

Developing Asia and the world

Developing Asia

Overview

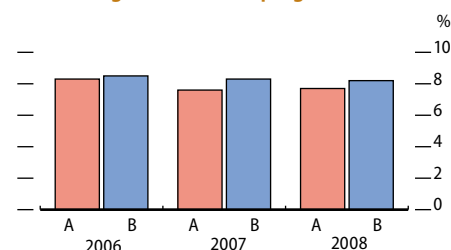
Developing Asia's prodigious growth continued through the first half of 2007, setting the scene for another bumper year. The region is now expected to expand by 8.3%, revised up from 7.6% projected in March's *Asian Development Outlook 2007* (Figure 1.1.1). Growth in 2008 is currently anticipated to slow gently to 8.2%. But this *Update* cautions that the outlook for 2008 is now hazy. The likelihood of growth slowing more abruptly than this *Update*'s central projections suggest is rising.

Revisions to 2007's growth projections are again heavily influenced by exceptionally strong performance in both the People's Republic of China (PRC) and India. In the first half of 2007, the PRC grew at 11.5%, faster than at any time since 1994. India, building on its fastest growth in 18 years in FY2006 (which ended in March 2007), registered growth of 9.3% in the first quarter of FY2007. Together, the PRC and India account for 55.3% of total gross domestic product (GDP) in developing Asia and so exert a powerful influence on regional trends (Figure 1.1.2). Their impact on aggregate projections and outcomes would be greater still if weights were calibrated in purchasing power parity terms rather than by the Atlas method (see the technical note, *Estimating subregional and regional growth for developing Asia*, in Part 4). The momentum of the PRC and India is expected to sustain solid regional performance through 2008.

Though these two countries' imprint dominates, a more general pattern of fast and, in places, accelerating growth is evident. The Philippines enjoyed its fastest growth in almost 20 years in the first half of 2007, and Indonesia's trend growth rate is steadily edging up. Central Asia, with oil and gas prices remaining high, continues to expand at a double-digit pace. So far, downside surprises have been few, though the process of healing Nepal's economy is slow and the Fiji Islands is now expected to contract more sharply in 2007 than previously thought.

So far, the storm in global credit markets has created only some turbulence in developing Asia—equity markets fell by an average of just 6% in August (Figure 1.1.3). Yet it is not clear whether the storm has blown itself out or merely paused. Financial innovation in global credit markets has succeeded in dispersing risks but this has created opacity about these risks' true magnitude and location. Increasing wariness about trading

1.1.1 GDP growth, developing Asia



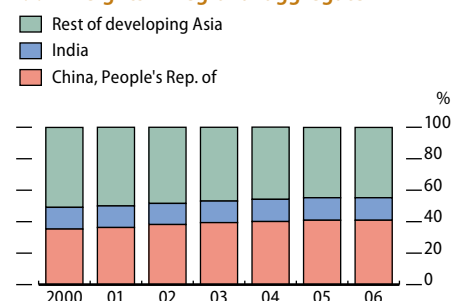
A = ADO 2007; B = ADO 2007 Update.

Note: Full-year data have led to upward revisions for 2006.

Source: Asian Development Outlook database.

[Click here for figure data](#)

1.1.2 Weights in regional aggregate



Source: World Bank, *World Development Indicators* online database, downloaded 16 February 2007.

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in complex and now seemingly risky instruments has caused liquidity to evaporate, hobbling price discovery, and raising uncertainty about valuations that cannot be marked to market. These difficulties have led investors to retreat to safer assets.

In this climate, banks have been defensive, hoarding liquidity in anticipation of the need to lend to their off-balance-sheet investment vehicles and to buttress doubtful collateral. These structured investment vehicles face the prospect of difficulties in refinancing their short-term maturing liabilities, such as commercial paper, the proceeds of which have been invested in longer-term securities whose quality is now in doubt. Central banks have been active suppliers of needed liquidity to the banking system through their discount windows.

As the informational fog is likely to lift slowly, financial markets could remain jittery and disorderly for some time yet. Only incoming data can provide clues about the possible impact of the credit market squeeze on the outlook for economic growth and inflation. Data released in September on job losses in the United States (US) have led markets to view a cut in the Fed Funds rate at its September meeting as a virtual certainty. Though central banks will remain concerned about the health of the banking and broader financial systems, their key decisions on the overall direction of monetary policy are most likely to be driven by core objectives on inflation and output. They have other instruments at their disposal to boost liquidity and support the payments system.

