

The global slowdown and developing Asia

Introduction

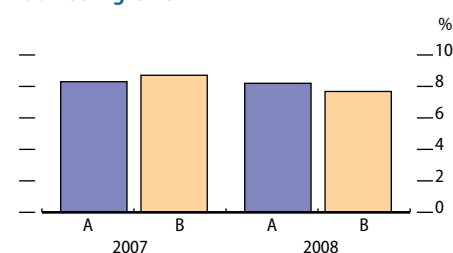
Developing Asia's economy is expected to expand by 7.6% in 2008 (Figure 1.1.1), picking up a shade to 7.8% in 2009. These projections suggest a slowdown from 2007's outcome, now estimated at 8.7%, the highest in 19 years. Still, growth projections for the next 2 years are only slightly below the recent historical trend (Figure 1.1.2) and would constitute a solid performance in an unsteady global economy.

Growth is expected to decelerate in most of developing Asia's economies in 2008, with only a few likely to match or better 2007's performance. Both the People's Republic of China (PRC) and India are projected to cool. In the PRC, growth of net exports is set to fall in 2008 and this will check expansion. In India, where domestic demand accounts for most output growth, a modest slowdown is seen. But growth is expected to ease in many other countries, too. Projected growth rates for Central Asia and for Southeast Asia are below those of 2007. Only the Pacific Islands is forecast to do better than last year.

Rising food and fuel prices are stoking headline inflation, but economic speed limits have also been tested, with recent output growth straining capacity. On the demand side, sustained balance-of-payments surpluses have seeped into domestic liquidity and credit expansion. The expected moderation of growth in 2008 and narrowing of current account surpluses may provide some respite. Nevertheless, trend inflation is rising (Figure 1.1.3) and the projected headline rate is expected to be the highest in a decade.

Risks to the baseline growth forecasts outlined in *Asian Development Outlook 2008 (ADO 2008)* are firmly to the downside. A coincident slowdown of output growth in the G3 economies—United States (US), European Union (EU), and Japan—now looks set for 2008, with only a moderate and highly uncertain pickup forecast in 2009. As new data are released, G3 growth forecasts are being cut. If the global slowdown is concentrated in sectors such as electronics, textiles and garments, and toys, as recent data appear to suggest, this would hurt Asian exporters. Although developing Asia is now exporting more to other emerging economies—the Middle East, Russian Federation, and elsewhere—this is unlikely to compensate fully for losses in the much larger, more established markets.

1.1.1 GDP growth

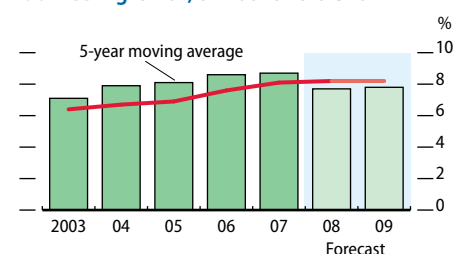


A = Asian Development Outlook 2007 Update; B = Asian Development Outlook 2008.

Sources: Asian Development Outlook database; staff estimates.

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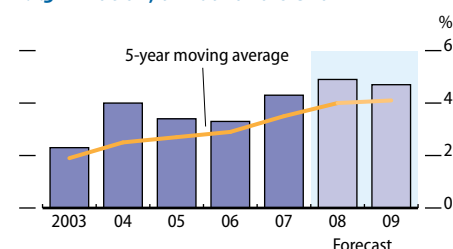
1.1.2 GDP growth, annual and trend



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.3 Inflation, annual and trend



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

There are other important uncertainties. Rising food and fuel prices could probe developing Asia's resilience. Countries that are net fuel and food importers are likely to be squeezed by adverse movements in their terms of trade; more so, when unit values of important export products are weakening, as they now are for garments and textiles. In some countries such as Pakistan, adverse terms of trade movements threaten to widen further already substantial current account deficits.

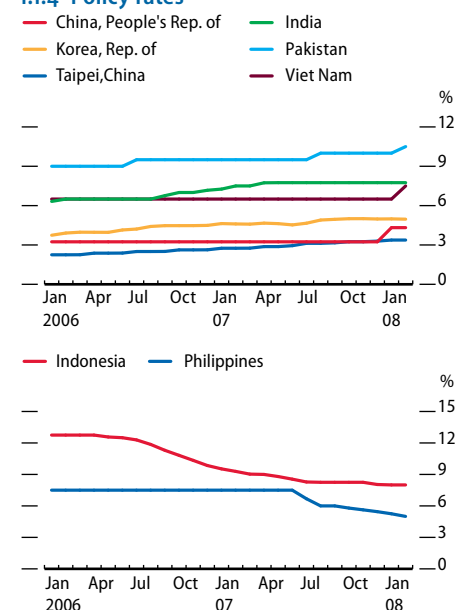
As highlighted in *ADO 2007 Update* of September last year, fuel subsidies and other methods of restraining retail prices are already costing developing Asia dearly. Though some recent hikes in administered prices have been made, for example in Bangladesh and India, these are trailing international price increases with the result that the gap between border and domestic prices is again widening. Such open-ended fiscal commitments have high social opportunity costs and, in the absence of "exit strategies," could eventually threaten macroeconomic balances. Recently introduced food subsidies, intended to soothe social pressures, are now adding to fiscal worries. If there is a respite from rising prices, as the *ADO 2008* baseline assumes, payments and fiscal risks should recede. But if food and fuel prices soar further—a possibility that cannot be ruled out—some governments may be faced with tough structural adjustments.

More general inflation risks also lurk and could limit policy options (if the deceleration of growth gives cause for concern). In the PRC, the consumer price index (CPI) climbed by 8.7% in February, the steepest rise in 11 years. In Central Asia, inflation is running in double digits, and in many other countries it is expected to accelerate this year. Monetary policy responses have been mixed (Figure 1.1.4) and occasionally lag price developments. The authorities in some economies are anxious that rising interest rates may attract capital inflows and put further upward pressure on nominal exchange rates. But if central banks attempt to resist (rather than manage) nominal currency appreciation, they will eventually court elevated inflation expectations as pressures build for the real exchange rate to appreciate. Sharp cuts in US interest rates are exacerbating pressures and will raise sterilization costs. If inflation expectations are allowed to ratchet up, this will risk long-term damage to productivity growth and to the credibility of central banks.

A key message of *ADO 2008* is that, although problems will spread from the global economy to developing Asia—a process that is already visible in high-frequency trade and financial data—the region's growth in 2008 is much more likely to moderate than to lurch down. Developing Asia is not immune to global developments, but neither is it hostage to them. In the near term, Asia's structural transformation, robust productivity growth, and favorable policy climate will continue to support healthy growth. The outlook for credit may well tighten, but the regional financial system—which is still mainly built around bank credit—should be largely insulated from the huge deleveraging now under way in the US.

There should be no room for complacency. Asia's growth is neither preordained nor guaranteed, and if economic vigor is to last, countries must address a raft of challenges. Today, weaknesses limit policy options and are mere bumps along the road to progress. However, left unattended,

1.1.4 Policy rates



Sources: Datastream; CEIC Data Company Ltd.; both downloaded 24 March 2008.

[Click here for figure data](#)

they could become inescapable road blocks along that path and a serious source of vulnerability.

Part 2 of this 20th anniversary issue of *ADO 2008, Workers in Asia*, looks beyond Asia's immediate issues and investigates the different challenges related to the creation of productive work and jobs in Asia. The first of three chapters, *Young Asians: A squandered talent*, analyzes developing Asia's capacity to fully redeem the demographic dividend of its many young people now moving into the labor force. *Asia's skills crisis* discusses the skills gap between what workers have acquired and the skills they need in economies that aim to move up the "value ladder." The last chapter, *Asian workers on the move*, analyzes the benefits to countries of the recent tectonic shifts in migration within Asia. All three chapters offer policy suggestions on what developing Asia can do to maximize the dynamism of its economies, and its people.

Part 3 presents, in a country context, overviews of recent economic performance, forecasts for the next 2 years, and the development challenges facing each country. Part 4 presents a brief analysis of the "errors and omissions" line in Asia's national accounts data.

In the following section of this chapter, *Global outlook* explains the wider backdrop for developing Asia's prospects. Economic conditions in the major industrial countries are reviewed with the spotlight on the possible implications of the still-unfolding credit crisis in the US. The evolution of the crisis affecting US credit markets is assessed and the policy challenges are identified. Prospects are then briefly reviewed for the US, eurozone, and Japan. This sets the scene for an examination of how a global downturn might be transmitted to developing Asia.

In the section, *The uncoupling myth: The G3 slowdown and developing Asia*, ties between developing Asia and the wider global economy are scrutinized at different levels. Macroeconomic models that capture historical linkages suggest that a combination of adverse shocks to output growth in the G3 and real exchange rate appreciation in developing Asia would register in slower growth, but that the effects are modest relative to potential output growth. Trade channels account for most of the spillover to Asia, though domestic demand could also be crimped by higher real interest rates. A more disaggregated look at the impact of slower consumption spending in the G3 suggests a fast-working—and in some cases substantial—drag on Asian exports. Drilling down further, patterns in recent manufacturing trade statistics show that developing Asia is already feeling the pinch from a slowdown in Japanese and US demand, particularly for cyclically sensitive consumer products.

Looking inside Asia, trade data still reveal strong economic complementarities between the PRC and other economies of East and Southeast Asia. The notion that cross-border linkages are being weakened as the PRC substitutes local for external suppliers finds little support. Vertically integrated supply chains that crisscross East and Southeast Asia remain an important mechanism that disperses and propagates the impacts of external shocks. Virtually all the increase that has occurred in intraregional trade in manufactured goods in recent years has been in parts and components. Final goods demand in the PRC still accounts for only a small share of exports from other Asian countries—though that share may be climbing.

Asia's financial markets are becoming more closely meshed with global markets. Most measures of financial integration, and thus potential contagion, have greatly strengthened over the past decade. Through these channels Asian borrowers will feel the pinch in international credit markets and Asia's bourses are likely to experience heightened volatility. But as Asia's banks are still the main originators of domestic credit, and their leverage and exposure to unsafe securities are low, the possibility of the credit crunch washing onto Asia's economic shores seems remote. Most Asian economies also have ample foreign reserves in the event of an unexpected rush to sell domestic currency.

In the final section, *Reasons to be nervous: Commodity prices and inflation*, the role of rising fuel and food prices in stoking inflation is considered. Net fuel and food importers are at particular risk of adverse terms of trade movements, and countries that choose to try and cushion the effects of rising border prices on consumers face a potentially large fiscal bill. A jump in long-run inflation—and fuel and food are major components of most household budgets in Asia—is perhaps a clearer short-run danger to developing Asia than moderating growth.

Global developments complicate the current picture. Although the slowdown in global demand should ease inflation pressures, deep cuts in US interest rates would add to them if Asian economies do not allow greater flexibility in nominal exchange rates. Lower interest rates also tend to make commodities more attractive as assets and so may support high prices (Figure 1.1.5), though the effects on inflation should be transitory. Any passive acceptance by Asia of an upward drift in inflation could deal a hard blow to long-run productivity growth. Even moderate inflation typically proves costly to get rid off. Conversely, price controls and extensive price subsidies, though they may temporarily corral inflation expectations, are not the answer and would stymie market adjustment processes.

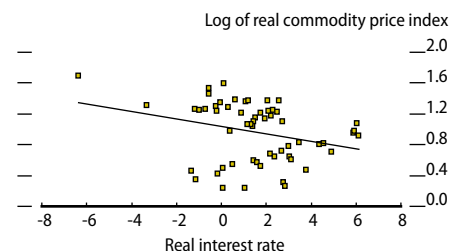
Global outlook

Financial market turmoil

Adjustments in real economic activity are now in train. As new economic data are released, pundits have been revising down their estimates of growth. In January 2008, the International Monetary Fund (IMF) cropped its growth forecasts for the G3. Consensus forecasts of growth for the three main economic blocs have tracked steadily down through the March 2008 release (Figure 1.1.6). The baseline *ADO 2008* assumptions in Table 1.1.1, anchored in IMF analysis, were last updated in mid-February and more recent news would possibly warrant cuts to these growth estimates.

The global economy's health has taken a turn for the worse. What initially appeared in mid-2007 as a domestic problem in the US housing market has now infected the broader financial system in the US and in Europe and is spilling over into the real economy worldwide. The discovery of substantial credit risks camouflaged by complex, collateralized securities has exposed highly leveraged investors to substantial losses and in some cases led to insolvency. Problems are

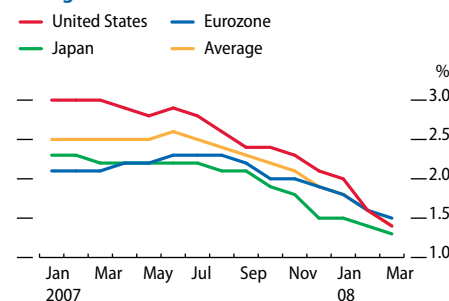
1.1.5 Real commodity prices and real interest rates, 1950–2007



Sources: Commodity Research Bureau, available: www.crbtrader.org; US Department of Labor, Bureau of Labor Statistics, available: www.bls.gov; Federal Reserve Board, available: www.federalreserve.gov; all downloaded 24 March 2008.

[Click here for figure data](#)

1.1.6 Consensus forecasts for 2008 GDP growth



Source: Consensus Economics, Inc., *Consensus Forecasts*, various issues.

[Click here for figure data](#)

1.1.1 Baseline assumptions for external conditions

GDP growth (%)	2006 Actual	2007 Actual	2008 ADO 2008 projection	2009 ADO 2008 projection
Industrial countries^a	2.7	2.3	1.5	1.9
United States	2.9	2.2	1.5	2.0
Eurozone	2.7	2.6	1.6	2.0
Japan	2.4	2.1	1.5	1.5
Memorandum items				
US Federal Funds rate (average, %)	5.0	5.0	2.75	2.9
Brent crude oil spot prices (average, \$ per barrel)	65.4	72.7	85.0	95.0
Nonfuel commodity prices (% increase)	24.5	15.7	0.2	-5.7
CPI inflation (OECD, average)	2.6	2.5	2.7	2.4
World trade volume (% increase)	10.1	7.5	7.0	7.7

^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; Bloomberg; World Bank, *Commodity Price Data and Prospects for the Global Economy Forecast Summary*, available: www.worldbank.org; OECD Main Economic Indicators, available: www.oecd.org; IMF World Economic Prospects, available: www.imf.org; all downloaded 28 March 2008; staff estimates.

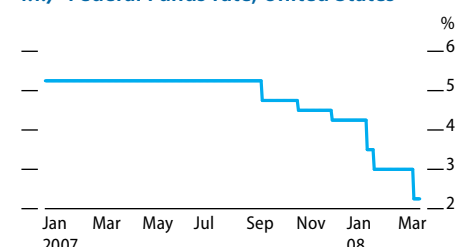
no longer confined to the “subprime” mortgage market. Troubles are amplifying and spreading—and are yet to run their full course. Nobody cares to predict what may still turn up.

Initially, much of the pain centered on banks whose balance sheets were forced to shelter the damaged assets of their (unregulated) investment entities (so-called structured investment vehicles). This sapped bank liquidity and required fresh equity to replace depleted capital. Difficulties ensued in the short-term money markets and markets for commercial paper as potential lenders lost confidence in borrowers’ ability to repay and in the true value of the collateral that they had pledged.

Now, troubles have overwhelmed non-deposit-taking (investment) banks. Balance sheets that had been puffed up on leverage and inflated asset values have been badly punctured. As investors have sold into a falling market to limit losses and to meet collateral requirements on their leveraged portfolios, they have succeeded only in tipping the market further down and raising broader market risks. The ability of all but the most creditworthy borrowers to refinance has been seriously impaired and, as investors dump assets whose values can no longer cover their debts, defaults are rising. Insurers that had acted as guarantors against default—“enhancing” credit quality and transferring risks—are now facing steeply rising claims and are scrambling to replenish their capital. As the New York Federal Reserve has warned, an unstable dynamic has been unleashed that threatens the functioning of the US and other funding markets.¹

Alarmed by clear risks to the financial system, and a rising probability of recession, the US Federal Reserve has slashed its target policy interest rate. Since its peak in September 2007, the Fed Funds rate has been gouged by 300 basis points (bps) in only 5 months (Figure 1.1.7). In the eurozone, where there had been an expectation that interest rates would track up in 2008, short-term policy rates are on hold despite inflation reaching a 14-year high of 3.3% in February. The prospects of rapid

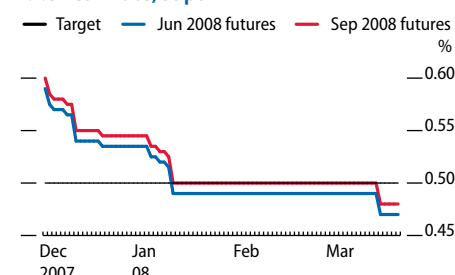
1.1.7 Federal Funds rate, United States



Source: Datastream, downloaded 26 March 2008.

