Developing Asia: Riding out the global storm

Introduction

The global economy is in trying times. The financial crisis has spread and has severely affected even those countries with limited exposure to the problems of the United States (US) subprime market. Troubles in financial markets were exacerbated by the spike in oil and non-oil commodity prices. As a result, developing Asian economies are being caught between rising inflation pressures and weakening growth prospects.

Part 1 of this *Asian Development Outlook 2008 (ADO 2008) Update* provides an assessment of the outlook for the global economy and analyzes the impacts on developing Asia of global economic conditions. In the *Global outlook* section, the international economic conditions underlying the revised regional outlook in this *ADO 2008 Update* are discussed (Table 1.1.1). The performance of the G3 economies (US, eurozone, and Japan) in the first half of 2008 is reviewed and prospects for the next 2 years presented. A protracted slowdown in the G3 is now seen. An evaluation of the outlook for international commodity prices follows, providing a snapshot of the short-term prospects for oil and food prices. High global commodity prices are expected to prevail in the foreseeable future.

The section, *Impacts on developing Asia*, takes a look at the channels by which worsening global conditions are transmitted to the region. Slower growth in industrial countries is setting back developing Asia's export sector. The US subprime crisis has evolved into a general credit crunch that is threatening to curtail the region's access to finance. Elevated commodity prices are requiring some pass-through to domestic producer and consumer prices.

The final section, *Prospects for developing Asia*, summarizes the revised outlook for the region after considering the changed global growth and commodity price environment. Risks to this outlook are then identified.

Global outlook

In the first 3 months of 2008, the G3 economies held up surprisingly well. The US economy expanded at a quarter-on-quarter, seasonally adjusted

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1.1.1 Baseline assumptions for external conditions

	2006	2007	2008		2009	
	Actual	Actual	*ADO 2008*	*Update*	*ADO 2008*	*Update*
GDP growth (%)						
Industrial countries[a]	2.7	2.2	1.5	1.3	1.9	1.1
United States	2.8	2.0	1.5	1.3	2.0	1.0
Eurozone	2.8	2.6	1.6	1.4	2.0	1.4
Japan	2.4	2.1	1.5	1.0	1.5	1.0
Memorandum items						
US Federal funds rate (average, %)	5.0	5.1	2.8	2.3	2.9	2.0
EU refinancing rate (average, %)	2.8	3.8	3.6	4.1	3.8	4.3
Japan overnight call rate (average, %)	0.2	0.5	0.5	0.5	0.5	0.5
Brent crude spot prices (average, $ per barrel)	65.4	72.7	85.0	120.0	95.0	109.0
Nonfuel commodity prices (% increase)	29.1	17.0	0.2	20.0	-5.7	5.0
CPI inflation (OECD, average)	2.9	2.7	2.7	3.7	2.4	2.6
World trade volume (% increase)	9.2	6.8	7.0	4.8	7.7	5.0

[a] Growth rates for industrial countries are a GDP-weighted average for the US, eurozone, and Japan.

Sources: US Bureau of Economic Analysis, available: www.bea.gov; Eurostat, available: http://europa.eu.int; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp; World Bank, *Commodity Price Data* and *The Global Outlook in Summary*, available: www.worldbank.org; Organisation for Economic Co-operation and Development, *Main Economic Indicators* and *Economic Outlook*, available: www.oecd.org; International Monetary Fund, *World Economic Outlook*, available: www.imf.org; staff estimates.

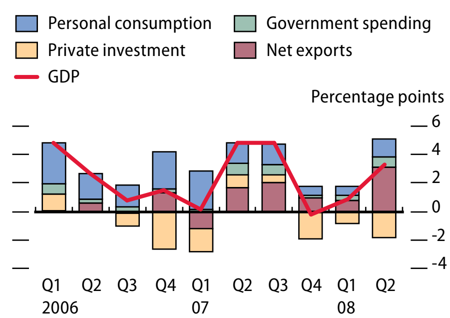
annualized rate (q-o-q, saar) of 0.9%. In both the eurozone and Japan, growth was sharply above expectations, at 2.6% and 2.8%, respectively (q-o-q, saar). However, these numbers appeared to be the calm before the storm. In the second quarter, the eurozone and Japanese economies contracted, and while growth in the US was much stronger than in the first, this was partly due to the impact of the tax rebates given to households, the effects of which are likely to have dissipated by the second half of the year.

United States

Growth in the first half was underpinned by personal spending on nondurable goods and services, net exports, and government consumption (Figure 1.1.1). Tax rebates amounting to $100 billion supported retail sales in May through June, but its one-off effect is likely to wane in the third and fourth quarters. Conversely, expenditures for durable goods declined in the first half, and housing investment contracted for the 10th straight quarter in April–June. Consumption prospects are shrouded with pessimism as confidence indicators continued to slide. In June, the Conference Board Consumer Confidence Index fell to its lowest reading since February 1992, and the University of Michigan Consumer Sentiment Index dropped to a 28-year low.

While some pickup in sentiment is evident going into the third quarter, prospects for the consumer remain fragile. Import demand for consumer manufactures remains weak (see the Annex to Part 1). At least until recently, the steady weakening of the US dollar had been a bane to US importers, but a boon to exporters. In the second quarter, the trade gap fell to its lowest level in 8 years, contributing 3.1 percentage points to

1.1.1 Contributions to GDP growth, United States



Source: US Department of Commerce, Bureau of Economic Analysis, available: www.bea.gov, downloaded 29 August 2008.

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growth. Without net exports, the economy would have barely expanded by 0.2% during the period.

The housing sector remains a major drag on the economy. Housing starts are still falling, foreclosures are mounting, and prices are still tumbling, indicating that the housing recession has not bottomed out (Figure 1.1.2). If previous housing cycles are any indication, the ongoing housing rout could extend for several more months. The worst housing recession in US history resulted in a 64.7% decline in housing starts from peak to trough; the current rate is 57.5%.

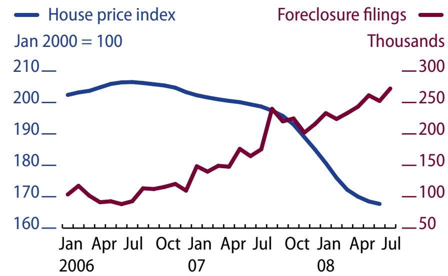
The housing crisis has hurt many financial institutions and dented confidence in financial markets. Many banks have suffered steep losses, and according to the Federal Deposit Insurance Corporation, 117 more banks and thrifts are considered in trouble, the largest number on record since mid-2003. Equity values have sharply fallen, both in terms of the Standard & Poor's composite index and of the financials index. This has eroded household wealth and limited the value of collateral that can be used for borrowing. Overall credit conditions have tightened, not only for housing loans but also for consumer loans. More stringent credit standards are making it difficult for households to refinance debt, which could lead to more defaults.

Job market conditions, too, remain weak. The unemployment rate is rising, hitting 6.1% in August. More than 600,000 jobs have been lost in the first 8 months of the year, and filings for initial unemployment benefits are mounting. Institute for Supply Management indexes show employment contracting in nonmanufacturing, but starting to pick up in manufacturing (Figure 1.1.3). However, more job cuts are expected as firms downsize in the wake of rising input costs and weak demand. These factors will put further pressure on consumer spending.

Business conditions are not too rosy either. Through May, the index of industrial production was slipping and capacity utilization was falling. Though gains were recorded in manufacturing in June and July, this was mainly due to the resumption of production following an end to a strike at automotive plants that had started in February. The only bright spot is the robustness of exports, but this too could suffer if input and transport costs continue to climb, and if the dollar maintains its recent strengthening.

Headline inflation is accelerating (Figure 1.1.4). In July, consumer prices increased by 5.6% compared with 2.4% the previous year, the highest recorded rate since January 1991. Median inflation expectations for the next 5 years are currently at 3.2% (though down from the 21-year high registered in May and June). The recent softening in gasoline and food prices has provided households with some respite, but with global food and oil prices anticipated to stay elevated in the medium term, household budgets will remain under pressure. Indeed, general pessimism over short-term economic conditions has restrained spending over the last few months, in spite of the tax rebates: households saved 4.9% of their incomes in May, 2.5% in June, and 1.2% in July, up from 0.2% in the first 4 months of the year. In addition, any embedding of higher inflation expectations would further imperil growth prospects. Since April, heightened inflation pressures, coupled with downside risks to growth, have compelled the Federal Reserve to keep the policy rate steady. For the rest of 2008, monetary authorities are projected to stay with this stance.

1.1.2 Housing market indicators, United States



Source: Standard & Poor's, Case-Shiller Home Price Indices, available: www.standardandpoors.com; RealtyTrac, available: www.realtytrac.com; both downloaded 1 September 2008.

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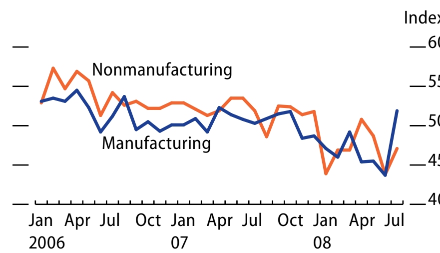
1.1.3 Institute for Supply Management employment indexes, United States



Note: A reading below 50 indicates a contraction.

Source: Datastream, downloaded 1 September 2008.

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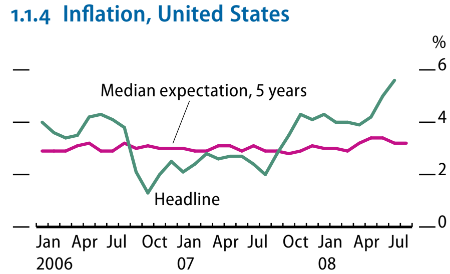
1.1.4 Inflation, United States



Source: Datastream, downloaded 2 September 2008.

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In the near term, the major threat to the US economy—emanating from the protracted housing and financial crisis, commodity price inflation, and consequent asset price declines—is the perpetuation of a downward spiral involving both the financial and real sectors. On the whole, however, the performance of the US economy will depend on how soon the credit crisis eases, and how well consumers and businesses adjust to high prices.

Eurozone

Investment spending and robust exports were the main growth contributors to the eurozone economy in the first quarter of 2008 (Figure 1.1.5). While performance surprised on the upside, it concealed a mixed picture of the health of the eurozone's economies. Germany was the engine of growth, expanding at a very healthy 5.2% (q-o-q, saar), driven by exports and corporate investment. However, many eurozone economies performed worse than the eurozone average, with the economies of Ireland and Portugal contracting.

With a high first quarter base, expectations were for a sharp slowdown in the second quarter. In fact, a 0.8% contraction was seen, reflecting shrinkage in the eurozone's three largest economies (France of 1.2%, Germany of 2.0%, and Italy of 1.1%). These economies were hit by the confluence of escalating commodity prices, the strong euro, and higher lending rates. Manufacturing activity also slowed and new orders declined as producer prices climbed. As a result, household spending, investment, and exports all declined in the April-June quarter, clipping economic growth by 1.9 percentage points.

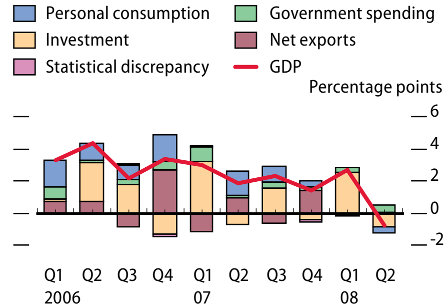
Destinations for eurozone exports are diversified, but the US remains a major market, accounting for about 13% of the total. This implies that deteriorating prospects for the US economy, beginning in the second half of 2008, could adversely affect its import demand and reflect a corresponding slippage in eurozone exports. Combined with a stronger euro, this would mean eurozone exports could face headwinds in world markets.

Business and consumer sentiment data are gloomy. The eurozone Economic Sentiment Index fell to a 5-year low in August, reflecting a general weakness in all confidence indicators, from consumption to construction, industry, retail trade, and services (Figure 1.1.6).

Spillover from the US housing crisis is taking its toll on the eurozone. European banks have disclosed nearly $230 billion in write-downs, yet concerns persist about the speed at which they remove "toxic debt" from their balance sheets. As credit conditions tighten, corporate and consumer debt defaults have started to rise. In addition, Ireland and Spain (plus the non-eurozone United Kingdom) have their own housing woes. All these developments suggest a moderation of growth going into the second half of 2008 and beyond.