Clearly, it is still early days and events in credit markets and the wider economy have become more difficult to predict. It would certainly be rash to assume that growth in developing Asia, particularly in 2008, would be immune to these unfolding processes. Though growth might slide in 2008 by more than foreseen in this *Update's* central projections, a sharp dive still seems unlikely. Developing Asia's defenses against external shocks are solid: its financial systems are by and large in good shape and while isolated cases of overheating are in evidence, there is no general malaise. If growth were to slip a gear there is also some latitude to adjust domestic policies.

A key message of this *Update* is that beyond the immediate impacts of gyrations in the global economy, developing Asia's growth prospects will continue to depend on how well countries cope with their own domestic challenges. In terms of macroeconomic management, some countries are trying to juggle too many objectives given the instruments at their disposal. While exchange rate regimes are certainly more flexible than they once were, there is scope for still-greater flexibility (Figure 1.1.4).

Evidence presented in Part 2, *Export dynamics in East Asia*, suggests that from the perspective of developing durable export platforms, familiar supply-side factors (including the quality of infrastructure and the business investment climate) play a critical role. This analysis also confirms the continuing importance of external demand for the buoyancy of regional exports. But the influence of real exchange rates on exports appears complex and more subtle than its impact on demand alone. Finally, though Asia is adjusting to high oil prices, adjustments in some countries still have some way to go (see Box 1.1.1, *Evolution of retail fuel prices in Asia*). The opportunity costs of subsidies on gasoline, diesel, and kerosene remain high, and add to fiscal stresses.

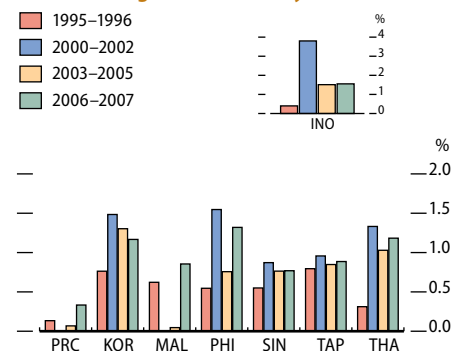
1.1.3 MSCI emerging markets, Asia



MSCI = Morgan Stanley Capital International, Inc.

Source: Bloomberg, downloaded 3 September 2007.

1.1.4 Exchange rate flexibility



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

Note: Data refer to average absolute monthly percentage changes in exchange rate against the US dollar.

Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; www.cbc.gov.tw; all downloaded 10 September 2007.

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Global risks to the outlook now appear accentuated. The possible implications of a US slowdown for developing Asia are assessed below. But other risks remain. Avian flu is still a significant source of uncertainty with potentially devastating consequences, and concerns remain about growing trade protectionism. Geopolitical and security risks are heightened in some parts of the region, and political uncertainties, with important elections coming up, obscure the outlook for some countries.

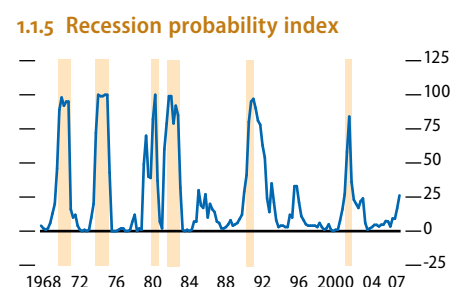
Can developing Asia weather a US slowdown?

The odds are still against a recession in the US, but they are narrowing. The baseline forecast in this *Update* is that the US will experience a slowdown in 2007 and that growth will then pick up in 2008. It is expected that any acceleration in 2008 will be gentle and that output will remain below its potential level. Yet there is now much greater uncertainty around this baseline projection, with the “tails” on the probability of bad outcomes getting fatter. One measure now puts the chances of a US recession at over 1 in 4, its highest value since the last quarter of 2001 (Figure 1.1.5). The question is whether developing Asia could weather a much sharper slowdown than is currently anticipated.