[Click here for figure data](#)

1.1.8 Call rate, Japan



Source: Datastream, downloaded 25 March 2008.

[Click here for figure data](#)

slowing mean that a cut in eurozone rates in 2008 cannot be ruled out. A cut in yen interest rates, inconceivable only a few months back, is also possible (Figure 1.1.8).

Yet despite aggressive US Fed Funds rate cuts, credit spreads have widened in the US and the flight to cash and high-quality securities has persisted (Figure 1.1.9). Even qualified borrowers are having difficulty in obtaining funding as banks buttress their liquidity against the possibility of losses. Confidence about the solvency of counterparties continues to ebb despite substantial liquidity support to markets.

Efforts to support the functioning of money and funding markets are now being closely coordinated among the central banks of the G10 economies. Efforts outside the US have focused largely on ensuring liquidity in the interbank market and in the eurozone dollar market. But most of the action has been in the US where the Federal Reserve has taken unprecedented steps to extend support to “primary dealers” (all of which are nondepository financial institutions) as well as to banks. On 16 March, the discount window was opened to primary dealers, providing unlimited credit in return for pledges of investment-grade collateral, with credit being extended up to 30 days. In some ways, the Federal Reserve is now acting as a lender of last resort to nondepository financial institutions that may be facing difficulties in the wholesale funding markets. At each step, the Federal Reserve has relaxed conditions on collateral and pricing and extended greater flexibility on maturity. Through a substantial guarantee to JP Morgan, the Federal Reserve has also in effect underwritten the acquisition of Bear Stearns, the US’s fifth-ranking investment bank, after it became clear that Bear Stearns was in all likelihood insolvent.

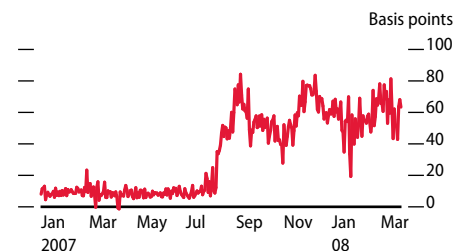
In this complex and dynamic environment, there is considerable dissonance about the outlook and appropriate policy responses (Box 1.1.1).

United States

News coming out of the US economy points to a slowing of demand in the first months of 2008. There is no end in sight to the rout in the housing market. Foreclosures are rising, housing starts are in free fall, inventories of unsold units are piling up, and house prices continue to tumble (Figure 1.1.10). Difficulties have now spread beyond housing into the wider economy. Institute for Supply Management indexes (Figures 1.1.11 and 1.1.12) show that, despite an uptick in the nonmanufacturing index in February, both manufacturing and nonmanufacturing indexes signal contraction. A variety of other survey data paint much the same picture. The University of Michigan Consumer Sentiment index (Figure 1.1.13) was at a 5-year low in March. A contraction in February’s retail sales has confirmed these early warning signals. To say the least, producers and consumers in the US are in a highly cautious mood.

Labor market indicators, which often lag other developments, are now weakening as well. March 2008’s data release from the Bureau of Labor Statistics shows a reduction in nonfarm seasonally adjusted payrolls between January and February of 63,000. This is the largest drop since March 2003. Most sectors in the US economy, other than public services, are shedding jobs. Private sector job losses in February exceeded

1.1.9 12-month US\$ interbank spreads

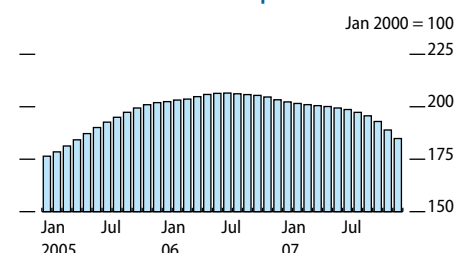


Note: Spreads refer to the difference between the interbank rate and the overnight index swap rate.

Sources: Bloomberg; Datastream; both downloaded 27 March 2008.

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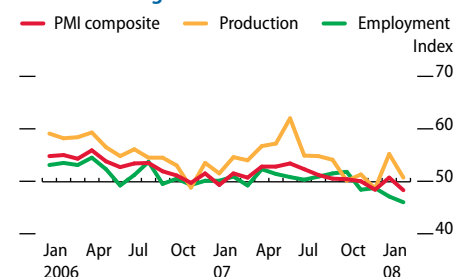
1.1.10 Case-Shiller home price index



Source: Standard & Poor’s, available: www.standardandpoors.com, downloaded 17 March 2008.

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1.1.11 Institute for Supply Management manufacturing index

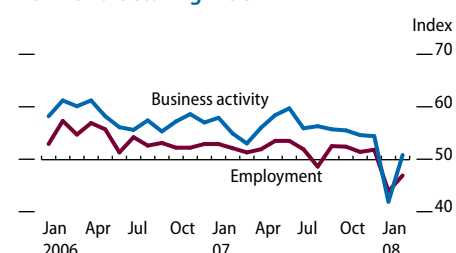


PMI = Purchasing Managers Index.

Source: Datastream, downloaded 17 March 2008.

[Click here for figure data](#)

1.1.12 Institute for Supply Management nonmanufacturing index



Source: Datastream, downloaded 17 March 2008.

[Click here for figure data](#)

1.1.1 Purging imbalances or breaking the economic fall?

Pundits disagree about what needs to be done about the current credit crisis in the United States.

One perspective is that the current setback is an inescapable consequence of a buildup of credit-fueled excesses there, regulatory failures in financial markets, and structural imbalances across the global economy. Accordingly, the solution lies in putting right these excesses, failures, and imbalances. Elements of the solution would include coordinated policy adjustments that better apportion global demand and supply, and steps to damp pro-cyclical credit growth in financial markets, including regulatory and prudential measures that put the brakes on incentives for risk origination in rising markets.

Analysts observe that the goal of restoring longer-term financial sustainability and solvency should not be confused with macroeconomic stabilization objectives. Indeed, those who believe that the priority should be on purging imbalances see a—possibly painful—correction as unavoidable. Cutting short-term interest rates cannot repair insolvent institutions or fix asset price misalignments. When risks of credit default are thought to be very high, short-term policy rates may have little purchase on market rates or credit flows.

For example, if everybody believes that house prices will continue to tumble, it will be difficult to tempt rational borrowers with even zero-interest mortgages. Likewise, lenders would be foolish to swap their cash for crumbling housing collateral. And there are significant risks built into aggressive interest rate cuts: a sharp rise in future inflation and a replay of a reckless cycle of credit boom and bust would be highly damaging.

Yet the political reality is that monetary and financial policy must attempt to balance an interest in protecting the normal functioning of the funding market against the threats presented by bailouts, moral hazard, and raised inflation expectations. When the macroeconomic and financial stakes are so high—and they appear to be so, particularly in the US economy—erring on the side of

caution makes sense. If the interplay of growing financial stresses and weakening demand is such as to take the US economy tumbling down a deflationary path there will be no second chance for monetary policy.

In such an environment, interest rate cuts that are complemented by other measures—including fiscal spending—may soothe economic pain and help break the downward spiral in confidence. Though there is a strong possibility that the effectiveness of a monetary stimulus will be diluted by rising saving and weakened credit transmission, it may provide some relief.

Other channels may help too. A steeper yield curve may support profitability for beleaguered banks. And through their (short-run) effects on the real exchange rate, interest rate cuts may also spur net exports. Central banks can help in other ways, including liquidity-support measures that help enhance the credit standing of financial market institutions. Ultimately, fiscal support may be needed to deal with insolvencies and debt restructuring.

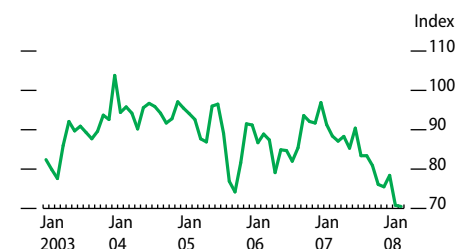
Despite divergent views on the likely effectiveness of monetary and financial policy, there is broad agreement that the circumstances that let risks build and multiply must be addressed. Over the longer term, these conditions are likely to entail a reconsideration of many aspects of financial regulation and supervision. The list of areas that needs study and possible attention is long, and would start with adequacy of liquidity and capital cushions; financial disclosure; valuation of complex assets, risk models, and risk rating; and unevenness of regulation and oversight in closely related activities.

Questions about whether central banks have instruments that are fit for managing complex financial systems (of which deposit-taking institutions are a shrinking part) also warrant close scrutiny. Whatever conclusions emerge, there must be a healthy balance between regulation on the one hand, and the role of markets and competition in disciplining errant behavior on the other.

100,000. Earlier payroll numbers for January and December were also revised down, confirming the downward trend in employment. The US unemployment rate has so far held firm but only because workers who have become discouraged in their search for work are leaving the labor force.

Rising headline inflation, stoked by increases in gasoline and to a lesser extent food prices, is taking cash out of households' wallets. Real disposable income is probably falling and data also show a decline in household financial and real estate wealth (Figure 1.1.14). These trends cast a pall over prospects for consumption in the first half of 2008. Fiscal measures will put about 1% of GDP into taxpayers' pockets from the second quarter and easier credit conditions—if in fact interest rate cuts

1.1.13 University of Michigan Consumer Sentiment index



Source: Datastream, downloaded 24 March 2008.

[Click here for figure data](#)

work (Box 1.1.1 above)—are expected to provide a fillip later in 2008. Growth of net exports could also provide important near-term support for aggregate demand.

Hunches about the depth and duration of the slowdown for the rest of 2008 (and possibly through 2009) diverge widely. The most recent labor market data and weaknesses in consumer sentiment both signal a distinct possibility of a contraction in output. The key to the near term is likely to be determined by how credit markets function. If they seize up and therapies work slowly, the expected recovery later in 2008 and in 2009 may not even materialize. Core as well as headline inflation is now showing a rising trend and yields on inflation-protected securities suggest that underlying inflation expectations are rising (Figure 1.1.15). A conjunction of rising inflation expectations and further deterioration in the real economy would undoubtedly make the Federal Reserve's job even tougher, and could limit scope for interest rate cuts.

Eurozone

Financial troubles have reverberated across the Atlantic. Though Europe has not experienced a subprime mortgage crisis, its banks have taken losses as subprime securities prices have fallen. In Germany, three small local banks have failed. Lending has tightened and market rates have risen.

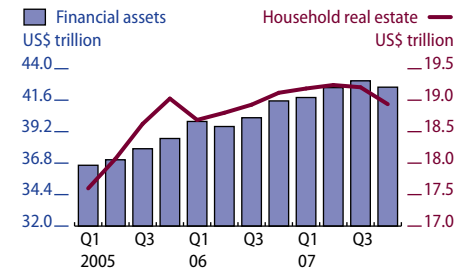
Recent signals from the real eurozone economy are mixed. GDP growth slowed in the fourth quarter of 2007 but then, following 2 months of weak data, industrial production jumped in January (Figure 1.1.16). Germany's export performance has held up well and the business mood is buoyant.

Business confidence in other European countries is not quite so perky, and the eurozone-wide confidence index dipped in February. Other signals are mixed. Although labor market conditions have improved, as unemployment rates continue to inch down, consumer confidence has plummeted (Figure 1.1.17). Indicators of the outlook for the services sector are distinctly gloomy. Inflation is now running at its highest level in 14 years, reaching 3.3% in February. Rising fuel and food prices are adding to inflation and there are concerns that rising wage costs may aggravate inflation pressures.

Growth in the eurozone in 2008 is likely to fall significantly below the outcome in 2007 (2.6%). In March, the European Central Bank (ECB) cut its own projection for 2008 to 1.7% from its earlier forecast of 2.0%. The European Commission's estimate and a range of private sector forecasts are also drifting down. A variety of troubling developments, including the real appreciation of the euro, is likely to restrain output growth. That said, the probability of a recession in the eurozone seems more distant than in the US.

The dependence of Europe's exports on demand in the US is hotly debated. One line of thought is that declining dependence on the US market—only 7% of Germany's exports now go there—and diversification toward Asia and oil exporters mean that, as Germany's exports uncouple from the US, so too will Europe's (Figure 1.1.18). It is for this reason, so the argument runs, that robust export growth has continued despite the appreciation of the euro against the dollar.

1.1.14 Gross private wealth, United States

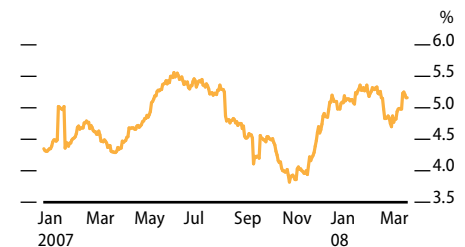


Note: In real, Q1 2005 prices.

Source: Federal Reserve Board, available: www.federalreserve.gov, downloaded 24 March 2008.

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1.1.15 Yield on Lehman Brothers US TIPS index

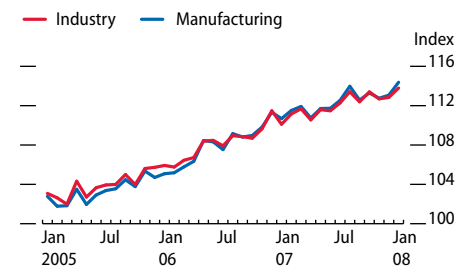


TIPS = Treasury inflation-protected securities.

Source: Datastream, downloaded 29 March 2008.

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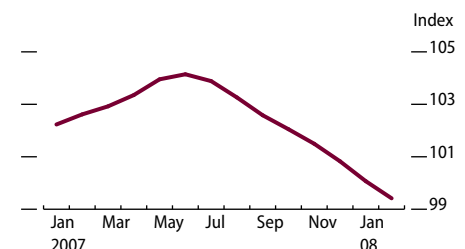
1.1.16 Industrial production, eurozone



Source: Eurostat, available: <http://europa.eu.int>, downloaded 25 March 2008.

[Click here for figure data](#)

1.1.17 Consumer confidence, eurozone



Source: Datastream, downloaded 24 March 2008.

[Click here for figure data](#)

Recent research by Deutsche Bank,² however, pours cold water on this thesis. Over a protracted period, Germany's exports have closely tracked broader measures of price competitiveness and there is no reason to think that this relationship is about to break down. Moreover, exports from other eurozone economies, including Italy and Spain, appear to be much more sensitive to the value of the euro than Germany's. In real effective terms, the euro appreciated by 5% in 2007 (Figure 1.1.19). As the impact of the euro's appreciation on exports and industrial output passes through to prices, the support that exports have provided to growth is likely to dissipate. Also, if the US slowdown percolates through to moderation of growth in other regions, this impact will be transmitted indirectly to the eurozone.

Other factors—including high oil prices; housing market troubles in countries such as Ireland, Spain, and the United Kingdom; and rising wage cost pressures in Germany—may also weigh on demand and growth in Europe. There is a risk, too, that credit market conditions will tighten further. Continental European businesses are highly dependent on bank finance and through this channel are exposed to credit market troubles. The full extent of European bank exposure to the credit market crisis is not yet known.

On a brighter note, if unemployment continues to fall and consumption sentiment turns around this may provide some favorable economic ballast. But labor market conditions cannot swim against broader economic currents indefinitely.

Policy support for eurozone growth in 2008 is likely to be limited. Fiscal options are theoretically constrained by agreements under the Stability and Growth Pact, and the ECB seems unlikely to cut interest rates until it sees hard evidence of economic slowing and retreating inflation expectations. Though the ECB has now softened its hawkish rhetoric on the inflation outlook, monetary policy adjustments, when made, are very unlikely to emulate the aggressive and anticipatory movements of the Federal Reserve.

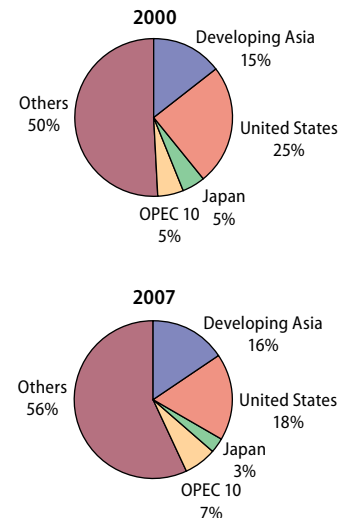
Japan

Despite unexpectedly strong fourth quarter GDP growth in 2007 (3.5% measured on an annualized basis), trouble is brewing in Japan too.

Several factors are weighing on Japanese prospects. Most immediately, export demand, which has been the mainstay of growth, is likely to be constricted by a slowdown in global economic growth. The US is still a large market for Japan, accounting for over 30% of its exports when indirect demands are taken into account, and the slowdown there as well as in Europe will curtail demand. Robust growth in developing Asia may help, but it too is expected to moderate.

A cheap yen has been one of the major factors supporting Japanese export growth in the past, but its recent sharp appreciation will likely dent exports (Figure 1.1.20). In trade-weighted terms, the yen appreciated by 10% in the 6 months to January 2008. Early indications of export slowing are already appearing. As measured in the Purchasing Managers Index, export orders fell below 50 in February, their lowest level in 3 years, indicating probable future contraction. However, the slowdown is not yet apparent in actual exports, with growth of 8.7% in February.