Even with a strong euro, eurozone economies have not been spared the mounting costs of global oil and food. Inflation has breached the European Central Bank target of "close to, but below 2%" since September 2007 (Figure 1.1.7). By July, consumer price increases averaged 4.1% as inflation in major eurozone economies climbed: 5.3% in Spain (a 16-year high), 4.0% in France (a 17-year record), and 3.4% in Germany (the highest since December 1993). In August, inflation eased slightly as energy

1.1.5 Contributions to GDP growth, eurozone



Source: Eurostat, available: http://ec.europa.eu/eurostat, downloaded 4 September 2008.
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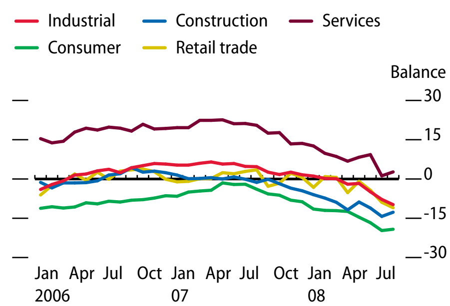
1.1.6 Confidence indicators, eurozone



Source: Datastream, downloaded 31 August 2008.
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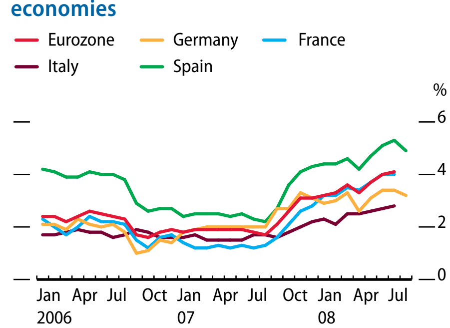
1.1.7 Inflation, eurozone and its major economies



Source: Datastream, downloaded 1 September 2008.
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prices moderated. But if current exchange rate trends continue (and the euro does not substantially appreciate), the pass-through of high global commodity prices is set to continue through the second half.

Labor market conditions have remained generally firm, with the unemployment rate stable at about 7.2–7.3% since September 2007, well below the near-9% rates seen during an extended period in 2004 and 2005 (Figure 1.1.8). However, job market conditions risk worsening if mounting prices squeeze profits and if firms begin cutting jobs. So far, wages have been steadily rising, and this could further exacerbate price pressures.

Inflation concerns prompted the European Central Bank to raise its refinancing rate by 25 basis points in July, despite its worries about slowing growth. Rising inflation has hit real incomes, damping consumer sentiment, and slowing retail sales. As higher prices persist, consumers are likely to restrain their spending. Trade prospects are not positive either, partly because slower growth in the eurozone's top two export markets, the United Kingdom and the US, is expected to continue to limit exports.

With accelerating inflation, monetary authorities are constrained from implementing accommodative measures to reignite growth. Although the average fiscal deficit in the eurozone is projected to stay at about 1% of GDP in 2008, variations among members are seen. France and Italy could lift growth by providing a stimulus package but are constrained by the 3% deficit limit under the Stability and Growth Pact. Germany can afford a fiscal boost, but has not reached a political consensus to give one. Apart from the €20 billion stimulus plan approved in Spain, no other fiscal stimulus seems imminent in the rest of the major eurozone economies.

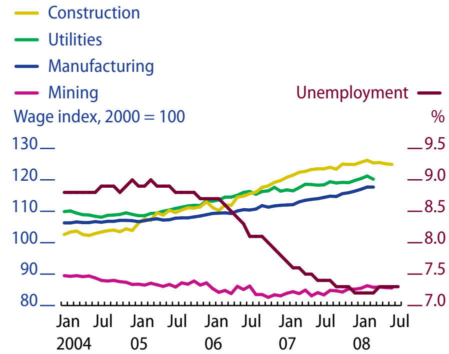
Japan

The profile of economic performance in Japan in the first 6 months of 2008 was similar to the eurozone's, with strong first-quarter growth but contraction in the second. The positive contribution of exports and household spending to growth in the first quarter was largely reversed in the subsequent quarter (Figure 1.1.9). Japanese exports slowed not only to the US, but also to other major markets. In addition, rising consumer prices held back private spending. The slight lift provided by housing investment early in the year was not sustained. Business investment also declined in the first two quarters.

Exports maintained an expansionary, though slowing, pace in April and May, supported by a weakening yen (Figure 1.1.10). However, June exports unexpectedly fell by 1.8% despite the depreciation of the local currency in both nominal and trade-weighted terms. This indicates that Japanese exports were feeling the impact of the global slowdown. In July though, exports rebounded as the People's Republic of China (PRC) overtook the US as Japan's largest market. However, that month's growth of 8.0% was still lower than the 11.7% registered in the same period of 2007. Shipments to the US declined for the 11th straight month, while those to Europe and the rest of Asia recovered. Meanwhile, import growth surged by 18.2%, trimming the trade surplus to Y85.5 billion. If exports continue to slow, their contribution to second half growth could ease further.

Japan is suffering from a rapid worsening of its terms of trade, paying much more for its imports than what it gets from its exports (Figure 1.1.11).

1.1.8 Labor market indicators, eurozone



Source: Datastream, downloaded 2 September 2008.
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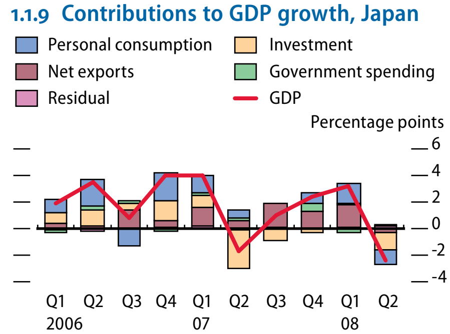
1.1.9 Contributions to GDP growth, Japan



Source: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp, downloaded 12 September 2008.
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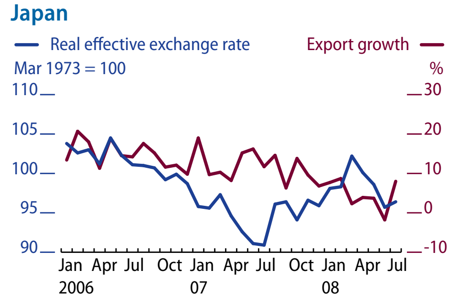
1.1.10 Exchange rate and export growth, Japan



Source: Datastream, downloaded 1 September 2008.
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In the first 7 months of 2008, export prices decreased by 5.2% while import prices rose by 12.6%. Rising import costs are taking a toll on firms, pinching corporate profits. In the first half of 2008, profits fell by 11.4%, and expectations are for the profit slump to endure. This is likely to hurt capital spending in the coming quarters. With higher costs eroding profits, firms are increasingly reluctant to hire. The unemployment rate thus climbed to 4.0% in April and remained at about that rate until July.

General pessimism over short-run business conditions prevails. Machinery orders registered a contraction in June, and manufacturing production remains wobbly. In addition, results of the Tankan survey (of large manufacturers) in the second quarter showed largely deteriorating sentiment. The index of business conditions (also for large manufacturers) fell for the third straight quarter, and that for nonmanufacturing industries dropped for the fourth successive quarterly period. Wholesale prices increased to a 27-year high of 7.1% in July. As businesses are unable to pass on rising costs to consumers, production is expected to shift down a gear.

Similarly, consumption spending may not hold up in the coming months, because confidence in the economy is flagging, with the national consumer confidence index slumping by 29.3% and the Tokyo consumer confidence index by 26.5% in July. These falls are largely related to price increases: national headline inflation hit a nearly 11-year high of 2.3% in July as fuel and food prices mounted. Household spending had been declining since March (Figure 1.1.12). And as wage growth fell to 0.5% in June, real wages are dropping significantly against the rising consumer prices, in turn hurting retail sales. Falling equity prices are also taking a toll on firms and consumers. From its end-2007 value, the Nikkei 225 index declined by 14.6% by end-August amid concerns about declining corporate profitability. This is likely to limit firms' funding sources and take more money out of consumers' pockets, further clipping domestic spending in the near term.

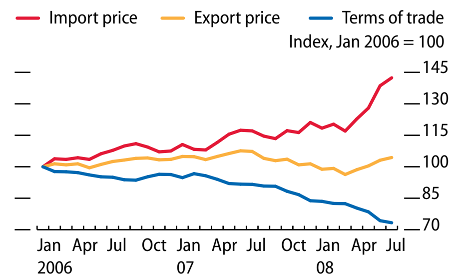
Against this gloomy backdrop, on 29 August the authorities unveiled an Y11.7 trillion economic stimulus package that is set to help consumers and firms cope with high oil and food prices. The package includes tax cuts for low-income families and loan guarantees for small and medium companies. Despite its scale, analysts have generally been wary about the actual impact of the package in boosting the economy.

Japan's growth outlook remains fragile, as concerns about the global slowdown, as well as high oil and food prices, crimp prospects. Inflation is expected to remain elevated for the rest of the year, and this could keep a lid on spending. Trade growth is projected to slow. These downside risks to growth are set to persist through 2008 and are likely to overshadow inflation concerns. Consequently, no monetary tightening by the Bank of Japan over the rest of this year is expected. This accommodative policy stance is projected to be maintained through 2009, keeping the overnight call rate at 0.5%.

Commodity prices

A prolonged boom in the world economy has fueled an extended expansion in global demand for oil and non-oil commodities. As economies prospered, they underpinned an upward shift in demand for all types of commodities, but one that was unmatched by an appropriate

1.1.11 Terms of trade, Japan



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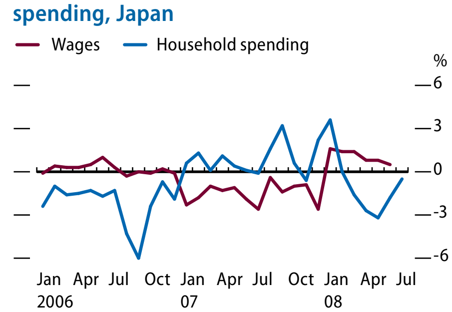
1.1.12 Growth in wages and household spending, Japan



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shift in supply. As a result, price pressures for food, oil, and other primary commodities began to intensify between 2003 and early 2007. However, the continued high-growth and low-headline-inflation environment deluded firms and households into ignoring the price signals. The prevalent view was that such pressures would eventually dissipate, which in turn encouraged them not to adjust their behavior, and demand persistently outpaced supply.

Over time, the gap between the demand for, and the long-run supply capacity of, commodities grew tighter and the slightest shock was amplified into large market disequilibrium and volatility (Figure 1.1.13). Between the fourth quarter of 2007 and the first 7 months of 2008, commodity prices scaled new heights. Volatilities increased in the price of oil, but even more so in food prices.

Food

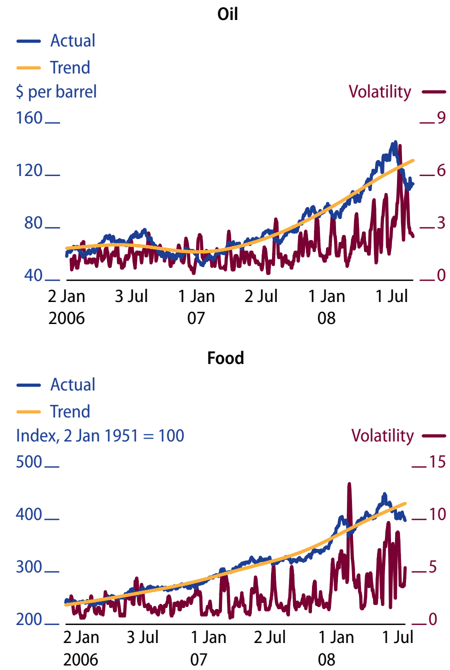
Food prices had been declining in real terms for nearly five decades (barring the food crisis in the 1970s produced by the first oil shock). However, after 2000 food prices began to stabilize and then to gradually rise. Demand was outstripping supply as income and population growth overtook growth in farm productivity. By 2006, expectations of higher prices had taken hold as the appetite for all commodities increased with the acceleration of world economic growth and the emergence of large developing countries, particularly in Asia. Four general drivers responsible for the runup in food prices between the third quarter of 2007 and mid-2008 may be identified: oil prices; movements in the US dollar; mandates for biofuel production; and financial speculation (see the chapter, *Causes of high food prices*, in Part 2).