Despite rapid expansion in developing Asia and other parts of the world, the US remains the dominant economy globally in terms of its weight in GDP and in global financial market transactions. The US share of world exports is second only to that of the euro zone, and the country is the world’s top importer. Though it is true that the weight of other regions, including developing Asia, is rising, and that their internal markets are becoming more closely integrated, it does not automatically follow that they have become impervious to the fortunes of the world’s largest economy.

Other than economic size, there are several other reasons why the US is still likely to exercise a noticeable pull on other regions, and particularly on developing Asia. The first is that tighter regional trade ties are largely complementary to external trade linkages with the US. Indeed, in East and Southeast Asia, closer trade integration emerges largely as a result of back and forth trade in intermediate goods and parts, much of which is assembled in final goods for export to the US and other industrial countries. *Asian Development Outlook 2007* (Figure 1.5.5, p. 69) estimates that just under 79% of the merchandise that leaves Asia’s ports eventually ends up in external markets. A chill in the US is therefore likely to send a downdraft along the region’s supply chains. In a recent study at the European Central Bank, Dees and Vansteenkiste (2007) estimate that working back along the chain of direct and indirect demand for the region’s exports, a 1% reduction in US GDP could instigate a contraction of 0.37 percentage points in developing Asia’s GDP, having allowed for influences transmitted through adjustments to demand in other regions.

The explosive growth and integration of global financial markets constitute a second reason why significant uncoupling seems unlikely. “Home bias” in international financial markets is waning and investors increasingly have a global reach. There is compelling evidence not just of



Note: The chart was prepared using US GDP growth data for the second quarter, released on 27 July 2007.

Source: http://www.econbrowser.com/archives/2007/07/recession_proba_2.html, downloaded 31 August 2007.

1.1.1 Evolution of retail fuel prices in Asia

The global economy has been experiencing rising fuel costs, with the price of crude oil nudging \$80 per barrel in early September 2007. Rising global consumption, coupled with supply restraint from the Organization of the Petroleum Exporting Countries (OPEC) and sluggish growth in non-OPEC oil production, has led to a tight market. Demand is expected to outrun supply in 2007, resulting in a drawdown of oil stocks.

In this context of rising and high fuel prices, some governments have sought to moderate the pass-through to consumers. To assess the extent of their interventions, retail prices in developing Asia were surveyed by Asian Development Bank resident missions in August 2007. The results of their survey update earlier exercises described in *Asian Development Outlook (ADO) 2006* (published in April) and the *ADO Updates* of 2005 and 2006. (As for those publications, the basic methodology is that developed by the German Technical Cooperation, which runs similar surveys, the last being in November 2006.)

Retail fuel prices from the various surveys were compared against three benchmark prices and classified into four price bands. The first benchmark is Brent crude. Retail prices below this benchmark are subsidized and fall in the first price band, BC. The second benchmark is retail fuel prices in the United States (US). Prices above crude but below the US benchmark fall in the second price band, AC. The US fuel price is used as the cost recovery price; however, a range of factors, such as local processing and distribution costs, determines actual cost recovery for specific countries.

The third benchmark is retail fuel prices in Luxembourg, assigned as the European Union (EU) benchmark. Luxembourg fuel prices reflect EU-wide taxes, and allow for environmental costs. Fuel costs above US prices but below Luxembourg prices fall in the third price band, AUS, and suggest greater cost recovery, but are unlikely to mean that the consumer pays for environmental costs. Retail prices above the EU benchmark are put in the fourth price band, AEU.

The left panel of Table 1 presents data for retail diesel prices drawing on four surveys from 2004 to 2007 (*ADO 2005 Update*, *ADO 2006*, *ADO 2006 Update*, and the latest survey). It shows that over the 12 months between August

