Highlights—*ADO 2008 Update*

Moderating growth and rising inflation have characterized developing Asia in the first 8 months of 2008. High international commodity prices are likely to stay for the long haul and have exacerbated homegrown inflation pressures. But containing inflation in the face of a serious global downturn will lead to a slowdown in regional growth in 2008 and 2009. This short-term sacrifice is required for longer-term economic, social, and political gain. Prudent macroeconomic management with reforms tackling the fundamental causes of tight commodity balances is also essential, if developing Asia is to ride out the global storm, weigh anchor, and set course for faster medium-term growth and modest inflation.

Key messages

- Developing Asia's 9.0% expansion in 2007 was the highest in almost two decades. However, the many years of robust growth supported by accommodative monetary policies buttressed excessive aggregate demand that nurtured price pressures. Turbulence in global markets has fanned the flames of inflation. Developing Asia's consumer price inflation is therefore seen rising from 4.3% in 2007 to 7.8% in 2008 before ebbing to 6.0% in 2009. The confluence of these external and internal factors is expected to slow growth to 7.5% in 2008 and 7.2% in 2009.

- In many countries, demand-pull rather than cost-push factors are causing high prices. Monetary policy thus has a major role in containing these price pressures, and regional economies need to address rising inflation even at the expense of slower (short-term) growth. Central banks should impose the requisite tightening measures to prevent inflation from becoming entrenched in their economies.

- Risks—such as a prolonged slowdown in major industrial countries, continued elevated levels of international oil and food prices, persistence of high inflation, and policy reticence—are bearing down on the regional outlook, which is more heavily tilted to the downside than in April.

- The myth of uncoupling has been exploded. The worsening outlook for major industrial economies is buffeting developing Asia's export, equity, and offshore bond markets. The region clearly remains heavily reliant on industrial countries for its exports and has not uncoupled from their business cycles. The loss of investor confidence in industrial countries' equity markets has crossed over to Asia. The risk premium on dollar-denominated offshore bonds of Asian issuers has risen sharply since the outbreak of the subprime crisis in the United States. If the global slowdown extends beyond 2009 therefore, the repercussions for the region could be severe.

- The global oil market remains tight. While oil prices are likely to soften somewhat in the short run, they will stay high and volatile. Since food prices are heavily influenced by oil prices, the days of cheap food also seem to be over.

- Developing Asia will have to learn to adjust to this high global commodity price environment and to undertake the necessary structural reforms. But first, it must reestablish macroeconomic stability through sound monetary, fiscal, and exchange rate policies.

- Political pressures are building up in some countries, and these could result in the authorities' reluctance to pass needed reforms, and this risks deepening macroeconomic imbalances. Prolonged periods of political instability could inhibit investment and affect growth prospects in the medium term.

Outlook for 2008 and 2009

- Events in the first 8 months of 2008 suggest some major changes in the external environment affecting the assumptions made in April when *Asian Development Outlook 2008* was released. The slowdown in the G3 (United States, eurozone, and Japan) is now seen continuing until the end of 2009. As a result, growth in the volume of world trade will slow. Both food and fuel prices, which have surged this year, are forecast to come down but will remain higher than in 2007 for the rest of this year and next. With the continuing turmoil in financial markets, the cost of new capital will become higher, and access harder, for developing Asia.

- In addition to the regional slowdown in growth and jumps in inflation, current account surpluses are diminishing and deficits are widening. Currencies are depreciating, putting upward pressure on inflation. Another danger is that although central banks have begun to tighten monetary policy, some may have let the inflation genie out of the bottle by doing too little, too late, since interest rates in most countries are still lower than inflation.

- Containing inflation will take time as monetary policy works with a lag. In 2009 when inflation is reined in, regional growth will slow—also hit by the slowdown in export growth to the G3.

- East Asia is expected to decelerate to 8.0% growth in 2008 and to 7.7% in 2009, from 9.6% in 2007. Growth rates in all East Asian economies are forecast to ease. Aggregate inflation in the subregion is expected to rise from 3.9% in 2007 to 6.1% in 2008 before declining to 4.8% in 2009. But overall, a soft landing is projected for East Asia.

