Highlights—*ADO 2008*

Developing Asia's economic growth in 2008 will taper off from its multiyear high in 2007. Inflation is expected to climb to its highest level in a decade. Under the weight of subsidies for food, fuel, and power, fiscal positions are at risk. But developing Asia is not exposed to the threat of massive financial deleveraging, and its credit markets should continue to function in an orderly manner.

Synopsis

- Developing Asia recorded the highest growth in almost two decades in 2007—averaging 8.7%. A coincident slowdown in the United States (US), Europe, and Japan; surging food and fuel prices; and a credit crisis in global financial hubs notwithstanding, growth in 2008 is expected to be a robust 7.6%, only slightly below the past 5 years' average. Though Asia will not be immune to the global slowdown, neither will it be hostage to it.

- Despite subsidies and a raft of administrative measures that are restraining price rises, inflation is expected to accelerate in 2008 and could yet trigger an upward cost-price spiral. Taming inflation expectations and reining in fiscal deficits that are being bloated by fuel, food, and power subsidies are challenges facing a range of countries. Hardships and threats to poverty that are posed by rising food prices in particular may be more effectively tackled through targeted, direct cash transfers.

- Beyond these immediate bumps in the road, longer-term growth prospects will depend on how successfully countries tackle a variety of structural constraints. These are examined in their individual country contexts in Part 3 of *Asian Development Outlook* (*ADO*) *2008*.

- In Part 2, *ADO* highlights the importance of providing relevant skills and job opportunities for Asia's burgeoning labor force. Solutions will differ from place to place, and priorities will also differ. But some of the ingredients that are likely to be necessary if Asia is to use the talents of its workers wisely, and not squander them, include better schooling and curricula; targeted support for youth job training; more liberal immigration policies for unskilled as well as skilled workers; removal of occupational restrictive practices that protect "insiders"; the overhaul of tertiary education systems; and a larger role for the private sector in the delivery of training and educational services at all levels.

Performance in 2007

- In many countries, growth in 2007 tested speed limits and was above what can be sustained over the medium term. For the region, growth is estimated to have been 8.7%, the fastest in nearly two decades.

- Signs of overheating initially appeared in quickly escalating asset prices but then spilled over into rising consumer prices. Price hikes in international commodity markets have aggravated inflation pressures. By November 2007, inflation had risen to an 11-year high in the People's Republic of China (PRC) and had reached double digits in Viet Nam and Central Asia by the end of the year.

- Current account surpluses widened again, and rose by over 1% of GDP in East Asia relative to 2006. The PRC posted a record current account surplus of $353 billion. Surpluses widened significantly in Southeast Asia. South Asia remained in deficit.

- Accelerating growth was led by the PRC, which expanded by 11.4%, its fastest rate in 13 years. The PRC's share of regional GDP (measured at market exchange rates) continued to advance. For East Asia as a whole, growth accelerated to 9.3%. Inflation remained in check in most of East Asia other than the PRC. Mongolia, too, had high inflation averaging 9.0%, up from 5.1% in 2006.

- India grew apace. At 8.7%, growth was only marginally softer than the torrid pace of the previous 2 years. Bangladesh, Pakistan, and Sri Lanka consolidated recent gains. Nepal's growth sputtered despite some easing of political tensions. Inflation pressures were very high in Sri Lanka, and inflation accelerated to 20%. Bangladesh and Pakistan also had comparatively high rates of 7.2% and 7.8%, respectively.

- Growth in Southeast Asia inched up to 6.5%. The Philippines expanded at a 30-year high of 7.3%, and Viet Nam continued to grow quickly. Indonesia accelerated to 6.3%; Malaysia picked up gently; but Thailand—where consumer and business confidence faded in a context of heightened political uncertainty—moderated. Inflation pressures began to creep up toward the year's end in most of the subregion. Viet Nam's monthly inflation rate hit double digits late in the year.

- Central Asia, which is experiencing an oil and mineral boom, grew at 11.6%. Booming oil revenues and remittances are stoking rapid spending growth. Inflation has become the number one problem in the subregion. Central Asia as a whole saw its current account surplus drop to 1.8% of GDP from 3.3% in 2006.

- Growth in the Pacific strengthened to 3.1% thanks to a strong resurgence in Papua New Guinea. However, political problems kept growth in check in the Fiji Islands. Timor-Leste rebounded from the difficulties of 2006. Inflation in the Pacific accelerated and the current account balance was in deficit.