1.1.18 Export destinations, eurozone

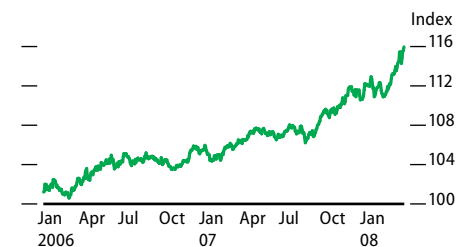


OPEC 10 = Algeria, Islamic Republic of Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

Source: Eurostat, available: <http://europa.eu.int>, downloaded 24 March 2008.

[Click here for figure data](#)

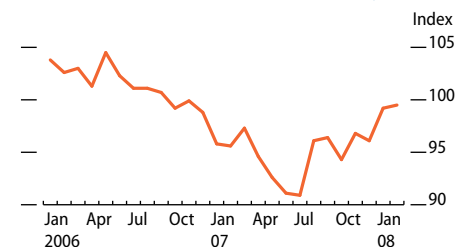
1.1.19 Real effective exchange rate, euro



Source: European Central Bank, available: www.ecb.int, downloaded 29 March 2008.

[Click here for figure data](#)

1.1.20 Real effective exchange rate, yen



Source: Bank of Japan, available: www.boj.or.jp, downloaded 27 March 2008.

[Click here for figure data](#)

Domestic demand is unlikely to replace exports' contribution to growth. Residential construction growth is still in negative territory following regulatory changes in 2007, though this one-time reduction in the level of demand should begin to fade from growth statistics in the second quarter. There may even be catch-up of residential investment, deferred in 2007, if the mood among households holds up, but the corrosive effects of a rising yen and raw material prices on industrial profits are likely to subdue nonresidential investment. Nevertheless, if there is a bounce after the housing-induced contraction in 2007, fixed investment may grow in 2008.

Japanese consumers continue to have little appetite for spending. Consumer confidence is at a 3-year low (Figure 1.1.21). Real wages are barely growing, if at all, and hours worked are now beginning to dip. In a context of considerable fiscal uncertainty and an aging population, Japanese households are saving industriously for retirement. Equity prices, often a good barometer of the Japanese consumer's mood, are tumbling (Figure 1.1.22). With the prospect of stagnant disposable incomes and declining wealth, it seems that consumption growth will decelerate in 2008.

Japan is still struggling to reduce its public debt, limiting the scope for fiscal measures in support of growth in 2008. Likewise, there is little wiggle room for monetary policy with interest rates hovering close to the nominal floor of zero. In these circumstances, Japan's growth too is likely to slow in 2008. The Japanese Government has itself recently downgraded its growth forecast and is now expecting growth of just 1.3% this year.³

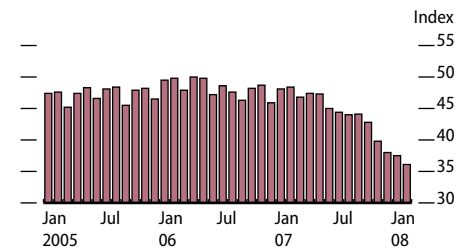
Summary

These are highly uncertain times for the global economy. Forecasts vary widely for just how difficult the next 12–24 months could be. The variance of macroeconomic growth forecasts of GDP has widened (Figure 1.1.23). One concern is that the absence of a reliable economic compass may heighten the risk of policy mistakes. Another is that the complex nature of the problems in credit markets and the changes wrought by financial innovation may render orthodox monetary policy ineffective.

In this environment, it is particularly important to keep close to rapidly developing events and to revise judgments in light of new information. The most significant departure from earlier assessments is that *ADO 2008* now expects a coincident slowdown in the US, Europe (including the UK and some other non-eurozone countries), and Japan in 2008, possibly extending into the early part of 2009. Whether these slowdowns eventually materialize in the data as technical recessions (two consecutive quarters of contraction) is still an open question—certainly in the eurozone and Japan—but their coincident nature will definitely limit opportunities for Asian producers to switch to new markets. If recessions of significant depth and duration were to occur, there is a strong risk of rising protectionist measures in industrial countries, squeezing exports by low-cost producers in Asia and elsewhere.

Robust growth in developing Asia will make a welcome and significant contribution to global growth in 2008. *ADO 2008*'s baseline projections suggest that just over one fifth of global growth in 2008 will be attributable to developing Asia, though the region is yet to reach a

1.1.21 Consumer confidence, Japan



Source: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp, downloaded 17 March 2008.

[Click here for figure data](#)

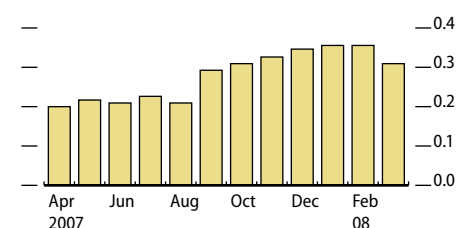
1.1.22 Nikkei 225 stock prices



Source: Datastream, downloaded 19 March 2008.

[Click here for figure data](#)

1.1.23 Standard deviation of consensus forecasts for 2008 GDP, G3 economies



G3 = United States, eurozone, Japan.

Source: Consensus Economics, Inc., *Consensus Forecasts*, various issues.

[Click here for figure data](#)

point where it can provide a significant cushion against slower demand growth in the G3. Indeed, to replace just a 1 percentage point reduction in US consumption demand growth, developing Asia would have to add another 1.3 percentage points of GDP growth—but in fact, developing Asia is much more likely to decelerate in 2008.

The uncoupling myth: The G3 slowdown and developing Asia

The theme of uncoupling is one that has received considerable attention recently. It is certainly true that over a protracted period, rapid growth in developing Asia has had much more to do with Asian countries successfully exploiting opportunities for economic catch-up with richer industrial countries than with them hitching a ride on broader global growth (Figure 1.1.24). But it would be a mistake to assume that wider global developments do not matter for developing Asia (ADB 2007a, 2007b). Industrial-country growth exercises an influence on Asia, but the impact appears to be asymmetric (IMF 2007). When these countries are on the upswing of their business cycle, it is difficult to detect any impact on economic momentum in developing Asia, yet when their growth slows rapidly, Asia usually feels a downdraft. Box 1.1.2 presents one approach to quantifying these impacts using a global macroeconomic model. In the remainder of this section, ties between developing Asia and the G3 are viewed from a variety of other perspectives.

G3 non-oil import demand and Asia's exports

Previous issues of *ADO* have demonstrated the strong links between non-oil imports in the G3 economies and Asian exports (ADB 2007a). The high and rising correlations of Asian exports with non-oil imports in the G3 during the first few years of this century indicate that Asian exports are highly synchronized with G3 import demand (Figure 1.1.25).⁴

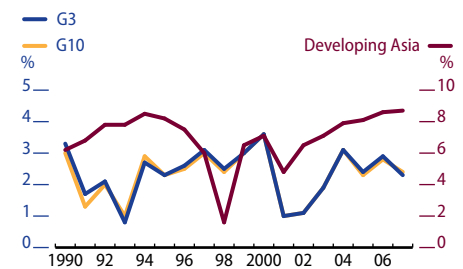
The links between US non-oil import demand and Asian exports are shown over a period of three decades. The relationship has become tighter in the most recent decade relative to the 1980s and 1990s (Figure 1.1.26).

In the case of the eurozone, the correlation has also strengthened in the current decade relative to the second half of the 1990s (Figure 1.1.27 below). The correlation is slightly less than in the US case but still quite robust, and indicates that Asian export activity has become more, not less, synchronized with external demand.

In the case of Japan (the largest national export market for some Asian economies such as Indonesia and the second largest for others), the correlation between non-oil imports and Asian exports has been positive over a longer period and has strengthened over time (Figure 1.1.28 below).

Therefore, even though intra-Asian trade has been expanding more rapidly than Asia's trade with the rest of the world, Asia has become ever more closely linked by globalization to the major global markets of the G3. This stems from the nature of Asian trade, with intra-Asian trade driven by vertically integrated Asian production chains and extra-Asian trade driven by G3 demand for the final goods produced in these networks (ADB 2007a).

1.1.24 GDP growth

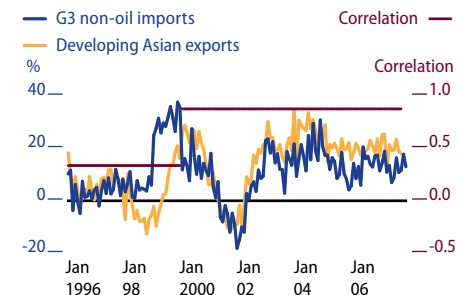


G3 = United States, eurozone, and Japan; G10 = Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States.

Sources: World Bank, *World Development Indicators* online; 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; Statistics Canada, available: www.statcan.ca; all downloaded 24 March 2008; *Asian Development Outlook* database.

[Click here for figure data](#)

1.1.25 Correlations between growth in developing Asian exports and G3 non-oil imports

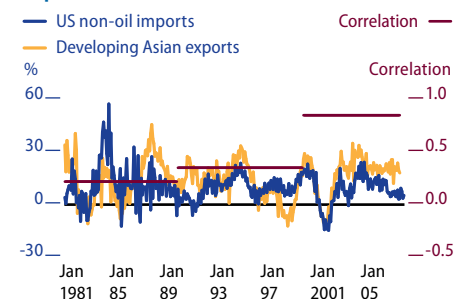


Note: Developing Asian exports exclude those from Taipei, China.

Sources: International Monetary Fund, *Direction of Trade Statistics*, February 2008; US Census Bureau, available: www.census.gov; Eurostat, available: <http://europa.eu.int>; CEIC Data Company Ltd.; downloaded 24 March 2008.

[Click here for figure data](#)

1.1.26 Correlations between growth in developing Asian exports and US non-oil imports



Note: Developing Asian exports exclude those from Taipei, China.

Sources: International Monetary Fund, *Direction of Trade Statistics*, February 2008; US Census Bureau, available: www.census.gov; downloaded 24 March 2008.

[Click here for figure data](#)

1.1.2 Asian fallout from slower global growth

On the basis of the most recent update of the Oxford Economics quarterly global model (February 2008), the impacts of global shocks on developing Asia are traced. Two sets of shocks are considered.

In the first, a simultaneous 1 percentage point reduction in GDP growth in the United States, Japan, United Kingdom, and the eurozone is imposed over 2 years. In this scenario, interest and exchange rates are held fixed. In the second, and in addition to the assumed negative shock to growth, it is assumed that there is a 10% real depreciation of the US dollar against all other currencies except the Hong Kong dollar (for which a peg holds). Considering that the yuan nominally appreciated at an annualized rate of over 20% in January 2008, this exchange rate “shock” is plausible.

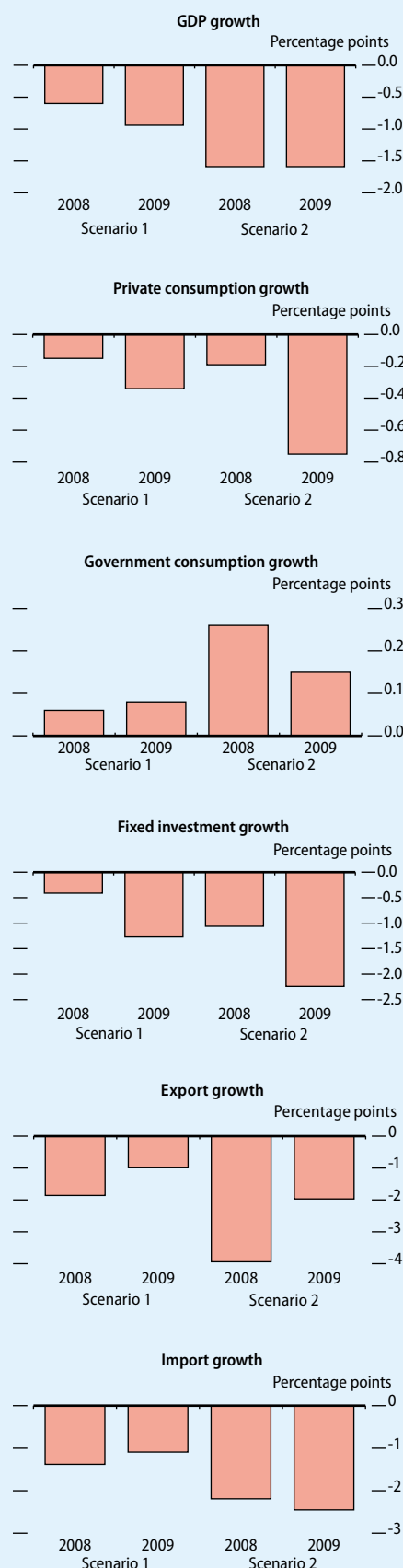
The box figures show that a coincident reduction in the industrial world reduces growth in developing Asia by 0.6 percentage points after 12 months, followed by a 1 percentage point reduction over the baseline in the following 12 months.

The region's strong trade links with industrial economies trigger the negative impact. Slower growth in the US, Japan, United Kingdom, and the eurozone reduce demand for Asia's exports. Asian export growth is squeezed by almost 2 percentage points in the first 12 months, with knock-on effects on income. Lower income growth holds domestic demand in check, easing price pressures and reducing inflation. With nominal interest rates fixed, reduced inflation raises real interest rates, reining in consumption and investment spending growth.

Singapore is hardest hit by the assumed shock, with growth in private consumption and fixed investment falling, respectively, by 0.9 and 0.5 percentage points within 1 year. India is barely affected, with GDP growth declining by a mere 0.3 percentage points, as private consumption nudges down. Export growth in the People's Republic of China and Taipei, China suffers the heaviest blow, crimping growth in both by over 0.6 percentage points in the first year.

With an attendant real currency appreciation, the repercussions of a negative shock to global growth become more acute for Asian economies. The region's exports become more expensive, making them less attractive in world markets. As a result, the adverse impact on Asian exports broadens, with export growth projected to drop by 4 percentage points within 12 months.

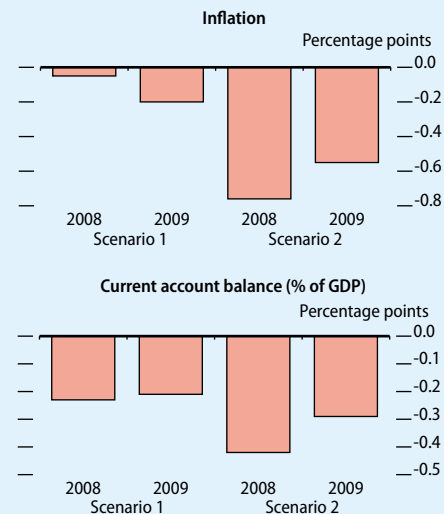
Taipei, China; People's Republic of China; and Republic of Korea show the most pronounced export slowdowns. Again, growth in private consumption and investment is arrested by rising real interest rates. Though the appreciation of Asian currencies makes imports cheaper,



1.1.2 Asian fallout from slower global growth (*continued*)

declining incomes reduce import demand so that import growth drops on a net basis. Overall, developing Asia's growth is cut back by 1.6 percentage points within a year, a full percentage point larger than the outcome when real exchange rates are steady.

These simulation results show that more than a global slowdown, a further sharp depreciation of the US dollar could cut Asia's growth in the short run. However, long-run growth prospects in developing Asia would still depend on the factors driving productivity growth and economic catch-up. Ultimately, rising real incomes will exert forces that will cause real appreciations that rebalance East Asia's economy more toward domestic demand. The risks are in real exchange rates badly overshooting, not in them merely appreciating. [Click here for figure data](#)



The importance of the G3 markets for developing Asia is explored in the next section, with a focus on the linkage between the volume of retail sales in the G3 and the volume of Asian exports.

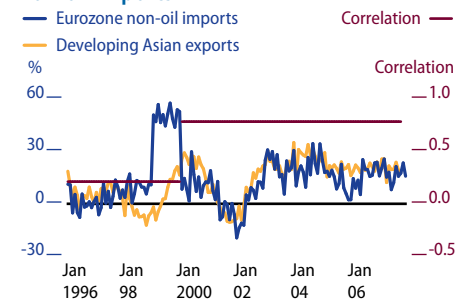
The uncoupling hypothesis: New evidence from G3 retail sales and Asian exports

Simple correlations between import growth in the G3 and Asia's export growth are revealing but other views of the data are possible. In this section, a statistical model is used to examine links between US, eurozone, and Japanese retail sales (as a proxy for demand) and export performance in nine Asian economies. Due to data limitations, only economies from East and Southeast Asia are included in the analysis.

The statistical model is estimated using monthly export data of the nine economies during 2000–2007, and retail sales of the G3. All data are suitably deflated and are measures of real economic activity. The approach chosen (Box 1.1.3 below) exploits the correlation between exports within Asia, as spillover effects along Asian supply chains are likely to be an important source of transmission of external shocks. Simple correlation analysis confirms that export performance across the nine Asian economies is highly synchronized. On average the correlation coefficient among them is around 0.8, with the highest correlations between the PRC; Hong Kong, China; Republic of Korea (hereafter Korea); Singapore; and Taipei, China.

