter of 2009 has been mild. Indeed, retail sales remain weak and car registrations have slowed as the generous subsidy schemes are being terminated in several countries. High and growing unemployment remains a drag on private consumption—and in the European Union more broadly. For the countries that experienced a bust in domestic asset price bubbles, such as Ireland, Spain, and the UK, households' balance sheets need to deleverage further for household consumption to pick up.

In Japan, in contrast, private consumption was the first among the demand components to pick up, contributing to growth for 3 consecutive quarters. The recovery in consumption was driven by "eco-friendly" stimulus policies and by a car trade-in subsidy. As these programs have been extended in scope and duration, private consumption this year will continue to benefit from public support.

The global pulse of private consumption is, therefore, not strong. Many consumer confidence indexes—especially in Europe—showed signs of fragility in the first months of the year (Figure 1.1.9) on the back of still weak labor markets. Retail sales, too, have begun to flag a little, after recovering sharply during the second half last year (Figure 1.1.10).

In countries that are still recovering from the detritus of a property bubble burst, households are undergoing the protracted process of repairing their balance sheets, which will require an extended period of lower spending. In the US, outstanding household debt has contracted for an unprecedented 7 consecutive quarters, but it still remains abnormally high at well above 100% of disposable income. Stagnant job markets across the major industrial countries (Box 1.1.3) weigh heavily on prospects for further expansion of consumption.

1.1.9 Consumer confidence, major industrial economies



Note: The confidence indicator for eurozone is calculated as the arithmetic average of the difference between positive and negative answers given in percentage points of total answers. A positive reading indicates bullish sentiment, and vice versa.

Sources: Survey Research Center: University of Michigan. http://research.stlouisfed.org; Economics and Social Research Institute. Cabinet Office. http://www.esri.cao.go.jp; Bloomberg (all accessed 27 March 2010).

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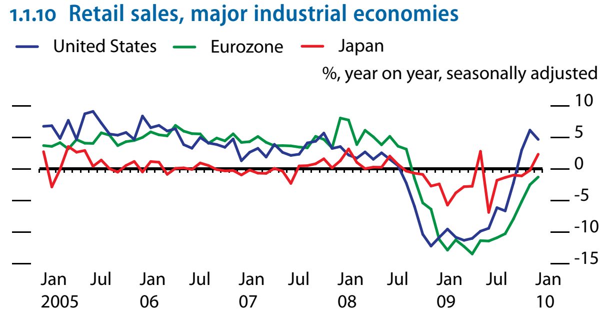
1.1.10 Retail sales, major industrial economies



Sources: US Census Bureau. http://www.census.gov; Ministry of Economy Trade and Industry. http://www.meti.go.jp; Eurostat. http://www.ec.europa.eu/eurostat (all accessed 27 March 2010).

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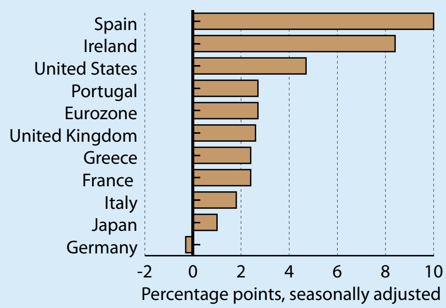
1.1.3 Threat of jobless recovery

The pace of the economic recovery is likely to be slow given sluggish private sector prospects, specifically the slow improvement of labor markets. Elevated unemployment persists in many industrial countries, such as 10.1% in France, 7.5% in Germany, and 19.0% in Spain in February this year (Box figure 1). In the US, unemployment has stuck at 9.7% through the first quarter of 2010, and a broader measure of underutilized labor (which adds those who have given up searching or are employed part time involuntarily to those unemployed) hovered near 17%.

1 Harmonized unemployment rate difference, January 2008 to February 2010



Note: Latest data for Greece and the United Kingdom are December 2009; for Japan, January 2010.

Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 30 March 2010).

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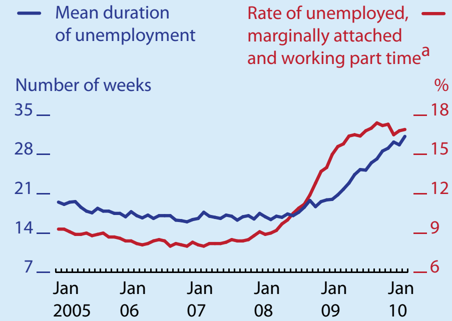
The apparently jobless recovery may stem from a variety of reasons. Cyclically, companies may tend to overhire during a boom, exaggerating the rise in unemployment in an extended recession. Structurally, production shares by industry change, such that some laid-off workers may not have their old jobs to go back to. Prolonged underutilization of workers can lead to deterioration in human capital and labor productivity, raising the structural unemployment rate (and undermining the economy's potential growth rate).

During the early phase of any economic recovery, companies face uncertainties—strength of recovery in consumer spending, changes in consumer habits—making them reluctant to hire workers. Firms therefore often meet early increased demand by relying on temporary workers and more overtime work.

The data themselves are worrisome. The average length of US unemployment rose above 30 weeks by early this year (Box figure 2), while in the eurozone one unemployed person out of three has been jobless for over a year. The largest increase in the year to the third quarter of 2009 is recorded for the categories of unemployed between 3 and 11 months (Box figure 3).

2 Unemployment, United States



[a] As share of labor force plus persons marginally attached to the labor force.

Source: US Bureau of Labor Statistics. www.bls.gov (accessed 4 April 2010).

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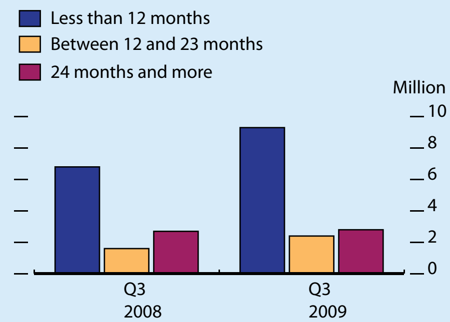
3 Number of unemployed by duration, eurozone



Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 5 April 2010).

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In Japan, too, the omens are not good. For the first time since 2003, unemployment exceeded 5% in July 2009, and has only edged back to 4.9% since, as only four jobs were on offer for every 10 applicants. Improving industrial production toward the end of 2009 has generated little new full-time employment. As of February 2010, the index of regular workers' employment shows no sign of improvement, while overtime surged 11.4% from a year earlier.

In the next couple of years, income constraints and wealth erosion will likely prompt discouraged workers and female workers to reenter the labor force on signs of economic recovery. The same factors may also encourage workers to delay retirement. Either scenario will boost the labor force, helping keep unemployment high. And if hiring in the private sector grows only sluggishly, it will be unable to absorb the labor force increase.

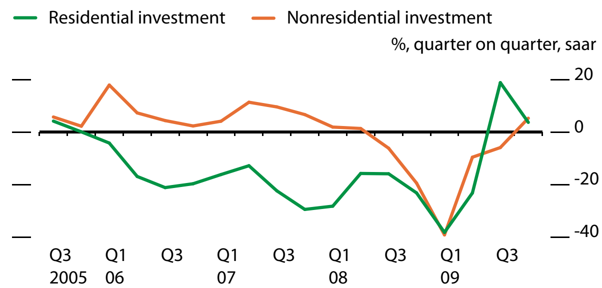
The recovery in consumption was helped by temporary support imbedded in some fiscal stimulus packages. But deflated wealth in property-boom countries (and the related cleanup of household finances), coupled with weak job market prospects suggests that consumption will not be a strong growth driver in the medium term. What, then, about investment?

Hesitancy in private investment

Facing rising and at times enormous uncertainty in economic activity, private investment tumbled from late 2008, and this was responsible for much of the GDP contraction in 2009. Gross capital formation subtracted more than 3 percentage points from GDP growth in the US—a magnitude beyond what happened during the oil crises in the 1970s. Similarly, Japan and the eurozone suffered severe investment downdrafts. While gross fixed capital formation improved steadily across these economies during 2009 and early 2010, it is still far from contributing to overall growth.

US investment showed buoyant growth in the fourth quarter in 2009. The turnaround was supported by the pickup in residential investment and robust inventory restocking. Business inventory adjustments added a surprising 3.9 percentage points, a reversal of the drag this component had on GDP during the depths of the crisis. Nonresidential investment, however, remained weak (Figure 1.1.11). While residential property prices seemed to have hit the trough and are recovering, commercial property prices are still low, and demand remains weak.

1.1.11 Private investment growth, United States



saar = seasonally adjusted annualized rate.

Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 26 March 2010).

Click here for figure data

Inventory adjustments have also progressed in the eurozone, contributing 0.3 percentage points to GDP growth in the second half of 2009. However, capital spending is likely to remain depressed in the near term, as capacity utilization remains weak and firms continue to keep low inventories despite improving demand. Residential investment recovery has been slowed by a particularly harsh winter, which postponed construction work, and is likely to remain subdued during 2010.

In Japan, private investment edged up in the last quarter of 2009 after recording 6 consecutive quarters of decline until the third quarter of last year, but it has yet to show clear signs of recovery. New house building is still at low levels, reflecting tight financing conditions for real estate firms and a distressed labor market situation. Machinery orders inched up by 1.9% year on year in December after declining for 17 consecutive months since the second half of 2008. Corporate investment, however, may still be sluggish as the Tankan survey (of both large manufacturers and nonmanufacturing industries) showed only a slow improvement in negative sentiment on the back of still-declining corporate profits and uncertainty over the strength of the global recovery.

Whether, globally, private investment and corporate activities will help sustain growth this year and next is uncertain, particularly once restocking is complete. Indicators related to private investment are still weak across the industrial economies.

The trend in the number of building permits is a useful indicator of future developments in housing markets and construction, and offer a pointer to the level of current corporate optimism and future investment.

Unfortunately, the number issued remains sluggish across the major industrial countries (Figure 1.1.12).

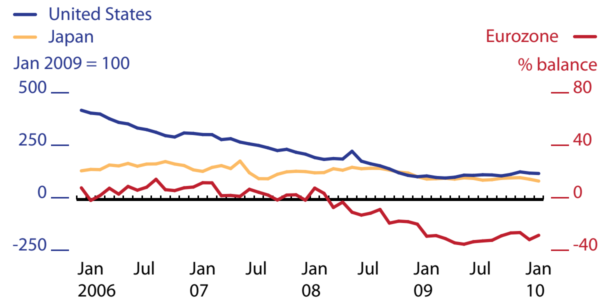
New orders for capital goods, another indicator of investment strength, are still weak and may not yet have hit their nadir. Industrial production, which tends to lag new orders for capital goods, also appears soft without any clear sign of improving soon (except for Japan where the recent surge in exports contributed to the latest pickup in manufacturing output).

Japan's capacity utilization index, too, increased by 45% by January this year from its trough in February 2009 (Figure 1.1.13). However, those for the US and the eurozone remain at around 70%, or well below the historical average of above 80%.

Putting the evidence altogether, while the fourth quarter investment performance was striking in the US, it may not be sustainable in the coming quarters based on the other indicators. There is some hope for Japan, though, which may see a pickup in private investment earlier than the other two economies. Hence, as with consumption, the world should expect to see only a gradual recovery in private investment in 2010.

Does external demand—the third leg of the private demand sources—offer better prospects than the first two?

1.1.12 Building permits and construction activity



Note: US: New privately owned housing units authorized by building permits; Japan: New construction starts, private dwellings; eurozone: Residential building activity development over the past 3 months measured as "balances," i.e., the differences between the percentages of respondents giving positive and negative replies.

Sources: Eurostat. http://www.ec.europa.eu/eurostat; Japan Ministry of Land, Infrastructure, Transport and Tourism. www.mlit.go.jp; US Department of Commerce. Bureau of Economic Analysis. www.bea.gov (all accessed 5 April 2010).

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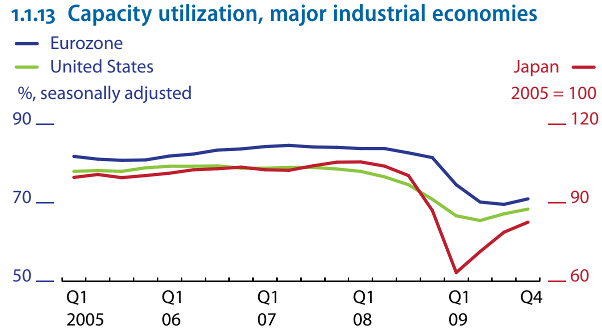
Role of international trade in the recovery

The gradual recovery of international trade is as much a consequence as it is a driving force of the economic bounceback. Reflecting the large role played by global supply chains in production, the traded parts and components of many manufactured goods cross borders several times, magnifying the effect of changes in global demand for final products on growth in trade volume. This helps explain why trade volume contracted much more strongly than global GDP during the global downturn, and why its recovery has outpaced that of production since. As inventories have rebuilt and as new industrial orders have increased to meet the gradual pickup in global demand, international trade in both capital and consumption goods has been recovering, at a pace exceeding that of income growth.

1.1.13 Capacity utilization, major industrial economies



Sources: Board of Governors of the Federal Reserve System. www.federalreserve.gov; Ministry of Economy Trade and Industry. http://www.meti.go.jp; European Commission. http://ec.europa.eu (all accessed 29 March 2010).

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In 2009, as US consumers continued to rebuild their household balance sheets by raising saving, demand for imports declined such that imports fell by 23%—much more than exports at 18%—almost cutting the US trade deficit to about $520 billion from $840 billion in 2008. This has led net exports to be the only other contributor to GDP growth aside from the public consumption in 2009. But this trend toward reduced current account imbalances does not appear durable. As the US recovered in the second half, net exports again subtracted from growth.

The picture is different from the US in the eurozone and Japan. Improving export performance often helps drive these economies out of recession. During the second half of last year, the rebound of eurozone and Japanese trade was particularly pronounced with regard to demand

for merchandise exports from developing Asia, confirming the region's leading role in the global recovery.