Oil prices carry a large influence on the direction of food prices, since the price of oil has direct and indirect impacts on production costs. For one, food prices are dependent on input prices, a large part of which is fertilizer. Its feedstock comes from natural gas, whose prices move in tandem with oil prices. Second, agricultural machinery and equipment are powered by diesel fuel, an oil product. Finally, oil prices determine transportation costs, which affect the final price of food products. Oil price adjustments thus ripple through to food prices by way of these channels.

Movements in the US dollar affect food prices as well (Figure 1.1.14). Many globally traded food commodities are priced in US dollars, and so expectations about the value of the US dollar against the euro and other major currencies affect the demand for food commodities, which in turn are reflected in food prices. In the first half of 2008, for instance, the weakening of the US dollar relative to the euro rendered the euro price of commodities lower, making it more attractive for end users paying in euros to increase their demand, bidding up the dollar price of commodities in the process.

Mandates for biofuel production have also caused variations in certain food prices. The corn-based ethanol subsidy program in the US partly accounted for the runup in corn prices since mid-2007. Similarly, the oilseeds-based biodiesel program in the European Union (EU) (beginning in 2001) and in the US (starting in 2004) helped raise oilseed prices. Incentives for biofuel production have thus encouraged farmers around the globe to shift land use away from food production and

1.1.13 Commodity prices and their volatility



Notes: Volatility is defined as the 10-day standard deviation of the differences between actual and trend prices. Food prices are represented by the Commodity Research Bureau foodstuffs spot price index. Oil prices are represented by the Brent crude benchmark.

Source: Datastream, downloaded 1 September 2008.

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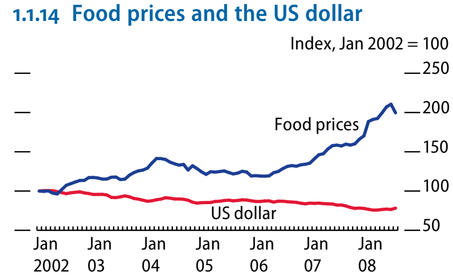
1.1.14 Food prices and the US dollar



Notes: Food prices are represented by the Commodity Research Bureau foodstuffs spot price index. The US dollar is valued at its real effective exchange rate.

Sources: Board of Governors of the Federal Reserve System, available: www.federalreserve.gov; Datastream; both downloaded 2 September 2008.

Click here for figure data

into corn and oilseeds. These biofuel mandates feed the complex inter-commodity linkages running from oil to corn to soybeans to vegetable oils (including palm oil in Asia).

Financial speculation has also motivated commodity price changes to some degree. Low interest rates and the subprime crisis in the US have induced investors to search for other asset classes with higher returns. This has increased the number of players placing bets on commodities. The impact of financial speculation on food prices is similar to that of hedging against the expected movements of the US dollar. The linkages among commodity futures markets, financial markets, and commodity spot markets are not well defined but are likely to help explain the increased volatility in spot prices in recent months.

Besides the general drivers of food prices, factors such as weather and disease, stock levels, political decisions, and hoarding are specific to certain crops and help explain the recent episode of high prices. Last year's drought in Australia, for instance, was partly responsible for limited wheat supplies that contributed to a price spike early this year. In the same vein, the turnaround in Australia's production reversed the uptick in wheat prices after early April.

Stocks of rice, wheat, and corn have been declining since 1999, providing a limited cushion to supply and demand fluctuations (Figure 1.1.15). As a result, small movements in the supply–demand equation translate into large price adjustments for these commodities. This is a major reason why the disruption in Australian wheat supplies last year generated a significant price response in the global market.

Political decisions have also been determinants of recent food price hikes. The increase in international rice and wheat prices, for example, elicited protectionist responses from exporters and anxious responses from importers. As rice prices gradually became elevated, major rice exporters such as Cambodia, PRC, India, and Viet Nam restricted or even banned exports, further limiting already low global supplies. At the same time, the world's largest rice importer, the Philippines, decided to increase its rice stockpile, paying premium prices for whatever supplies it could get in the world market. The combination of these political decisions further tightened supplies in the market and set off a panic among importing countries and traders and contributed to a period of very high rice prices.

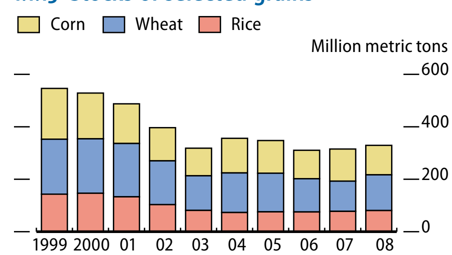
Rising food prices in domestic markets in turn drew a similar panic reaction among consumers, triggering a certain degree of hoarding. As domestic rice prices climbed, all types of consumers—households, farmers, traders, rice millers—bought more to guard against future price increases. The cumulative impact of this jolt in demand provided a trigger for higher rice prices in the global market.

In summary, the recent runup in food prices cannot be explained by a single factor, but rather by the confluence of general and specific factors.

Oil

Oil prices have been steadily rising since 2003. The main difference between the current price runup and previous steep price elevations is the source of the shock (Figure 1.1.16). The price increases of 1973–74 and 1979–80 were caused by supply disruptions that triggered rapid price surges. The higher prices swiftly reduced demand and restored balance in

1.1.15 Stocks of selected grains



Source: Foreign Agricultural Service, United States Department of Agriculture, available: www.fas.usda.gov, downloaded 1 September 2008.

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the market. The current episode is a positive demand shock from strong growth in developing countries' demand for oil. Robust global economic growth has also bolstered demand. Demand consistently outpaced supply in the last few years, forcing prices higher and higher. The tight supply–demand balance has left little surplus capacity to cushion the impact of supply and demand shocks. As a result, prices have not only increased but have also become more volatile.

Apart from the fundamentals of supply and demand, nonfundamental factors such as financial speculation, US dollar depreciation, and fuel subsidies have contributed to the price surge. The impact of the first two factors is similar to their impact on food prices. For the third, government policies that subsidize retail fuel prices have shielded consumers from rising prices, and thus weakened consumers' incentives to adjust their behavior. Yet these nonfundamentals have played only a supporting role to that of supply and demand fundamentals, and it is these that explain the bulk of the post-2003 oil price surge.

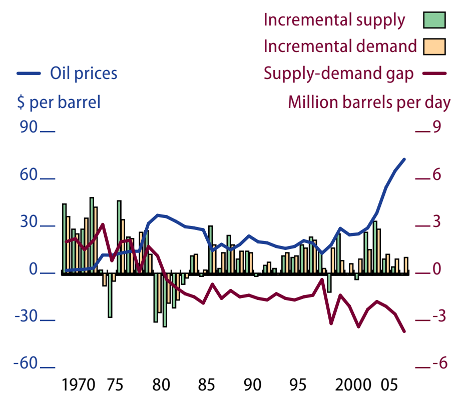
The future course of oil prices will be ultimately determined by the future drivers of demand and supply (see the chapter, *Are high oil prices here to stay?*, in Part 2). The most powerful demand driver will continue to be developing countries' large and growing appetite for oil. In particular, the demand for transportation fuels in the developing world is set to take off because of explosive growth in ownership of motor vehicles. There are no commercially viable substitutes for gasoline and diesel, which implies continued robust growth for oil demand. Another related key demand driver is global economic growth. Historically, a 1% increase in world growth corresponds to a 0.5% increase in oil demand. But the ongoing phaseout of fuel subsidies, improvements in oil efficiency, and use of alternative fuels will help reduce the demand for oil.

In terms of future supply, output by non-Organization of the Petroleum Exporting Countries (non-OPEC) is expected to surge in the next 2 years. Thereafter, however, non-OPEC production is likely to enter an extended period of gradual decline. Growing global demand and stagnant non-OPEC output puts the burden of satisfying incremental global demand squarely on the shoulders of OPEC. However, several factors suggest that adequate investment in new production capacity will not be made.

For one, resource nationalism is limiting the access of large international oil companies to the vast hydrocarbon potential of the OPEC countries. This matters because these companies usually have the most capacity, in terms of capital, technology, and know-how to seek and exploit new oil reserves. Government-owned national oil companies, which have largely displaced international companies as the main producers in OPEC countries, are less willing to make the investments that will see output capacity keeping up with robust global demand growth.

This interplay of future demand and supply drivers suggests that the oil market will remain tight in the foreseeable future. The fundamental driver of this tight supply-demand balance is strong global demand growth, especially from developing countries, and the failure of global supply to keep up—that is, a continuation of the same pressures that have characterized the oil market since 2003. These pressures are expected

1.1.16 Oil market indicators



Source: BP *Statistical Review of World Energy*, June 2008, available: www.bp.com, downloaded 1 September 2008.

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to keep inflation-adjusted oil prices at above $100 per barrel until 2020, along with pronounced price volatility.

These higher and more volatile prices represent an external shock to Asia that is largely beyond the region's control. What is well within its control is how it adjusts to the shock and manages the fallout, and appropriate government policies can facilitate the necessary regional adjustment. Such policies should give priority to promoting more efficient oil use, limiting short-run supply disruptions, and encouraging price transparency.

Impacts on developing Asia

One key message brought across by *ADO 2008* (ADB 2008) is that the region of developing Asia remains heavily reliant on the G3 economies for its major export markets and has *not* uncoupled from industrial countries' business cycles. That uncoupling is a myth is confirmed in the discussion that follows on Asia's trade and financial sectors in the first half of 2008.

Manufactured exports

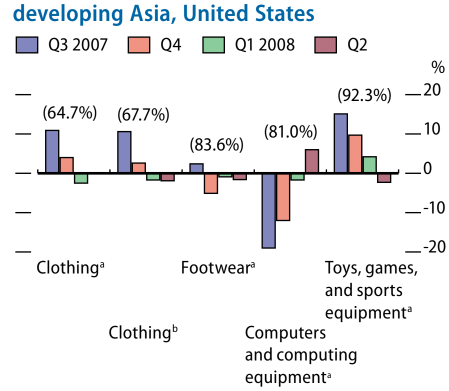
A sharp slowdown in the G3 economies is under way. Price pressures are now expected to be felt for longer than forecast in April, and this has constrained the authorities' use of an easing in monetary policy to provide a fillip to slowing growth. The probability that the global downturn will be long and drawn out has therefore increased, implying that demand for Asian exports is likely to be sluggish for longer than expected in April. Evidence for imports from the US, EU, and Japan for the first half of 2008 confirms this (see the Annex to Part 1).

Developing Asian manufacturers supply about two thirds of clothing imports to the US, with the PRC as the leading supplier. Since 2007, however, US demand for imported clothing, both in value and volume terms, has been on a downtrend (Figure 1.1.17). This cutback is hitting Asian manufacturers hard, and exports from the region contracted in the first half of 2008. A similar, though more pronounced, downturn is evident for footwear. US shipments of footwear have been shrinking since the fourth quarter of 2007. With manufacturers in developing Asia accounting for close to 85% of the US market for imported footwear, slower US demand is translating to weaker regional exports.

Apart from clothing and footwear, developing Asia is also a significant supplier of US imports of toys, games, and sports equipment. Quarterly data suggest that the market for these items seems to be lagging the clothing and footwear markets. While a downturn in the sector is likewise apparent, a contraction appeared only in the second quarter of 2008. As the region almost completely supplies the US import market for these goods, a prolonged weakening of demand could adversely affect developing Asian manufacturers. In contrast, the market for computers and computing equipment has shown some recovery, with growth in imports turning positive in the second quarter. However, this could just be a temporary blip reflecting the impact of the tax rebates in the US, and could well dissipate in the second half.

Japan's imports from developing Asia are weakening as well

1.1.17 Growth in selected imports from developing Asia, United States



[a] $, value. [b] Square meters, volume.

Notes: Figures in parentheses indicate developing Asia's market share in the United States import market in 2008 for the indicated product. Developing Asia comprises the Association of Southeast Asian Nations, People's Republic of China, and South Asian Association for Regional Cooperation.