More sophisticated, model-based estimates of the strength of the relationship between retail sales in the G3 and Asian exports are presented in Table 1.1.2 below. The coefficients associated with G3 retail sales in all nine Asian economies are almost all positive, and most are statistically significant. For example, 3 months after a 1% rise in US retail volumes, the PRC's exports rise by 0.79%. For the eurozone, the lag is longer (5 months) and the impact smaller (0.35%). Though the estimates suggest that the PRC's exports respond to a rise in Japanese retail volumes after just 2 months, this particular estimate is not statistically

1.1.27 Correlations between growth in developing Asian exports and eurozone non-oil imports

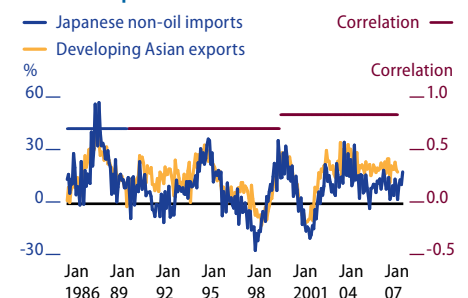


Note: Developing Asian exports exclude those from Taipei, China.

Sources: International Monetary Fund, *Direction of Trade Statistics*, February 2008; Eurostat, available: <http://europa.eu.int>; downloaded 24 March 2008.

[Click here for figure data](#)

1.1.28 Correlations between growth in developing Asian exports and Japanese non-oil imports



Note: Developing Asian exports exclude those from Taipei, China.

Sources: International Monetary Fund, *Direction of Trade Statistics*, February 2008; CEIC Data Company Ltd.; downloaded 24 March 2008.

[Click here for figure data](#)

1.1.3 The (unrestricted) vector auto-regression model

Vector auto-regression (VAR) statistical methods are routinely used to capture the statistical relationships among a system of interrelated variables over time and to analyze the dynamic impact of random disturbances on the system of variables. The VAR approach sidesteps the need for structural modeling by treating every endogenous variable in the system as a function of the lagged values of all variables in the system. The standard representation of a VAR is as follows:

$$e_t = A_1 e_{t-1} + A_2 e_{t-2} + \dots + A_p e_{t-p} + B X_t + \varepsilon_t \quad (1)$$

where e is a k vector of endogenous variables, X is a d vector of exogenous variables, A_1, A_2, \dots, A_p and B are matrices of coefficients to be estimated, and ε is a vector of innovations that may be contemporaneously correlated but are uncorrelated with their own lagged values and uncorrelated with all of the right-hand side variables.

In examining the impact of the G3 slowdown on exports in nine Asian economies, a VAR model is used because exports in these economies tend to be correlated. In particular, the emergence of product fragmentation and trade in parts and components has increased intraregional trade interdependence so that exports in the region have become highly correlated. Equation (1) can be rewritten in terms of exports and the G3 demand as follows:

$$ex_t = A_1 ex_{t-1} + A_2 ex_{t-2} + \dots + A_p ex_{t-p} + B_{11} US_t + \dots + B_{1n} US_{t-n} + B_{21} EU_t + \dots + B_{2n} EU_{t-n} + B_{31} Japan_t + \dots + B_{3n} Japan_{t-n} + \varepsilon_t \quad (2)$$

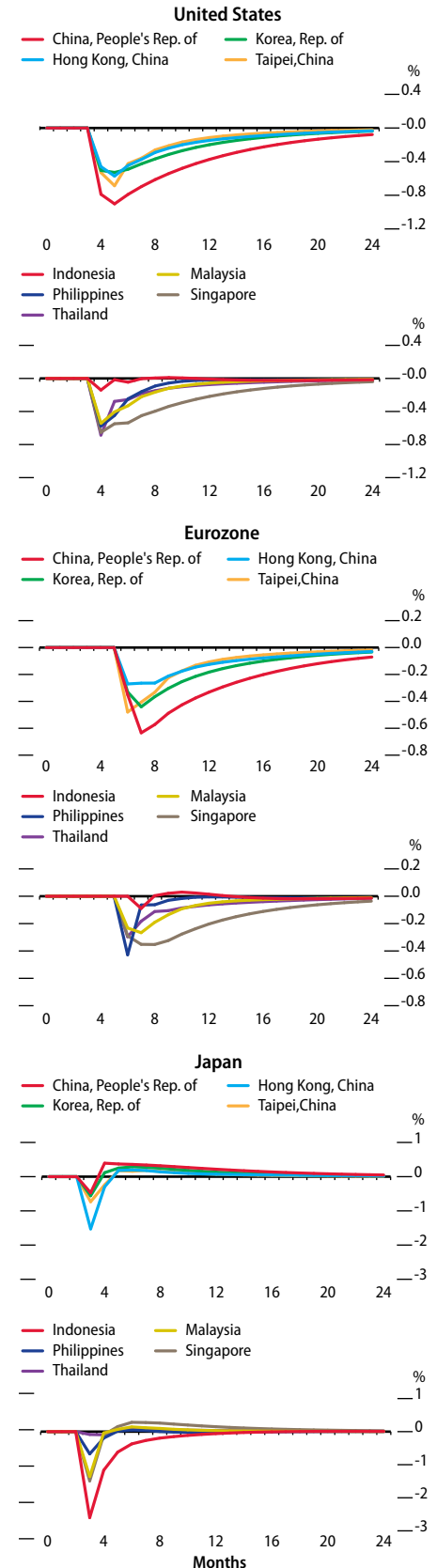
where ex is the vector of (real) exports in nine Asian economies, US , EU , and $Japan$ are the demand, represented by (real) retail sales, of the US, eurozone, and Japan, respectively. Since only lagged values of the endogenous variables appear on the right-hand side of the equations, simultaneity is not an issue and ordinary least square estimation yields consistent estimates.

The Schwarz information criterion is used to select the lag length of the unrestricted VAR model. According to this criterion, the first lag of unrestricted VAR is chosen. In fact, there are other criteria for choosing the lag order of VAR models and these suggest third and seventh order lags. However, almost all variables become insignificant when the lagged values of all the endogenous variables are expanded to the third and seventh order. Diagnostic tests do not significantly improve relative to the first lag order of the VAR model. Meanwhile, all models (the first, third, and seventh lag orders) suggest the stability (stationary character) of the estimated VAR. Based on estimation results and diagnostic tests, the first lag model of VAR is preferred.

reliable, and should be interpreted cautiously. The single largest response is for Indonesian exports to Japan, which 2 months after a 1% rise in retail volumes jump by 2.62%. Japan is Indonesia's single biggest export market, accounting for 21% of its total exports in 2002–2006.

These estimates suggest that the ongoing slowdown in the G3 could have a substantial cumulative effect on Asian exports if it were to persist.

1.1.29 Total impacts of 1% temporary decrease in G3 retail sales on Asian exports



Note: The vector auto-regression model takes account of both direct and indirect (through intraregional exports) impacts of modeled shocks.

Source: Staff estimates.

[Click here for figure data](#)

1.1.2 Estimated impacts of changes in retail sales in United States, eurozone, and Japan on Asia's exports

	United States		Eurozone				Japan	
	Coefficients (third lag)	T-ratio (third lag)	Coefficients (fifth lag)	T-ratio (fifth lag)	Coefficients (sixth lag)	T-ratio (sixth lag)	Coefficients (second lag)	T-ratio (second lag)
China, People's Rep. of	0.79	[4.50]	0.35	[2.29]	0.16	[1.25]	0.47	[0.51]
Hong Kong, China	0.46	[2.96]	0.27	[1.99]	0.02	[0.21]	1.53	[1.89]
Indonesia	0.14	[1.00]	-0.11	[-0.84]	0.16	[1.43]	2.62	[3.42]
Korea, Rep. of	0.50	[5.36]	0.33	[4.02]	0.09	[1.29]	0.56	[1.14]
Malaysia	0.54	[4.96]	0.23	[2.42]	0.00	[-0.01]	1.36	[2.38]
Philippines	0.58	[3.14]	0.43	[2.67]	-0.12	[-0.89]	0.67	[0.70]
Singapore	0.65	[5.56]	0.29	[2.82]	0.00	[0.00]	1.49	[2.44]
Taipei,China	0.53	[4.12]	0.48	[4.27]	0.09	[0.91]	0.73	[1.10]
Thailand	0.68	[7.18]	0.30	[3.55]	0.04	[0.56]	0.09	[0.17]

Note: The underlying model passes a battery of tests indicating that the estimates are statistically reliable.

Source: Staff estimates.

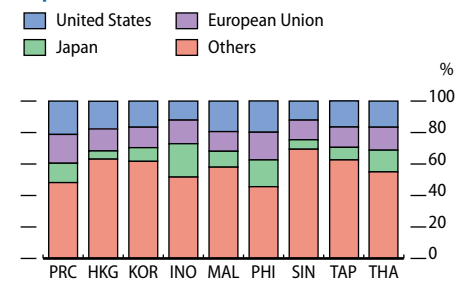
The Asian economies and export sectors likely to be hardest hit by the G3 demand slowdown vary depending on the share and composition of exports into the individual G3 markets and the severity of the slowdown in each of the G3 economies.

One advantage of the model is that by including indirect demands it allows estimation of the contagion (multiplier) effects across the nine Asian economies from the G3 demand slowdown (Figure 1.1.29).⁵ Inclusion of the induced impacts that travel down Asia's supply chains is likely to amplify the direct impacts shown in Table 1.1.2, and it is probable that these effects will depend on the strength of intraregional links through the PRC to the G3.

The model results suggest that the PRC is likely to suffer the most from falling consumer demand in the US. (The shares of the G3 economies in Asia's exports are shown in Figure 1.1.30.) In 2006, the latest year for which data are available, the US market accounted for more than 20% of the PRC's exports, up from 16% in 1995. For the other Asian economies, the US market accounted for about 15% of exports on average in 2006, down from an average of 21% in 1995. Shipments from the PRC and from Hong Kong, China are weighted more toward consumer products that are sensitive to consumer discretionary spending, including garments and miscellaneous manufactures, than are shipments from Korea, Malaysia, Philippines, Singapore, and Thailand which export machinery. Indonesia is less exposed to slowing US demand because it exports relatively greater amounts of food and raw materials than the other Asian economies.

The PRC also has the greatest exposure to a slowdown in the eurozone among the Asian economies, with about 18% of exports destined for that market. The eurozone is a significant destination for low-cost consumer goods exports from the PRC; Korea; and Taipei,China as well as from Malaysia, Singapore, and Thailand. There is some impact on the Philippines, but it dissipates quickly. Again, Indonesia's exposure to a slowdown in the eurozone is cushioned by the high proportion of food and raw materials in its exports. The smaller impacts stemming from the eurozone are probably a reflection of the fact that machinery exports dominate Asia's sales to the eurozone. This may make Asia less vulnerable to a short-term decrease in retail sales but if the slowdown persists, durable goods purchases may also fall and cut into Asian exports.

1.1.30 Shares of G3 economies in Asia's exports, 2002–2006



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

Sources: International Monetary Fund, *Direction of Trade Statistics* CD, February 2008; CEIC database, downloaded 27 February 2008.

[Click here for figure data](#)

Indonesia is most exposed to a slowdown in the Japanese market. As it exports a large volume of primary products directly to Japan, indirect effects coming through a reduction in exports of third countries are unlikely to be important. For the PRC, the statistical estimate of the impact of Japanese retail volumes is not reliable. The PRC exports a large volume of garments, textiles, and footwear to Japan (but more so to the US) and these are highly cyclically sensitive product groups. But the PRC also exports a comparatively large volume of food to Japan, which tends to be less sensitive to income, and this may be influencing the net result. Backward linkages from the PRC to other Asian countries from its exports of garments and food are likely to be weaker than for other goods. Korea's exports are also sensitive to a decline in Japanese retail volumes, despite a modest share of Japan in Korea's total exports.

Evidence from cyclically sensitive manufactured exports

The aggregate analysis of imports and exports and the country breakdown within the G3 and East and Southeast Asia suggest the likelihood of significant impacts on Asian exports of a G3 slowdown. In this section, disaggregated trade data are examined to see if such effects can be traced in the recent evolution of shipments of manufactured goods. Specifically, the impact of weaker consumer demand in the US and Japan on key Asian manufactured exports is probed using quarterly data for the former and 6-monthly data for the latter. An attempt is also made to see if the weakness has spilled over into the EU and if this is also translating itself into more sluggish shipments of Asian products. The knock-on effects on commodity shipments through weakened exports between G3 members as a result largely of the US economy's weakness are also considered. South Asian as well as East Asian and Southeast Asian countries are covered in this part of the analysis.

United States: Evidence of consumer demand contraction and implications for Asian exports of manufactures

US consumer demand accounts for approximately 70% of the \$14 trillion US economy and this represents a huge slice of world effective demand. The US consumer has in part fueled the Asian boom over the past 5 years by providing a strongly growing market for Asian manufactures. US retail sales are essential to growth in important labor-intensive manufactures as well as in more technology- and capital-intensive products. US import demand for garments is a bell-wether for how US consumer weakness is likely to impact developing Asia—particularly countries that rely heavily upon garments as their chief export product (such as Bangladesh, Cambodia, Lao PDR, Nepal, Pakistan, and Sri Lanka).

Clothing and footwear are sensitive to consumer sentiment and imports of these products account for almost all US consumption. Unlike durable consumer goods, purchases of garments and footwear are highly discretionary.⁶ Moreover, orders for clothing are placed frequently and must be met by just-in-time delivery so that a downturn in one month's orders will be reflected in the next month's shipments (Rosen 2002, pp. 180–182). If this is the case, examination of quarterly clothing shipments to the US over the course of 2007 and year-on-year growth rates in each quarter may be particularly revealing. Clothing

shipments are closely monitored by the US Department of Commerce, which has established an Office for Textiles and Apparel for the purpose of providing real-time data on the volume and value of imports from all world suppliers of textiles and garments.

For descriptive simplicity, data are presented for three Asian groupings: PRC, the Association of Southeast Asian Nations (ASEAN), and the South Asian Association for Regional Cooperation (SAARC)—combinations that encompass the vast bulk of clothing shipments from Asia to world markets, including the US. Volumes are measured in million square meter equivalents.

The overall picture that emerges is stark. Garment exports to the US from developing Asia, whether measured in volume or value terms, weakened steadily over the course of 2007. First quarter growth is robust, second quarter growth is about in line with overall US demand growth, but the third quarter slips and the fourth is flat (Figures 1.1.31 and 1.1.32). Exports from the PRC have grown more slowly in each successive quarter of 2007 and were virtually flat in the fourth. In contrast, ASEAN managed to increase its growth in the fourth quarter relative to earlier quarters by taking advantage of the constraints facing PRC shippers under US product-specific safeguards.⁷

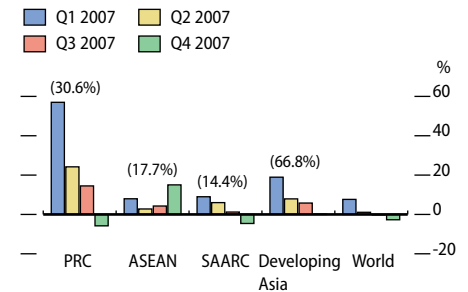
SAARC suppliers, which include garments giants such as Bangladesh, India, and Pakistan, failed to take advantage of the constraints on the PRC and actually saw their volume growth rates crumble after the second quarter, falling to one third of the previous quarter's growth in the third and then retreating absolutely in the fourth. In value terms, the third quarter's performance was half that of the previous quarter, and there was virtually no growth in the fourth quarter. World suppliers as a whole saw growth steadily erode as the year wore on; the impact of the subprime crisis and a loss of confidence are clearly indicated in the much slower growth in world shipments in the third quarter and the contraction in the fourth for both volumes and values.

If retail sales of garments can be taken as an indicator of consumer appetites more generally, the picture that emerges is one of deepening gloom—and gloom that is touching Asian suppliers.

A second example of recent trends in US consumer demand is that of footwear shipments—a product group that is complementary to clothing and would be expected to show similarity in patterns of retail sales and of import orders and deliveries. Imports of footwear from leading Asian suppliers, including the dominant PRC, and from the world as a whole are shown in Figure 1.1.33.

As in the case of garments, footwear for US consumption is almost all imported.⁸ Footwear is unregulated by safeguard quotas and is protected mainly by tariffs that average about 10% in the case of most Asian suppliers. Footwear imports unambiguously reflect a sharp contraction in consumer demand and retail sales in the fourth quarter of 2007 from which even the PRC is unable to escape. The quarterly pattern observed in US consumer demand and imports from Asia clearly reflects a sharp slowdown with shipments from all suppliers (including the PRC) falling by about 5% year on year. Indonesia, a fairly large exporter of shoes, takes a brutal hit during 2007 with annualized shipments contracting by 19%.