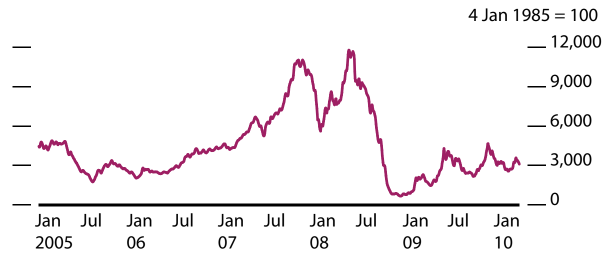
For both the eurozone and Japan, exports to developing Asia remained strong throughout 2009. In the case of Japan, robust export growth in automobile parts and components to the People's Republic of China led this growth but exports of computer chips to Taipei,China and to Malaysia were also strong. If this surge in external demand is transmitted to corporate profits, fixed investment, and employment, both the eurozone and Japan will be on a slightly firmer footing again.

While it is still too early to point to any definite trends, there are signs that developing Asia may contribute to the recovery by increasing its role as a net importer of US high-technology manufactured goods such as aerospace, information technology, and pharmaceutical products (Box 1.1.4).

What are the prospects for world trade and its role in the global recovery? Leading trade-related indicators suggest a steady pickup in trade volume this year and beyond. The Baltic Dry Index—an indicator of demand for shipping services—rebounded significantly in early 2009 and has kept up this momentum, pointing to increased economic activity (Figure 1.1.14).

New export orders, too, seem to be holding up well (Figure 1.1.15). The recovery in world trade is both a cause and a consequence of the recovery in global GDP. As such, the positive leading indicators for trade growth bode well for growth in the major industrial economies. Taken together, though, with the weak consumption and investment demand, is there enough private demand to sustain the recovery?

1.1.14 Baltic Dry Index



Source: Bloomberg (accessed 26 March 2010).
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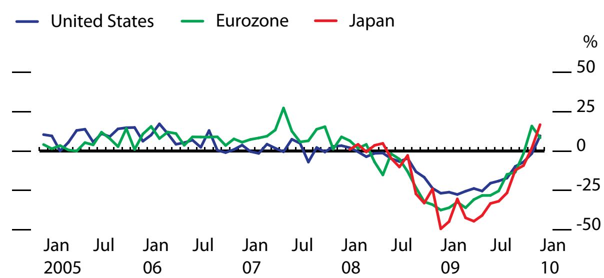
1.1.15 Growth of new orders of durable goods



Sources: US Census Bureau. http://www.census.gov; Ministry of Economy Trade and Industry. http://www.meti.go.jp; Eurostat. http://www.ec.europa.eu/eurostat (all accessed 27 March 2010).
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Uncertainty in private demand

All in all, permanent forces have not emerged strongly to take over the transitory sources. A shift from the public policy support to the private forces may not be as smooth as hoped for. As many of the emergency measures are being unwound, growth prospects are clouded by the weak spots. There is considerable uncertainty surrounding the strength of the global recovery.

Cautious return to global growth

Despite this uncertain environment, the *Asian Development Outlook 2010* (*ADO 2010*) forecasts that the mild recovery in the major industrial economies will continue through 2010–2011 (Table 1.1.1). GDP in the US, Japan, and eurozone will expand by 1.7% in 2010 and slightly accelerate to 2.0% in 2011, rates that are still less than potential growth. A mild recovery in world trade is also projected for 2010–2011.

Outlook for industrial country growth and world trade

The US led the major industrial countries in terms of the strength of its recovery in 2009. The demand components of GDP turned broadly positive in the third quarter (2.2% growth) accelerating to 5.6% in the fourth—a far cry from the 6.4% contraction suffered in the first quarter.

1.1.4 Developing Asia in the new export economy of the United States

During the high-growth years prior to the global financial crisis, developing Asia's prosperity was furthered by the United States (US) absorbing much of the large and expanding volume of global exports. US merchandise trade deficits during 2006–2008 averaged nearly $1 trillion annually, providing a strong and steady external market for the world's exporters, particularly those in developing Asia.

Before the crisis, the US trade balance had started to adjust, with net exports expanding at a modest pace in 2007–2008. With the onset of the crisis, however, US trade—and with it, world trade—contracted. The US trade deficit fell by one-third in 2009 as its imports collapsed even faster than its exports.

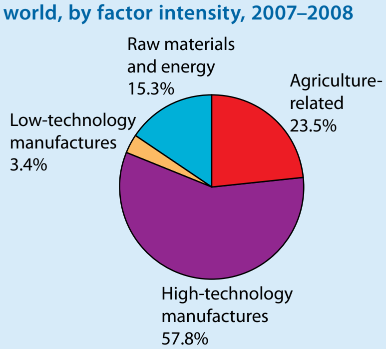
Coming out of the crisis, US households and firms will have to reduce their debt by saving a higher share of disposable income and profits, which will further narrow the trade deficit in the short term. Whether the US can sustain the increase in exports relative to imports in the long term is an open question.

What industries are emerging from the rebalancing of US trade and how will this affect developing Asia?

To explore these questions, US International Trade Commission data on total net exports were compiled into detailed product categories (specifically, the 4-digit level of aggregation in the harmonized system of tariff classifications for those products that averaged at least $100 million in real net exports during 2007–2008). The 2007–2008 average of real net exports was used for the precrisis levels. The detailed product groups were then grouped by factor content into four broad categories: high-technology manufacturing, low-technology manufacturing, agricultural-related, and raw materials and energy. Two hundred and thirty-one detailed products met the criteria with an overall average value of over $246 billion (in 2001 prices), nearly 58% of which were in high-technology manufacturing (Box figure 1).

Next, data from the same source were examined for the group of economies that account for the bulk of US exports to developing Asia: the People's Republic of China (PRC), India, ASEAN-10, and the newly industrialized economies. Data were compiled into the same detailed product categories as was used for total trade, where real net exports averaged at least $10 million per year in 2007–2008. In the precrisis period, the US had net exports to developing Asia of at least $10 million per year for 177 of the 231 products—with an even greater concentration in the high-technology category (60%) (Box figure 2).

1 United States real net exports to rest of the world, by factor intensity, 2007–2008

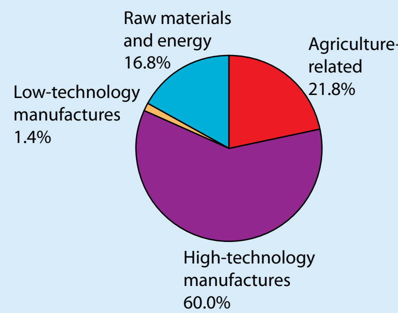


Note: Data refer to net exports of over $100 million. Real values were derived using the average of export and import price indexes.

Source: United States International Trade Commission. Interactive Tariff and Trade DataWeb. http://www.usitc.gov/ (accessed 26 February 2010).

Click here for figure data

2 United States real net exports to developing Asia, by factor intensity, 2007–2008



Note: Data refer to net exports of over $10 million. Real values were derived using the average of export and import price indexes.

Source: United States International Trade Commission. Interactive Tariff and Trade DataWeb. http://www.usitc.gov (accessed 26 February 2010).

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In contrast to the precrisis performance, in 2009 there was a huge shift in US net exports from high-technology to the other three categories and especially agriculture, but this is almost certain to be reversed as recovery unfolds. Much of this apparent shift was a result of the worldwide collapse in demand for new aircraft (the most important product in US net exports in "normal" years) and in information technology products. With new commercial airliners coming off the assembly lines soon, this shift is likely to be reversed.

Interestingly, India, ASEAN-10, and the newly industrialized economies are destinations for US high-technology net exports to an even greater extent than for the world as a whole. In contrast, the PRC tends to receive a lower portion of high-technology net imports (28%) but a larger share of agriculture-related (41%) and raw materials and energy products (30%) than the world as a whole.

As developing Asia renews its emphasis on improving the quality of life and improving health and environment, its demand for US-produced high technology goods is likely to accelerate and thus to contribute to a more balanced global trade relationship. This will be mutually beneficial as the US seeks to raise saving and exports and to curb consumption and imports.

Reference

William E. James. Forthcoming. Asia's Role in the New United States Export Economy. *ADB Economics Working Paper Series*. Asian Development Bank, Manila.

1.1.1 Baseline assumptions for external conditions

	2008 Actual	2009 Actual	2010 *ADO 2010* projection	2011 *ADO 2010* projection
GDP growth (%)				
Major industrial economies [a]	0.2	-3.5	1.7	2.0
United States	0.4	-2.4	2.4	2.6
Eurozone	0.6	-4.1	1.1	1.6
Japan	-1.2	-5.2	1.3	1.4
World trade (% change)				
Merchandise exports volume	1.5	-12.0	7.1	8.1
Prices and inflation				
Brent crude spot prices (average, $ per barrel)	97.3	61.7	80.2	84.6
Energy price index (% change)	40.1	-36.9	8.0	8.1
Food and beverage price index (% change)	23.3	-13.1	4.7	2.9
CPI inflation (G3 average, %)	3.2	-0.2	1.4	1.3
Interest rates				
US Federal Funds rate (average, %)	1.9	0.2	0.3	1.0
EU refinancing rate (average, %)	3.9	1.3	1.1	1.5
Japan interest rate (average, %)	0.5	0.1	0.1	0.2
US$ Libor [b] (%)	2.7	0.3	0.3	1.3

[a] Average growth rates are weighed by GNI, Atlas method. [b] Average rate on 1-month US$ deposits.

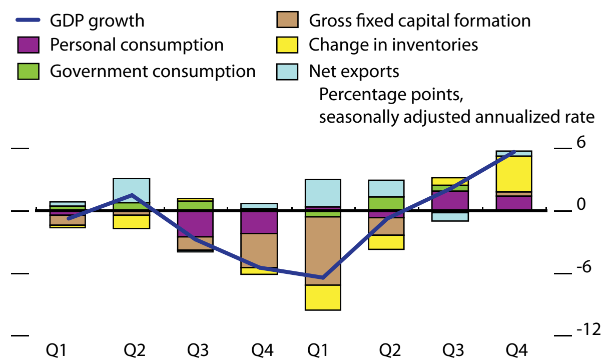
Sources: US Department of Commerce, Bureau of Economic Analysis. http://www.bea.gov; Eurostat. http://www.ec.europa.eu/eurostat; Economic and Social Research Institute of Japan. http://www.esri.cao.go.jp; World Trade Organization. http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary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

Private consumption and inventory restocking led the turnaround and were joined by private fixed capital accumulation in the last quarter (Figure 1.1.16). However, GDP still contracted by 2.4% for the year. The index of leading indicators in the US provides support for the view that the trough in economic activity has passed (Figure 1.1.17). The index reached its lowest in February 2009 and has since risen for 11 consecutive months.

Labor market concerns and persistent finance sector weakness weigh heavily on the prospects for the US economy this year and next. The uncertainty surrounding the extent to which fiscal and monetary stimulus can be maintained further clouds the picture. The sources of growth beyond the first half of 2010 are uncertain. The projections are for a moderately paced recovery, with GDP expanding by 2.4% in 2010 and 2.6% in 2011. While this appears strong when compared to the forecasts for the eurozone and Japan, the downside risks make for a fragile US outlook.

After contracting by 2.5% and 0.1% (quarter on quarter) in the first and second quarters of the year, respectively, the eurozone pulled out of recession in the third quarter of 2009 with a 0.4% increase in GDP (Figure 1.1.18). This brought to an end a recession lasting 5 consecutive quarters, and the strength of recovery exceeded consensus expectations. However, the nascent optimism was soon damped by the release of fourth

1.1.16 Contributions to GDP growth, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 1 April 2010).

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quarter data, showing eurozone growth to have stalled, as France's strong performance (0.6%) was offset by stagnation in Germany (0.0%) and contraction in Italy (0.3%) and Spain (0.1%). For all 2009, the eurozone economy is estimated to have contracted by 4.1%.

Looking ahead, confidence indicators provide positive signals for continued expansion of eurozone activity (Figure 1.1.19), but industrial production and internal demand remain subdued, while unemployment figures are still rising. Assuming a robust recovery of external demand for eurozone exports as the main driving force in the years ahead, against a slow and gradual rebound in domestic demand, eurozone GDP is forecast to expand by an anemic rate of 1.1% in 2010 and by 1.6% in 2011.

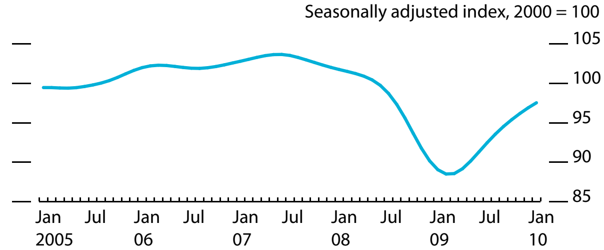
Further risks to the eurozone's outlook relate to the impact of worsening labor market conditions on household saving and consumption, and the combined effect of low capacity utilization and higher interest rates on firms' investment spending. With both the consumption and investment components of demand likely to remain fragile over the entire forecasting period, any unexpected disruption to external demand, including from Asia, risks putting the eurozone's recovery in jeopardy.

Japan's economy is on the recovery path, but it is far from being self-sustainable. Expansionary policies and the upturn in exports to developing Asia have been the main drivers of recovery so far. Initially, it was public demand, both consumption and capital formation, which helped lift the economy from its deep first-quarter dip in 2009 (Figure 1.1.20). Then, private consumption and net exports came in, in the second quarter. As public investment softened in the second half, public consumption became the sole contributor to overall growth in 2009. As a result, Japan's GDP contracted by 5.2%—the worst in its postwar history.

Although the rebound in exports is hoped to serve as an engine of growth, there is an increasing awareness that the degree of external demand (of a limited set of trading partners) dependence needs to be reduced, and that Japan's source of growth needs to come from domestic sources (Box 1.1.5).