Sources: United States International Trade Commission Dataweb, available: dataweb.usitc.gov; United States Office of Textiles and Apparel Dataweb, available: http://otexa.ita.doc.gov; both downloaded 28 August 2008.

Click here for figure data

(Figure 1.1.18). All regional suppliers of Japan's clothing imports have been adversely affected by the declining value of its purchases. Japanese footwear imports also deteriorated, with supplies from Cambodia and the PRC falling sharply. In terms of computers and computing equipment, the downturn is more severe, with imports from the PRC and Southeast Asia falling by over 25% in 2007 and 5% in the first half of 2008.

Growth of EU clothing import volumes sharply decelerated in the first 5 months of 2008, but unlike Japan and the US, there was still some growth (Figure 1.1.19). In value terms, however, clothing shipments to the EU were almost stagnant. This implies a decline in unit values, which is reflective of the strengthening of the euro against major currencies during the period. Footwear imports to the EU are also showing signs of weakening, dropping by about 2.6% from January through May 2008. Most regional suppliers have been adversely affected by a fall in demand for their footwear exports. In terms of computers and computing equipment, growth in EU imports is still sluggish but less so in the first 5 months of 2008 compared with 2007. PRC suppliers recovered somewhat, but Southeast Asian suppliers are still feeling the pain of weaker EU import demand.

In summary, general declines are recorded in G3 imports of clothing and footwear, for which developing Asian countries are the dominant suppliers for retailers in the US, EU, and Japan. For computers and computing equipment, there are some trend variations. Overall, the key message of this section is that as the G3 continues to weaken, developing Asia will face bleaker prospects for its manufactured exports. Slower growth in the G3 and spillovers of the global slowdown into emerging economies will limit the increase in the volume of world trade to about 4.8% this year from 6.8% in 2007. This suggests that prospects for trade *within* developing Asia could deteriorate: as final demand for the region's exports diminishes, so too will intraregional trade in intermediate parts and components.

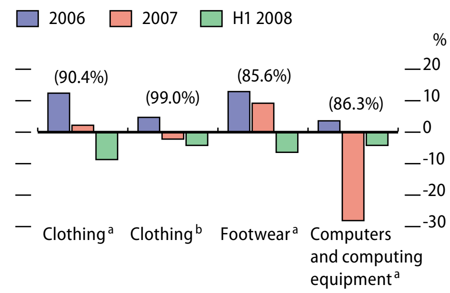
A welcome fillip to world trade could have been grasped in July of 2008 in the form of a World Trade Organization Doha Round Agreement. Sadly, however, ministers were unable to do this (Box 1.1.1). A resumption of negotiations is unlikely in the next couple of years.

Financial stability

The contagious effect on developing Asia of the still-unfolding US subprime crisis has largely been indirect so far. More precisely, the G3 economic slowdown precipitated by the crisis has sharply curtailed the G3's imports of Asian goods, denting the overall economic performance of a highly export-dependent region (see *Manufactured exports* above). While the indirect trade channel has been the predominant transmission of contagion, the direct financial channel should not be ignored. After all, the Asian crisis of 1997–98 was essentially a financial crisis that stemmed from structural weaknesses in the region's financial systems. Furthermore, despite impressive progress since the crisis, the depth, breadth, and sophistication of Asia's financial markets continue to trail those in the G3. The risks of a second Asian crisis have abated, but not disappeared.

The overall impact of the subprime crisis on Asia's financial stability has been relatively limited to date. (See Lee and Park 2008 for a more

1.1.18 Growth in selected imports from developing Asia, Japan



a ¥, value. b Kilograms, volume.

Notes: Figures in parentheses indicate developing Asia's market share in Japan's import market in 2008 for the indicated product. Developing Asia comprises the Association of Southeast Asian Nations, People's Republic of China, and South Asian Association for Regional Cooperation.

Source: Japan Customs, Ministry of Finance, available: www.customs.go.jp, downloaded 19 August 2008.

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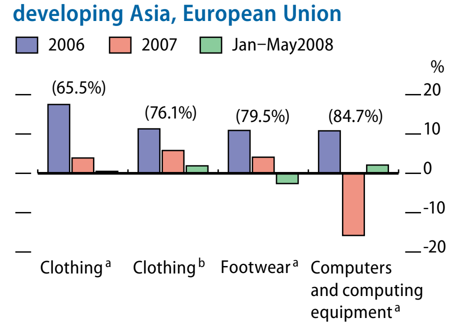
1.1.19 Growth in selected imports from developing Asia, European Union



a €, value. b Kilograms, volume.

Notes: Figures in parentheses indicate developing Asia's market share in the European Union's import market in 2008 for the indicated product. Developing Asia comprises the Association of Southeast Asian Nations, People's Republic of China, and South Asian Association for Regional Cooperation.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 18 August 2008.

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1.1.1 Collapse of Doha Round negotiations: Should anyone care?

A marathon of trade negotiations ran on in late July in Geneva at the World Trade Organization (WTO) as ministers sought to reach an agreement. Instead, they failed, leaving in limbo an agreement on lowering tariffs for agricultural and nonagricultural products, on providing greater access for internationally traded services, on strengthening intellectual property protection, and on streamlining customs procedures around the globe.

The issue on which the negotiations came to an impasse is the seemingly innocuous one of the special safeguard mechanism in agriculture, by which developing countries are allowed to impose temporary duties on farm products during a surge of low-priced imports in order to protect the livelihoods of farmers. In the current context of high international food prices, it is paradoxical that fear of low-cost imports would forestall an agreement.

The other irony is that ministers from major food-exporting countries, chiefly the United States and India, could not agree on the terms and conditions for the special safeguard mechanism, even though safeguards have always been an integral part of the framework of international trade law.

Should anyone care? Opinions sharply diverge among economists and officials handling the negotiations. Brazil's trade minister lamented the collapse and made vigorous efforts to try to revive the negotiations. The Director-General of WTO, Pascal Lamy, insisted that with this round of negotiations " … what we have on the table is at least two or three times greater than from any previous round of negotiations." The Doha Round was meant to be a development agenda that would lift many millions of rural poor out of poverty in Asia, Africa, and Latin America by reducing rich-country farm subsidies and high agricultural tariffs.

Dani Rodrik, a leading academic economist, argues the Doha Round was never a development round and that it would be at best a mixed blessing for the poor. The subsidy cuts in the rich countries would mainly redistribute income to rich consumers and taxpayers there. The poor in the developing world would be left with paltry gains from reduced tariffs in commodities like sugar and cotton but might suffer from reduced rich-country export supplies of food that could drive up domestic food prices for imported staples.

Antiglobalization groups have also applauded the collapse of the Doha Round as, in their view, it would lead more poor African farmers to be dependent on foreign markets for cash crops, when the poor need more and cheaper food. Others objected to the cuts in tariffs that would erode the preferential treatment that some least-developed and developing countries are granted under the Generalized System of Preferences and other unilateral preference programs such as "Everything But Arms" of the European Union.

Most trade economists disagree with these extreme views of huge benefits or outright losses to the developing world from the round's successful conclusion. However, the timing of the collapse in the midst of a global slowdown that is slashing growth in the volume of international trade is unfortunate. Something overlooked in the heated agricultural negotiations is the nonagricultural market access (NAMA) gains that were left at the negotiating table. These gains may not have been a huge feast but they would at least have been a hearty lunch for manufacturers in the developing world.

Impact of the formula for reducing bound tariff rates in the package proposed by the nonagricultural market access negotiating group

Product groups	Final bound duties		Applying the "package" formula[a]	
	Average	Maximum	Average	Maximum
Australia				
Textiles	18.30	55.00	5.57	6.98
Clothing	41.10	55.00	6.70	6.98
Leather, footwear, etc.	14.40	55.00	5.14	6.98
Canada				
Textiles	10.60	18.00	4.56	5.54
Clothing	17.20	18.00	5.46	5.54
Leather, footwear, etc.	7.60	20.00	3.90	5.71
European Union				
Textiles	6.50	12.00	3.59	4.80
Clothing	11.50	12.00	4.72	4.80
Leather, footwear, etc.	4.20	17.00	2.75	5.44
Japan				
Textiles	5.40	25.00	3.22	6.06
Clothing	9.20	13.00	4.28	4.95
Leather, footwear, etc.	17.70	724.00	5.51	7.91
United States				
Textiles	7.70	34.00	3.92	6.48
Clothing	11.40	32.00	4.70	6.40
Leather, footwear, etc.	4.60	55.00	2.92	6.98

[a] To current average and maximum tariffs in manufacturing sectors of export interest to developing Asia in selected industrial countries.

Note: The formula used to calculate the new average (AVG) and maximum (MAX) bound tariffs is:

$t_1 = (a \times t_0) / (a + t_0)$, where t_0 is the previous bound tariff rate; a is the coefficient for developed Members ($a = 8$); t_1 is the final bound tariff rate.

Sources: World Trade Organization Secretariat, "Market Access for Non-Agricultural Products" Report by the Chairman, Ambassador Don Stephenson to the Trade Negotiations Committee, Negotiating Group on Market Access, JOB(08)/96, 12 August 2008; World Trade Organization, International Trade Center UNCTAD/WTO 2007, "World Tariff Profiles 2006," WTO Secretariat, Geneva, Switzerland.

1.1.1 Collapse of Doha Round negotiations: Should anyone care? *(continued)*

Implementing the formula adopted by the NAMA negotiating group of WTO would have had the favorable feature of cutting down to size the peak tariffs that are still blocking market access to Asian exporters in the industrial economies (Box table). For example, adopting the formula would have cut maximum tariffs to a fraction of existing levels in key sectors of export interest to developing Asia. This would also have slashed average bound tariffs while reducing the variance of tariffs across these key industries.

These tariff cuts would indeed have had the effect of reducing preferences in the Generalized System of Preferences and Everything But Arms programs—but these programs cover only a tiny fraction of exports from developing countries. And cutting down the tariff peaks would have had the salutary effect of sharply eroding the discriminatory preferential treatment under bilateral free trade agreements. The gains for Asia from the NAMA could have been substantial.

The commercial interests that underlie international trade negotiations are real and substantial. No model exists that can calculate the gains that would arise from the combination of lower tariffs and more open services or from better disciplines than such trade-destroying practices as antidumping and convoluted rules of origin. The political task of explaining that failure also has—likely significant—costs is something that has been badly neglected, particularly by leaders in Washington, Brussels, and Tokyo. A lurch toward protectionism is one cost the world cannot at present afford.

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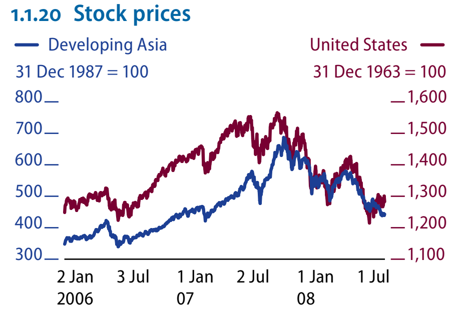
comprehensive analysis.) This is because Asia's commercial banks, which continue to play a dominant role in Asian financial systems despite the rapid development of capital markets, had limited direct exposure to subprime mortgages and structured credit products. The improvement in the financial health of Asian banks since the Asian crisis is evident in the current ratio of nonperforming loans, capital-adequacy ratios, rates of return, and other key indicators. In short, the limited magnitude of the shock and a stronger capacity to withstand adverse shocks has enabled Asian banks to weather the financial turbulence emanating from the subprime crisis.

The two areas of Asian financial systems where the subprime crisis has had some impact are equity markets and offshore bond markets. Share prices have suffered heavy losses since the fourth quarter of 2007 (Figure 1.1.20), driven largely by mounting concerns over the deteriorating global economic outlook and its impact on Asia. The loss of investor confidence in Asian equity markets closely mirrors that of the US, and the two markets have moved in tandem since the second half of 2007. The risk premium on dollar-denominated offshore bonds of Asian issuers has risen sharply since the outbreak of the subprime crisis (Figure 1.1.21). The deterioration of investor confidence in the offshore bond market has been especially evident for Pakistan. Not surprisingly, the widening of credit spreads has curtailed the issue of new bonds from the region. Such tightening of financing conditions has not yet spilled over into local currency bond markets.