1.1.31 Growth in shipments of clothing to the United States (volume)



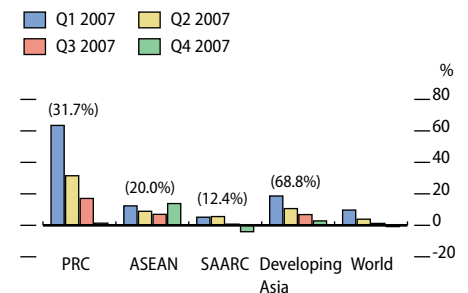
ASEAN = Association of Southeast Asian Nations; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation.

Note: Figure in parentheses indicates share in US clothing imports.

Source: United States International Trade Commission Dataweb, available: <http://www.dataweb.usitc.gov>, downloaded 28 February 2008.

[Click here for figure data](#)

1.1.32 Growth in shipments of clothing to the United States (\$, value)



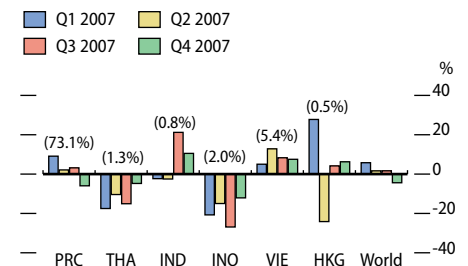
ASEAN = Association of Southeast Asian Nations; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation.

Note: Figure in parentheses indicates share in US clothing imports.

Source: United States International Trade Commission Dataweb, available: <http://www.dataweb.usitc.gov>, downloaded 28 February 2008.

[Click here for figure data](#)

1.1.33 Growth in shipments of footwear to the United States (\$, value)



HKG = Hong Kong, China; IND = India; INO = Indonesia; PRC = People's Republic of China; THA = Thailand; VIE = Viet Nam.

Note: Figure in parentheses indicates share in US footwear imports.

Source: United States International Trade Commission Dataweb, available: <http://www.dataweb.usitc.gov>, downloaded 28 February 2008.

[Click here for figure data](#)

A third example of a product group for which US consumption is heavily import dependent—toys, games, and sports equipment—is also worth examining. Imports and sales of these items are likely to be more strongly influenced by seasonal demand than clothing and footwear as they are extremely popular as gift items in the winter holiday season. Hence, one would expect third and fourth quarter imports to rise strongly relative to the first and second quarters. The growth of this product group is also likely to be strongly influenced by consumer sentiment and discretionary income. Again, as with footwear, the PRC is the dominant supplier of these items to the US import market, with a share of over 80% in 2006 and 2007 (Figure 1.1.34).

This product group is important for many other exporters in Asia. The pattern of growth over the course of 2007 clearly reflects a slowdown year on year as each successive quarter shows a reduced, albeit strongly positive, growth rate. The fourth quarter's outturn of single-digit growth after starting the first and second quarters with growth in excess of 30% is sobering—and for most Asian suppliers fourth quarter contraction has the same feel of export stagnation that is seen in clothing and footwear. Countries whose currencies strongly appreciated against the dollar in 2007, such as Korea and Thailand, have seen their growth rates fall the most.

A cursory examination of shipments of consumer durables does not show the patterns seen in more sensitive semi-durable goods for which US consumption is heavily import dependent, but this is likely to change if the downturn endures over the first half of 2008 or longer. Already reports of steep cuts in sales of automobiles in early 2008 are coming in, along with further evident weakness in consumer sentiment and in retail sales more generally.⁹

A broader look at the value of developing Asia's exports to the US, including mineral fuels, when deflated by the US import price index shows a clear pattern of deceleration in the second half of 2007 relative to the same period in 2006 (Figure 1.1.35).

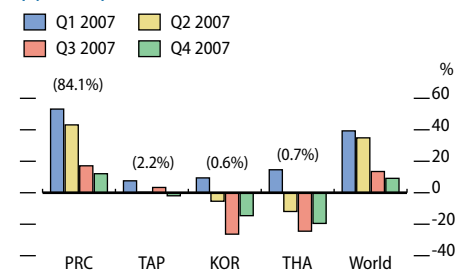
Japan's faltering recovery and impact of consumer anxiety on Asian exports

Japanese consumption is not as large as that of the US but the country is still one of the premier markets for exports of manufactured goods from the rest of Asia. It remains the second-largest national economy worldwide and still outweighs the PRC in terms of overall purchasing power with a real GDP of \$3.8 trillion versus \$1.9 trillion for the PRC in 2006 in 1990 constant US dollars, or \$4.4 trillion versus \$2.7 trillion in current dollars (UNSD 2008). Japan also has a higher consumption-to-GDP ratio than the PRC, although it is less import dependent. In the case of Japan, data are examined over two half-years in 2007 compared with the same periods in 2006 (that is, January–June and July–December).

Imports of clothing and accessories of clothing from all suppliers were growing at a healthy 4% in yen value terms in the first half of 2007 but then contracted in the second (Figure 1.1.36).

In particular, imports from the dominant supplier, the PRC, underwent a sharp reversal from growth to contraction in the second half. Imports from ASEAN also slowed in the second half relative to

1.1.34 Growth in shipments of toys, games, and sports equipment to the United States (\$, value)



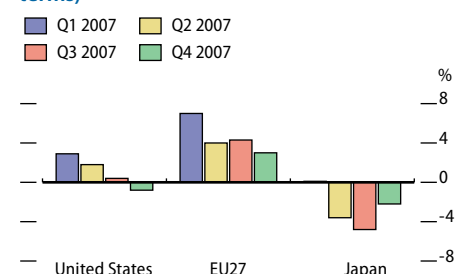
KOR = Republic of Korea; PRC = People's Republic of China; TAP = Taipei, China; THA = Thailand.

Note: Figure in parentheses indicates share in US imports for the indicated product.

Source: United States International Trade Commission Databweb, available: databweb.usitc.gov, downloaded 28 February 2008.

[Click here for figure data](#)

1.1.35 G3 total import growth, 2007 (real terms)

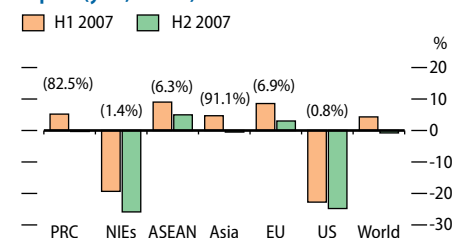


Note: European Union (EU) 27 excludes intra-EU trade.

Sources: United States International Trade Commission Databweb, available: databweb.usitc.gov; Japan Ministry of Finance, available: www.customs.go.jp; Eurostat, available: epp.eurostat.ec.europa.eu; all downloaded 28 February 2008.

[Click here for figure data](#)

1.1.36 Growth in shipments of clothing to Japan (yen, value)



ASEAN = Association of Southeast Asian Nations; EU = European Union; NIEs = newly industrialized economies; PRC = People's Republic of China; US = United States.

Notes: Figure in parentheses indicates share in Japanese imports for clothing. Asia is as defined by the Ministry of Finance, Japan.

Source: Ministry of Finance, Trade Statistics, News Release, various issues, available: http://www.customs.go.jp; downloaded 23 February 2008.

[Click here for figure data](#)

the first but remained in positive territory. Imports from the newly industrialized economies (NIEs) of Hong Kong, China; Korea; Singapore; and Taipei, China experienced very sharp reductions of 19% in the first half and almost 26% in the second. Thus, led by the PRC, the whole of Asia experienced a switch to contraction in the second half and this ensured that imports from all suppliers declined. Perhaps surprisingly, given developments in the foreign exchange markets, imports to Japan from the EU remained positive while those from the US were down sharply, by over 20% in both the first and second half. Conversion of these imports into US dollars flattens out growth over the two periods to an average of 0.5% but still leaves imports from the PRC in negative territory in the second half (Figure 1.1.37).

This impression of weakness in consumer purchases appears to apply as broadly to Japan as to the US. Japanese imports of computers and computer parts (Figure 1.1.38) fell in both half-years (and by double-digits in the second).

Electrical machinery growth also weakened as the year progressed with growth of about 10% in the first half, declining to about 6% in the second.

The pattern of growth over the 4 quarters varies according to whether one uses yen or US dollars. Looking at Japan's general merchandise imports from developing Asia, on the basis of growth in yen values, the impression of weaker rather than stronger growth in the fourth quarter is reinforced. This is likely to be reflected in weaker export growth in developing Asia at the start of 2008.

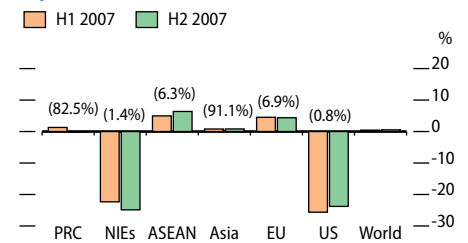
EU Trade: A last bastion of G3 demand for Asian exports—or the beginning of the end for the Asian export boom?

The availability of data limits the extent to which the impact of demand changes in the EU on developing Asia can be assessed. However, the data that run through the third quarter of 2007 indicate that consumer demand in the EU held up rather well compared with the US market. For example, clothing imports from developing Asia continued to grow by about the same pace in the third quarter as the first half of 2007 (Figure 1.1.39). Growth in the euro value of imports of clothing showed slower growth for the PRC in the third quarter but still ran at double-digit rates. In contrast, growth from ASEAN and SAARC (as groups) was negative over the first 3 quarters of 2007. The complex systems of preferential trade that the EU maintains explain this performance.¹⁰ The individual performances by Asian suppliers, aside from the PRC, are influenced by the varying extent to which they enjoy preferential access to that market.

Looking at general imports (Figure 1.1.40), it appears that demand was strong in the fourth quarter but this may mask the underlying situation. Unfortunately, no data on volumes were available as of March 2008. Another way to assess the situation is to examine export data from developing Asian sources. Again these are very limited but as the figures indicate, early 2008 data suggest that growth is decelerating in most cases relative to 2007 (Figure 1.1.41).

The impact of the slowdown in the G3 on their trade is likely to become more severe as the slowdown deepens. Preliminary data for 2008 are compared with annual data for 2007 in the cases of the US and

1.1.37 Growth in shipments of clothing to Japan (\$, value)



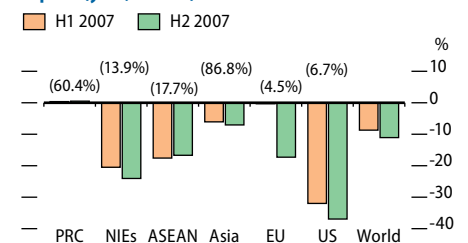
ASEAN = Association of Southeast Asian Nations; EU = European Union; NIEs = newly industrialized economies; PRC = People's Republic of China; US = United States.

Notes: Figure in parentheses indicates share in Japanese imports for clothing. Asia is as defined by the Ministry of Finance, Japan.

Source: Ministry of Finance, Trade Statistics, News Release, various issues, available: <http://www.customs.go.jp>; downloaded 23 February 2008.

[Click here for figure data](#)

1.1.38 Growth in shipments of computers to Japan (yen, value)



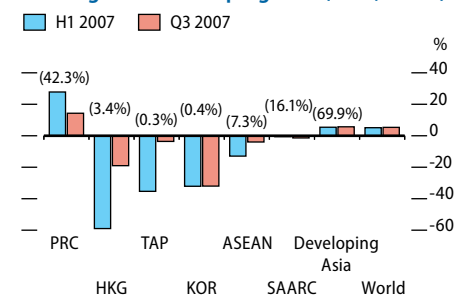
ASEAN = Association of Southeast Asian Nations; EU = European Union; NIEs = newly industrialized economies; PRC = People's Republic of China; US = United States.

Notes: Figure in parentheses indicates share in Japanese imports for computers. Asia is as defined by the Ministry of Finance, Japan.

Source: Ministry of Finance, Trade Statistics, News Release, various issues, available: <http://www.customs.go.jp>, downloaded 23 February 2008.

[Click here for figure data](#)

1.1.39 Growth in European Union imports of clothing from developing Asia (euro, value)



ASEAN = Association of Southeast Asian Nations; HKG = Hong Kong, China; KOR = Republic of Korea; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation; TAP = Taipei, China.

Notes: Figure in parentheses indicates share in EU imports for clothing. EU excludes intra-EU trade.

Sources: EmergingTextiles.com, EU Clothing Imports in First Half 2007 and EU Clothing Imports in Third Quarter 2007.

[Click here for figure data](#)

Japan, and they show that the slowdown is indeed reducing the growth of exports between the two largest national economies in the world. Imports of the US and Japan from the EU in 2008 are showing signs of weakness compared with annual imports in 2007. The growth rates for shipments from the EU slip from 6.4% to 4.2% in the US and from 9.4% to 4.6% in Japan.¹¹

This section has until now focused on the G3 as a source of demand for developing Asia's exports. Conversely though, robust growth in developing Asia may provide a cushion as a source of demand for G3 exports. Equally, it is possible that strong final demand in Asia may benefit intra-Asian exports. In the next section, the role of the PRC in propagating the external downturn is examined through its role in generating intraregional trade in final consumer and investment goods.

Is the PRC uncoupling from developing Asia?

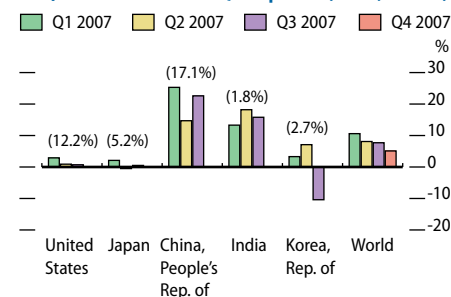
The results from the economic models presented above indicate that intraregional trade linkages are likely to transmit a G3 demand slowdown within Asia. In particular, the results confirm an important role of the PRC in intraregional trade and linking that trade with global markets. As illustrated in ADB (2007a, 2007b), the increasing importance of intraregional trade is attributed mainly to the parts and components trade, with the PRC functioning as an assembly hub for final products in Asian production networks. Recent studies by Cui and Syed (2007) and Albaladejo and Lall (2004), however, suggest that trade patterns in Asia are now changing.

In particular, the PRC's demand for imports of intermediate products from Asian economies has been declining as a share of its imports, and the domestic content of its exports has risen. If this is indeed true, it would imply that the PRC is shifting from being an export hub for the rest of Asia and is deepening backward linkages domestically. Such a structural shift would seem to imply that the PRC would be even more exposed to an economic slowdown in the G3, and that other economies in East and Southeast Asia may be more sheltered. The data presented here, however, suggest that these shifts may be more apparent than real.

Over the past 5 years, the PRC's trade surplus has grown over fivefold in US dollar terms and it has also risen hugely as a share of its GDP. The rise in the trade surplus over the past 3 years stems from a slowdown in import growth relative to export growth. Import growth declined from more than 35% a year in 2004 to less than 20% a year by mid-2007 while export growth decelerated from 34% to 27% over the same period. Does this dramatic slowing of import growth suggest substitution toward intermediate goods in the PRC's production of exports?

Looking at intraregional trade balances, after 4 years of being in deficit with the remainder of Asia, the PRC has been running surpluses since early 2006. Cui and Syed (2007) believe that the slowdown in the PRC's import growth reflects important structural changes. Their thesis is that large investments and technological upgrading have boosted domestic production capacity, especially for intermediate products, leading to a decline in the import content of exports. These trends would seem most apparent for home electrical appliances, ordinary machinery, and high-tech products.

1.1.40 Growth in EU 27 imports (euro, value)

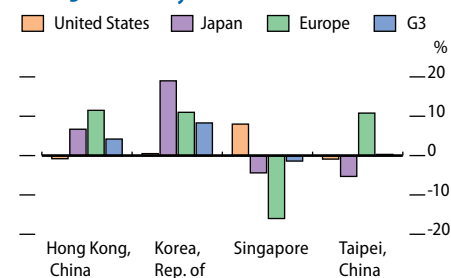


Notes: Figure in parentheses indicates market share in total EU imports. EU excludes intra-EU trade.

Sources: EmergingTextiles.com, EU Clothing Imports in First Half 2007 and EU Clothing Imports in Third Quarter 2007.

[Click here for figure data](#)

1.1.41 Growth of selected Asian exports to the G3 in January 2008



Note: For Hong Kong, China, Europe comprises Germany, Netherlands, and United Kingdom; for Korea and Singapore—the EU 27; and for Taipei, China—France, Germany, Italy, and United Kingdom.

Source: CEIC Data Company Ltd., downloaded 7 March 2008.