The prolonged recession is further straining the already disturbing fiscal situation in Japan, in which general government debt reached 189% of GDP by the end of 2009, the highest among industrial nations. The expected increase in bond issuance to finance the deficit may start adding upward pressure on financing costs this year. The worsening fiscal situation too poses a threat if tax revenues do not recover as fast and financing cost starts to climb. (Figure 1.1.21) Overall, the outlook for Japan remains sluggish while the stimulus measures are gradually unwound. The sources of growth, particularly after the second half of this year, are uncertain, leading to relatively pessimistic growth projections of 1.3% in 2010 and 1.4% in 2011.

1.1.17 Composite leading indicators, United States



Source: Bloomberg (accessed 23 March 2010).

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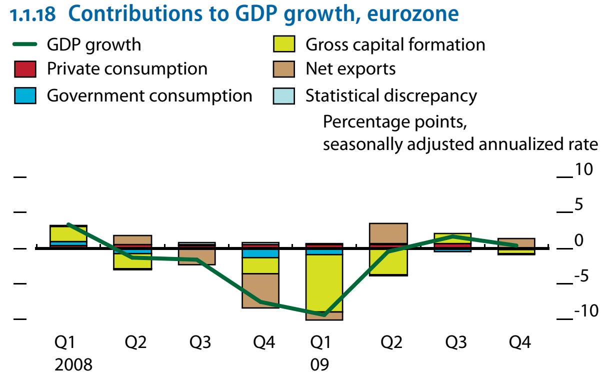
1.1.18 Contributions to GDP growth, eurozone



Source: CEIC Data Company (accessed 7 April 2010).

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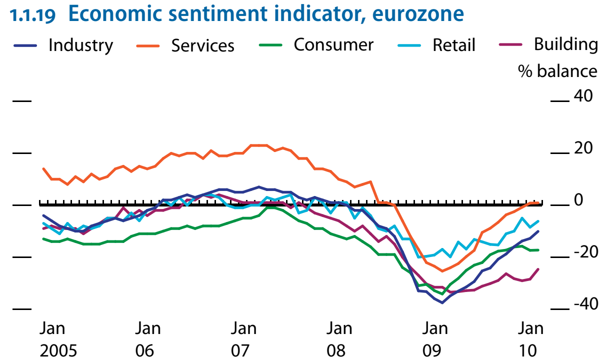
1.1.19 Economic sentiment indicator, eurozone



Note: Computed as the difference between the percentages of respondents giving positive and negative replies.

Source: European Commission. http://ec.europa.eu (accessed 30 March 2010).

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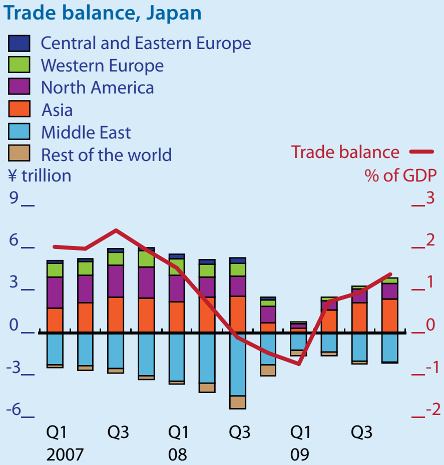
1.1.5 Rebalancing growth and the New Growth Strategy in Japan

Japan will, over the longer term, have to rebalance its economy so as to reduce its dependence on exports of its sophisticated products to the major industrial economies. Even in the short term, these markets are extremely unlikely to revert to their precrisis levels of Japanese imports.

Japan's exports to Asia are now rebounding (Box figure). In particular, capital goods exports to the People's Republic of China (PRC) have increased due to the stimulus outlays on infrastructure. But it is unclear if exports to the PRC—and to the other smaller markets in Asia—can be sustained to drive recovery in Japan.

Trade balance, Japan



Sources: Trade Statistics of Japan. Ministry of Finance. http://www.customs.go.jp; Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (both accessed 17 March 2010).

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In an attempt to move away from the export-led growth model, the government announced a "New Growth Strategy" at end-2009. Instead of emphasizing output growth (as many previous strategies have done), it seeks to assign more importance to improving people's welfare more generally; to focus on new sources of domestic demand (rather than on promoting supply); and to promote closer Asian economic integration.

The strategy aims to increase domestic demand–led growth by a focus on safeguarding the environment, boosting tourism, improving health services, and strengthening technology. The idea is to take advantage of the aging population and to utilize the country's achievements in advanced technology to develop products where potential markets are large (both domestic and abroad).

This focus, while serving to reduce vulnerability to changes in the external environment by stimulating an enlarged domestic demand, would also lead (on the supply side) to the development of new products and processes, thus contributing to rebalancing the sources of growth. Japan's potential growth and international competitiveness would be also boosted.

How the goals in the strategy are to be achieved is not, however, clear. In the budget for FY2010, social welfare expenditure will grow by 9.8% from what was planned in the initial budget for FY2009 (under the previous government) to ¥27.3 trillion, while spending on public works will fall by 18.3% to ¥5.8 trillion, the lowest level in 32 years (Box table).

FY2010 budget allocation

Major expenditure	Amount (¥ trillion)	% change (FY2009 to FY2010)
Social security	27.3	9.8
Education and science	5.6	5.2
National defense	4.8	0.3
Public works	5.8	-18.3
Miscellaneous and others	9.3	2.7

Note: "Others" include expenditures for pensions for former military personnel, economic assistance, official development assistance, promotion of small and medium-sized enterprises, energy, and food supply.

Source: Based on Ministry of Finance. 2009. *Highlights of the Budget for FY2010*, p. 2. http://www.mof.go.jp

These moves reflect increasing direct transfers to households to boost domestic demand, as the new party of government pledged at the election last year. Other concrete measures to support the strategy are yet to be announced.

To fund the FY2010 budget, however, the government is planning a record bond issuance of ¥44.3 trillion, partly because tax revenues are projected to fall to ¥37.4 trillion this year, the lowest level since FY1984. Yet Japan's wobbly fiscal trajectory in the next few years at least suggests that such transfers are unsustainable, nor are enough to achieve the new strategy's goals.

While greater details will be disclosed in the coming months, it seems apparent that the strategy will have to entail more significant structural reforms than it currently does to yield any visible outcome to rebalance Japan's sources of growth. Potential areas for such reforms include promoting deregulation in key major nontradable industries such as airlines and medical care.

World trade volume (as measured by merchandise exports) contracted by an estimated 12% in 2009, and this sharp reversal accompanied an overall global economic contraction of about 2.2%. Quarterly estimates of world merchandise trade (exports) in current dollars during 2009 indicate that growth declined year on year by as much as 33.2% in the second quarter of 2009 but exhibited mild growth of 3.9% in the fourth quarter.

Overall trade after the first 3 quarters of 2009 was a cumulative 30% below the level of the same period in 2008. With the recovery of world GDP growth to 2.7% in 2010, world trade volume is also expected to recover, to 7.1%. In 2011, with GDP forecast to rise by 3.2%, world trade is set to increase by 8.1%.

Outlook for commodity prices and industrial country inflation

Some commodity prices, such as food, are trending upward, but recently oil prices have been relatively steady. However, with the output gap still large, inflation will remain under control in the major industrial countries.

Commodity prices have begun to trend upward in tandem with the global economic recovery, with a particular thrust coming from demand by emerging market economies (Figure 1.1.22). The drop in prices since the spike in mid-2008 masks the fact that commodity prices in 2009 have remained elevated compared to the average of 2005–2007, the years immediately preceding the spike.

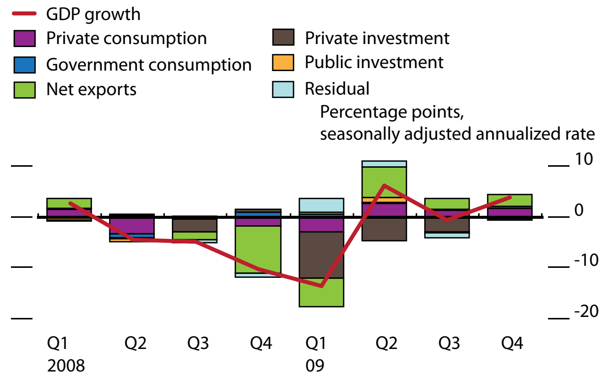
After falling from their peak in July 2008, energy prices hit a trough in the first quarter of 2009 and have been rallying since. By January 2010, the energy commodity price index, which includes coal, crude oil, and natural gas, had risen 57% from the low base of a year earlier. (In comparison, nonenergy commodity prices rose by 25% in the same period.) This rebound in prices, despite generally high inventories, can be primarily attributed to the expected strong demand in the near term as global economic activity picks up. While elevated prices encourage producers to boost supply, most producers—especially in the extractive industries—cannot do so quickly. Energy prices are expected to rise by about 8% annually in 2010–2011.

On oil specifically, the average monthly price of crude oil (Brent crude spot) has recovered from its low of $41.34 per barrel in December 2008 to $74.76 per barrel in February 2010. Prices are expected to range between $80 and $85 per barrel in 2010–2011 (Box 1.1.6).

For most of 2009, prices of base metals went up in sync with the gradual recovery in industrial production and reflected some supply constraints. The metals and minerals price index increased by 46% in January 2010, compared to the same month of the previous year, consistent with the acceleration of global industrial activity. Further price increases are expected.

Prices of agricultural goods in 2009 were more stable and lower than in the previous year (Figure 1.1.23). Throughout 2009, food and

1.1.20 Contributions to GDP growth, Japan



Source: Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 22 March 2010).
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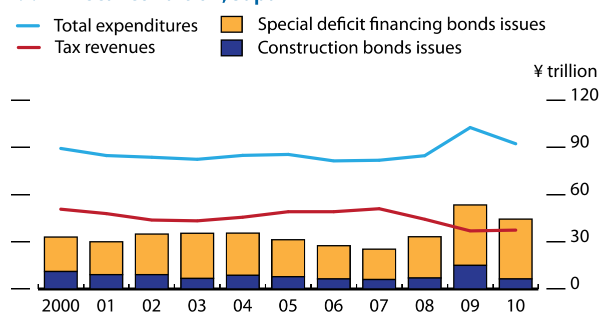
1.1.21 Fiscal condition, Japan



Source: Ministry of Finance. http://www.mof.go.jp (accessed 30 March 2010).
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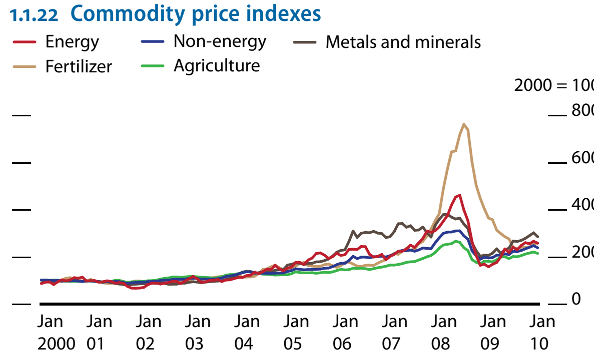
1.1.22 Commodity price indexes



Source: World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 5 April 2010).
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1.1.6 Recent global oil price trends and short- to medium-term prospects

Introduction

One potentially significant external variable that could impinge on the region's performance is the path of global oil prices. The general pattern of oil prices for 2009 was a marked but fitful climb. An intensification of the upward momentum in 2010 would burden the region, with sizable terms-of-trade losses and additional inflation pressures. An unexpectedly robust global recovery could lead to an unexpected strong surge in global oil demand.

What is the likely trajectory of oil prices in the short and medium term, and what are the key drivers?

Oil-price rally in 2009–2010: On the back of developing country demand

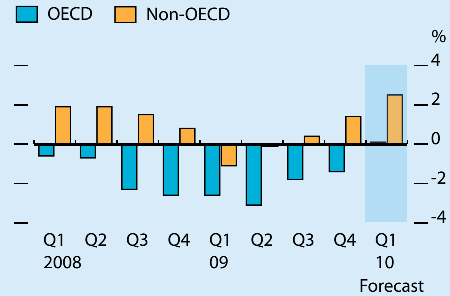
The global crisis had a pronounced impact on global oil prices. Just before the crisis in July 2008, prices surged to a record high of over $140 per barrel. Due to a dramatic weakening of demand as a result of the crisis, they collapsed toward $40 in a few months. Prices have bounced back since the end of 2008 as the Organization of the Petroleum Exporting Countries (OPEC) quickly cut its output target by 4.2 million barrels per day (mb/d) from September 2008. Output reduction was substantial, and amounted to about 15% of total OPEC output and 5% of total world supply. Another major driver behind the rebound in oil prices has been the improvement in the global economic outlook.

Economic recovery has been visibly faster and stronger in non-Organisation for Economic Co-operation and Development (OECD) countries, in particular developing Asia, than in OECD countries. The OECD versus non-OECD growth gap, which is expected to persist in the short term, was already evident in the global pattern of oil demand in 2009 and is continuing to make itself felt again in 2010. More specifically, in 2009 OECD accounted for the entire drop in world demand of 2.2 mb/d whereas non-OECD demand remained stable.

Global oil demand is projected to grow by 1.2 mb/d in 2010. OECD oil demand is projected to remain in negative territory in 2010, declining by 0.2 mb/d. Although United States demand will grow again, OECD Europe and Japanese demand will continue to shrink, albeit marginally.

On the other hand, reflecting the much firmer footing of recovery outside OECD, non-OECD demand is likely to gather momentum. Aggregate non-OECD demand will grow by about 1.4 mb/d on average, with the People's Republic of China, India, and Brazil leading the way. A look at the quarterly trends further confirms that the slump in world oil demand was concentrated in the OECD (Box figure 1).

1 OECD and non-OECD oil demand growth



OECD = Organisation for Economic Co-operation and Development.

Source: Facts Global Energy (2010).