Outlook for 2008 and 2009

- A global slowdown is now under way. A coincident slowing of growth is expected in the economies of the US, European Union, and Japan. The *ADO* baseline forecasts have been revised down significantly over the last few months and, as new data are released, analysts in the public and private sectors continue to cut their growth forecasts.

- A credit crisis has gripped the US. Success of the Federal Reserve and the Treasury in coping with economic and financial market stresses is yet to be seen. The depth and duration of the US slowdown will have knock-on effects elsewhere in the global economy. The consensus view is that after a difficult first half of 2008, growth in the US should pick up in response to fiscal stimulus and aggressive interest rate cuts. It is unclear whether normal monetary transmission mechanisms will be effective in markets where confidence in counterparties appears to have been seriously weakened.

- Though the prospect of a recession in either the eurozone or Japan looks less likely than in the US, growth is expected to decelerate sharply there. Appreciation of both euro and yen real exchange rates is likely to dent export growth, and in both economies, consumer confidence is also ebbing.

- World commodity prices have soared again, testing new highs. Cyclical factors associated with the global slowdown may help mitigate this upswing. Prices may come off but are likely to be maintained at historically high levels.

- Developing Asia remains tied to global activity through traditional trade channels and, increasingly, through its closer integration in international financial markets. Nevertheless, in an unsteady global environment, favorable policy conditions and the productivity growth associated with the region's modernization and structural transformation will continue to sustain strong growth.

- During 2008, both the PRC and India are expected to slow. The PRC is expected to grow by a solid 10% in 2008 and India by a still-healthy 8%. In the past 18 months, both countries have tightened monetary policy, raising interest rates and placing higher reserve requirements on banks. The PRC has also taken a variety of steps to cool a booming export sector, including withdrawal of export subsidies and the imposition of new taxes. India's real exchange rate has appreciated, whereas the yuan moved less. In 2008, slower growth of global demand will likely have a more pronounced effect on the PRC, which is considerably more open to trade than India.

- Growth in East Asia is expected to decelerate in 2008 to 8.1%. Fixed investment growth is expected to slow somewhat as a result of tighter monetary policy in the PRC. Rebalancing growth there toward domestic consumption and away from exports and investment in industry will depend on the success of a wide range of reforms. Hong Kong, China; Mongolia; and Taipei,China will also slow, as a result both of the deterioration in the global economy and of their links with the PRC.

- Southeast Asia will slow to 5.7%, its export prospects damped by the slowdown in the global economy. In addition, efforts to prevent inflation from getting out of hand will moderate growth in Viet Nam from the fast pace of recent years. Only Thailand is expected to record higher growth after a return to normalcy in politics.

- South Asia is expected to slow in 2008, chiefly on the moderation of growth in the Indian economy. Bangladesh, Pakistan, and Sri Lanka will be affected by the growth slowdown in major markets as garment exports are expected to register declines, and may suffer terms of trade losses.

- In Central Asia, growth is expected to decelerate sharply to 7.5% in 2008 from double-digit rates in recent years. This is mainly due to a weaker expansion in Kazakhstan, the largest regional economy, where a sudden halt in capital inflows to domestic banks triggered a sharp reduction in lending and a downturn in the non-oil economy. Growth in a number of the region's non-oil countries is slowing, in part due to efforts to cool inflation.

- Growth in the Pacific Islands is expected to pick up largely because Papua New Guinea, the biggest economy in the subregion, is benefiting from high global commodity prices and an associated jump in government revenues. Fiji Islands is forecast to grow slightly after contracting in 2007. Timor-Leste is expected to maintain moderate growth, funded by oil revenues. Growth in many of the smaller Pacific economies is forecast to slow in 2008, and two of them are likely to experience economic contractions.

- Inflation in developing Asia is expected to accelerate and could hit a decade-long regional high. Inflation will be highest in Central Asia where it will remain in double digits. As the PRC's inflation rate shifts up, so too will that of East Asia. In the other subregions, inflation is also expected to edge up over the course of the year.

- Developing Asia's current account surplus is expected to narrow, to about 5.3% of GDP, from 6.4% in 2007. The narrowing of the surplus will be mainly attributable to slowing export growth, particularly in East and Southeast Asia. Oil- and mineral-rich Central Asia is expected to post a stronger surplus in 2008 while South Asia's deficit is seen changing only a little.