[Click here for figure data](#)

But there is no consensus on these points. Some pundits (as for example Gilboy 2004, Athukorala 2007) have observed that the slowdown in the PRC's import growth may be a reflection of temporary overinvestment in certain sectors and is likely to be short-lived. They argue that supply-side complementarities between the PRC and its East and Southeast Asian neighbors remain significant and that the likelihood of export crowding-out by domestic producers in the PRC tends to be vastly exaggerated.¹²

A closer look at the data shows that, overall, the share of parts imports in the PRC import basket is still increasing. Moreover, export data do not suggest a growing role for the PRC as an intermediate parts supplier. The share of parts in total manufacturing exports did gradually rise over 1992–2002 but has since stabilized at around 15%. In contrast, the share of parts in total manufacturing imports has risen steadily, more than doubling in the past 15 years. In 2006, imports of parts accounted for almost 37% of total manufacturing imports, up from 16% in 1992 and 29% in 2000 (Figure 1.1.42).

In East Asian economies, the share of parts in total manufacturing exports has grown strongly, nearly doubling between 1992 and 2006, to 33%. The share of parts in total manufacturing imports has also risen. These patterns suggest growing specialization in intermediate goods production, with a high degree of vertical integration among these economies. For Southeast Asian economies, the shares of parts in total manufacturing exports and imports have also steadily risen. Malaysia, Philippines, and Singapore stand out as being heavily specialized in parts trade. Only Thailand gives any sign of a decline in such trade. The establishment of Thailand as a hub for the automotive industry would appear to have curbed its cross-border parts trade. The share of parts exports declined from 30% in 2000 to 21% in 2006, and the import share from 35% to 27% over this period.

In South Asia, too (albeit from a small base), intermediate goods trade is on the rise. The share of parts in total exports has increased from 2% in 1998 to around 6% in 2006. The share of parts imports has been relatively stable at around 12% over the past 15 years.

The largely unskilled labor-intensive manufacturing industry is the only sector in which trade in parts/intermediate products is in decline. In the PRC, such a decline strongly reflects a reduction in intra-industry trade in textiles (ADB 2007a, p. 90). The share of fabric imports in total manufacturing imports in the PRC has declined significantly over the past 15 years, from almost 7% in 1992 to only 1% in 2006, mirroring a huge investment in textile machinery and production capacity in the textile and clothing industries there in anticipation of the PRC's membership in the World Trade Organization (WTO) (ADB 2007a, p. 93).

In Figure 1.1.43 the composition of Asia's exports is shown for parts and components for different geographic groupings within developing Asia. These data confirm the importance of parts trade within the region: the export share of parts rises within the region and the PRC becomes an important export destination for parts from, particularly, East and Southeast Asia. Importantly, the underlying data do not provide any strong indication that other Asian final goods exports to the PRC are rising strongly.

1.1.42 Share of parts and components in total manufacturing trade



Note: The five-digit industries from UNCOMTRADE are used to separate parts and components from final manufacturing products. Classifications used to separate parts and components from final products are based on lists provided by Athukorala (2006). The lists contain 225 categories at the five-digit SITC level.

Source: United Nations Comtrade database, DESA/UNSD, downloaded 28 January 2008.

[Click here for figure data](#)

The reliance of industrial production in the PRC on imported parts and components has risen over the past decade (Figure 1.1.44). The share of parts imports in gross industrial output rose from only 1.7% in 1992 to almost 6% in 2006. To date, PRC industrial investment, and that of multinational enterprises in particular, has not been involved significantly with parts production. Naughton (2007) observes that foreign-invested enterprises are overwhelmingly concentrated in the final assembly stage of production, which is the most labor-intensive layer in production processes spread over many countries. Basic research, product design, and physical capital- and human capital-intensive stages of the production process tend to be carried out in the home countries of multinational enterprises or in other Asian countries that are in a more advanced stage of industrial development than the PRC.¹³ A slight decline in the share of parts imports in gross industrial output over the past few years is likely to be a reflection of reduced import content for the garment industry. The import value of fabric to gross output in that industry has continuously declined, to 10% in 2006 from 26% in 2000.¹⁴

In summary, the data show that the PRC has not become a significant producer or exporter of parts and components. In contrast, parts trade in other subregions (East Asia, Southeast Asia, and South Asia) is generally on an upward trajectory, with rising shares for exports and imports. The parts share of PRC imports has also risen. The idea that the PRC has been able to replace imported supplies with domestic components is not supported by these trends. The claim that the PRC now provides an important source of demand in final goods markets for other Asian countries also sits ill with the data. The base share of final demand is small (ADB 2007a, p. 95) and virtually all growth in intraregional trade in recent years has been attributable to parts and components. Therefore, although the characteristics of intra-Asian trade may have started to change, it will be some time yet before they fundamentally alter the nature of the transmission of external shocks.

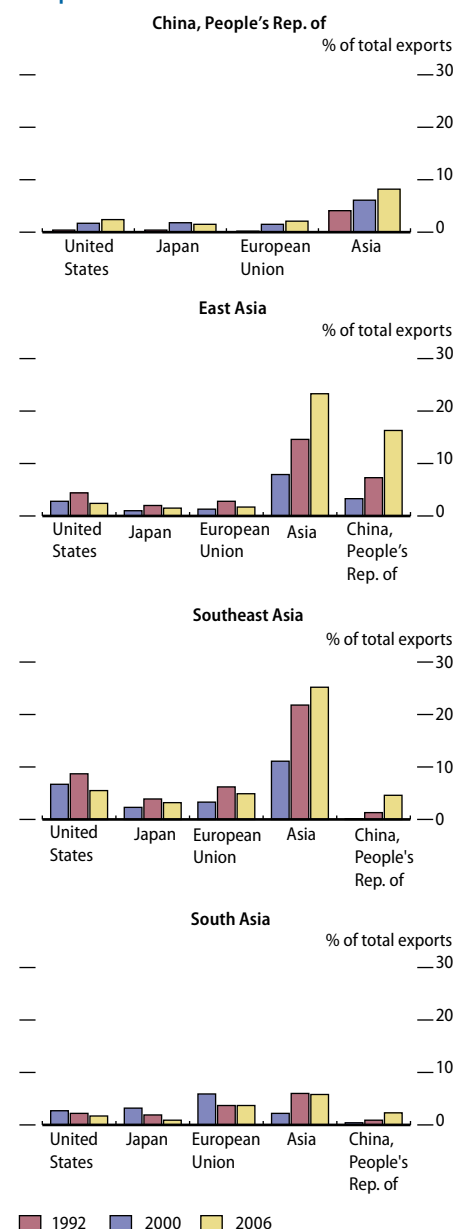
So far, the center of focus has been on the transmission of the slowdown in the G3 to developing Asia through its exports and vertically integrated trade channels, particularly within East and Southeast Asia. But there are other possible channels through which impacts may be felt. In the next section, the potential for financial contagion is examined.

Financial integration and contagion

Each global slowdown is different. Current difficulties have followed an extraordinary period for global financial markets—tremendous growth, deepening integration, and rapid financial innovation. The potential for financial contagion in an increasingly borderless world of international capital movements has clearly risen.

McKinsey's annual report, *Mapping global capital markets* (McKinsey Global Institute 2008) observes that at the end of 2006, the major economies of developing Asia held assets to the value of \$14.2 trillion, equivalent to 250% of combined GDP. Developing Asia's financial asset holdings are dominated by the PRC, which possesses a bit over a half of them, with Korea and India together accounting for 40%. In the PRC, financial assets are over 300% of GDP, whereas in India the corresponding ratio is just over 200%. Although the PRC's financial

1.1.43 Asian exports of parts and components to different destinations



Notes: East Asia excludes the People's Republic of China and Mongolia. South Asia comprises India and Pakistan. Southeast Asia excludes Cambodia, Myanmar, and Viet Nam. Asia is as defined in the United Nations Comtrade database.

Source: United Nations Comtrade database, DESA/UNSD, downloaded 28 January 2008.

[Click here for figure data](#)

system is still bank dominated, asset distribution in other markets is more evenly balanced among equities, debt, and deposits. However, in some countries such as India, Indonesia, and Philippines, government has a large profile in debt markets, with only a small private sector presence. In 1990–2006, the stock of financial assets in developing Asia grew at an average rate of 15.5% a year, easily outrunning growth of nominal income.

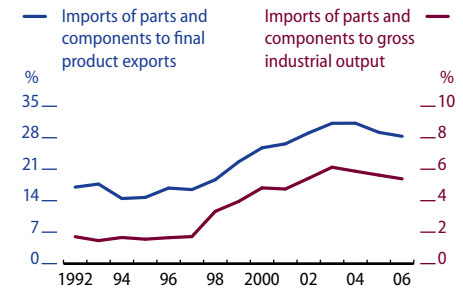
Financial deepening in developing Asia has occurred during a period in which the “home bias” in financial asset investment has been weakening. In 1990, cross-border capital flows amounted to just 5.2% of global GDP. By 2006, this figure had more than tripled to 17.2%. As a share of total global assets, financial investments overseas have increased from 28.9% of total assets in 1995 to 44.6% by 2006 (Figure 1.1.45). Yet, though cross-border capital flows have been growing much faster than trade, trade flows still dominate in absolute size. In 2006, total cross-border capital flows amounted to 62.1% of global imports.

For developing Asia, gross capital inflows in 2006 were a shade below \$300 billion, equivalent to 4.6% of GDP or 11.6% of its total exports. Inflows have climbed steeply since 2001 when they were just \$39 billion, but have also more than doubled from their precrisis peak of \$125 billion in 1996. In addition, developing Asia is also a large net lender to the rest of the world, with net capital outflows from East Asia alone reaching \$539 billion by 2006. Notably, the PRC was the world’s single largest exporter of capital that year. Data from IMF’s Coordinated Portfolio Investment Survey suggests that while the share of East Asia’s cross-border capital investments in other East Asian countries has grown quickly and that the share of investments in the US has declined, this picture changes if the definition of East Asia is widened to include Japan. Japan still invests heavily in the US and invests little in East Asia. Moreover, a major source of portfolio investment in East Asia is the US. Kim and Lee (forthcoming) estimate that in 2006 the US accounted for about 38% of the total portfolio liabilities of East Asia (excluding Japan), little changed from its 37% share in 2001.

Cross-border capital flows exhibit a pronounced upward trend, but with periodic sharp breaks from trend. In the past decade, flows contracted in absolute value in 1997–1998 and in 2001–2002. Recent reversals coincided with the Asian crisis of 1997–98 and with the bursting of the dot-com bubble and the US recession of 2001. Although from a much smaller base, a contraction also occurred in the early 1990s when there was a global recession. The most volatile component of cross-border capital flows has been cross-border lending and deposits, with foreign direct investment being the most stable. Surprisingly perhaps, cross-border investments in equity markets have been quite stable, with investments in debt securities being comparatively volatile (Figure 1.1.46).

The rapid expansion of global capital markets and the even faster growth of cross-border capital flows suggest that the potential for the financial transmission of global shocks is likely to have increased. Direct evidence on this point from Asia is fragmentary. Kim and Lee (forthcoming) show that East and Southeast Asian equity markets now track the US equity market more closely than before the Asian crisis and that within East and Southeast Asia, markets are also more closely synchronized with each other than a decade ago (Figure 1.1.47). Chai and

1.1.44 Import content ratios

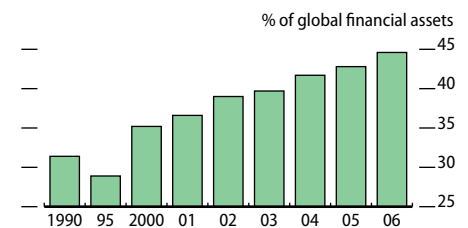


Note: The five-digit industries from UNCOMTRADE are used to separate parts and components and final manufacturing products. Classifications used to separate parts and components are based on lists provided by Athukorala (2006). The lists contain 225 categories at the five-digit SITC level.

Sources: United Nations Comtrade database, DESA/UNSD; CEIC Data Company Ltd.; both downloaded 14 February 2008.

[Click here for figure data](#)

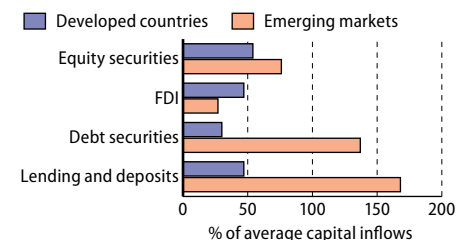
1.1.45 Global foreign investment assets



Source: McKinsey Global Institute (2008), available: www.mckinsey.com, downloaded 17 March 2008.

[Click here for figure data](#)

1.1.46 Mean absolute deviation of capital inflows, 1996–2006



Note: Measured as deviation from data filtered with Hodrick-Prescott filter to account for the time series trend; based on sample of 34 emerging and 26 developed economies.

Source: McKinsey Global Institute (2008), Exhibit 2.16, available: www.mckinsey.com, downloaded 17 March 2008.

[Click here for figure data](#)

Ree (2005) note that although regional factors have played an increasingly important role in explaining equity market movements in East Asia, markets in the region have closer ties with the US than with one another. Another measure of financial integration—the covered interest rate differential—does not show much change in 2000–2007, but suggests closer integration of East Asian markets with the US than with Japan (Kim and Lee forthcoming).

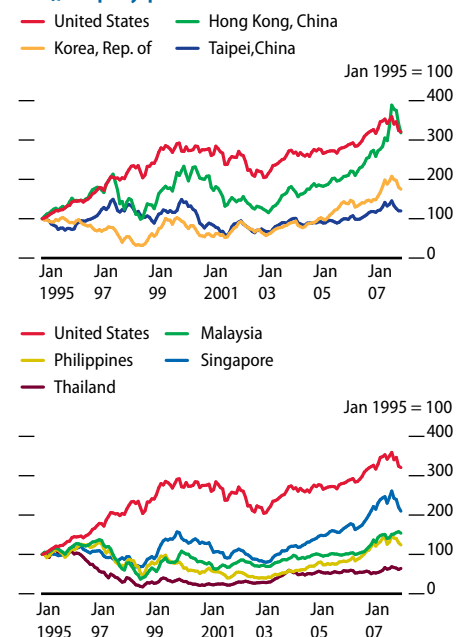
Kim and Lee (forthcoming) also look at the extent to which East Asian economies engage in “risk sharing” with each other and with the rest of the world. In circumstances where risk sharing among countries is high—shocks in one country are dispersed and are partially absorbed by others—close financial integration can be expected to align consumption paths across countries. The empirical evidence points to significant risk sharing between East Asia and the global economy (suggesting that in response to a shock to global consumption, consumption in East Asia would change by between 30–50%) but not within East Asia.

Given Asia’s presence and growing participation in international financial markets, it would be surprising if a global slowdown were not to make itself felt through asset market adjustments. Credit spreads have widened for Asian borrowers in offshore markets and this should deter debt issuance. Equity markets in Asia have also moved closely in step with those of the US, and the erosion of wealth can be expected to lead to some belt-tightening by households. Investors may also find it more difficult to raise capital in volatile domestic equity markets. Cross-border lending might also be expected to slow and even dip, if previous episodes of financial distress provide a reliable indication. But where interest rates are expected to rise and there is an expectation that domestic currencies will appreciate, this may attract capital inflows. Also, some Asian debt may look like a good bet alongside fast degrading debt in mature markets.

Evidence on these points is still fragmentary. But data from the Institute for International Finance (2008) show that both equity and syndicated loan issuance by “Emerging Asia” held up well comparing the September to February period 2006–2007 with the same period in 2007–2008, but that bond issuance fell sharply, by 31%. Developing Asia’s dependence on the offshore funding market is, however, small.

There is little hint of significant vulnerability within Asia’s bank-dominated financial systems. Despite close financial coupling, the direct exposure of banks in developing Asia to US subprime mortgage debt or to other “unsafe” assets is believed to be small. The region’s banks are, in general, reasonably well capitalized and profitable and appear not to have indulged in leveraged investment activities on a large scale. Recent data on real loan growth show that it is increasing in many countries, including Indonesia, Korea, and Singapore (Figure 1.1.48). Only in countries where there is significant domestic monetary tightening, such as the PRC, is there evidence that real loan growth is decelerating. These data do not suggest that a credit crunch is imminent. Nevertheless, in some countries banks may be exposed to risks of rising bad debts, especially where there is significant lending to support investment in inflated equity or property markets. Currency mismatches on bank balance sheets have recently surfaced as a source of risk in a few economies.

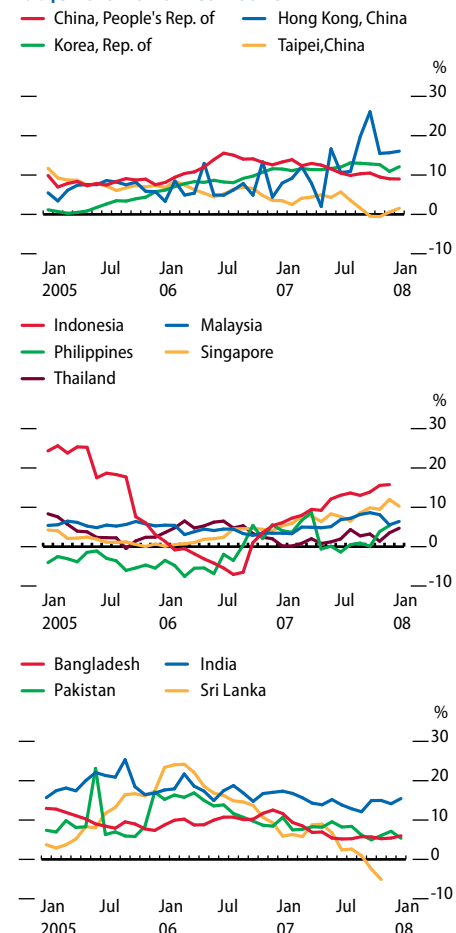
1.1.47 Equity price indexes



Source: Datastream, downloaded 25 March 2008.