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Short term: Ample supply likely to contain price pressures

Global supply and demand trends point to a further rise in inventories during 2010, even after 2009's significant buildup. While global demand is projected to rise by 1.2 mb/d in 2010, global supply of oil and oil substitutes is projected to rise by as much as 1.5 mb/d.

The increase in output will come from a variety of sources—700,000 barrels per day (b/d) from OPEC, 300,000 b/d from non-OPEC, 400,000 b/d in OPEC natural gas liquids, and further increases in biofuel supply due to government mandates. The resulting excess supply will further add to inventories and exert downward pressure on prices.

The main source of uncertainty surrounding this baseline scenario is the speed and strength of global economic recovery. In particular, the global demand increment may overshoot the projected 1.2 mb/d by a sizable margin if OECD's recovery surprises on the upside.

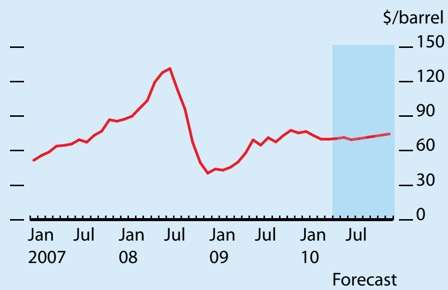
The generally soft price outlook raises some questions about whether OPEC members will comply with their output quotas in the coming months. Any drop in compliance and consequent increase in aggregate output will further add to downward pressures. Offsetting this supply-side factor is the possibility of unexpectedly robust rebound in the industrial countries. Taking all the relevant factors into consideration, Dubai crude is expected to average $70–$80 per barrel in 2010, with a gradual increase during the course of the year (Box figure 2).

Medium and long term: Fundamentals to reignite upward price pressures

At a broad level, the plausible range of prices is between a fairly robust floor of around $50–$60 per barrel, protected by OPEC, and an unsustainable peak of $150. In fact, in

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

2 Dubai crude oil prices



Source: Facts Global Energy (2010).

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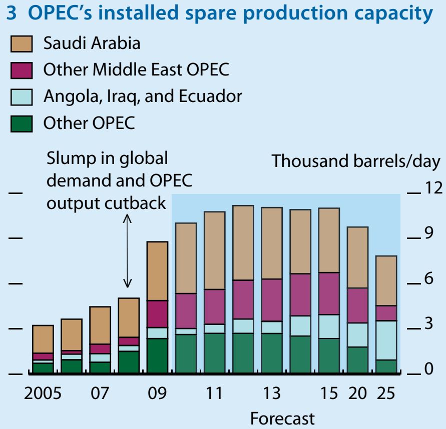
the medium term, oil prices are unlikely to go above $100 on a sustained basis. The dominant feature of the market, at least through the medium term, is the large amount of spare production capacity being carried by the OPEC members (Box figure 3).

3 OPEC's installed spare production capacity



OPEC = Organization of the Petroleum Exporting Countries.

Source: Facts Global Energy (2010).

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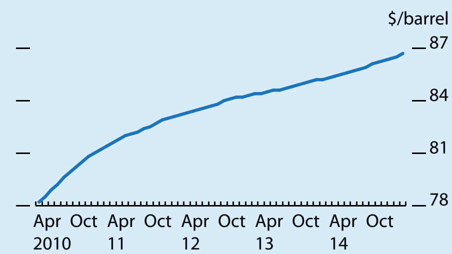
Installed spare capacity is likely to increase from around 4 mb/d in 2007 to 10 mb/d by the end of 2010. This rapid expansion is due to a combination of soft demand and new production capacity. Significantly, this level of spare production capacity in OPEC will be only slightly less than the record high of 1982.

Beyond the short term, as the global crisis recedes, supply and demand fundamentals will reassert themselves. In particular, strong demand growth from developing countries, in particular the People's Republic of China and India, will exert upward pressure. An anticipated increase in marginal costs will also push up prices. At the same time, structural demand growth from developing countries will begin to play a bigger role in price determination. The perception of the futures markets is that global oil prices are set to rise in the medium term. In fact, NYMEX crude futures for 2015 are trading at about $10 above current spot prices (Box figure 4).

4 NYMEX forward price: West Texas Intermediate crude



NYMEX = New York Mercantile Exchange.

Source: Facts Global Energy (2010).

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Asia's need to use the short term to prepare against price pressures in the medium term

The impact of the global financial and economic crisis on the global oil market cannot be overstated. To a large extent, the rebound in prices during 2009 reflects the gradual reversion of prices toward values consistent with oil market fundamentals.

Since mid-2009, prices have stayed relatively stable in the $70–$80 per barrel range. In the short term, ample spare capacity will limit the scope for price increases. However, upward pressures are likely to reemerge by the middle of this decade and those pressures are set to intensify by its end.

Therefore, the next 5 years offer a relatively narrow opportunity for Asian governments to take the necessary measures to prepare their economies for a medium-term environment of higher prices and greater volatility. Foremost among those measures should be policy actions that catalyze firms and households to use energy more efficiently.

Reference

Based on Facts Global Energy. 2010. Oil Price Outlook and Implications for Developing Asia. Background note prepared for the Asian Development Bank. March.

raw materials price indexes fell by 17% and 14%, respectively, reflecting weaker demand for food, feed, and biofuel; good harvests; and larger stockpiles of key agricultural commodities, particularly maize, rice, and wheat (Figure 1.1.24). But these prices rose steadily in the second half of 2009 as a result of robust demand, rising fertilizer prices, and adverse weather conditions. Overall, the forecast is for moderate increases in the food and beverage index: 4.7% in 2010 and 2.9% in 2011.

Consumer price movements in the US remain subdued. Core inflation (that is, consumer prices excluding food and energy) averaged 1.7% in 2009 and 1.4% in the first 2 months of 2010 (Figure 1.1.25). Rising fuel and food prices, though, have led to a more rapid increase of consumer prices overall. The CPI inflation gradually picked up in 2009, and accelerated to 2.4% in January–February 2010. As GDP growth is still below its potential, inflation is manageable, and inflation expectations are in check, the Federal Reserve is likely to maintain its 0% to 0.25% target for the Federal Funds rate through the first half of 2010.

Eurozone inflation remained subdued throughout the year, due to the high and persistent output gap and growing unemployment. The year-on-year Harmonized Index of Consumer Prices indicates fourth quarter eurozone annual inflation at 0.43%, back from a temporary dip into deflation during the third quarter, mainly on account of declines in global commodity prices.

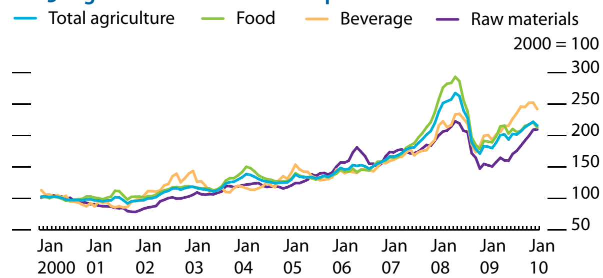
Annualized headline inflation in the eurozone reached 1.0% in January 2010 and is expected to pick up further as global commodity prices increase and recovery gains momentum. However, inflation pressures on wages and consumer prices will be damped by sluggish economic growth, subdued credit expansion, and low capacity utilization. Consumer price inflation is therefore expected to remain subdued, and to increase gradually to 1.3% in 2010 and to 1.7% in 2011.

In Japan, however, the concern is a declining consumer price index. Excluding volatile fresh food, it declined constantly in 2009 averaging 1.3% year on year (Figure 1.1.26). The decline was initially due to the base effects of the high oil price in 2008, but prices started to fall broadly in the second half of last year. In December, prices of 377 of the total 585 items in the consumption basket fell compared to the previous month, confirming deflation pressures. Yet, given the recent pick up in private consumption, the CPI deflation was gradually being whittled back, to 1.2% in February.

Risks to the global outlook

The *ADO 2010* forecasts for the global economy are conservative—continued mild expansion of GDP in the US, eurozone, and Japan, with an uptick in international trade

1.1.23 Agricultural commodities price indexes



Source: World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 5 April 2010).

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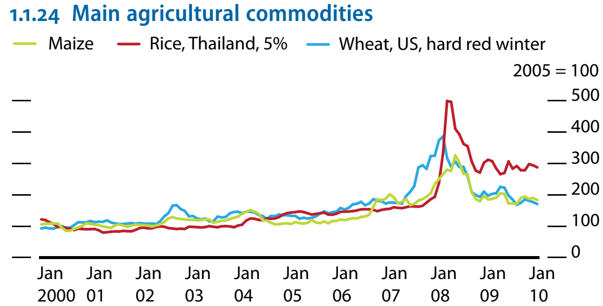
1.1.24 Main agricultural commodities



Source: International Monetary Fund. Primary Commodity Prices database. http://www.imf.org (accessed 5 April 2010).

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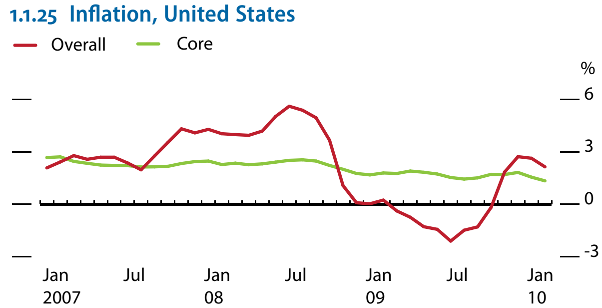
1.1.25 Inflation, United States



Source: US Department of Labor. Bureau of Labor Statistics. http://data.bls.gov (accessed 23 March 2010).

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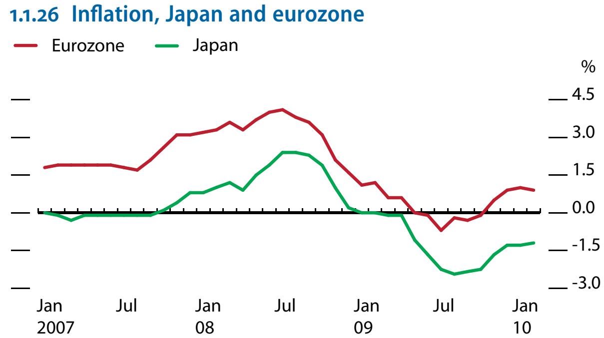
1.1.26 Inflation, Japan and eurozone



Note: Overall excluding fresh food, Japan.

Sources: Eurostat. http://www.ec.europa.eu/eurostat (accessed 30 March 2010); CEIC Data Company (accessed 7 April 2010).

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and manageable inflation rates. Yet the still-fragile outlook for major industrial economies has to contend with various downside risks.

Continued weakness in US mortgage markets. US residential property prices have picked up slowly from their 2009 trough. Yet nearly one-quarter of mortgaged properties in the US still have loan balances that exceed their market values. If mortgage defaults continue to rise, credit market difficulties will become even deeper and harder to resolve. With the specter of large mortgage defaults hanging over them (directly or through holdings of derivative instruments), financial institutions may be hesitant to restart lending to businesses. Such an incomplete resumption of credit flows could further disrupt the real economy, weakening the prospects for recovery.

Mistimed macroeconomic policy responses. Massive macroeconomic stimulus measures provided support to the major industrial economies during the depth of the crisis, and helped usher in the mild recovery in the latter half of 2009. Already, policy makers have begun to unwind some of the temporary emergency measures, particularly those with set expiration dates.

Other stimulus measures—such as tax cuts or reduced interest rates—may require direct intervention to reverse. As discussed earlier, the timing of such actions is critical, since policy makers have to balance the need to provide an environment that fosters the recovery today, while keeping an eye on signs of future problems such as inflation, asset bubbles, and unsustainable public debt. Mixed signals, including rising asset prices concurrent with increasing loan delinquencies and weak labor markets, further complicate the task of getting the timing right.

Weakening fiscal sustainability. Although liquidity constraints generally eased by early 2009, financial markets still suffered intermittent episodes of turbulence. With the emergency past (it would seem), attention has shifted to a new source of stress in global financial markets: the deteriorating fiscal balances of many industrial countries. As the Dubai and Greek crises highlight, sovereign risk may be on the rise with dire consequences for financial stability.

Jump in commodity prices. Even though commodity prices plummeted with the global slowdown, they have remained above their 2005–2007 average. Non-oil commodity prices—particularly food—are again on the rise. As happened during the 2008 price spike, rising food prices could lead commodity producers to halt exports in the name of food security, which would only exacerbate the problem. Such terms-of-trade shocks for the major industrial countries would contribute to inflation pressures.

In comparison, oil-market supply and demand conditions suggest only moderate price changes in the next couple of years. Large inventory levels and excess capacity throughout the supply chain should prevent abrupt price increases—though geopolitical conflict would likely push up the price of oil, undermining the global recovery.

Persistent global imbalances. A medium-term risk to the global outlook is the failure of external deficit and surplus countries to take measures to reduce their imbalances. US households' saving rate has risen as they adjust their balance sheets, but whether it will be sustained

long and deep enough to unwind that country's contribution to global balance-of-payments imbalances is uncertain. Asia, for its part, will have to undertake structural reforms to shift its demand away from excessive dependence on the US export market. Failure by either set of economies to make the necessary adjustments may reignite the growth of global imbalances, ultimately leading to another bout of global instability.

Incoherent international policy coordination. Another medium-term concern, poor international policy coordination could delay global financial regulatory reform and also global rebalancing. Building a resilient global financial system, which absorbs and diminishes shocks rather than amplifying them, is crucial to support vibrant economic growth. Coordinated policies are important for regulations to be effective, particularly among the G20 group of countries, so as to avoid "regulatory arbitrage," a situation where financiers direct resources toward institutions in the least regulated markets. Multilateral cooperation is equally crucial to avoid bilateral conflicts over exchange rate and trade issues. Yet despite the huge issues at stake, there has been limited progress in cross-country coordination of efforts so far. Without such efforts, financial vulnerabilities that induce volatile cross-border capital flows will persist, posing future challenges for policy makers.