- In 2009, growth in developing Asia is expected to pick up a bit. This projection assumes modest recovery in the global economy beginning later in 2008 and carrying through 2009, an outcome that is far from guaranteed. Though favorable policies and structural conditions should carry growth in the near term, emerging fiscal and inflation stresses have the potential to pull down growth.

- Inflation pressures should recede slightly in 2009. The forecast deceleration in inflation is based on an assumption of some moderation in commodity prices through 2009 and monetary policies that lean against inflation pressures. Current account surpluses are expected to narrow further in 2009, and should help rebalancing, and at an aggregate regional level may fall below 5% of GDP. Even if global demand growth recovers, it is likely to be modest, and real exchange rates are expected to appreciate for many Asian economies.

The myth of uncoupling

- *ADO* looks at the issue of "uncoupling". Evidence is marshaled that emphasizes that developing Asia (East and Southeast Asia) remains closely tied to global goods markets, despite burgeoning intraregional trade. Static export shares for finished products from other Asian countries to the PRC suggest that the PRC has not yet asserted itself as a significant market for final goods exports. Diversion of trade to other regions such as the Middle East and the Russian Federation helps, but cannot fully compensate for slowing demand in much larger, established markets.

- A close look at recent links between monthly retail sales in the US, eurozone, and Japan and exports in nine economies of East and Southeast Asia (in *The uncoupling hypothesis: New evidence from G3 retail sales and Asian exports*) shows powerful impulses that run from the G3 backward through the region. The precise nature of responses to G3 demand impulses depends on where the impulse occurs; on the extent of direct and indirect linkages to that market; and on the composition of the country's exports. Those countries that have high export shares of goods (such as food) that are less sensitive to income changes respond less to external demand shocks.

- Recent trends in Asia's exports of consumer manufactured products (*Evidence from cyclically sensitive manufactured exports*) confirm that cyclically sensitive sectors, such as garments and textiles, footwear, toys, and computers and office equipment, are quickly decelerating in both US and Japanese markets. For low-cost manufacturing countries, like Bangladesh and Cambodia, the impacts from textiles and garments are significant. In durable goods sectors, such as machinery, there is as yet little evidence of a slowdown in Asia's exports, but in these sectors, lags between changes in demand and shipments of exports are likely to be longer.

- The PRC's role in the evolution of intraregional trade linkages in East and Southeast Asia has been pivotal. In the past decade, the PRC has established itself as an assembly hub exporting final goods to markets outside the region and drawing in parts and components for assembly from other Asian economies. Through this vertically integrated network, changes in global final demand register first in the PRC and then cascade back through the region. Some pundits have suggested that this pattern is now changing and that the PRC is increasingly substituting locally produced intermediate goods for those that it once imported. A close look at the evidence (*Is the PRC uncoupling from developing Asia?*) suggests that these shifts are more apparent than real and that the established supply networks remain firmly in place. The PRC is still largely specialized in low-cost, labor-intensive assembly activities. Export shares of parts and components from other countries to that country show no signs of tailing off yet.

- Over the past decade, developing Asia's financial markets have undoubtedly become more closely meshed with those in the rest of the world. Financial asset growth has fast outrun growth of nominal GDP, and cross-border holdings of assets and liabilities have flourished with the retreat of "home bias". Indeed, a wide variety of indicators show that East and Southeast Asian financial markets are now much more closely integrated with international markets than with each other. Asia has latched on fast to the global financial system. Yet the likelihood of a credit crunch washing ashore seems remote. And though credit conditions can be expected to tighten, which

may trim investment and household spending, the prospect of abrupt deleveraging of Asia's bank-centered financial system appears remote. Nevertheless, domestic risks to Asia's banks remain, and they need close attention within broader financial and macro policy frameworks.

- Lastly, the point bears repeating that the domestic conditions supporting growth in developing Asia are strong. That said, prospects will also depend on Asian countries' ability to tap the potential of overseas markets, and this would be threatened by any significant rise in trade or investment protectionism. If the global economy were to slump, rising protectionism could present a significant risk for developing Asia.