- Weakening external demand and the impact of policy tightening has trimmed GDP growth in the People's Republic of China to a still-rapid 10.4% in the first half of 2008. Private consumption remained robust because income growth outpaced inflation. The 10.0% growth forecast for 2008 is maintained and that for 2009 is brought down slightly to 9.5% on the expectation of a reduced trade surplus and slower investment growth. After rising to 7.0% in 2008, inflation is forecast to decelerate to 5.5% in 2009.

- Southeast Asian growth is projected to slow from 6.5% in 2007 to 5.4% in 2008 and to stay around that rate next year. Rising inflation is generally damping growth in consumption. Primary commodity exporters in the subregion benefited from higher commodity prices in the first half of 2008. For example, Malaysia's exports gained from rising prices of palm oil and crude oil. Southeast Asia's inflation is forecast to more than double from 4.0% in 2007 to 9.4% in 2008 before pulling back to 6.9% in 2009. Double-digit inflation is projected this year for Cambodia, Indonesia, Lao People's Democratic Republic, Philippines, and Viet Nam. Curbing inflation is the crucial macroeconomic challenge in most Southeast Asian countries.

- In Viet Nam, macroeconomic turbulence intensified in the first several months of 2008. Inflation accelerated sharply and the trade deficit widened. In response, the Government changed its priority from spurring growth to curbing inflation and reducing the trade deficit. Growth is forecast to decelerate from 8.5% in 2007 to 6.5% in 2008 and to 6.0% in 2009. The corresponding inflation rates are 8.3% in 2007, climbing to 25.0% this year and still high at 17.5% in 2009. Risks to these projections are tilted to the downside.

- South Asia's growth will decelerate from 8.6% in 2007 to 7.1% in 2008 and to 6.7% in 2009. Inflation is forecast to more than double from 5.5% to 11.8%, and then recede to 9.2% in this 3-year period. Current account deficits are forecast to widen significantly. Overheating from excessive aggregate demand, aggravated by imported cost-push factors, has made inflation the critical macroeconomic concern. South Asia needs to strengthen its macro management as well, to rein in fiscal deficits and so avoid a hard landing.

- In India, growth in the April–June quarter of the current fiscal year (ending March 2009) slowed to 7.9% from the 9.2% seen in the first quarter of FY2007, for the slowest rate of growth since 2004. Inflation in the first quarter of FY2008 was 9.5% compared with 5.3% in the same quarter a year earlier. India's monetary policy has been tightened significantly. The inflation forecast for this and the next fiscal year are 11.5% and 7.5%, respectively. Growth is forecast to edge down from 7.4% in FY2008 to 7.0% in FY2009 as inflation is ironed out. A pause in growth accompanied by prudent macroeconomic management and reforms to improve efficiency and productivity would set the stage for the pursuit of a higher growth trajectory over the medium term.

- A slowdown is under way in Central Asia. From a strong rate of 11.6% in 2007, growth is forecast to be clipped to 7.6% in 2008 before rising gently to 8.0% in 2009. Inflation is forecast to rise from 11.3% in 2007 to 15.4% this year before coming back to 11.4% next year. Rising oil prices have boosted the current account balances of hydrocarbon exporters such as Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. As countries in the Middle East have done, these countries should use their earnings bonanza to diversify the structure of their economies. Hydrocarbon importers such as the Kyrgyz Republic and Tajikistan have suffered from high oil prices, but have been helped by remittance inflows. Increasing food prices, however, are having adverse consequences throughout the subregion.

- Aggregate growth in the Pacific subregion is forecast to double to 4.8% in 2008 from 2.4% in 2007, mainly because of a stronger expansion in resource-rich Papua New Guinea, the biggest economy. However, about half the 14 economies are expected to grow at a slower pace or contract in 2008. Next year, aggregate growth is projected to ease to 3.4%. Higher global oil and food prices have contributed to sharply higher inflation, which is now projected at 8.7% this year (from 3.3% in 2007) and 6.4% next year. The higher cost of living is seriously hurting vulnerable groups, such as those without fertile land or living in remote areas. Greater efforts are required to reduce the oil intensity of these economies and to turn back the clock and produce more food domestically.

- In the whole of developing Asia, accelerating inflation, moderating growth, and depreciating currencies call for a sober assessment of macroeconomic priorities for the short and medium term, and the design of a major reform agenda for the medium and long term.