Developing Asia's prospects in the recovery

Developing Asia weathered the harsh external environment in 2009—emerging first from the global turmoil—helped by decisive policy responses. Economies with large domestic markets performed well, while those relatively more dependent on external demand suffered. Yet even these weakened economies, where activity plunged in the early months of the year, strengthened by year-end.

In tandem with the improving global outlook, developing Asia's growth is expected to rebound in 2010. The region's growth should accelerate beyond 2008's outturn, though it will still come in below 2007's record 9.6% growth.

As in the major industrial countries, developing Asia's outlook is fraught with uncertainty as support from fiscal and monetary stimulus gives way to private demand sources. Authorities in the region face inflation risks stemming from maintaining expansionary monetary policies, and most of them will begin normalizing their operations as recoveries become more solid. Developing Asia's ability to maintain strong domestic demand will be tested while external demand picks up only slowly.

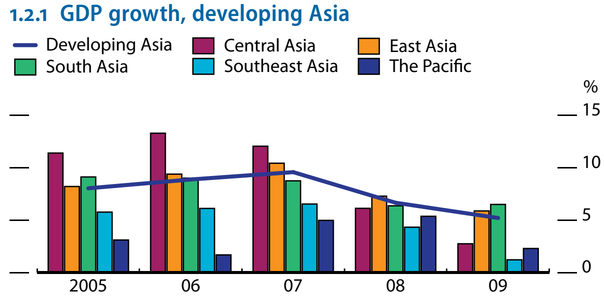
Recent trends

Growth in 2009 decelerated across developing Asia with only South Asia performing slightly better than in 2008. Developing Asia's growth fell by 1.4 percentage points to 5.2% in 2009 (Figure 1.2.1).

The aggregate performance of the East Asian subregion, where GDP expanded by 5.9%, stemmed almost entirely from the 8.7% expansion in the People's Republic of China (PRC). The PRC's performance was based heavily on its exceptional fiscal and monetary stimulus. The Republic of Korea grew marginally, helped by fiscal stimulus and currency depreciation, but global headwinds battered the economies of Hong Kong, China; Mongolia; and Taipei,China, all of which contracted in 2009.

Southeast Asia's growth slowed sharply to just 1.2% in 2009, the weakest outcome since the Asian financial crisis of 1997–98. Aggregate GDP would have declined had it not been for relatively high growth of 4.5% in Indonesia, the biggest economy in this subregion. Indeed, half the 10 economies contracted (Brunei Darussalam, Cambodia, Malaysia, Singapore, and Thailand), as the global recession cut into exports and investment flows.

1.2.1 GDP growth, developing Asia



Source: Asian Development Outlook database.
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The story in South Asia was somewhat different, partly because major countries report figures in fiscal year terms, which shifts the severely hit first quarter to the previous year. Growth in 2009 inched up to 6.5% from 6.4% in 2008 but only India and Afghanistan saw gains. India

experienced a strong rebound in growth to an estimated 7.2% for the year, despite a drought-impacted crop. 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.

The Pakistan economy again slowed, but fiscal imbalances narrowed. A worsening security environment and power shortages obstructed any meaningful improvement in economic performance. The annual rate of growth slipped, too, in Bangladesh, Bhutan, the Maldives, Nepal, and Sri Lanka, but Sri Lanka experienced a marked revival from May, after the end of its long civil conflict.

Central Asia saw growth plummet 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 managed to eke out a 1.2% expansion despite banking distress and depressed non-oil activity.

Growth in the Kyrgyz Republic and Tajikistan was sharply clipped, in part on reduced workers' remittance inflows and economic difficulties elsewhere in Central Asia and in the Russian Federation. The oil and gas producers (Azerbaijan, Turkmenistan, and Uzbekistan, but excluding Kazakhstan) experienced only a moderate slowing in growth.

Growth in the Pacific pulled back to 2.3% in aggregate in 2009, from 5.4% a year earlier. Papua New Guinea, the biggest of these economies, grew by 4.5% (slowing from 2008), supported by fiscal spending and initial investment associated with expectations of a large new liquefied natural gas 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.

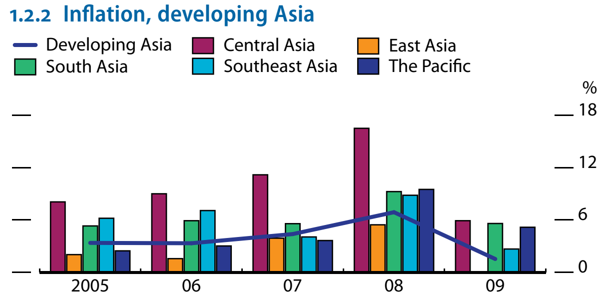
The significant output gap across developing Asia coupled with food and fuel prices that were lower than their 2008 averages led to a sharp decline in regional inflation (Figure 1.2.2). Aggregate inflation in East Asia was flat, with the PRC and Taipei,China both recording deflation.

Inflation in both South Asia and the Pacific almost halved in 2009 while that of Southeast Asia decelerated by around two-thirds. Central Asia's inflation rate of about 6%, though much below the average of the past 5 years, remained the highest of all the subregions.

In many open economies, such as Indonesia; Korea; Taipei,China; and Thailand, imports fell even more steeply than exports, so that current account surplus as a share of GDP increased. However, overall, developing Asia's current account surplus as a share of GDP fell for the second year, to 4.9% from 5.4%, as the imbalance narrowed in all subregions except for Southeast Asia (Figure 1.2.3).

Most notably in the PRC, the current account narrowed by a significant 3.6 percentage points to 5.8% from 9.4% due to reduced exports and robust domestic demand.

1.2.2 Inflation, developing Asia



Source: Asian Development Outlook database.

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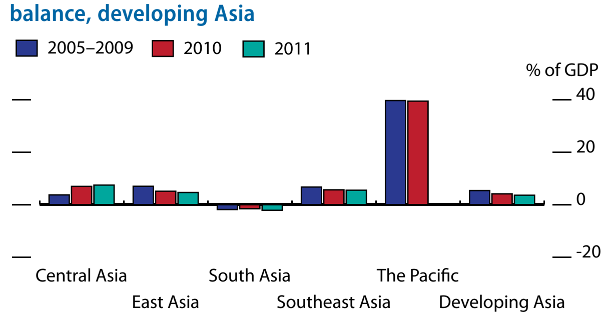
1.2.3 Five-year average and forecast of current account balance, developing Asia



Source: Asian Development Outlook database.

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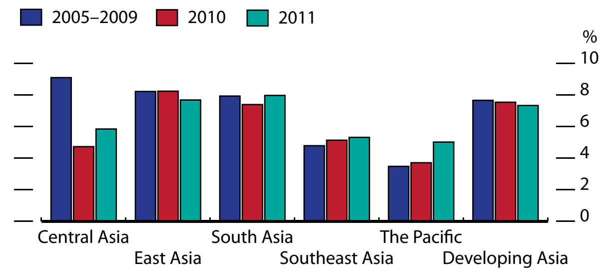
Outlook

With global recovery now under way, the outlook for developing Asia looks brighter. GDP growth is forecast to rebound to 7.5% in 2010, with every subregion expected to perform better than last year. On the assumption that the global economy will continue to recover (slowly) and with softening domestic demand as monetary and fiscal policies are normalized, regional growth is projected to slow a bit to 7.3% in 2011 (Figure 1.2.4).

Despite steep declines, commodity prices in 2009 remained elevated compared to the period before the commodity price boom. As global economic recovery started to impact, they began an upward trend, and as food and energy are major components of Asia's consumer price indexes, their rebound will force developing Asian policy makers to keep a close eye on inflation pressures. Still, with the pickup in economic activity and the impact of monetary policy easing becoming more tangible, inflation is expected to accelerate a little, to an average of 4.0% in 2010 and 3.9% in 2011 (Figure 1.2.5).

1.2.4 Five-year average and forecasts of GDP growth, developing Asia



Source: Asian Development Outlook database.
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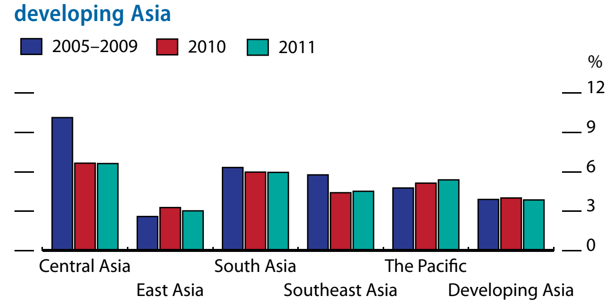
Growth in the five economies of East Asia is forecast to accelerate to 8.3% in 2010, with strong recoveries in the three that shrank last year (Hong Kong, China; Mongolia; and Taipei,China). GDP growth will remain buoyant in the PRC, while Korea is expected to rebound to 5.2%, driven by stronger private investment and consumption and the pickup in global trade.

Similar factors will benefit both Hong Kong, China and Taipei,China. But while East Asia's exports will recover from their contraction in 2009, the contribution to growth of net exports will be tempered by the rise in imports as domestic demand increases.

Inflation is expected to nudge up to an average of 3.3% in the region. All East Asia's economies (again, apart from Mongolia) will record current account surpluses.

In 2011, all five economies are likely to see a slight easing in the pace of expansion, partly a result of a phasing down of stimulative policies and because this year's rebound will set a high base. The PRC is forecast to grow by 9.6% in 2010, up by about one percentage point from 2009. Aggressive fiscal and monetary stimulus is being adjusted, but will continue contributing to strong growth. Buoyant domestic demand will be backed by firmer external 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 in the PRC is seen picking up to 3.6% this year and 3.2% next year. Rising asset prices are a concern, particularly real estate prices in major coastal urban centers, which calls for close monitoring and possible regulatory intervention.

1.2.5 Five-year average and forecasts of inflation, developing Asia



Source: Asian Development Outlook database.
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Against the backdrop that external demand will only slowly pick up, strong domestic demand should further narrow the current account surplus in the PRC as well as economies such as Hong Kong, China; Korea; and Taipei,China. East Asia's outlook for the current account surplus is a decline to 5.1% in 2010 and 4.7% in 2011.

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 recovery in investment. The five economies that shrank in 2009 will return to growth in 2010. In 2011, the pace of growth in most of the subregional economies will likely quicken a bit. Inflation is seen averaging a moderate 4.5% in 2010 (the outlier is Viet Nam, where consumer prices might rise by 10%, partly on account of last year's rapid growth in money supply and local currency devaluation). The subregional current account surplus will decline, mainly owing to the expected rise in imports as domestic consumption recovers.

Growth is expected to pick up in most South Asian countries in 2010. India will lead the group with projected 8.2% growth. Its rebound a year earlier and continued strong expansion stem largely from domestic demand conditions—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 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. Bangladesh, Nepal, Pakistan, and Sri Lanka all rely heavily on workers' remittances to offset large trade deficits. These earnings have held up quite well over the past 2 years, helping narrow their current account imbalances in 2009.

Recovery is slow in Central Asia, but the subregion is expected to grow faster than in 2009 throughout the forecast period, underpinned by recovery in the Russian Federation and higher oil prices. A still weak non-oil exporting economy in Kazakhstan will hold back its overall growth only slightly to 2.5% in 2010. The Armenian and Georgian economies are projected to turn around but record anemic growth (also about 2%). Both the Kyrgyz Republic and Tajikistan should see slightly accelerating expansions of about 4%–6%.

Inflation is seen edging up in Central Asia in the next 2 years to about 6.7%. Stronger oil prices will bring higher current account surpluses for the hydrocarbon exporters. 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 International Monetary Fund.

Aggregate growth in the Pacific is forecast to rise to 3.7% in 2010, mainly owing to accelerations 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 2% or less. Papua New Guinea will likely see a spurt in growth from 2011, based on a large new liquefied natural gas project. Subregional inflation is seen staying at around 5.3% both this year and next.

Sources of Asia's growth during and beyond the crisis

Despite the steep fall in global trade, developing Asia outperformed the rest of the world in 2009 (Figure 1.3.1), a surprising outcome for an export-oriented region. With prospects for global recovery fragile, how it did this is important for the regional outlook.

Openness and domestic demand

Developing Asia started 2009 facing the collapse in external demand from the major industrial countries. Exports from developing Asia plunged in the first half of the year—by 24.5% in the first quarter and 23.5% in the second. Economies more open to trade suffered more than the relatively closed ones. Equally, although it is true that the regional financial system as a whole was not affected severely by the crisis, the financially more open economies suffered more than relatively closed economies.

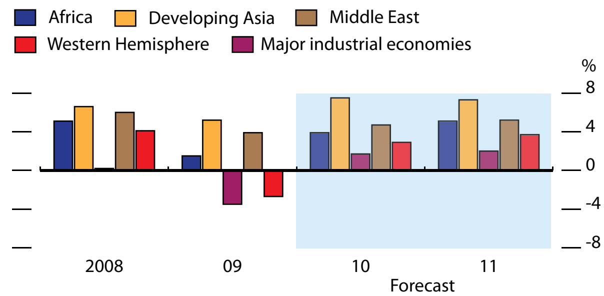
While the collapse in regional trade was about as much as the decline in goods to the major industrial countries (38% versus 40%, Figure 1.3.2), this understates the importance of industrial-country trade. The US, eurozone, and Japan have a predominant role as final goods importers. The collapse in regional trade was itself due to crumpled import demand from the major economies as the movement of parts and components along cross-border production networks stalled.

Varied GDP growth performance across Asia highlighted the importance of resilient domestic demand—both consumption and investment—when hit by a large external shock. The severe impact of the export collapse was felt particularly through the fall in business sentiment and hence private investment. The impact was particularly severe for the more open economies: in six of 12 economies (shown in Figure 1.3.2) that experienced severe export contractions, the fall in gross capital formation was the main factor taking economic activity so low in 2009. Increased uncertainty, particularly for export orders, reduced business investment.