[Click here for figure data](#)

1.1.48 Growth of real loans



Sources: International Monetary Fund, *International Financial Statistics* online; CEIC Data Company Ltd.; both downloaded 26 March 2008.

[Click here for figure data](#)

Global financial turbulence may even have a silver lining for some large surplus-savings countries in developing Asia. A reduction in net private capital inflows, as forecast by the Institute for International Finance (2008), may ease pressures on domestic liquidity. Financial trauma in more mature markets has also created a gap between the global demand for equity capital and its ready availability. This offers investment opportunities for countries with foreign exchange assets in excess of their reserve needs.

Summary

Evidence suggesting that Asia has “uncoupled” from the global economy is scant. The relationships embedded in large empirical models of the global economy, such as the Oxford Economics model (Box 1.1.2 above), are broadly confirmed by fresh evidence drawing on recent high-frequency time-series analysis of the links between retail demand in the G3 economies and exports in developing Asia (see *The uncoupling hypothesis: New evidence from G3 retail sales and Asian exports*, above). Both suggest that developing Asia’s exports do respond quickly and in some cases strongly to variations in G3 demand. Precise impacts differ depending on the source of the demand shock and trade structure. Close inspection of data for cyclically sensitive manufacturing exports confirms slowing across developing Asia in precisely those sectors that would be expected to feel the effects of a global downturn first. Evidence from durable goods exports and from the EU will have to await the release of data.

The PRC’s role in the transmission and buffering of shocks could be pivotal. Yet the evidence marshaled above (*Is the PRC uncoupling from developing Asia?*) suggests that strong growth of domestic demand in the PRC is unlikely to provide a buffer for other countries because their export presence in the PRC’s internal final goods market is still limited. Moreover, through their ties along vertically integrated supply chains, East and Southeast Asian economies will be hit by any slowing in demand for the PRC’s exports to G3 markets.

Developing Asia’s ties to global financial markets have greatly strengthened in the past decade. The stock of financial assets as a proportion of GDP in developing Asia has risen quickly, as has cross-border ownership of assets and liabilities. Despite the unmistakable trend toward stronger financial coupling, the impacts of global credit market difficulties on developing Asia are expected to be limited. Domestic banking systems, which still play a significant intermediation role, generally appear well positioned to weather the global storm.

Finally, the point bears repeating: though developing Asia’s economy is not immune to the vicissitudes of global demand, its longer-run growth trajectory will be much more a function of structural and supply-side dynamics. To maintain momentum, countries will have to address and overcome a variety of constraints (see Part 3 of *ADO 2008*). In the short run, the impact of the global slowdown is likely to be modest: even a highly unfavorable global scenario that dents growth in developing Asia by more than forecast in the *ADO 2008* baseline should not leave lasting scars. The main risks to future growth lie elsewhere: in reversals of market access and of trade liberalization, and in the failure to meet domestic challenges.

Reasons to be nervous: Commodity prices and inflation

Food and fuel are core elements in Asian household budgets. Rising prices pose serious economic challenges and risk spilling over into more general inflation pressures. In early 2008, prices of a raft of commodities have reached all-time highs in real terms. Figure 1.1.49 shows the path of real oil prices over the last 27 years. Commodity food price indexes are now also testing new heights (Figure 1.1.50). High food prices raise particular concerns about the circumstances of the urban poor and food-deficit, poor rural households. Rising rice prices are of particular concern in developing Asia with countries such as Pakistan and Philippines being major net importers (Figure 1.1.51).

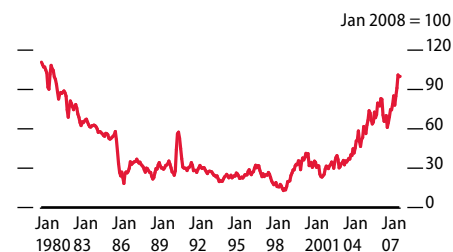
Though some of the factors influencing prices such as geopolitical events or weather-related impacts are likely to fade, there are also strong structural factors—both on the demand and the supply side—that are pushing up prices of food and fuel and these have some mutually reinforcing effects (Boxes 1.1.4 and 1.1.5). Oil prices have consistently risen by an average of about \$10 per barrel annually in nominal US dollar terms since 2002 bringing its average price in the year ending in February 2008 to \$95 per barrel. Rice prices in US dollars per metric ton, again in nominal US dollar terms, roughly doubled between December 2002 and December 2007 (from \$188 to \$372) but in early 2008 have exceeded \$500 per metric ton.¹⁵ Though it is unlikely that price rises will be sustained secularly, the outlook for the next 2 years is for continuing upward pressure. There is also a risk that cost inflation may lead to demands for upward adjustment of money wages or increased fiscal outlays to subsidize food and fuel consumption. The subsequent monetization of the fiscal costs coupled with accelerating wage increases are potential triggers for an inflation spiral of prices and costs.

Inflation pressures, stoked by rising food and fuel prices, are building in much of developing Asia. Headline CPI inflation rates accelerated in 26 of Asia's developing economies in 2007 relative to 2006, remained constant in one, and decelerated in 17—for the bulk of the populace in the region CPI inflation rates have gone up. There is the prospect of accelerating inflation in 2008, despite administrative restraints that hold recorded numbers in check (Table 1.1.3).

Food prices make up a significant part of the weights used in the calculation of headline inflation and food price indexes show a strong positive correlation with the CPI indexes across developing member countries for which data are available (Figure 1.1.52). Food accounts for 59% of the CPI weights in Bangladesh, 57% in India, 55% in the Philippines, 33% in the PRC, and 42% in Viet Nam.

Empirical studies of the relationship between inflation and poverty and income inequality tend to support the view that poverty incidence and reduced shares of the bottom quintile in the distribution of household income are associated with high inflation (Blank and Blinder 1986, Cardoso 1992, Datt and Ravillon 1996, and Romer and Romer 1998). Without a doubt, rising food prices hurt the urban poor. It forces them to spend more of their income on food and less on other essentials such as education and health (Son forthcoming).

1.1.49 Brent crude oil price

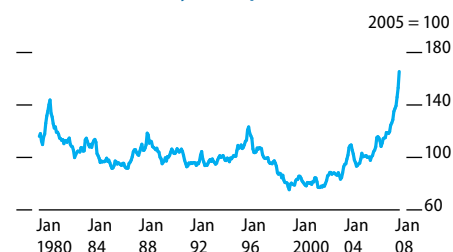


Note: Prices are in real terms, deflated by industrial countries' consumer price index.

Sources: International Monetary Fund, *Primary Commodity Prices*, available: www.imf.org; *International Financial Statistics* online database; both downloaded 14 March 2008.

[Click here for figure data](#)

1.1.50 Commodity food price index

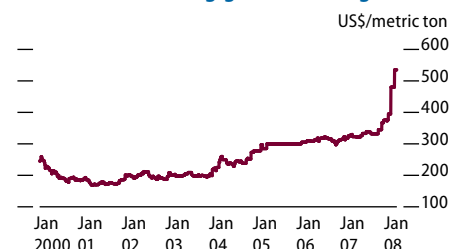


Note: Comprises cereals, vegetable oils, meat, seafood, sugar, bananas, and oranges.

Source: International Monetary Fund, *Primary Commodity Prices*, available: www.imf.org, downloaded 18 March 2008.

[Click here for figure data](#)

1.1.51 Rice, Thai long grain 100% B grade



Source: Datastream, downloaded 31 March 2008.

[Click here for figure data](#)

1.1.4 Structural factors behind high oil prices

Structural factors are driving oil prices higher in world markets. First is the fact that production from the Organization of the Petroleum Exporting Countries (OPEC), and non-OPEC production must rise even to meet short-term forecasts of demand.

The International Energy Agency (2008) sees demand rising by 1.7 million barrels a day in 2008 with most of the added demand coming from the People's Republic of China, India, and the oil-producing countries of the Middle East themselves.

The reasons underlying the difficulty in supply keeping up with demand are complex but have to do with domestic political constraints within the OPEC countries and the fact that non-OPEC production has peaked and is set to decline.

Alternative fuels such as unconventional sources of oil (tar sands), biofuels, and natural gas are difficult to develop and involve large investments and lags of up to 5 years between investment and production.

Rapid growth and urbanization mean that demand for

transportation services is growing rapidly and despite the development of hybrid engines using combinations of fuel, there is no meaningful short-term substitute for oil-based fuels for transportation services on air, land, or sea.

In addition, speculative demand in oil futures may also be playing a role in the recent price spikes. The rising price of oil is closely associated with the price of natural gas as can be seen in sharp increases in fertilizer prices. The price of diammonium phosphate—a fertilizer produced from feedstock of natural gas—has risen from \$260 per ton in 2006 (period average) to \$828 in February 2008.

Higher costs of energy inputs also affect electricity costs for use of pump irrigation systems, tractor and harvester/thresher fuel costs, and the cost of transporting inputs and outputs related to agricultural production.

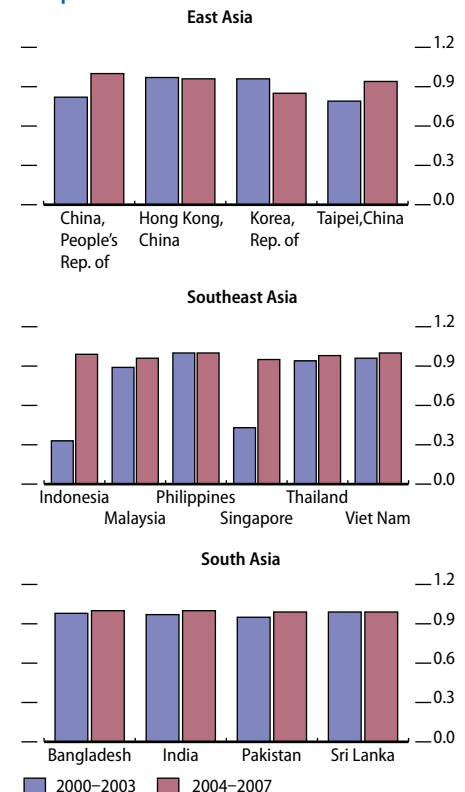
Econometric analysis has shown that food and oil prices move closely together through time in such a way that a rise in oil prices has a statistically significant positive impact on food prices (Imai, Gaiha, and Thapa 2008).

1.1.3 Inflation trends in developing Asia (% per year)

	2003–2007 Actual	2008 Forecast		2003–2007 Actual	2008 Forecast
Central Asia					
Armenia	3.9	5.5	Kyrgyz Republic	5.4	12.0
Azerbaijan	8.7	13.0	Tajikistan	10.8	17.0
Georgia	7.4	9.5	Turkmenistan	7.4	9.0
Kazakhstan	8.2	17.4	Uzbekistan	6.8	10.9
East Asia					
China, People's Rep. of	2.6	5.5	Mongolia	8.0	10.5
Hong Kong, China	0.4	3.4	Taipei, China	1.2	2.3
Korea, Rep. of	2.9	3.4			
South Asia					
Afghanistan	12.9	10.2	Maldives	3.5	6.0
Bangladesh	6.2	9.0	Nepal	5.5	7.0
Bhutan	4.1	4.5	Pakistan	6.5	8.0
India	5.2	4.5	Sri Lanka	10.2	16.2
Southeast Asia					
Cambodia	4.3	5.5	Philippines	5.2	4.0
Indonesia	8.6	6.8	Singapore	1.1	5.0
Lao People's Dem. Rep.	8.9	5.0	Thailand	3.2	4.0
Malaysia	2.2	2.7	Viet Nam	7.0	18.3
Myanmar	20.4	-			
The Pacific					
Cook Islands	2.2	3.0	Papua New Guinea	4.7	5.2
Fiji Islands	3.3	4.6	Samoa	5.6	5.1
Kiribati	0.5	3.5	Solomon Islands	7.9	7.0
Marshall Islands, Rep. of	2.3	3.4	Timor-Leste, Dem. Rep. of	3.2	7.0
Micronesia, Fed. States of	2.9	3.5	Tonga	8.9	5.3
Nauru	2.8	3.0	Tuvalu	3.2	3.5
Palau, Rep. of	3.6	3.5	Vanuatu	2.0	3.0

Source: Asian Development Outlook database.

1.1.52 Correlation of main CPI to its food components



Source: CEIC Data Company Ltd., downloaded 14 March 2008.

[Click here for figure data](#)

1.1.5 Structural factors driving food prices

What are the structural factors underlying the surge in food prices, aside from the direct impact of high and rising oil prices?

Von Braun (2007) cites the following: (i) demand that is driven by high economic growth and urbanization, particularly in India and the People's Republic of China, and associated changes in diets that require more grain to produce the same amount of calories for consumption; (ii) supply constraints arising from competition for agricultural land and its conversion, increasing scarcity of fresh water; and migration of labor from agricultural to nonagricultural activities; (iii) direct competition for key food crops for nonfood demand (such as biofuels); (iv) underinvestment in agricultural technologies and infrastructure that have contributed to slow growth of yields per hectare of agricultural land; and (v) climate change, which is increasing the incidence of drought and flooding that hit agricultural production (though

this last point has been strongly challenged by other commentators).

The structural explanation for rising prices of cereals is evident in the case of rice—global rice stocks have fallen and are expected to reach 25 year lows at just 70 million tons this year, down from 150 million tons in 2000 (USDA 2008).

Offsets of course are likely on the supply side but only if relative prices are allowed to provide the correct signals to farmers. The strength of supply-side responses may also depend on exogenous variables such as rainfall over the medium term.

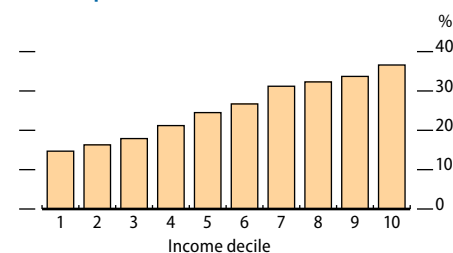
Trade policies currently greatly distort international price signals in agriculture and lessen the likelihood of rapid and efficient supply responses. Rice prices are of overwhelming importance in developing Asia because well over 50% of its population relies on rice as a staple of consumption, and nearly 70% of agricultural land is given over, at least seasonally, to rice production.

The relationship between food prices and rice prices in particular and the incomes of poor rural households is complicated by the fact that many marginal farmers produce rice. The impact largely depends upon whether households are net buyers or net sellers of foodstuffs or can source rice consumption directly from their own production and stocks. The ability of rural households to afford food may be positively influenced by higher farmgate prices for their outputs so that selling more homegrown rice makes them better off as they can sell high-quality rice and buy lower-quality rice or other substitute foodstuffs. However, data taken from expenditure surveys of rural households in India show that the lowest income decile's consumption of homegrown rice is less than 20% of its total consumption, so that people in that decile may well be worse off when food prices increase (Figure 1.1.53).

Precisely because of the potential social hardships posed by higher food prices, governments throughout developing Asia are considering various measures to restrain price increases and secure supplies. Import duties on food and cereals are being temporarily cut in some countries and in others exports are being taxed or indeed restricted to boost domestic supplies. Net food importers have been prepared to pay premium prices to secure supplies of staples such as rice. In a number of countries, such as the PRC, administrative price controls on foodstuffs have been introduced, after a sustained period of price liberalization (Box 1.1.6).

The fiscal implications of subsidies on food, fuel and, in some countries in developing Asia, on closely related inputs into food production such as fertilizer and electric power consumption for irrigation pumps, threshing machinery, and tractors are worrisome. For example, in Indonesia fuel subsidies alone ate up 12% of the central government budget in 2007 and it is estimated that the budgetary cost of fuel and electric power subsidies with oil prices at \$100 per barrel would rise to almost \$26 billion in 2008 (Kong and Ramayandi 2008).¹⁶ In India,

1.1.53 Share of home-grown in total rice consumption, India



Note: Per capita averages were defined using only households consuming rice, with 1 the lowest income decile and 10 the highest.

Source: Staff estimates based on data from National Sample Survey Organisation, Socio-economic Survey, Round 61, Schedule 1, 2004/05.

[Click here for figure data](#)

1.1.6 Subsidies and policies related to pricing of food, fuel, and power in developing Asia

Bangladesh

- The Government will distribute a cash subsidy of Tk7.5 billion to farmers for procurement of diesel for irrigation in the peak *boro* season.