Nervousness about commodity prices and inflation

- Developing Asia's voracious appetite for commodities, along with other factors, is contributing to global price rises. Real prices of fuel and derivative products have reached all-time highs, and food prices are now soaring. To cushion consumers, and to head off potential social stresses, many Asian governments have subsidized or otherwise controlled prices of basic commodities such as kerosene, rice, and wheat. For example, Indonesia spends inordinate amounts of budgetary resources on fuel subsidies alone, much larger than moneys spent on public sector delivery of health and education combined. If oil should average $100 a barrel in 2008, as opposed to Indonesia's original budget assumption of $60, then fuel and electric power subsidies will rise by over $17 billion relative to the 2008 budget assumptions. If governments do not rethink these expensive and inefficient subsidy programs, fiscal costs could escalate sharply and require painful adjustments (or accelerating inflation, or both) later.

- The risk of an inflation spiral in Asia is palpable and warrants close attention. Indeed, published inflation rates disguise the true extent of underlying inflation pressures due to the presence of subsidies, administrative price controls, and cuts in excise taxes. The appropriate monetary response partly depends on whether price pressures are seen as temporary, and so are likely to recede, or as more structural and durable. But developing Asia cannot afford to bet on an orderly and imminent retreat of price pressures.

- The best approach is to tackle the problem at its roots. For some countries this may require a more flexible approach to exchange rate management. Attempts to resist currency appreciation by allowing interest rates to track down with global rates would only aggravate inflation pressures. For other countries, it may require close examination of fiscal spending levels and priorities. In some circumstances, targeted measures, for example, clearing away chokepoints on trade and distribution, may be required to relieve cost pressures.

Workers in Asia

- Part 2 of *ADO—Workers in Asia*—examines, in three chapters, key longer-term issues facing Asia's economies and particularly its workers. It looks at: whether developing Asia is at risk of failing to realize its "demographic dividend"; skills mismatches and shortages in key professions; and issues of surging international labor migration within developing Asia. The chapters offer some views on what developing Asia should do to maximize the dynamism of its economies, and of its people.

Young Asians: A squandered talent

- Developing Asia is passing through a demographic phase that has a high share of young adults in the total population. This "youth bulge" has enormous potential for stimulating economic growth through productive employment, asset creation, and investment. The growth opportunity must be harvested within the next two or three decades.

- However, there are major difficulties to this. For example, youth unemployment and joblessness are on the rise, disproportionately affecting three groups of young people—women, workers with little education, and those in rural areas.

- Also, poor education and training are increasingly pushing poor, young workers into informal sector jobs, often at low pay and in miserable working conditions. And although the level of education attainment has risen across all skills groups, the returns to education are falling.

- Broadly, the ingredients of an appropriate policy environment include strengthening the relevance and quality of school curricula; providing support for vocational training; and helping kick-start job schemes that will impart relevant skills.

Asia's skills crisis

- Developing Asia is suffering from a growing dearth of skills, especially among professional occupations such as accountants, doctors, engineers, and pilots. The shortage is serious enough, potentially, to harm productivity of entire industries and the economy as a whole.

- To a large extent, the problem is one of success—Asia's rapid growth and structural change. Fast-rising living standards have fueled the demand for finance, medical care, and other skills-intensive services. The structural nature of the skills gap suggests that it is likely to afflict developing Asia for years to come.

- Measures to help alleviate Asia's skills shortages, even in the short run, include attempting to stem the "brain drain" and encouraging Asian emigrants to return home; making it easier for skilled non-Asians to live and work in the region; relaxing occupational restrictions that currently favor "insider" workers' groups; and raising retirement ages.

- Longer term, Asia needs to invest in its education systems, making them more appropriate to the demands of its modernizing economies.

Asian workers on the move

- Migration within Asia is surging, driven by divergences in demography and by widening disparities in economic opportunities between even neighboring countries. No longer do Asian migrants consider only industrial economies.

- These intra-Asian migration trends are likely to become more pronounced. Yet current policies toward immigration remain quite restrictive in most Asian economies, narrowing opportunities for the region to benefit from greater labor mobility and integrated labor markets.

- Asian economies—both sending and receiving—could realize important gains by working together to liberalize intra-Asian movements of all workers, not just the highly skilled. Efforts to promote regional cooperation on and liberalization of immigration, that would complement deepening integration in goods and capital markets, hold great promise. Yet a vision of an integrated Asian labor market has still to emerge.