Business sentiment and investment picked up in the second half of the year, particularly in Hong Kong, China; Korea; Taipei,China; and Malaysia (Figure 1.3.3). Buoyant import demand from the PRC seemed to account for this turnaround (Figure 1.3.4) because demand from the industrial economies was still subdued.

The three largest economies—the PRC, India, and Indonesia—stood out in terms of investment, which contributed

1.3.1 World GDP growth, 2008–2011



Notes:

Africa: Composed of 50 countries: Algeria, Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, 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, United Republic of Tanzania, Togo, Tunisia, Uganda, Zambia, and Zimbabwe.

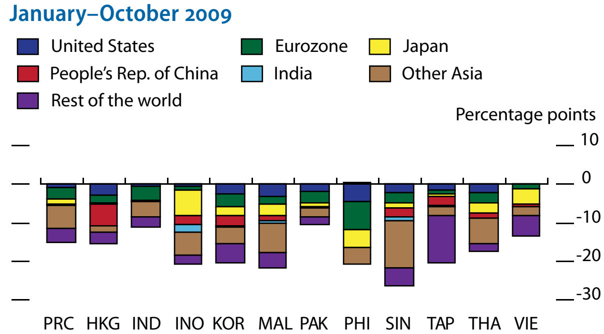
Middle East: Composed of 14 countries: Bahrain, Egypt, Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.

Western Hemisphere: Composed of 32 countries: Antigua and Barbuda, Argentina, the 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 estimates based on data from International Monetary Fund. 2009. *World Economic Outlook*. October. Washington, DC; World Development Indicators online database; *Asian Development Outlook* database (accessed 6 April 2010).

Click here for figure data

1.3.2 Contributions to export contraction in selected Asian economies, by destination, January–October 2008 vs January–October 2009



PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.

Note: Data for Taipei,China are for full year 2009.

Source: International Monetary Fund. Direction of Trade Statistics (accessed 13 March 2010).

Click here for figure data

to their GDP growth throughout 2009 (Figure 1.3.5). Large fiscal stimulus packages and generally upbeat business sentiment supported their corporate sectors. Consumption, too, was notably steady in these three economies throughout the year. Strong private consumption was also seen in the Philippines, though investment contracted. These four economies managed not only to avoid large fluctuations in GDP growth but also posted no single quarter of contraction.

Developing Asia's exports to the major industrial countries are strengthening (Figure 1.3.6). Yet with recoveries of these economies expected to be weak, developing Asia's engine of growth has to come from domestic sources or from trade with other regions. Box 1.3.1, focusing on the economies where export sectors were badly hit, shows how the pickup in domestic demand helped create services sector jobs while manufacturing (catering mainly to the export sector) was still weak.

Improving domestic demand appears to be the major driver in the region's recovery so far. At the same time, US households are beginning to save more. Do these trends foreshadow an unwinding of the global current account imbalances?

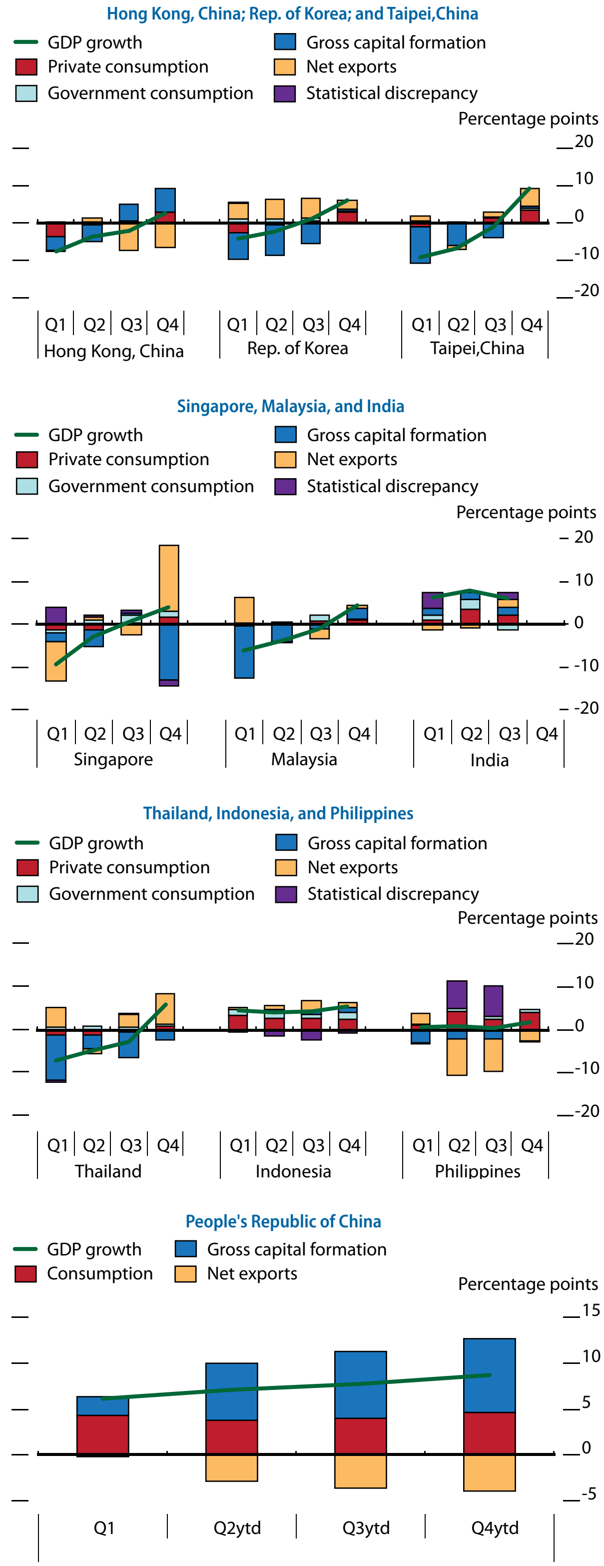
Early evidence suggested a move toward reduced imbalance. On the deficit side, the US current account narrowed significantly from its depth in 2005. In world GDP terms, it contracted from 1.65% in 2005 to 0.64% in 2009. This decline was matched by the adjustment in surplus countries, namely in Japan, the Middle East, and the Russian Federation in 2009 (Figure 1.3.7). The sharp decline in US import demand as well as lower oil and commodity prices are reflected in the shrinking current account surplus in these economies.

US households are expected to remain cautious in their spending while they adjust their balance sheets, moderating consumption growth—and hence import demand from developing Asia—in the coming quarters. As such, the narrowing of developing Asia's trade surplus is expected to continue in the next 2 years. The large fiscal and monetary stimulus packages quickly rolled out by governments across the region were basically an attempt to boost domestic demand to compensate for collapsing external demand.

It appears that the collapse of global trade during the crisis and developing Asia's policy responses have helped kick start the rebalancing process. Yet it is far from certain that the region's greater reliance on domestic demand will be maintained. Sustaining a more balanced growth model also means addressing several internal structural issues, as argued in *ADO 2009*.

Developing Asia's contribution to the global imbalances—its persistent high current account surpluses—has been driven mainly by excess saving. Resolving this problem means removing the policy bias toward specific sectors and interest rate distortions that induce excess corporate saving. Strengthening domestic financial systems and underdeveloped social safety nets will reduce households' need to accumulate precautionary saving.

1.3.3 Quarterly contributions to growth (demand), selected Asian economies, 2009



Note: For the People's Republic of China, contributions to growth are in terms of year-to-date figures. Consumption combines private and government consumption.

Sources: National Bureau of Statistics. http://www.stats.gov.cn; Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr; CEIC Data Company (all accessed 22 March 2010).

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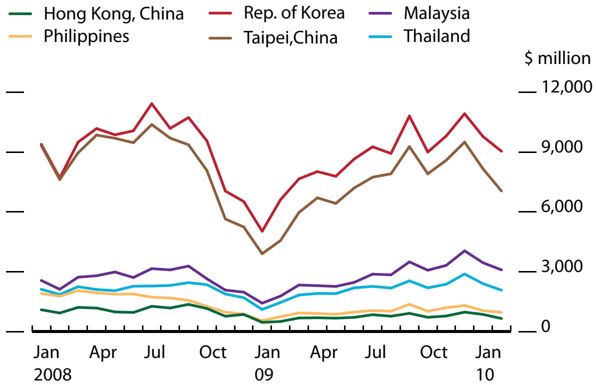
1.3.4 PRC imports from developing Asia



Note: Data for Hong Kong, China includes reexports.
Source: CEIC Data Company (accessed 3 April 2010).
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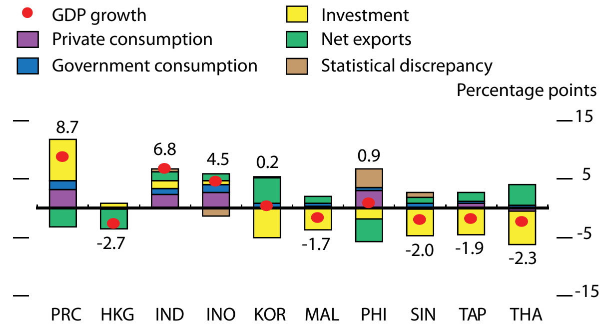
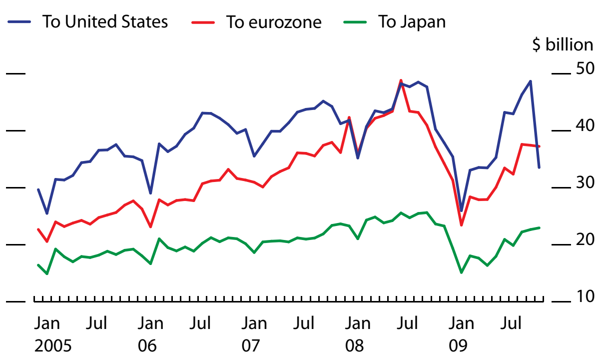
1.3.5 Contributions to growth (demand), selected Asian economies, 2009



PRC = People's Rep. of China; 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 advanced estimates of GDP at constant market prices.
Source: Asian Development Outlook database.
Click here for figure data

1.3.6 Exports of developing Asia to major industrial countries



Sources: International Monetary Fund. Direction of Trade Statistics. http://www.imfstatistics.org/dot; CEIC Data Company (both accessed 8 April 2010).
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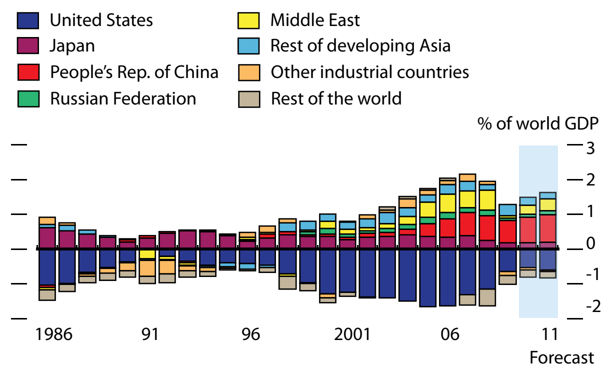
1.3.7 World current account balance



Sources: International Monetary Fund. 2009. World Economic Outlook database. October. www.imf.org (accessed 7 April 2010); *Asian Development Outlook* database.
Click here for figure data

The region also needs to wean itself from excessive dependence on exports to countries outside the region and rely to a greater extent on domestic demand. As discussed in *ADO 2009 Update*, expansion of intraregional trade among Asian countries, especially in final goods, will provide the region with an additional source of resilience against external shocks. Further progress in regional free trade agreements (FTAs) would play an important role to support sophistication of production network in the region (Box 1.3.2).

It remains to be seen how well Asian governments can manage the transition from the unbalanced precrisis economic structure to a more balanced postcrisis structure. In the medium term, unwinding of global imbalances requires higher saving and lower consumption in the US. Even in the short term, it may take some time for the industrial economies' appetites for imports to fully recover, making greater reliance on strong domestic demand and intra-Asian trade a matter of necessity rather than choice.

As the global crisis recedes and Asian countries begin to exit from their fiscal and monetary expansion, rebalancing based on public spending will diminish. But in the end, the main thrust of the stimulus

1.3.1 Trading Asia: Uneven job recovery

As recovery took hold in the open trading economies of developing Asia, jobs were created much faster than in industrial economies. However, progress varied across sectors: the increase was more significant in services; in manufacturing it was sluggish, or the position even worsened (Box table).

Official unemployment rates, selected Asian economies

	2008			2009			
	Q2	Q3	Q4	Q1	Q2	Q3	Q4
China, People's Rep. of	-	4.0	4.2	-	4.3	-	4.3
Hong Kong, China	3.3	3.7	3.9	5.1	5.5	5.6	4.7
Indonesia	-	8.4	-	8.1	-	7.1	-
Korea, Rep. of	3.1	3.1	3.1	3.8	3.8	3.6	3.3
Malaysia	3.5	3.1	3.1	4.0	3.6	3.6	3.5
Philippines	8.0	7.4	6.8	7.7	7.5	7.6	7.1
Singapore	2.8	1.9	2.4	3.0	4.1	2.9	2.1
Taipei,China	4.0	4.3	5.0	5.8	5.9	6.0	5.7
Thailand	1.4	1.2	1.3	2.1	1.7	1.2	1.0

- = not available.

Note: Data for Indonesia refer to February for Q1 2009 and August for Q3 2009; for the Philippines, data refer to quarterly data collected in January, April, July, and October of each year; for Taipei,China data refer to March for Q1, June for Q2, September for Q3, and December for Q4; for the PRC, data refer to the official urban unemployment rate.

Sources: CEIC Data Company; Singapore Ministry of Manpower. http://www.mom.gov.sg; websites of national statistical agencies concerned (all accessed 26 March 2010).