People's Republic of China

- Pump prices for gasoline, diesel, and jet fuel were raised by 10% in November 2007.
- In early March 2008, a CNY189.28 million subsidy was provided to students of universities managed by the central Government, equivalent to CNY20 per person per month in March–June.
- Local governments are to allocate subsidies to the colleges that they manage according to the same criteria.
- On 12 March 2008, more funds were allocated to college students from financially vulnerable homes as a temporary food subsidy.
- The target is to provide CNY20 each month to all college students in the country, and an additional CNY20 to students coming from financially vulnerable homes (about 20% of the total).
- The central government budget earmarked for agriculture, farmers, and rural areas reached CNY562.5 billion (\$79.2 billion) in 2008, CNY130.7 billion more than in 2007, including:
 - ◊ CNY48.2 billion for production materials purchases
 - ◊ CNY4 billion for farm tools
 - ◊ CNY7.07 billion for seeds.
- The Government promised to further increase financial support for agricultural production on 26 March 2008.
- In March 2008, Sinopec received CNY12.3 billion (\$1.7 billion) in government subsidies to compensate for losses incurred through government price controls, CNY4.9 billion of which will be allotted for 2007 losses and CNY7.4 billion for first-quarter 2008 losses. This is the third subsidy payment to Sinopec, after CNY5 billion in 2007 and CNY10 billion in 2005.
- The Government has frozen the prices of energy, transport, and water, and announced that producers of essential food items, such as meat, grain, eggs, and cooking oil, must seek approval before raising prices.

India

- The Government has long imposed price ceilings on a range of goods.
- It stockpiles food staples to ease supply constraints, i.e., buys foodgrains at guaranteed prices from farmers for distribution to the poor at subsidized rates through state-run shops.
- Gasoline prices were raised by Rs2 and diesel by Re1 on 14 February 2008.
- The Government sought parliamentary approval on 12 March 2008 for additional spending of Rs189 billion to enhance food and fertilizer subsidies, and issue oil bonds, including Rs38 billion for fertilizers, Rs58.24 billion for food, and Rs92.97 billion for securities for oil companies.
- The FY2007 subsidy is now estimated at Rs480 billion, higher than the budgeted Rs300 billion.

Indonesia

- The Government may have to nearly triple its planned 2008 fuel subsidy spending to around Rp130 trillion (\$14.1 billion).
- The original budget allocation was Rp45.8 trillion for oil subsidies, assuming oil prices were \$65 per barrel.
- The subsidy will be funded through the domestic bond market and privatization of state-owned enterprises.
- There is an explicit subsidy for food prices, with the cost to government expected to climb to Rp19.8 trillion (\$2.2 billion) in 2008 from Rp7.2 trillion (\$0.8 billion) estimated earlier.

Korea

- The Government is studying ways to limit increases in heating bills.

Malaysia

- The authorities spent RM35 billion–40 billion in 2007 subsidizing gasoline and natural gas costs.
- As of 25 March 2008, they indicated that they would keep fuel prices on hold.
- A policy to address subsidies will be announced later.

Philippines

- The cost of subsidizing rice sold by the National Food Authority could reach P21.7 billion in 2008, with an import cost of P29.40 per kilo but a selling price of P18.50 per kilo.
- The cost of importing rice in 2008 is estimated to equal the collection of value-added tax on fuel.
- The Department of Energy reduced tariffs on crude and petroleum product imports to 1% from 2% starting 1 April 2008.
- The Government is proposing to give the National Power Corporation a subsidy to help cap electricity prices.

Singapore

- The Government plans to give cash and rebates to needy citizens.

Taipei, China

- The authorities have imposed ceilings on gasoline and diesel prices after inflation climbed in November 2007 to a 13-year high.
- But Formosa Petrochemical Corp., one of two major fuel suppliers, unilaterally raised gas and diesel prices by about 10% on 1 April 2008.

Thailand

- In March 2008, the Government revived the diesel subsidy at B0.90 per liter for 6 months.

Viet Nam

- Diesel and fuel oil traders are partly subsidized.
- The Government still owes these businesses about D2 trillion (\$126 million) in subsidies for recent losses, despite payment of about D10.3 trillion.
- Fuel prices were raised on 25 February 2008, with gasoline prices up by 11.5% to D14,500 from D13,000 per liter and diesel and kerosene up by 36% to D13,900.

Source: Various news articles.

the new fiscal budget for 2008/09 is assumed to run a deficit equivalent to 3.1% of GDP, though this omits the state budget deficits as well as the cost of fertilizer and fuel subsidies, which are thought to be substantial.

Food subsidies are also costly. Using data from a rural household expenditure survey, estimates can be made of the cost of rice and wheat subsidies in rural India (Tables 1.1.4 and 1.1.5). Together, rice and wheat subsidies cost Rs23.5 billion in 2004/05.¹⁷ The amount of the outlay in the central government budget expenditure in 2007/08 to maintain the same level of subsidy will without a doubt be far greater as rice and wheat prices are now considerably higher.

The supply response of farmers globally and in developing Asia will eventually relieve the pressure, but only if markets are allowed to work and weather conditions and energy prices, which have a critical influence on fertilizer costs, accommodate the response. Efforts to accelerate technical progress and improve productivity through infrastructure, especially irrigation systems, and institutional support through credit markets and extension services, will also be important.

Movements of primary commodity prices are also thought to have important macroeconomic effects. They are leading to a dramatic shift in the commodity or barter terms of trade—in favor of oil and cereal and other raw material exporters and against those exporters of manufactured goods that also rely heavily on commodity imports (such as Korea, Pakistan, and Sri Lanka). The G3 countries that are large importers of mineral fuels have also experienced terms of trade reversals as a result of rising commodity prices. Table 1.1.6 shows which countries are net food and fuel importers and exporters and provides an indication of which countries may gain—and which stand to lose.

On balance, only Indonesia and Kazakhstan appear unambiguously to benefit from recent price rises as net food and oil exporters, and Indonesia only marginally so. Even though several Asian countries are net exporters of food, the oil bills they face are more than swamping the positive effects from net food export gains. Malaysia has net positive balance-of-payments effects from the movement in prices as its net oil exports vastly exceed its net food imports.

Trade price indexes for a selection of countries in developing Asia are shown in Figures 1.1.54 and 1.1.55. Constructing these indexes for a broader sample of countries was not possible due to data limitations. These data suggest that significant transshipment centers have seen a much more modest recent decline in their terms of trade, as they are cushioned from any adverse movements against domestic exports. Thus in Singapore, with about a 3% decline in 2007 (Figure 1.1.54) and Hong Kong, China, with about a 4% loss (Figure 1.1.55), the changes are modest. In contrast, large commodity-dependent East Asian economies are suffering far more serious consequences. Korea has seen an almost 50% deterioration since 2002, again with a sharp decline in mid-2007 that has likely worsened. Taipei, China shows a slightly more moderate decline of around 20% over the past 3 years.

Persistence of high and rising commodity and energy prices may force some tightening in monetary and fiscal policy in order to avoid inflation consequences even as income growth decelerates in the coming year.

Though few reliable data are as yet available, the likely deterioration

1.1.4 Household expenditure survey, 2004/05: Rice

Rice price—PDS (Rs per kilo)	4.75
Rice price—other sources (Rs per kilo)	10.00
Effective rice subsidy (Rs per kilo)	5.25
Total PDS rice consumed (kilograms)	3,580,310,327
Total effective rice subsidy (Rs billion)	18.80

PDS = Public Distribution System.

Source: Staff estimates based on data from National Sample Survey Organisation, Socio-economic Survey, Round 61, Schedule 1, 2004/05.

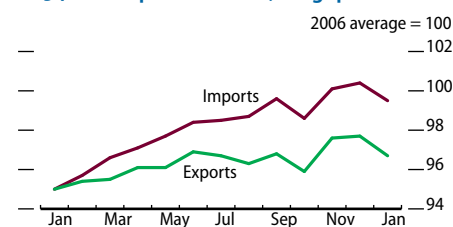
1.1.5 Household expenditure survey, 2004/05: Wheat

Wheat price—PDS (Rs per kilo)	4.70
Wheat price — other sources (Rs per kilo)	8.00
Effective wheat subsidy (Rs per kilo)	3.30
Total PDS wheat consumed (kilograms)	1,432,984,588
Total effective wheat subsidy (Rs billion)	4.73

PDS = Public Distribution System.

Source: Staff estimates based on data from National Sample Survey Organisation, Socio-economic Survey, Round 61, Schedule 1, 2004/05.

1.1.54 Trade price indexes, Singapore



Source: Singstat, *Monthly Digest of Statistics Singapore*, available: www.singstat.gov.sg, downloaded 7 March 2008.

[Click here for figure data](#)

1.1.6 Net food and fuel exports

	Net food exporter	Net food exports, 2007 (\$ million)	Net oil exporter	Net oil exports, 2007 (\$ million)
Bangladesh	Yes	1,055.6	No	-2,111.0
China, People's Rep. of	Yes	19,265.1	No	-84,707.3
Hong Kong, China	No	-6,718.6	No	-10,492.2
India	Yes	2,677.9	No	-38,522.6
Indonesia	Yes	3.6	Yes	272.9
Kazakhstan	Yes	1,050.7	Yes	28,435.0
Korea, Rep. of	No	-10,995.0	No	-71,872.7
Malaysia	No	-2,770.7	Yes	12,154.6
Pakistan	No	-797.5	No	-6,963.3
Philippines	No	-662.7	No	-9,662.0
Singapore	No	-2,240.2	No	-2,418.4
Taipei, China ^a	No	-2,778.6	No	-24,304.0

^a Taipei, China data are for January–October only.

Source: CEIC Data Company Ltd., downloaded 14 March 2008.

in the terms of trade in those economies in developing Asia that are reliant on food and fuel imports and that are exporters of labor-intensive manufactured goods—Cambodia, Nepal, Pakistan, and Sri Lanka—are likely to be severe and may add further downward pressure on income growth just as the rise in import prices puts further upward pressure on the CPI. India, in contrast, has a favorable export basket featuring iron ore, precious gems, and foodstuffs.

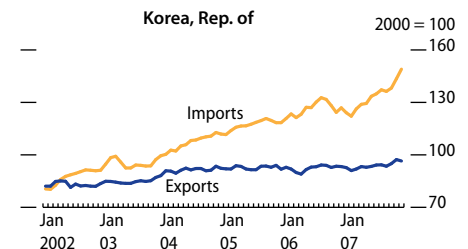
Southeast Asian economies that export a mixture of commodities including oil and gas along with manufactures are likely to be less exposed to terms of trade losses. The impact on the PRC is uncertain but is likely to be negative as well.

In summary, inflation pressures are mounting throughout the region (Table 1.1.3 above). Surges in food, fuel, and raw material prices are a result of both structural and cyclical forces, as well as unanticipated shocks. These are pushing up costs to firms and households and may soon elicit demands for higher wages. If costs escalate, firms will eventually have to pass them on in higher prices. Appropriate macroeconomic responses to accelerating inflation are likely to include tighter monetary policy and some exchange rate appreciation. Resisting appreciation by tracking global interest rates down would only aggravate inflation pressures. Though governments may be tempted to resist commodity price increases through administrative measures, these are likely to come with a high fiscal price tag, which may add to future inflation. Artificial restraints on prices and inflation today that blunt market incentives are only likely to lead to higher prices in the future. Carefully targeted direct income support for the poor, within strict budgetary limits, might better alleviate stresses, and at much lower cost.

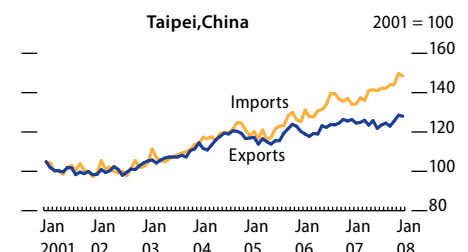
1.1.55 Unit value indexes



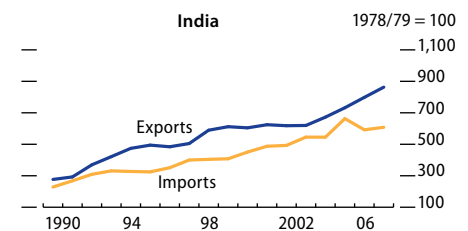
Source: Census and Statistics Department, available: www.censtatd.gov.hk, downloaded 7 March 2008.



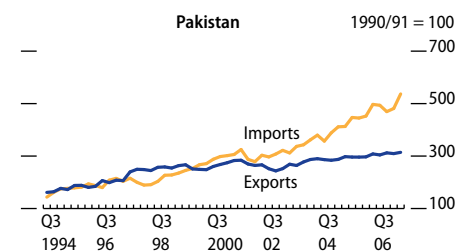
Source: Korean Statistical Information Service, available: www.kosis.kr, downloaded 14 March 2008.



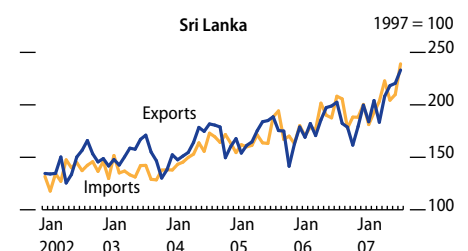
Source: CEIC Data Company Ltd., downloaded 14 March 2008.



Source: CEIC Data Company Ltd., downloaded 14 March 2008.



Source: CEIC Data Company Ltd., downloaded 14 March 2008.



Source: CEIC Data Company Ltd., downloaded 14 March 2008.

[Click here for figure data](#)

Endnotes

- 1 Available: www.newyorkfed.org/newsevents/speeches/2008/gei080306.html.
- 2 Available: www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000218642.pdf.
- 3 Available: www.rieti.go.jp/en/columns/s08_0001.html.
- 4 Developing Asia in this chapter comprises all developing member economies of the Asian Development Bank except Taipei,China, for which no comparable data are available. The eurozone comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.
- 5 In 2006, the PRC accounted for almost 50% of Hong Kong, China's total exports; 28% of Taipei,China's; and 21% of Korea's; but accounted for less than 10% of the total exports of Southeast Asia: 9.8% from Philippines, 9.7% from Singapore, 9.0% from Thailand, 7.7% from Indonesia, and 7.2% from Malaysia.
- 6 Consumer durables are long-lived goods for final consumption, the services of which can be enjoyed repeatedly over the course of at least 1 year. Nondurable consumer goods are items that are consumed once only such as beverages, food, and tobacco. Clothing and footwear are not treated as durables even though they last for years (Black 2002), perhaps reflecting the disposable nature of used shoes and clothing and their frequent purchase as seasons and fashions change.
- 7 For a more detailed examination of developments in garment trade in the categories for which the PRC is constrained under product-specific safeguards, see James (2008).
- 8 It is estimated that imports of shoes account for 99% of US sales and that the PRC provides 87.5% of imports by volume. High tariffs are equivalent to 40% of the retail price of some lower-cost imported shoes and are cited as onerous for low-income consumers by the sponsors of the Affordable Footwear Initiative Act of 2007 (see Hong Kong, China, Trade Development Council 8 November 2007, available: <http://marketinfo.tdctrade.com/>).
- 9 US general imports from the world actually grew faster in the fourth quarter than in previous quarters of 2007, reflecting seasonal effects of the holiday period and the spiking of the price of the largest category of imports—mineral fuels. Asia, however, experienced a slowing of growth in the third and fourth quarters relative to the first and second even without seasonal adjustments. Once mineral fuels are subtracted, overall quarterly growth was virtually flat in the second and third quarters and rose marginally (about 0.7%) in the fourth. One may expect the pattern in the eurozone to be similar to that of the US for the world (discussed subsequently).
- 10 See James (forthcoming).
- 11 Sources are United States International Trade Commission Dataweb, available: <http://dataweb.usitc.gov/scripts/REPORT.asp> and for Japan, Ministry of Finance, Trade Statistics, News Release, 30 January 2008 and 28 February 2008, available: <http://www.customs.go.jp>.
- 12 Even in clothing exports, the fear of the PRC is overblown (James 2008).
- 13 As pointed out in Athukorala (2007) and Dean and Tam (2005), the typical notebook computer made in a Taipei,China-owned factory in the PRC has processing chips made by Intel in Malaysia, an operating system made by Microsoft, a CD display screen sourced from Taipei,China or Korea, and hard-disk drives sourced from Japan. Domestic value added is only one third of the value of the output.
- 14 The import value of fabric are derived from HS codes: 5111, 5112, 5113, 5208, 5209, 5210, 5211, 5212, 5309, 5310, 5311, 5407, 5408, 5512, 5513, 5514, 5515, 5516, 6001, 6002, 6003, 6004, 6005, and 6006.
- 15 Futures prices for rice have been reported to be as high as \$745 per ton.
- 16 The increase would bring the total budgetary cost of fuel and electric power subsidies to \$25.9 billion as opposed to a budget line item of "only" \$8.3 billion, assuming an exchange rate of Rp9,100/\$1 (Kong and Ramayandi 2008, pp. 16-17).
- 17 The total subsidy value for rice and wheat is calculated at Rs23.5 billion, i.e., Rs18.8 billion for rice and Rs4.73 billion for wheat.

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