In the near future, the impact of the subprime crisis on Asia's financial stability is likely to be limited. The same factors that have so

1.1.20 Stock prices



Note: The developing Asian index is represented by the Morgan Stanley Capital International All Country Asia excluding Japan price index; the US index is represented by the Standard & Poor's 500 Composite price index.

Source: Datastream, downloaded 2 September 2008.

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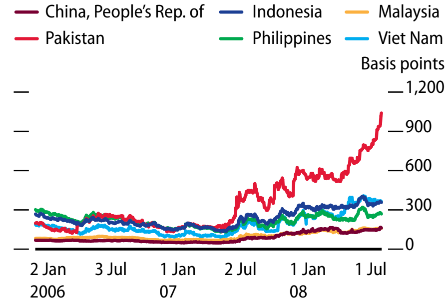
1.1.21 Credit spreads



Note: Data refer to JPMorgan Emerging Markets Bond Index sovereign stripped spreads.

Source: Datastream, downloaded 2 September 2008.

Click here for figure data

far shielded the region will continue to do so. More precisely, the relative good health of the region's financial systems will combine with their limited direct exposure to subprime mortgages to subdue the impact of the crisis. The one variable that could upset this optimistic assessment is the future course of the US subprime crisis. It is far from clear whether the crisis has run its full course, as evidenced by the continuous stream of bad news. For example, there is huge uncertainty about the economic and financial repercussions of the US Government placing Fannie Mae and Freddie Mac (which jointly hold or guarantee half of all US mortgage debt) in a government-run conservatorship. Bond holders, including many central banks, should not, though, suffer because of the more explicit guarantee on these obligations made by the Treasury when it announced the action on 7 September. If the subprime crisis worsens significantly, Asia is bound to suffer much more serious financial effects, including an abrupt reversal of the capital inflows that have held up well so far.

In terms of policy implications, it is critical for Asian governments not to draw the wrong lessons from the limited financial effects of the subprime crisis. It is true that the structural improvement of Asian financial systems since the Asian crisis has helped protect the region. Yet it is equally true that Asia was in some sense fortunate in that its banks had largely avoided exposure to subprime mortgages—clearly, any shock would have been far greater had exposure levels been substantially higher.

The more relevant general lesson for Asia is that even financially advanced economies such as the US are susceptible to financial crises arising from imprudent lending and unsound policies. This gives Asian countries greater reason to further buttress the post-Asian crisis structural reforms that have significantly strengthened their financial systems. A more specific lesson for Asian lenders, which have only recently begun to shift from financing companies to financing households, is that they will have to be more alert to the risks of mortgage lending.

Domestic prices and monetary policy

The degree to which the most recent hikes in global oil and food prices are transmitted to domestic producer and consumer prices in developing Asia is extremely varied. The rates of increase in these prices have generally outpaced the increase in domestic inflation. Nevertheless, international oil price increases are more easily passed on to domestic prices than global food price rises. Across the region, there is a common view that the latest runup in inflation is predominantly explained by such international factors. As a result, domestic monetary policy is seen as having a limited role to play in containing current inflation pressures.

In the first 8 months of 2008, global oil prices have risen by over 70%. While many countries in developing Asia have raised prices for products such as gasoline and diesel, local retail prices for kerosene have remained below international benchmark prices. With kerosene being heavily used by poor households, governments across the region have largely been subsidizing domestic kerosene prices. However, the rapid pace at which international oil prices escalated in recent months left many governments with little choice but to pass on rising costs to consumers and producers. As diesel prices in world markets climbed and overtook gasoline

prices, the option of cross-subsidization between gasoline and diesel quickly faded (Figure 1.1.22). Increases in diesel prices in the region thus largely outpaced gasoline price hikes. Overall, pump prices of gasoline and diesel in developing Asia have become more closely in line with international benchmark prices (see the chapter, *Are high oil prices here to stay?,* in Part 2).

Until last year, high oil prices had limited adverse effects on developing Asia's growth (see the section, *Macroeconomic effects of high oil prices*, in Part 2). The region even marked its strongest expansion in nearly two decades in 2007. However, the steep rise in international oil prices in recent months is expected to reduce regional incomes by raising overall production costs. Rising costs of imported inputs and of transportation will clip profitability and could affect employment and consumer spending. This will put a dent on regional growth and hasten inflation.

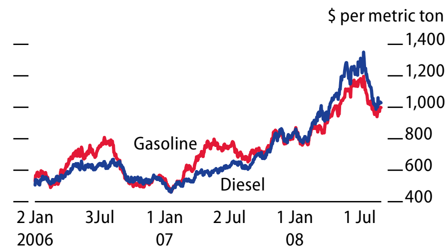
The transmission to domestic prices of higher international oil prices varies across countries. In most Southeast and East Asian economies, the process of adjustment has been faster and broader. In the Republic of Korea, Philippines, Singapore, and Thailand, domestic oil prices are deregulated and determined by market forces. Rising international oil prices are thus usually reflected fairly quickly in climbing domestic fuel prices. In contrast, fuel prices in the PRC and in many South Asian countries remain government-administered, and as such, hikes in domestic pump prices lag those of international oil prices.

As regards food prices too, the regional picture is diverse. For some exporters, international increases in rice prices are rapidly transmitted to domestic prices. An example is Thailand, the world's largest rice exporter. Variations in international rice prices are immediately reflected in domestic prices, to provide the correct incentive to rice farmers to increase production. For importers (such as the Philippines, the world's largest rice importer) the pass-through to domestic rice prices tends to be slow and incomplete (under the country's public rice distribution system). In some rice-exporting countries, the transmission of high global rice prices to domestic prices is also severely limited. This is especially true for countries such as India, which like the Philippines, has a public rice distribution system (see the chapter, *Causes of high food prices*, in Part 2).

Using a sample of nine developing Asian economies, the degree of pass-through to domestic prices of changes in international oil and food prices was estimated (see the chapter, *Inflation in developing Asia: Demand-pull or cost-push?,* in Part 2). The general finding is that the pass-through of fuel and food price shocks to domestic producer and consumer prices is incomplete. In addition, the transmission of international oil price hikes tends to be limited in countries with administered prices and relatively high fuel subsidies. In terms of food price shocks, the pass-through is generally lower than that for oil. Higher pass-through to producer prices is also registered in most food-exporting countries.

Variance decomposition analysis of domestic producer and consumer prices was also undertaken. Results show that factors other than external cost-push shocks, in particular excess aggregate demand and inflation expectations, account for a larger share of variations in domestic price

1.1.22 Fuel prices



Note: Gasoline prices refer to premium unleaded gasoline; diesel prices refer to gas oil; both free on board Amsterdam, Rotterdam, and Antwerp.

Source: Datastream, downloaded 2 September 2008.

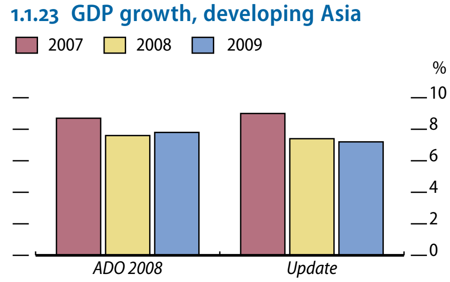
Click here for figure data

inflation. Variations in excess aggregate demand explain more than 60% of consumer price inflation in the PRC; inflation expectations account for about 40–50% of wholesale price variations in India and of consumer price variations in most other countries. In general, external cost-push factors such as oil and food price shocks explain at most 55% of producer price variations and 30% of consumer price changes.

This section thus knocks down the common view that rising inflation is due to external reasons, and as such domestic monetary policy is powerless. On the contrary, the main reason for variations in local producer and consumer prices is generally homegrown. Demand-pull inflation pressures have in fact been building up as a result of many years of robust growth accompanied by accommodative monetary policies. Domestic price strains were thus already forming and were exacerbated by the rapid escalation in global commodity prices.

Despite expectations of moderating global growth in 2009, the current limited transmission of external factors to domestic prices indicates that the pass-through will continue and generate further inflationary pressures in 2009. These suggest that authorities have an important role to play in curbing inflation through monetary policy. Specifically, tighter interest rate policies could have a powerful effect in anchoring inflation expectations and in crimping domestic demand. In addition, an economy's exchange rate policy must be in line with its tighter interest rate policy. This means that exchange rates in developing Asia may be allowed to appreciate to reduce the domestic cost of imports. Overall, monetary measures must be applied consistently and geared toward reducing liquidity in order to clip inflation pressures. The sequencing and pace of such measures are crucial in ensuring that policies actually work their way toward securing inflation expectations and limiting second-round effects.

1.1.23 GDP growth, developing Asia



Source: *Asian Development Outlook* database.
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Prospects for developing Asia

Despite the turbulence in global markets that disrupted developing Asia's performance in the first half of 2008, developing Asia's economic fundamentals are still sound. Still, growth in 2008 is expected to slow to 7.5% (Figure 1.1.23), revised down slightly from the 7.6% projected in April's *ADO 2008*. Next year's growth is forecast at 7.2%, lower than the previous 7.8%, but this forecast is less certain, as the outcome depends both on the duration and extent of the current global downturn and the runup in commodity prices, as well as on how Asian economies respond.

While *ADO 2008* correctly projected growth to slacken in many developing Asian economies in 2008, first-half data suggest that the deceleration is likely to be faster than it foresaw. Expansion in the Philippines and Viet Nam moderated to 4.6% and 6.5%, respectively, in the 6 months through June, while that for India slowed to 7.9% in the April–June quarter. In the Philippines, growth slowed because of softer household spending and weaker services output. In Viet Nam, inflation running above 20% crimped domestic demand. In India, investment slowed markedly as access to credit tightened and its cost increased.

Rising global prices of food and fuel stoked headline inflation across developing Asia, warranting significant upward revisions in inflation

forecasts. Inflation began to accelerate from the second half of 2007. In Pakistan, Sri Lanka, and Viet Nam, price increases are now exceeding 20%; in Viet Nam, food price inflation accounts for about three fourths of overall inflation. The increases have not been limited to food and fuel prices though, as rising raw materials costs have pushed up manufactured goods prices as well. Wage pressures are also building up in many Asian economies. Inflation in the region is now forecast to register an average of 7.8% in 2008 and 6.0% in 2009 (Figure 1.1.24).

Across developing Asia, the effects of the recent commodity price boom have been mixed. For primary commodity exporters in Central and Southeast Asia, the food and oil price jumps in the first half of 2008 provided an earnings bonanza. Malaysia's exports benefited from rising prices of palm oil and crude oil. The value of Indonesia's natural gas exports increased as international gas prices tracked high crude oil prices. Cambodia, Thailand, and Viet Nam all gained from the peak in rice prices in the first half of the year. In contrast, economies that depend on commodity imports experienced severe strains in their current accounts, and those that subsidized food and fuel, in their fiscal accounts as well. Most South Asian economies now have to deal with ever-widening current and fiscal account deficits.

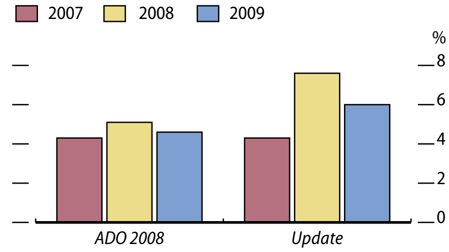
Significant uncertainties underlie the baseline projections in *ADO 2008 Update*. The major risks include: a prolonged slowdown in the G3; the continued elevated level of international oil and food prices; the persistence of high inflation in the region; the perils of policy reticence; and the ever-present threat of geopolitical disturbances.

As discussed above, a protracted slowdown in the G3 will adversely affect developing Asia's trade and financial sectors through a deceleration in demand for the region's manufactured exports and through limiting the access to and cost of funds for the region's corporations and households.

The sharp escalation of commodity prices provided a much-needed dose of reality that the world of cheap commodities was gone for the foreseeable future, and inflation pressures are now mounting worldwide. In developing Asia, many regional economies have already seen a return to double-digit inflation. If commodity prices stay elevated, developing Asia's gains in reducing poverty and inequality could be lost. Inflation pressures thus need to be curbed and the reality of higher commodity prices acknowledged and addressed.