Even if higher than in 2008, the unemployment rate in most of the economies in the table is on a declining trend, and the number of employed has started to increase. Total jobs in some Asian economies, led by Thailand, have recovered to or exceeded precrisis levels (Box figure 1), in sharp contrast to industrial countries.

1 Employment, selected Asian economies

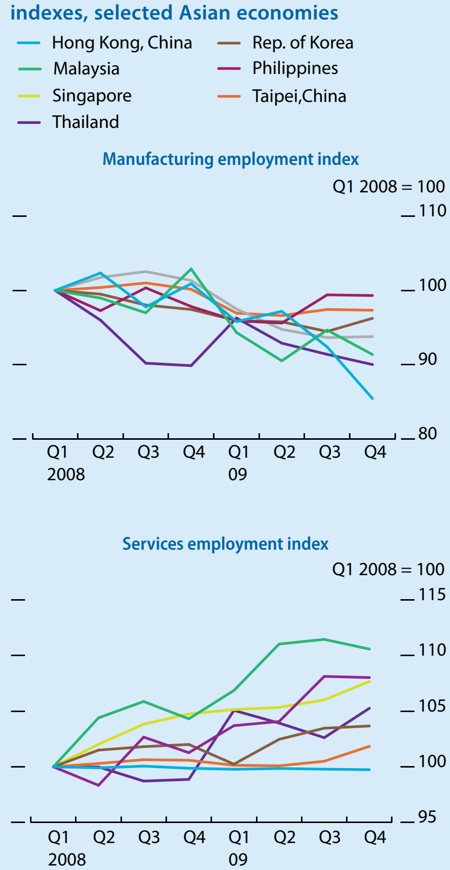
Sources: CEIC Data Company; Singapore Ministry of Manpower. http://www.mom.gov.sg; websites of national statistical agencies concerned (all accessed 26 March 2010).
Click here for figure data

But the rebound in employment appears anemic in Hong Kong, China; and in Taipei,China.

Naturally, it matters which types of jobs are lost, and which created. For many of Asia's more open economies, the initial brunt of the global financial crisis was seen in a swift export decline, hitting Asian enterprises and manufacturing employment. The latter impact came about because exports of manufactured goods constitute a large component of total exports among the sample economies—above 70% for Korea, Malaysia, the Philippines, and Singapore.

Despite growth in total employment, jobs in manufacturing have yet to recover to precrisis levels, though the number of services jobs has kept growing (Box figure 2). Notably, by the third quarter of 2009, total jobs in services had grown by more than 10% in Malaysia from early 2008, and more than 5% in the Philippines and Singapore. In

2 Manufacturing and services employment indexes, selected Asian economies



Sources: CEIC Data Company; Singapore Ministry of Manpower. http://www.mom.gov.sg; websites of national statistical agencies concerned (all accessed 26 March 2010).
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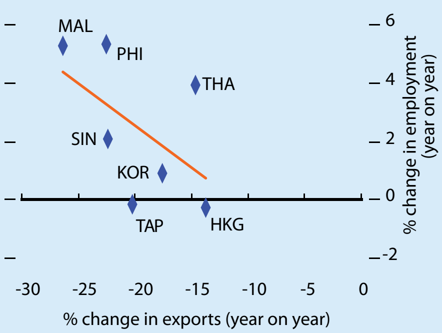
1.3.1 Trading Asia: Uneven job recovery (*continued*)

Malaysia, the expansion of services jobs was across the board, including higher value-added services.

Although it is too early to ascertain the driver behind this growth in services jobs, recovering domestic demand is certainly helping. However, this upward trend is in line with the long-run shift toward services in many developing Asian economies, which occurs as incomes rise.

The relationship between export growth and changes in employment is not straightforward (Box figure 3). Within the sample economies, those experiencing the greatest drop in exports curiously saw the biggest increase in total employment. As seen in Box figure 2 earlier, this could be due to a shift from manufacturing into services jobs. Or it could be due to transitory factors like the fiscal policy measures deployed to combat the crisis. These measures boosted private consumption, lifting retail sales in many economies.

3 Changes in exports and employment, selected Asian economies, Q3 2009 vs Q3 2008



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

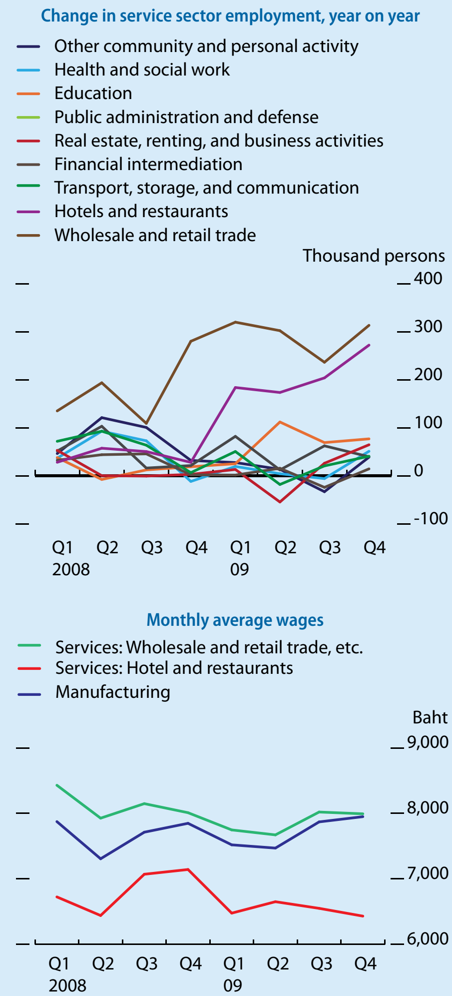
Sources: CEIC Data Company; Singapore Ministry of Manpower. http://www.mom.gov.sg; websites of national statistical agencies concerned (all accessed 26 March 2010).

Click here for figure data

So how can it be seen if this shift to domestic sectors is sustainable? One way is to ascertain whether the domestic sectors are in fact productive and offering competitive wages, and serving as an engine of growth. If services jobs are lower paid than manufacturing's, then, as soon as manufacturing resumes hiring, a swift reversal of trend is likely.

In Thailand, where total employment has grown the most since early 2008, the jobs lost in manufacturing are being replaced by services jobs. However, not all these new jobs are worse paid than manufacturing jobs. On the contrary, the services sector that has grown the most—wholesale and retail trade—has higher average wages than manufacturing (Box figure 4).

4 Changes in employment and average wages, Thailand



Source: Thailand National Statistical Office. http://www.web.nso.go.th (accessed 26 March 2010).

Click here for figure data

If the structural transformation in Thailand follows a path similar to that in Malaysia and Singapore, this shift may well continue and services jobs may form the majority of total employment.

Source

Niny Khor and Iva Sebastian. 2009. Exports and the Global Crisis: Still Alive, though Not Quite Kicking Yet. *ADB Economics Working Paper Series* No. 190. Asian Development Bank, Manila.

1.3.2 Business impacts and the Asian "noodle bowl" of free trade agreements

Amid the stalled Doha Round trade talks, free trade agreements (FTAs) offer a means to liberalize trade and sustain economic recovery in East and Southeast Asia—ASEAN-10; the People's Republic of China (PRC); Hong Kong, China; the Republic of Korea (Korea); and Taipei,China—plus Japan. FTA numbers have grown rapidly within this group—from three to 44 over the last decade—and another 85 agreements are at various stages of preparation.

The FTA surge is due to dissatisfaction with slow progress in global trade talks, the need to support sophisticated production networks through continued trade and investment liberalization, and a defensive response to the spread of FTAs elsewhere in the world.

The benefits and costs of these trade deals are the subject of polarizing debate in the region (for example, Baldwin 2006 and Bhagwati 2008). Advocates point out that such agreements strengthen the policies that underpin regional trade integration, laying the building blocks of multilateral liberalization.

Critics, though, worry that this wave of agreements is undermining the multilateral process and is fostering an alarming "noodle bowl" of overlapping rules of origin requirements, which may be costly to business. The lack of empirical evidence on business impacts of FTAs had previously made it difficult to resolve this debate and explore the policy implications.

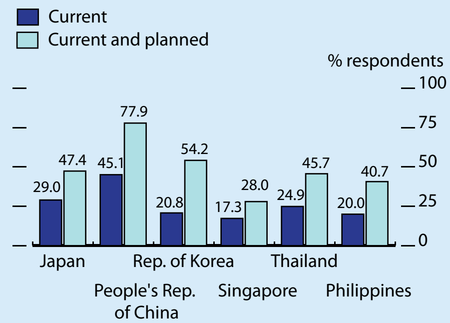
During 2007–2008, export-oriented manufacturing firms in the PRC, Japan, Korea, the Philippines, Singapore, and Thailand, were surveyed to canvass the views of those most affected by FTAs (Kawai and Wignaraja forthcoming). The surveys yielded a dataset of opinions from 841 firms, offering insights into several key questions.

Do firms use FTA preferences?

East and Southeast Asian exporting firms tend to use FTA preferences more than conventionally thought and may even increase their use in the future. In the sample, around 28% (237 firms) of the 835 firms responding to this question use FTA preferences. When those which plan to use FTA preferences are added (that is, capturing future intent as well as current use), the number nearly doubles to 53% (Box figure 1).

By country, the high level of FTA use among firms in the PRC can be attributed to the aggressive buildup of new and expanding production networks that required channeling resources across the region. In Japan, FTA use rates may be explained by giant manufacturing firms that are anchors for regional production networks, as well as by the many networks of private sector industry associations and public trade support institutions that provide services to help businesses adapt to FTA guidelines.

1 Utilization of FTA preferences



Source: Kawai and Wignaraja, eds. (forthcoming).

Click here for figure data

Thailand's relatively high use of FTAs is likely the result of the country's emergence as a regional production hub (automotive, for example), high rates of export-oriented foreign direct investment, and the government's reliance on FTAs as a tool of trade policy.

Even though current use is higher than expected, the majority of the East and Southeast Asian firms still do not take advantage of FTA preferences, facing many barriers to use. As the Box table shows, non-use of FTA preferences in the overall sample is explained by several factors.

What impedes firms from using FTAs?

Impediments to FTA use vary by country. In the PRC for instance, more than 45% of responding firms (102 firms) indicated lack of information on FTAs as the biggest impediment, followed by low margins of preference (14%). In Korea, low margins of preference (36%) and lack of information (34%) were the major reasons (delays and administrative costs linked to rules of origin and nontariff measures seemed less important there). In the Philippines, lack of information was overwhelmingly the most important impediment (70%), followed by delays and administrative costs, and rules of origin (31%).

1.3.2 Business impacts and the Asian "noodle bowl" of free trade agreements (*continued*)

Impediments to using free trade agreements

Impediment	Share of responses (%)
Lack of information	35.2
Small margin of preference	16.5
Delays and administration cost[a]	15.1
Use of EPZ schemes/ITAs	8.0
Confidentiality of information required[a]	7.3
NTMs in FTA partners	6.3
Rent seeking	6.1
Too many exclusions	5.6

[a] Rules of origin requirement.

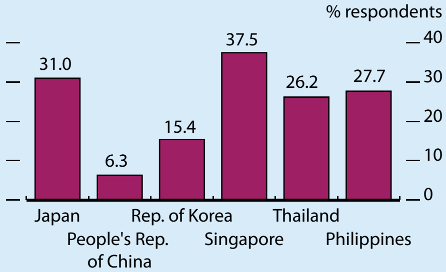
EPZ = export processing zone; FTA = free trade agreement; ITA = information technology agreement; NTM = nontariff measure.

Source: Kawai and Wignaraja, eds. (forthcoming).

Do multiple rules of origin impose a significant cost on business?

Only 20% of respondents reported that multiple rules of origin significantly added to business costs (Box figure 2). Singaporean firms had the most negative perceptions (38%) while PRC firms had the least negative (6.3%).

2 Burden imposed by multiple rules of origin



Source: Kawai and Wignaraja (forthcoming).

Click here for figure data

Though only a limited burden in the survey, more broadly, multiple rules of origin are potentially the most challenging aspect of FTAs (since they determine which goods enjoy preferential tariffs to prevent trade deflection among FTA members). Some studies on FTAs argue that complex rules of origin raise transaction costs for firms, while restrictive rules of origin deter the use of FTA preferences.

According to the survey, East and Southeast Asian firms seem to view FTAs as a benefit rather than a burden, and are currently using them to expand trade to a far greater degree than had been thought. A large majority of exporters did not view rules of origin as a significant hindrance to business activity.

Still, as more FTAs under negotiation begin to take effect and the complexity of the Asian noodle bowl intensifies, the negative business impact may be felt more.

In the medium term, therefore, consolidating overlapping bilateral FTAs into a simpler, regionwide FTA is important. That would offer a more efficient means to coordinate trade liberalization than the bilateral route while mitigating the risk of a noodle bowl.

One practical way forward might be to take the best features from each East and Southeast Asian FTA and design a "boilerplate regional agreement" that is both comprehensive in scope and consistent with World Trade Organization rules. Three regionwide FTA proposals are under discussion—an East Asian FTA (or ASEAN+3 FTA), a Comprehensive Economic Partnership Agreement (or ASEAN+6 FTA), and a Transpacific Strategic Economic Partnership Agreement (spanning APEC economies including the United States)—but it is not clear which will emerge, or when.

The formation of such a regionwide FTA may make it easier to achieve a deep Doha trade deal, if concessions on agriculture and industrial goods are already incorporated into the regionwide agreement. It would also spur the growth of Asian trade and investment through a larger regional market, the realization of economies of scale, and technology transfer. Further, it would insure against any rise in global protectionism, which would put Asia's trade and sustainable economic recovery at risk.

Source

M. Kawai and G. Wignaraja, eds. Forthcoming. Asia's Free Trade Agreements: Is Business Responding? Cheltenham, UK: Edward Elgar.

References

R. Baldwin. 2006. Multilateralizing Regionalism: Spaghetti Bowls as Building Blocks on the Path to Global Free Trade. *The World Economy* 29(11): 1451–1518.