- The immediate challenge is to rein in inflation pressures. Inflation in the region is largely homegrown and is explained by excessive aggregate demand fueled by years of accommodative monetary policy. For many countries, although international price shocks have added fuel to the fire, it was excessive aggregate demand growth that kindled the flames.

- Monetary authorities face a very difficult and complex environment. The external price shocks that first made themselves felt in 2003 have not been fully passed on to domestic consumers and producers in many countries. But there is no alternative to culling subsidies, in order to prevent major fiscal imbalances. Even if international commodity prices ease in the near term, the pass-through of higher prices will add to inflation pressures. Therefore, the general bias across the region toward monetary policy tightening is highly desirable.

- To restore economies to a higher growth path over the medium to long term, significant efficiency and productivity improvements are required to meet the challenge of the finiteness of resources, particularly land (and thus food) and fuel. The effective implementation of a reform agenda—one that focuses on consumers responding to market-oriented price signals and on producers improving efficiency and productivity—is imperative for countries to strengthen competitiveness, foster growth, and generate productive and decent job opportunities.

- The downside risks to developing Asia's growth prospects are now more apparent than in April. Global conditions are more volatile—the financial crisis has not yet fully run its course. High commodity prices and their increased volatility are likely to stay and geopolitical concerns are always in the background.

- Moderating growth and rising inflation in developing Asian countries require painful tradeoffs. Political realities in some countries make the decision process difficult. As a result, implementation of much-needed corrective policy measures may be delayed to the detriment of both the short- and medium-term outlooks.

Responding to commodity price shocks

- Elevated commodity prices and their pronounced volatility in international markets have been features of the first 8 months of 2008. Food and oil prices are closely interlinked. If high oil prices are here to stay, so are high food prices. This has important implications for developing Asia.

Oil: Prolonged period of high and volatile prices

- While oil prices have come down from their peaks of $147 per barrel in July 2008, they will stay high in the long run. Inflation-adjusted oil prices will remain well above $100 per barrel until about 2020, according to research commissioned by the Asian Development Bank.

- The price runup in oil has been driven mostly by the fundamentals of demand and supply. Surging global demand and the inability of global supply to keep pace have relentlessly generated upward price pressures.

- Limited surplus capacity has led to greater price volatility, amplifying the effects of even the smallest demand or supply shocks. Financial speculation may have compounded price spikes.

- In the future, global oil prices will continue to be determined by fundamentals. Global demand growth will be increasingly driven by demand from developing Asia and the Middle East. The growing appetite for transportation fuel will be of particular importance. On the supply side, the near-term peaking of output from oil producers who are not members of the Organization of the Petroleum Exporting Countries (OPEC), and constraints on the expansion of OPEC's output capacity in the medium term, will put severe strains on meeting incremental global oil demand.

- The tightening of the supply-demand balance will push up prices on a sustained basis, underpinning oil prices at above $100 a barrel. Failure by developing Asia to make painful but necessary adjustments today will lead to much larger costs tomorrow.

Oil price trajectory will have a macroeconomic impact

- The surge in oil prices has hardly touched the macroeconomic performance of developing Asia so far. However, the predicted long period of high and volatile oil prices is bound to affect prospects.

- Deterioration of terms of trade due to higher oil import costs will take a bite out of regional growth. Steeper transportation costs—from elevated fuel costs—will push up regional inflation. Higher shipping costs, too, may hurt export performance.

- Simulations point to the oil price shock crimping growth throughout the region in both the short and long run. However, this pullback will be limited, and insufficient to derail developing Asia's long-run growth momentum.

- These simulations also indicate that higher oil prices have a much bigger impact on developing Asia's inflation than on its growth, both short and long run. Therefore, taming inflation is the region's biggest macroeconomic challenge.

- The limited effect of the oil shock on growth suggests that the main cost of anti-inflation monetary tightening—slower growth—should be bearable.

Food prices to stay high

- The price of rice—the basic food staple for billions of Asians—has fallen from peak levels reached earlier this year yet remains more that twice as high as it was at the start of 2008. The surge in prices of rice and other staple foods reverses a decades-long decline in real prices.