Before developing Asia can undertake the structural reforms to adapt to this new world, it must first reestablish macroeconomic stability through sound monetary, fiscal, and exchange rate policies. Regional monetary authorities have begun to address rising inflation in recent months. Initially, responses seemed too little and too late. In most countries, real interest rates have turned negative (Figure 1.1.25). As a result, the impact of tightening measures on consumption has been limited, and such moves have been ineffective in curbing rapid price increases. Recently, central banks have become more aggressive in tackling inflation pressures, and indeed policy rate increases in, for example, India, Indonesia, Philippines, and Viet Nam, have exceeded market expectations. However, if central banks become reticent once more in terms of imposing the requisite tightening measures, inflation

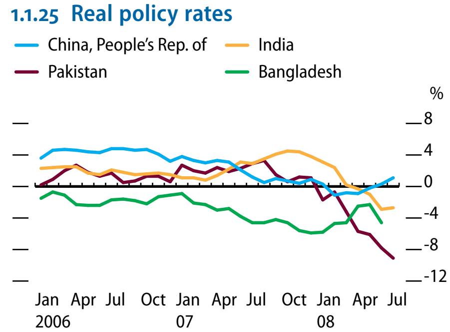
1.1.24 Inflation, developing Asia

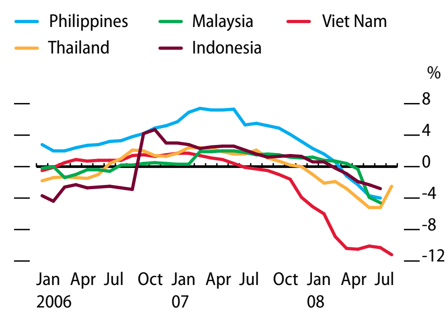


Source: Asian Development Outlook database.

Click here for figure data

1.1.25 Real policy rates





Source: CEIC Data Company Ltd., downloaded 2 September 2008.

Click here for figure data

could become ingrained in economies, eventually undermining long-run growth prospects.

Across developing Asia, oil subsidies have tested budgetary limits. For social reasons, many governments initially attempted to avoid fuel price increases, but eventually yielded as subsidy bills battered their fiscal accounts. Bangladesh, PRC, India, Indonesia, Sri Lanka, and Viet Nam have all reduced fuel subsidies. Even net oil-exporting Malaysia raised fuel prices by at least 40% in June (Figure 1.1.26). However, authorities in some countries have partly reversed earlier steps to curtail fuel subsidies. Malaysia and Viet Nam, for instance, reduced pump prices in August as crude oil prices came down from their $147 per barrel peaks. Admittedly, developing Asia's policy makers face a dilemma on food and fuel subsidies: reducing them now would increase inflation in the short term, but not doing so would generate fiscal trouble later, as well as inflation.

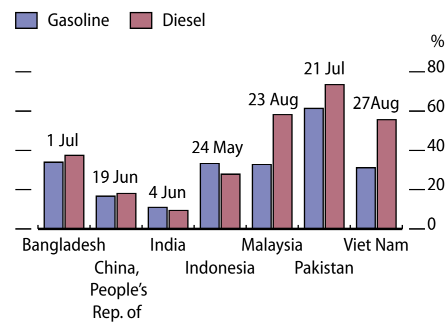
Despite their current limited pass-through to domestic prices, high global oil and food prices are prompting dissatisfaction among the region's population. To a certain extent, this has limited authorities' policy options for addressing rising inflation. With negative real interest rates, monetary tightening measures in the region are generally seen to be behind the curve, and the authorities do not regard the removal of fuel and food subsidies as a priority. This limited monetary policy response and the failure to remove subsidies stem partly from their unpopularity among both the authorities and the general population. With forthcoming elections in countries such as India and Indonesia in 2009, governments view such moves as detrimental to their re-election efforts.

Political systems are also fragile in some countries. In some South and Southeast Asian countries, governments are being challenged by the opposition, and this is likely to result in reluctance to undertake the needed reforms. Ruling governments are likely to focus on populist policies to discourage dissent. However, this runs the risk of exacerbating macroeconomic imbalances and clouding the economic outlook. Prolonged periods of political instability could inhibit investment and affect growth prospects in the medium term. Some countries have in fact been advised by credit agencies of possible downgrades if they do not restore macroeconomic stability. With troubles brewing in the global economy, political turmoil is the last thing the region needs. Issues of politics must take a back seat, and economic policies to address mounting economic risks must take a front one.

Security issues still pose a threat to economic prospects. According to assessments made by the World Economic Forum (2008), global geopolitical risks are likely to remain. If material security threats emerge, the movement of people, goods, and capital could be disrupted. This would adversely affect the global business environment, perhaps more so in developing Asia than elsewhere, where economies are closely linked via supply chains.

In summary, downside risks to developing Asia's growth prospects are now stronger than in April. Global conditions are more volatile—the financial crisis has not yet fully unraveled, high commodity prices seem likely to stay, and geopolitical concerns refuse to go away. Regional conditions are not too promising, either. Inflation rates are higher than expected, and are set to remain high as the pass-through to domestic

1.1.26 Cumulative fuel price increases in 2008



Notes: Dates reflect effectivity of latest price adjustments. For Malaysia, prices were increased on 5 June then partially reduced on 23 August. For Pakistan, prices were raised on 1 March, 16 March, 18 April, 1 May, 29 June, and 21 July. For Viet Nam, prices were hiked on 25 February and 21 July, then partly rolled back on 14 and 27 August.

Source: Various news articles.

Click here for figure data

prices completes its course. Political pressures are threatening to come to a head in some countries, and this could stall the implementation of much-needed corrective policy measures.

The rest of *ADO 2008 Update* is organized as follows. Part 2 looks at the major drivers of the recent runup in commodity prices and the extent of the price transmission mechanism from international to domestic prices. Oil, food, and other commodity prices have been steadily rising since 2003. But in early 2008, prices escalated sharply. While commodity prices are now off their recent peaks, prices remain elevated. Understanding the underlying causes of the recent price surge will enable developing Asia to undertake the reforms it needs to adapt to this new commodity environment. Part 3 provides subregional as well as individual assessments for nine selected economies of recent economic performance, projections for 2008 and 2009, and the risks that could significantly affect economic prospects. Part 4 offers a methodology to identify the possible sources of forecast errors for GDP growth and inflation.

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Annex: Impact of the G3 slowdown on selected Asian manufactured exports

Introduction

Asian Development Outlook 2008 (*ADO 2008*), printed in April this year, emphasized that the pronounced slowdown in the growth of the G3 economies—United States (US), eurozone, and Japan—was bound to take a toll on developing Asia. Weakened consumer demand in the G3 was seen in slumping retail sales data with direct consequences particularly for the manufactured consumer products that are a mainstay of Asian exports. The slide in the volume of imports of cyclically sensitive manufactured products from Asia was illustrated using quarterly data from the US and European Union (EU) and using half-yearly data in the case of Japan over the course of 2007.

In this annex, data on selected cyclically sensitive manufactured imports through the first half of 2008 provide a clearer picture of how the slowdown is affecting Asia, in particular East Asia (defined in this annex as Hong Kong, China; Republic of Korea; and Taipei,China), Southeast Asia, and South Asia. In a nutshell, Asian exports are likely to face difficulty over the rest of 2008 and well into 2009.

In this annex, disaggregated trade data are examined to demonstrate that the G3 slowdown has indeed had a negative impact on exports of manufactures from economies in developing Asia. The impact may be partially mitigated for some Asian countries, such as Indonesia, Malaysia, Thailand, and Viet Nam, which export commodities. The impact of sluggish demand in the G3 however, may eventually spread to commodities that have recently seen very high prices. In addition, weakness among the G3 economies may be mutually reinforcing and may sharply reduce growth in world trade volume in 2008 and 2009.

Weak consumer demand in the United States

Declines in consumer purchases of clothing items and footwear in US retail outlets have a direct and rapid impact on exports from developing Asia because over 90% of US sales are from imports. Clothing shipments from Asia and other trading partners are monitored by the Office of Textiles and Apparel (OTEXA) in the US Department of Commerce, which follows not only the value but also the volume of imports from all major suppliers, particularly the People's Republic of China (PRC). Product-specific safeguards limit the volume of shipments from the PRC in 24 major clothing categories ranging from socks and underwear to slacks, trousers, and shirts.[1] Many other items of clothing are unrestricted, however, and even in the categories with quotas, the volumes are allowed to increase by an agreed amount annually.

The PRC is by far the leading supplier of clothing to the US market and total imports from all suppliers exceed $70 billion annually. South

Asia and Southeast Asia are significant, and have expanded their shares of the US market ever since the global system of quotas was abolished on 1 January 2005.

For simplicity, data are presented for three Asian groupings: PRC, Association of Southeast Asian Nations (ASEAN), and South Asian Association for Regional Cooperation (SAARC), together constituting developing Asia. They encompass most of the major developing Asian suppliers of clothing to the US and collectively accounted for two thirds of global shipments to the US market in 2007.[2]

OTEXA provides volume data in million square meter equivalents and in current dollar value. As *ADO 2008* provided quarterly figures for 2007 compared with 2006 and showed that growth steadily deteriorated between the first and fourth quarters and became negative in the fourth quarter in volume terms, here the focus is on developments in the first half of 2008. Spending in the second quarter of 2008 was influenced by a fiscal stimulus program that had returned $100 billion to US households from mid-March through July. By end-June 2008, much of the fiscal stimulus from tax rebates had already reached US consumers. A survey of 34,000 households indicated that by mid-June, 19,000 had reported receiving their tax rebate checks with most of those reporting receipt of rebates having had them for 4 weeks (Broda and Parker 2008). The study revealed that the stimulus package was successful. However, clothing and footwear expenditures on average rose by the smallest amount of five expenditure categories, rising by only $32 over pre-rebate levels.

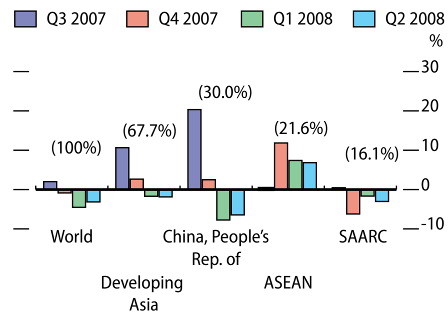
Thus the survey data support the analysis here that US consumers were cutting back on clothing purchases, though a little more slowly in April–June than in January–March (Figures A1.1.1 and A.1.1.2). The stimulus may have helped prop up retail sales but not by enough to reverse the decline in the real volume of purchases of clothing.

After slowing markedly in the fourth quarter of 2007, the volume of clothing exports from the PRC actually contracted in the first half of 2008, by over 7%. This fall was matched by a similar increase in the volume of exports from ASEAN. However, within the member states of ASEAN performance varied widely with growth in the Lao People's Democratic Republic (Lao PDR) and Viet Nam exceeding 20% but with other large suppliers, such as Cambodia and Indonesia, expanding by only around 4%. The Philippines and Thailand contracted.

The SAARC countries did more poorly, with nearly four consecutive quarters of no growth or contraction in the volume of exports to the US. Within SAARC, only Bangladesh avoided contraction in the first half of 2008 with a less than 1% increase. Although developing Asia's shipments of clothing to the US performed marginally better than all suppliers in the first half of 2008 (down 2% compared with down 3% for all suppliers), they were hardly immune from the contraction in US retail sales of clothing.

The value (in current US dollars) of shipments from the PRC contracted by nearly 10% year on year in the first quarter of 2008 and were still shrinking in the second, so that overall the value fell by about 6% in the first half of 2008. Again, the PRC's loss was ASEAN's gain as their shipments rose in value by around 5% in the first half of 2008. The Lao PDR and Viet Nam performed well with over 25% increases, but other

A1.1.1 Growth in imports of clothing (square meters, volume), United States



Notes: Figures in parentheses indicate share in US clothing imports for 2008. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC).

Sources: United States Office of Textiles and Apparel Dataweb, available: http://otexa.ita.doc.gov; author's compilations.