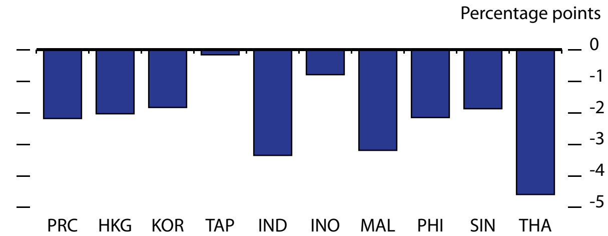
J. N. Bhagwati. 2008. *Termites in the Trading System: How Preferential Agreements Undermine Free Trade.* Oxford: Oxford University Press.

policy was immediate crisis response, rather than resolving a medium-term development issue. Aside from the temporary boost to a more balanced growth model, how effective was policy support in keeping developing Asia afloat?

Policy actions

Substantial (and often unprecedented) fiscal measures provided a direct boost to consumption and investment. In a selected group of economies, which together constitute more than 90% of developing Asia's GDP, the contribution of government consumption to growth was significant (Figure 1.3.5 above). The fiscal measures were supported by an extremely accommodative monetary stance. Various monetary measures were employed to provide the supportive environment for the recovery process. Policy rates were slashed by 234 basis points on average, which injected ample liquidity.

1.3.8 Change in fiscal balance over GDP ratio, 2009 vs average of 2004–2008



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

Source: Asian Development Outlook database.

Click here for figure data

Effectiveness of fiscal policy

Plunging external demand, compounded by weak domestic private demand, left the government as the consumer of last resort throughout developing Asia. In striking contrast to the Asian crisis a decade earlier, the region was unable to export its way out of the recession. Governments responded decisively with sizable fiscal stimulus packages (Figure 1.3.8). Indeed, the forceful and synchronized fiscal policy response was uncharacteristic for a region in which the use of countercyclical fiscal policy is uncommon. Developing Asia's macroeconomic focus has been more on keeping budget deficits under control rather than using spending and taxes to smoothen the business cycle.

But did developing Asia's "fiscal experiment," as it might be called, play a key role in maintaining regional resilience? The answer (discussed in detail in Part 2), would seem to be "yes." In particular, higher government spending had a positive effect on GDP during the worst of the slowdown. At a minimum, the fiscal stimulus is likely to have had a major positive effect on plunging business and household confidence by signaling the resolute commitment of regional governments to prevent an economic meltdown.

Effectiveness of monetary policy

The prudent policies and behavior of Asian monetary authorities and financial institutions certainly contributed to avoiding crisis, but luck may have played a role too, since Asian central banks had not been challenged by hard choices, unlike the advanced economies' central banks (or their own, prior to the Asian currency crisis).

Concurrent with the fiscal expansion, monetary policies were loosened to maintain adequate liquidity for the economy. Most central banks went beyond the usual operating channel of cutting the policy rate by pumping additional liquidity to the economy through either pursuing direct injection of liquidity or creating demands for domestic assets. Policy interest rates were cut sequentially from the last quarter of 2008 and, in most economies, have been kept at a decade low since.

This drop of policy rates initiated expansion in financial depth (measured by M2/GDP). Between the fourth quarter of 2008 and fourth

quarter of 2009, on average, financial depth grew by about 38% in a sample of 11 developing Asian economies (PRC; Hong Kong, China; India; Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam). Attributing this all to a change in policy rates would be misleading since that would suggest a percentage point decrease in the policy rate corresponds to an 18% growth in the ratio of M2 to GDP. Therefore, liquidity operations must have played a considerable role in promoting financial depth.

These monetary operations provided more comfortable room for the large fiscal expansion to play its role in cushioning the impact of the slowdown and promoting the region's strong recovery.

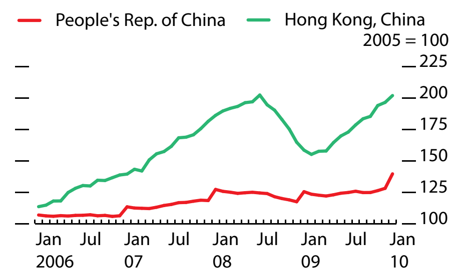
Both fiscal and monetary policies worked. Yet, as Asia's recovery picks up, policy makers are facing a new challenge—how to normalize the policy stance while continuing to support the recovery process and avoid creating new problems.

Beyond the crisis

While additional fiscal measures are unlikely to be implemented this year, the monetary measures are expected to continue to support the recovery process by maintaining an expansionary stance. Nonetheless, this stance throughout the region cannot be kept for too long and needs to be unwound once economies recover and are back to normal operations. Early indication of a pickup in inflation is emerging, most notably in India where wholesale price index inflation is reaching close to 10%.

On the back of the expectations for robust economic recoveries, asset prices, particularly of real estate, are also showing a surge, especially in the PRC and Hong Kong, China (Figure 1.3.9). In fact, initial unwinding, though not necessarily through an increase in the main policy rate, has already begun, or has been discussed in many economies (Table 1.3.1).

1.3.9 House prices, January 2006–January 2010



Source: CEIC Data Company (accessed 5 April 2010).

Click here for figure data

Table 1.3.1 Unwinding loose monetary policy

Economy	Actions taken by monetary authorities	Effective date
China, People's Rep. of	3-month bill yield was increased by 4.04 basis points	7 January 2010
	1-year bill yield was increased by 8.29 basis points	12 January 2010
	Cash-reserve ratio was increased by 50 basis points to 16%	18 January 2010
	1-year bill yield was increased by 8.3 basis points	19 January 2010
	3-month bill yield was increased by 4.04 basis points	21 January 2010
	Cash-reserve ratio was increased by 50 basis points to 16.5%	25 February 2010
India	Statutory liquidity ratio was increased by 100 basis points	October 2009
	Cash-reserve ratio was increased by 50 basis points from 5.0% to 5.5%	13 February 2010
	Cash-reserve ratio was increased by 25 basis points from 5.5% to 5.75%	27 February 2010
	Repurchase rate was raised by 25 basis points to 5.0% and the reverse repurchase rate by 25 basis points to 3.5%	19 March 2010
Malaysia	Overnight policy rate was raised to 2.25%	4 March 2010
Philippines	Peso rediscount rate was increased by 50 basis points to 4.0%	1 February 2010
	Peso rediscounting window was reduced from P60 billion to P40 billion	15 March 2010
	Loan value of eligible rediscounting papers was restored to 80% from 90%	15 March 2010
	Nonperforming loan ratio requirement of 2 percentage points above the industry average (from 10 percentage points) was restored for banks using the rediscounting facility	15 March 2010
Viet Nam	Key rate was raised from 7% to 8%	1 December 2009
	Interest rate cap on medium-term and long-term loans was removed	February 2010

Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/; Reserve Bank of India. http://www.rbi.org.in; Bank Negara Malaysia. http://www.bnm.gov.my; Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph; State Bank of Viet Nam. http://sbv.gov.vn

Central banks in the region need to closely watch how macroeconomic indicators develop and put more discipline in leaning against any threat of destabilizing aggregate domestic price levels and expectations, as soon as strong indications appear.

Additionally, surging capital inflows into several economies—especially those that have rebounded firmly and attracted investors with a rising risk appetite—are complicating macroeconomic management. In addition, the continued low policy rates in the major industrial countries and greater market liquidity have prompted speculative flows due to large interest-rate differentials and a resumption of some carry trades.

Economies faced with such surges have several options, including better coordination with industrial countries, from which much of these flows may originate in the search for better yields. The response need not be an immediate monetary tightening. In economies where recovery is firm, pursuing some fiscal tightening can ease pressures on rising interest rates. For others, accumulation of international reserves or allowing greater exchange rate flexibility may be more appropriate.

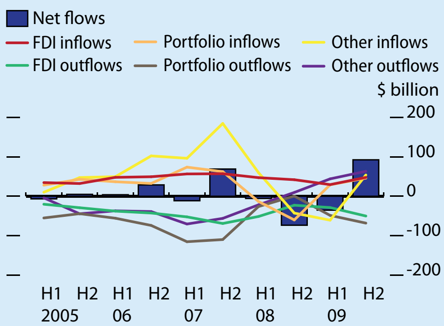
There is also room for applying macro-prudential policies, to deter the formation of asset and price bubbles or for financial institutions to accumulate buffers. Where institutional capabilities are well established, temporary use of carefully designed capital controls are one possible approach to deter disruptive short-term flows (Box 1.3.3).

1.3.3 Responding to surging capital flows

Developing Asia's vigorous recovery, alongside low interest rates in most industrial countries, has sucked in huge capital inflows. If these inflows had been driven by fundamental factors (and countries had the absorptive capacity), policy makers' concerns would be limited.

However, they were not driven in this way: Box figure 1 shows that the rebound after first half 2009 was carried by portfolio and other types of flows, such as investment by banks. On the back of the improving economic conditions, the portfolio inflows were significant in economies such as Hong Kong, China; the Republic of Korea; and Taipei,China, reaching a total of about US$46 billion in the second half of 2009.

1 Capital flows, developing Asian economies



FDI = foreign direct investment.

Source: ADB estimates based on data from CEIC Data Company; and from International Monetary Fund. International Financial Statistics online database (both accessed 31 March 2010).

Click here for figure data

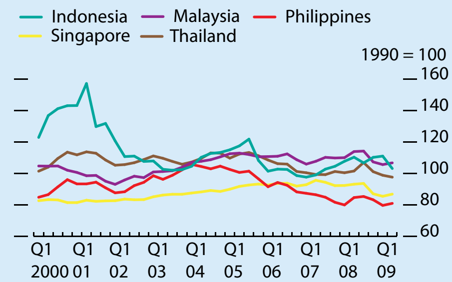
Expectation of currency revaluations and interest rate differentials triggered the speculative capital flows. As both these factors may well remain in play for some time, such inflows, too, will likely persist.

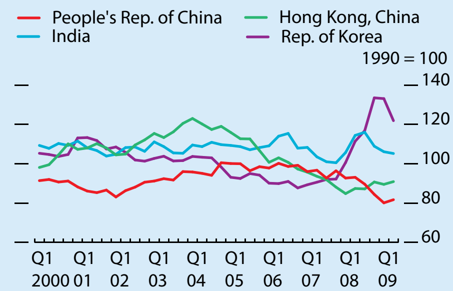
Abrupt surges in short-term capital inflows (a dominant feature of speculative capital) pose substantial risks to an economy, including excessive liquidity, economic overheating, asset price bubbles, and overall financial fragility. Yet if the central bank attempts to head off these risks, usually by sterilizing the inflows, this eventually induces significant real exchange rate overvaluation.

The surges in capital inflows have already lifted asset prices, both property and stocks, in some economies. In just over a year's time as of January 2010, property prices had grown sharply in some of the coastal cities in the People's Republic of China (PRC)—around 50% in Haikou and Sanya—and 28% in Hong Kong, China. Stock prices recovered, as measured by the MSCI Asia Pacific index, which climbed 78% from the trough on 9 March 2009 to end-March 2010.

The appreciation of the real exchange rate has become evident in some countries, including India, Indonesia, Korea, and Thailand (Box figure 2). However, because of significant intervention in foreign exchange markets, the degree of real exchange rate appreciation in the region has been limited.

2 Real exchange rates, developing Asian economies





Source: ADB estimates based on data from CEIC Data Company; and from International Monetary Fund. International Financial Statistics online database (both accessed 31 March 2010).

Click here for figure data

Given recent developments, additional capital restrictions appear likely. The PRC recently introduced additional capital control measures to block speculative inflows, and regulators there have greater power to investigate currency payments. They can also levy fines of 30% on unauthorized transfers of foreign currency. Other central banks are closely monitoring capital inflows.

Two policy issues relate to the buildup of capital in the region—exchange rate management and capital controls. Too much foreign exchange intervention could lead to serious repercussions of macroeconomic management in the region, especially risks emerging from exchange rate misalignments. Policy makers in some economies may need to reappraise their exchange rate policy, including considering stronger moves toward regional cooperation in exchange rate and reserves management.

Past experience shows that capital controls can be effective in the short run, but they tend to lead to deterioration in business sentiment if retained too long. In the medium to longer term, central banks should free the exchange rate to play its role as a shock absorber.

Also over the longer term, countries should progressively build their absorptive capacity to productively and efficiently use their capital inflows, especially in terms of finance sector reform and foreign exchange market development.

A case for monetary and fiscal activism?

Developing Asia quickly and strongly bounced back from the recent crisis. In fact, it led the world out of recession. This marks a complete reversal from the Asian crisis of 1997–98 when the region exported its way out of trouble.

What is all the more remarkable is that the region's turnaround has taken place against the backdrop of sluggish recovery in industrial countries. How did developing Asia manage to bounce back so quickly while its main export markets have yet to fully recover?

First, due to limited exposure to subprime assets, the region's banks and financial systems continued to function normally even during the depth of the crisis. The region is largely free from the structural problems, such as the high household debt plaguing the US.

Second, and far more important, was the large fiscal and monetary stimulus.

Still, Asian policy makers should be extremely cautious about reading too much into the apparent effectiveness of the fiscal stimulus during the global crisis, in particular, drawing lessons for normal noncrisis periods. For one, Asia's unprecedented fiscal expansion represented an extraordinary response to an extraordinary shock. As noted earlier, fiscal stimulus can have an enormous confidence-boosting effect during a severe shock. This benefit is much less important during a regular business cycle downturn.

Furthermore, it was precisely because Asia had ample fiscal space, the consequence of years of sustained fiscal prudence, that it was able to quickly unleash huge fiscal stimulus packages. More fundamentally, fiscal discipline laid the foundation for macroeconomic discipline and sustained growth in the past.

Part 2 explores this issue further—should Asia pursue fiscal and monetary activism after the crisis, or is it better served by a return to its basic macroeconomic framework of monetary and fiscal prudence?