- The causes of this runup are complex, but have four fundamental drivers. First, rapid economic growth in emerging economies, particularly the People's Republic of China and India, has put upward pressure on prices of a range of commodities, including food. Demand has simply outpaced supply. Second, a sustained decline in the dollar since 2004 has added to upward price pressure on dollar-denominated commodities—particularly on crude oil—and this has fueled a search for hedges against a weak dollar. Third, the combination of high oil prices and legislative mandates to raise production of biofuel substitutes for gasoline and diesel fuel has established a price link between feedstocks, such as corn and vegetable oils, and fuel prices. Fourth, to some degree at least, financial speculation arising from low interest rates has motivated commodity price changes.

- The price increases of the last year have some commodity-specific causes. Weather and disease problems reduced wheat supplies in 2007 in the face of mounting demand. Sharp incremental demand for corn as an ethanol feedstock helped explain the corn price rise, and the related shifts of cropland out of soybeans into corn partly explained the rise in prices of edible oils.

- The cause was different for rice. The price spike in 2008 was triggered by export bans in Viet Nam, India (the world's second- and third-largest rice exporters), and elsewhere that led to panic among buyers, consumers, traders, and farmers alike. This sudden withdrawal of supplies of rice in the thin international market drove prices spectacularly high.

- More basic underlying forces are at work and these must be addressed. Global stocks of grain have fallen sharply relative to demand, and stocks as a share of use are near historical lows. This destocking has taken place because the long-term trend to lower prices provided a disincentive to keeping large inventories of grain. Increased international trade between surplus and deficit countries allowed governments to maintain stable prices with low stocks.

- There has been an underlying trend for growth in demand to exceed that in supply, particularly for rice. (Over the past decade, population and income growth have far outpaced productivity growth as measured by rice yields per hectare.) This is a direct result of declining public investment in the infrastructure, institutions, and innovations that underpin agricultural productivity growth.

- Tightness in world market creates vulnerability to supply shocks. The world is just one supply shock away from another grain price spike. It will take several years of good harvests to rebuild stocks. To do this, the prices that farmers receive for their produce must stay high, particularly since input costs have risen with oil prices. Fertilizer prices, for example, have soared and transport and other fuel-related costs for farm machinery are also up.

- The world has seen a reversal of patterns, with declines in real food prices over the last three decades and the prospect of high food prices over the next decade or more. Asia must undertake structural reforms to adjust to a new environment of resource scarcity. Governments have to invest in public goods that support agricultural productivity growth and allow clear price signals to pass through to producers and consumers alike. Only a robust supply response by Asia's farmers can bring down prices to comfortable levels again.

Inflation in developing Asia: Demand-pull or cost-push?

- Contrary to popular belief, developing Asia's current inflation surge is largely homegrown. About 60% of regional consumer price inflation derives from two factors unrelated to external shocks, namely excess aggregate demand and inflation expectations. Years of lax monetary policies have bumped up aggregate demand and have led to widespread expectations of higher prices.

- External shocks such as surging global oil and food prices have played a less important role. This is partly because government subsidies and trade restrictions have limited the pass-through to domestic prices in many regional economies.

- These subsidies, though, are generally being reduced, largely because of their fiscally unsustainable costs in a world of high market prices. In addition, since the pass-through of external price shocks has so far been much greater for producer prices than for consumer prices, this points to increased pass-through to consumer prices in the coming months.

- Therefore, both falling subsidies and greater producer-to-consumer pass-through imply that cost-push inflation pressures are set to intensify in the near future.

- Since inflation is "largely homegrown," monetary tightening will remain a powerful tool for fighting inflation. The prospects of increased cost-push inflationary pressures in the near term reinforce the case for firmly anchoring inflation expectations preemptively and decisively.

- Yet monetary tightening is not without significant risks. In particular, the G3 slowdown will hit the region's export and growth performance. There is therefore a worry that monetary policy will reinforce a contraction even after demand had already begun to slacken. The risks should not, though, be exaggerated. The more urgent priority for monetary authorities is to contain inflation expectations.

- The region's growth prospects remain fundamentally sound, even after the G3 slowdown is factored in. Therefore, these risks do not diminish the broad policy message—that there has to be a reshifting of the basic monetary stance toward tightening throughout developing Asia.