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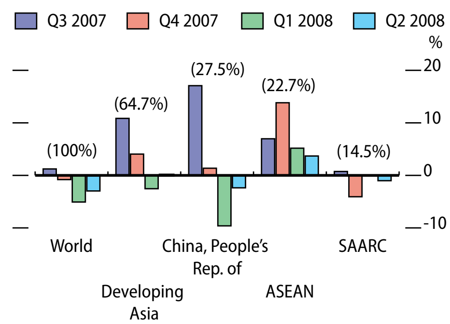
A1.1.2 Growth in imports of clothing ($, value), United States



Notes: Figures in parentheses indicate share in US clothing imports for 2008. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC).

Sources: United States Office of Textiles and Apparel Dataweb, available: http://otexa.ita.doc.gov; author's compilations.

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ASEAN members had no growth or even contracted. Among the SAARC countries, only Bangladesh showed growth, with a modest 7% gain in the first half of the year. Shipments from India, Pakistan, and Sri Lanka fell.

For developing Asia as a whole, the value of shipments in the first half of 2008 was down by a little over 1% compared with a world decline of 4%. The moderation of the contraction in April–June compared to January–March in clothing import growth may be attributed to the fiscal stimulus, but this is unlikely to persist into the second half of 2008. According to a sample of 19 major clothing retailers in July 2008, retail sales fell on average by 3.1% over those of the previous year.[3] Retail sales can be expected to weaken further once the fiscal stimulus dissipates over the next few months, with consequent reduced demand for imports from Asia.

Footwear imports account for virtually all US retail sales (around $20 billion in 2007) and show a pattern quite similar to clothing: the economies of developing Asia—especially the PRC—are dominant suppliers of the US footwear market with a share even larger than for clothing. Footwear imports are subject to import duties averaging around 10% with peak tariffs of over 40% for some low-end products, despite the fact there is virtually no footwear manufacturing in the US. As footwear is complementary to clothing, it is unsurprising that it, too, shows a downturn into contraction at the same time and along the same pattern as clothing at end-2007 and the first half of 2008 (Figure A1.1.3). As with clothing, the PRC has been hit hardest by the downturn in US retail footwear sales.

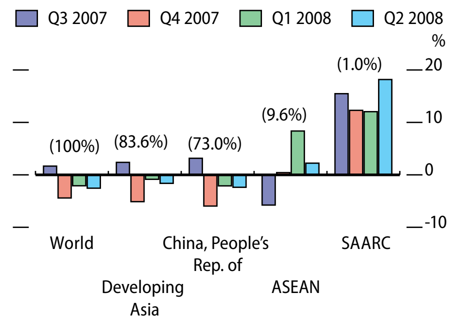
A conjecture is that PRC supplies are becoming less competitive relative to other Asian suppliers, possibly due to labor cost increases and the appreciation of the yuan. A new labor law in the PRC in late 2007 imposed additional costs on firms, particularly those that have large numbers of workers with several years' employment.

ASEAN and SAARC both recorded growth over the last three quarters, but collectively they supply only about 11% of US imports compared with over 70% from the PRC. Within ASEAN, only Viet Nam has performed well with all other suppliers such as Indonesia, Malaysia, Philippines, and Thailand seeing a fall in shipments over the last three quarters. SAARC supplies only a little over 1% of US import demand for footwear but is improving its performance steadily, taking advantage of the decline in competitiveness of other suppliers.

ASEAN has no room for complacency as inflation is accelerating in most member countries, with Viet Nam experiencing a consumer price index increase of over 25% in recent months. This is likely to raise costs and lead to shoe retailers placing orders in other countries where prices are less volatile.

A third example of a manufactured product line for which US consumption is heavily reliant on imports is toys, games, and sports equipment. The demand for these products is strongly influenced by seasonal factors with sales peaking around the US winter holiday months. Typically, about two thirds of annual shipments to the US are made in the last two quarters of the calendar year. In contrast to clothing and footwear, sales of toys, games, and sports equipment sustained growth into the first quarter of 2008 and only began to shrink in April–June (Figure A1.1.4). Consumer expenditures on these products are highly

A1.1.3 Growth in imports of footwear ($, value), United States



Notes: Figures in parentheses indicate share in US imports for the indicated product for 2008. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC).

Source: United States International Trade Commission Dataweb, available: www.dataweb.usitc.gov, downloaded 20 August 2008.

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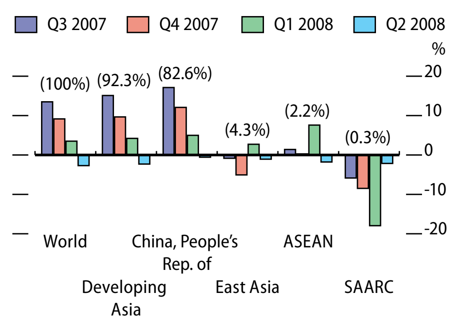
A1.1.4 Growth in imports of toys, games, and sports equipment ($, value), United States



Notes: Figures in parentheses indicate share in US imports for the indicated product for 2008. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC). East Asia comprises Hong Kong, China; Republic of Korea; and Taipei,China.

Source: United States International Trade Commission Dataweb, available: www.dataweb.usitc.gov, downloaded 20 August 2008.

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discretionary and are subject to consumer confidence. It may well be that purchases may have been buoyed by the fiscal stimulus and would have fallen more sharply in the second quarter in the absence of the rebate checks. The seasonal factor in demand may also help spur growth in the second half of 2008, particularly in the fourth quarter.

Developing Asia accounts for over 90% of imports of toys, games, and sports equipment with the PRC alone supplying over 80% of US imports. East Asia accounts for the next highest share of US imports with over 4%, compared with just 2% for ASEAN and less than 1% for SAARC.

The PRC saw its shipments of these items slip into negative territory in April–June 2008 and the same fate befell all groups of Asian suppliers. The steady deterioration of shipments to the US market of these items is significant as total shipments from developing Asia exceeded $25 billion in 2007.

The categories of manufactured goods considered above are all subject to consumer sentiment and discretionary spending behavior usually associated with nondurable goods. Purchase of a clothing item, a pair of shoes, or a stuffed toy does not require a large share of a household's or individual's budget. Investment goods or household goods of long-lasting use, in contrast, require a larger amount of funds and are likely to be more sensitive to conditions in credit markets, such as availability of bank loans and the rate of interest.

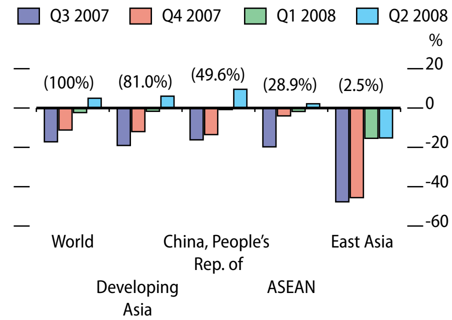
Computer[4] (HTS 8471) shipments amounted to $58.5 billion in 2007 and had fallen precipitously relative to 2006 and continued to decline in January–March 2008 before rebounding in April–June, compared with the same period in 2007 (Figure A1.1.5). The level of shipments was still, though, well below shipments in April–June 2006. Most of the recovery in shipments in the second quarter of 2008 (compared with the same period in 2007) is attributable to imports from the PRC, which accounts for nearly half of total shipments. ASEAN suppliers showed some rebound in shipments to the US as well, with some recovery in shipments from the second- and third-largest suppliers, Malaysia and Thailand, while those from East Asia continued to shrink.

Despite the growth in the second quarter of 2008, the value of shipments in this grouping is still quite weak vis-à-vis shipments in 2006. It is possible that the fiscal stimulus may have provided a boost to spending on computers in recent months, though this is likely to disappear in the second half of the year. The findings of the above survey of 34,000 households indicate that spending on durable goods such as appliances, electronics, and furniture rose sharply by $91 on average in the weeks following receipt of the rebates (Broda and Parker 2008). This may help explain the increase seen in April–June 2008 relative to the same period in 2007, but the effects are likely to be short-lived. The weakened demand for investment and tight credit conditions may therefore continue to damp shipments in the second half of 2008 and into 2009.

Japan's weakening economy

Growth in the largest economy in Asia faltered in the second quarter of 2008 and the outlook is for continued sluggish growth with worsening

A1.1.5 Growth in imports of computers and computing equipment ($, value), United States



Notes: Figures in parentheses indicate share in US imports for the indicated product for 2008. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation. East Asia comprises Hong Kong, China; Republic of Korea; and Taipei,China.

Source: United States International Trade Commission Dataweb, available: www.dataweb.usitc.gov, downloaded 20 August 2008.

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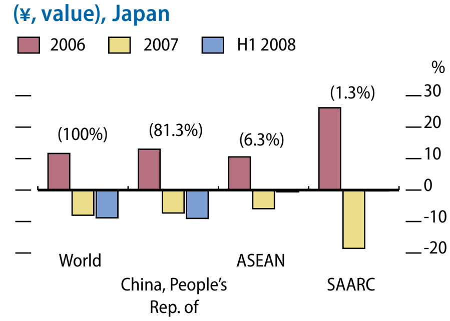
A1.1.6 Growth in imports of clothing (¥, value), Japan



ASEAN = Association of Southeast Asian Nations; SAARC = South Asian Association for Regional Cooperation.

Note: Figures in parentheses indicate share in Japan's imports for the indicated product for 2008.

Source: Japan Customs, Ministry of Finance, available: www.customs.go.jp, downloaded 19 August 2008.

Click here for figure data

consumer sentiment. The consumer confidence index fell to the lowest levels seen since 2001. The poor outlook for developing Asia's exports of consumer manufactured goods is indicated by the steady deterioration in retail sales in large department stores and consumption expenditures in the first 5 months of 2008 (Bank of Japan 2008a). Consumer goods imports fell sharply in real terms in the second quarter of 2008 by almost 7% compared with the same period in 2007 (Bank of Japan 2008b). The implication of the decline in consumer purchases at retail clothing outlets is for a continued decline of imports of clothing. Contraction in clothing shipments from developing Asia to Japan began in 2007 and continued into the first 6 months of 2008 (Figures A1.1.6 and A1.1.7).

All groups of developing Asian suppliers have been adversely affected by negative consumer sentiment and declining purchases in Japan, with the PRC having the worst performance among the three groupings of suppliers. The volume of shipments has contracted less steeply than the value of shipments, suggesting that unit prices of clothing items in yen have been falling, reflecting the weakening of the US dollar against the yen.

Footwear imports from developing Asia also declined in value over the first half of 2008, with particularly sharp declines from Cambodia and the PRC—the latter being by far the largest foreign supplier (Figure A1.1.8). This reinforces the general impression of softening consumer demand for labor-intensive manufactured products that are important exports from developing Asia. Shipments to Japan from Thailand fell by over 30% in the first half of 2008, while those from the second largest ASEAN supplier (Viet Nam) also slipped, by 1%.

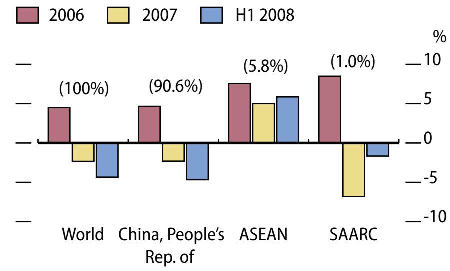
Imports of computers from Asian developing countries also continued to decline during the first half of 2008, after a disastrous performance in 2007 (Figure A1.1.9). This indicates that investment goods are also facing a weaker market in Japan for a second consecutive year. Shipments from the Philippines and Thailand fell the most, with shipments from the PRC and Singapore also in retreat. Thus it appears that Japan is experiencing a slowdown that is even broader than in the US. Japan has just unveiled an Y11.7 trillion stimulus package, but it is uncertain that wary Japanese consumers will actually increase their spending.

European Union imports set to decline?

With inflation on the rise, fueled by high commodity prices and concerns that inflation pressures are building globally, the European Central Bank has put its policy rate on hold despite growing signs of weakness in economic activity. Consumption is at best stagnant and is running out of steam in major countries with housing market problems and rising unemployment, such as Ireland, Spain, and United Kingdom. The slowdown is also apparent in recent data from Germany, the largest of the EU economies.

The outlook for a protracted period of low growth is another source of concern for developing Asia's export prospects in the second half of 2008 and in 2009, particularly for manufactured products such as clothing and footwear. The EU market for imports sourced from outside the Union (i.e., extra-EU imports) has been expanding, and in 2007 overtook the US in terms of size for clothing imports in dollar terms.

A1.1.7 Growth in imports of clothing (kilograms, volume), Japan



ASEAN = Association of Southeast Asian Nations; SAARC = South Asian Association for Regional Cooperation.

Note: Figures in parentheses indicate share in Japan's imports for the indicated product for 2008.

Source: Japan Customs, Ministry of Finance, available: www.customs.go.jp, downloaded 19 August 2008.

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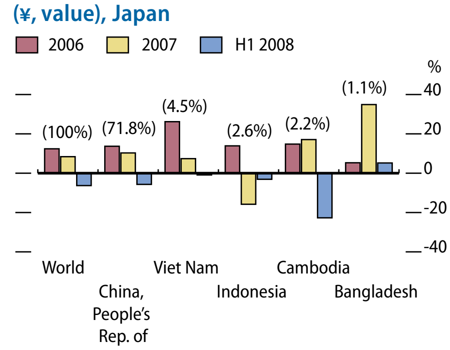
A1.1.8 Growth in imports of footwear (¥, value), Japan



Note: Figures in parentheses indicate share in Japan's imports for the indicated product for 2008.

Source: Japan Customs, Ministry of Finance, available: www.customs.go.jp, downloaded 21 August 2008.

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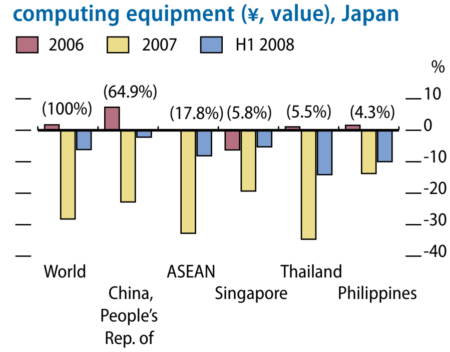
A1.1.9 Growth in imports of computers and computing equipment (¥, value), Japan



ASEAN = Association of Southeast Asian Nations.

Note: Figures in parentheses indicate share in Japan's imports for the indicated product for 2008.

Source: Japan Customs, Ministry of Finance, available: www.customs.go.jp, downloaded 19 August 2008.

Click here for figure data

So far this year, though, EU clothing imports have sharply decelerated. Volume growth has flattened to near zero for ASEAN and SAARC suppliers and, although the PRC has sustained growth, this has not been enough to prevent an extremely anemic performance for developing Asia taken as a whole (Figure A1.1.10). The region's share in extra-EU clothing imports is even larger than that in the US market in volume terms, at over three quarters, and is quite similar to that in the US market in value terms, at about two thirds (Figure A1.1.11).

Clothing exports from ASEAN members to the EU (with the single exception of Viet Nam) contracted in 2007. By value they grew in the first 3 months of 2008 but deteriorated sharply in April and May, resulting in a contraction for the first 5 months of 2008. A similar pattern is seen for clothing exports from SAARC members, where moderate growth was experienced in the first 3 months followed by sharp deterioration in April and May, with the net effect a contraction of exports also from SAARC for the first 5 months. Only the PRC has seen value growth in 2008, with less than a 2% rise in exports in the year, to May 2008.

Major countries from South Asia (Bangladesh, India, Pakistan, and Sri Lanka) have essentially tracked the world's and developing Asia's exports of clothing to the EU (Figure A1.1.12). A trend of contraction can be seen in Pakistan. For Bangladesh and India, the trend has been toward flat or falling growth rates, particularly when compared to 2006 rates of growth. Sri Lanka (which accounts for less than 2% of EU clothing imports) has been able to maintain a higher growth rate than its neighbors. Clothing shipments to the EU market from SAARC member countries benefit from duty-free treatment under the GSP Plus program. Shipments from Sri Lanka may not hold up in 2009 as Sri Lanka is likely to become ineligible for GSP Plus treatment, and tariffs will be levied on its clothing exports. Moreover, shipments may come under cost pressure as prices have tracked up by over 20% in recent months.

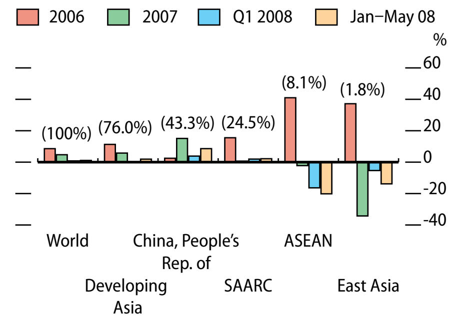
The EU market for footwear imports is roughly the size of the US market. Growth of footwear exports slowed in 2007 and shipments contracted for the PRC and ASEAN footwear exporters over the first 5 months of 2008. Shipments from the Philippines and Thailand contracted sharply in the first 5 months, falling by over 20%; those from Indonesia, Malaysia, and Viet Nam also contracted in January–May 2008, compared with the same period in 2007 (Figure A1.1.13).

SAARC shipments of footwear have not tracked the world's and developing Asia's rates of shrinkage, mainly because shipments have remained positive in value terms (Figure A1.1.14). By value, only Pakistan showed a contraction in 2008, while Bangladesh and India were able to achieve growth—albeit slow. However, all suppliers contracted in volume terms and, if prices begin to fall, this could result in a contraction by value in the second half of 2008 and in 2009.

It is clear that demand for the nondurable goods that feature prominently in Asian shipments to the EU market is in retreat and, as recent economic data including an across-the-board slowdown in economic activity in April–June 2008 indicate, the outlook for the rest of 2008 and 2009 is for further weakness that will inflict pain on Asian exporters.

The eurozone has yet to embark on a stimulus program and has also refrained from loosening monetary policy as inflation is already

A1.1.10 Growth in imports of clothing (kilograms, volume), European Union



Notes: Figures in parentheses indicate share in EU imports of clothing for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC). East Asia comprises Hong Kong, China; Republic of Korea; and Taipei,China.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 18 August 2008.

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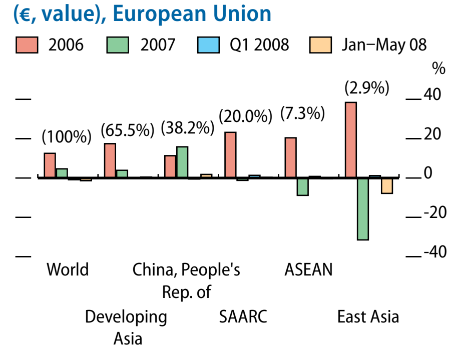
A1.1.11 Growth in imports of clothing (€, value), European Union

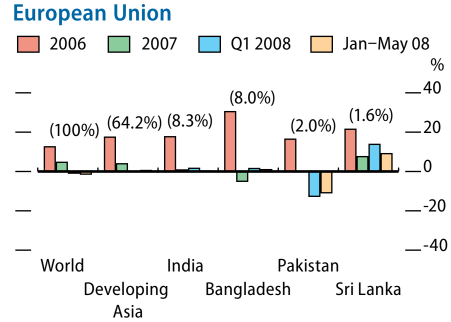


Notes: Figures in parentheses indicate share in EU imports of clothing for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC). East Asia comprises Hong Kong, China; Republic of Korea; and Taipei,China.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 18 August 2008.

Click here for figure data

A1.1.12 Growth in imports of clothing from selected South Asian countries (€, value), European Union



Notes: Figures in parentheses indicate share in EU imports of clothing for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations, People's Republic of China, and South Asian Association for Regional Cooperation.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 18 August 2008.

Click here for figure data

double the high end of the target range of 2% or less. Thus one might expect difficulties in consumer nondurables to worsen. In the case of durable goods the outlook is also pessimistic. Shipments of computers and related equipment fell in 2007 compared with 2006 and contraction continued from all groups of Asian suppliers in the first 5 months of 2008 (Figure A1.1.15).[5]

Major exporters of computer parts and equipment from ASEAN continued to suffer from double-digit contractions in shipments to the EU from 2007 into 2008. The biggest falls have been from Malaysia, followed by Singapore and the Philippines. Thailand has suffered the smallest decline; however, the contraction is still showing a worsening trend. Major East Asian exporters of computer parts and equipment followed the ASEAN trend of contractions in shipments to the EU in 2007; however, in 2008 so far, East Asia seems to have recovered some ground as shipments have grown (except from the Republic of Korea).

The main message of this annex is that the G3 slowdown will have strong repercussions for Asian exports in 2008 and, in all probability in 2009 as well. Forecasts of world trade volume have been slashed to 4.8% for 2008. Under these circumstances it is very likely that as demand in the G3 slackens, intra-Asian trade may also come under pressure as there will be less final demand and therefore less trade in intermediate parts and components.

Endnotes

1 See James (2008) for a description of the 24 restricted clothing categories and an analysis of how various major suppliers had performed in the US market after the restrictions were imposed.

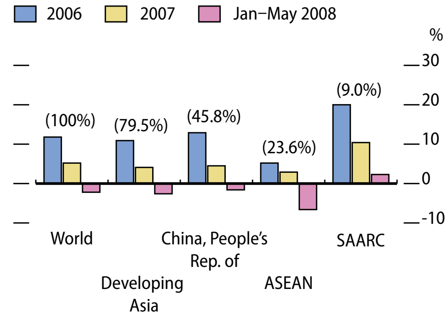
2 East Asia (as defined in this annex) also has exports of clothing to the US market and experienced sharp declines in shipments in volume (down 18%) and in value (down 12%) during the first half of 2008. However, it is losing its share of the US market for structural reasons that have been apparent since the quota system was dismantled under the Agreement on Textiles and Clothing (James 2008 and ADB 2006). It currently accounts for only 4% of US imports of clothing, although it is more significant as a supplier of textile products such as yarn, fabric, and industrial textiles.

3 The figure is the simple arithmetic average of sales growth in stores open at least 1 year in 19 major chains for July 2008 compared with the same month the previous year. Data are from www.emergingtextiles.com, downloaded 8 August 2008.

4 The Harmonized Tariff Schedule (HTS) commodity code 8471 comprises desktops, laptops, and other peripherals such as computer monitors, central processing units, keyboards, mice, memory devices, and optical readers.

5 SAARC countries are not major suppliers of computing equipment to the EU (nor the US or Japan).

A1.1.13 Growth in imports of footwear (€, value), European Union

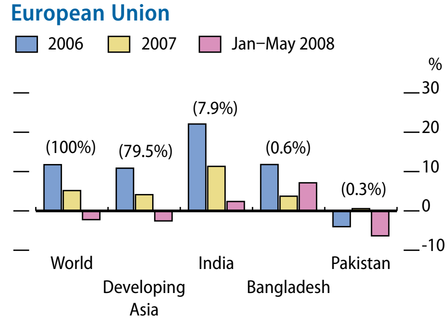


Notes: Figures in parentheses indicate share in EU imports of footwear for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation (SAARC).

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 21 August 2008.

Click here for figure data

A1.1.14 Growth in imports of footwear from selected South Asian countries (€, value), European Union

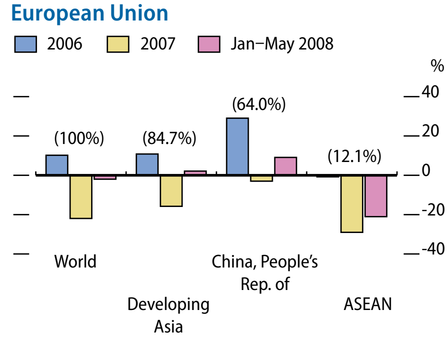


Note: Figures in parentheses indicate share in EU imports of footwear for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations, People's Republic of China, and South Asian Association for Regional Cooperation.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 21 August 2008.

Click here for figure data

A1.1.15 Growth in imports of computer and computer equipment (€, value), European Union



Notes: Figures in parentheses indicate share in EU imports for indicated product for 2008. EU excludes intra-EU trade. Developing Asia comprises the Association of Southeast Asian Nations (ASEAN), People's Republic of China, and South Asian Association for Regional Cooperation.

Source: Eurostat, available: http://epp.eurostat.ec.europa.eu/portal, downloaded 22 August 2008.

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