1 Movement of prices in terms of four price bands, diesel and gasoline

Economy	Diesel				Gasoline			
	Update 2005	ADO 2006	Update 2006	Update 2007	Update 2005	ADO 2006	Update 2006	Update 2007
Turkmenistan	BC	BC	BC	BC	BC	BC	BC	BC
Malaysia	BC	BC	BC	BC	AC	AC	AC	AC
Indonesia	BC	AC	AC	AC	AC	AC	AC	AC
Kazakhstan	AC	BC	BC	AC	AC	AC	AC	AC
Myanmar	BC	BC	AUS	AC	BC	BC	AC	BC
Azerbaijan	BC	BC	BC	AC	AC	BC	BC	AC
Pakistan	AC	AC	AC	AC	AUS	AUS	AUS	AUS
Viet Nam	AC	AC	AC	AC	AC	AC	AC	AC
Kyrgyz Republic	AC	AC	AC	AC	AC	AC	AC	AC
Uzbekistan	AC	BC	BC	AC	AC	AC	AC	AC
Bangladesh	AC	AC	BC	AC	AUS	AC	AC	AUS
China, People's Rep. of	AC	AC	AC	AC	AC	AC	AC	AC
Maldives	-	-	AC	AC	-	-	AC	AC
Sri Lanka	AC	AC	AC	AC	AUS	AUS	AUS	AUS
Afghanistan	AUS	AC	AC	AC	AC	AC	AC	AUS
India	AUS	AC	AC	AC	AUS	AUS	AUS	AUS
Tajikistan	AUS	AC	AC	AC	AUS	AC	AC	AUS
Thailand	AC	AC	AC	AC	AUS	AC	AC	AUS
Philippines	AC	AC	AC	AC	AC	AC	AC	AUS
Cambodia	AUS	AC	AUS	AUS	AUS	AUS	AUS	AUS
Taipei, China	AC	AC	AC	AUS	AUS	AC	AUS	AUS
Bhutan	AUS	AC	AC	AUS	AUS	AUS	AUS	AUS
Papua New Guinea	AUS	AUS	AUS	AUS	AUS	AUS	AUS	AUS
Lao People's Dem. Rep.	AC	AC	AC	AUS	AUS	AUS	AUS	AUS
Mongolia	AUS	AC	AUS	AUS	AUS	AC	AC	AUS
Nepal	AC	AC	AC	AUS	AUS	AUS	AUS	AUS
Singapore	AC	AC	AUS	AUS	AUS	AUS	AUS	AUS
Armenia	-	AC	AC	AUS	-	AUS	AUS	AUS
Timor-Leste, Dem. Rep.	AUS	AUS	AUS	AUS	AUS	AUS	AUS	AUS
Hong Kong, China	AEU	AEU	AUS	AUS	AEU	AEU	AEU	AEU
Fiji Islands	AUS	AUS	AUS	AUS	AUS	AUS	AUS	AUS
Korea, Rep. of	AUS	AEU	AEU	AEU	AEU	AEU	AEU	AEU
Memorandum items (prices in US cents per liter)								
Brent crude oil	27	40	49	47	27	40	49	47
US retail	57	76	80	77	54	77	85	75
Luxembourg retail	98	107	124	130	119	125	151	156

- = data not available; BC = below crude price; AC = above crude price but below US price; AUS = above US price but below Luxembourg price; AEU = above Luxembourg price.

Note: Economies arranged according to diesel prices in August 2007 (ascending order).

Sources: Surveys by ADB resident missions; national press reports; Bloomberg; Energy Information Administration, available: www.eia.doe.gov, downloaded 10 August 2007; German Technical Cooperation, *International Fuel Prices*, available: www.gtz.de/fuelprices.

2006 and August 2007, diesel prices have generally moved to higher price bands. In fact there is only one economy that has dropped to a lower-priced band. Nine economies have moved to the next highest price band. Out of 32 economies in the August 2007 survey, 12 charged retail prices above the US benchmark. But only one of these (Republic of Korea) had prices above the EU benchmark.

Comparisons of surveyed prices with gasoline benchmarks are shown in the right panel. There has been some back and forth movement of gasoline prices in Asia relative to the US benchmark. As reported in *ADO 2005 Update*, 53% of economies priced above the

1.1.1 Evolution of retail fuel prices in Asia (continued)

US benchmark. At publication of *ADO 2006* this was no longer true, as the US had racked up retail prices more quickly than the Asian economies in the sample, but by August 2007, some lagging economies in Asia had caught up with US price adjustments, so that two thirds of economies in the sample surpassed the US benchmark.

In terms of pricing regimes, Table 2 summarizes the August 2007 survey data on retail fuel price policies. At that date, fuel prices were still government controlled in more than half the economies in the sample. In limiting the pass-through effects of high crude prices to consumers, governments have resorted to direct and indirect means of controlling retail fuel prices.

Direct subsidies to lower retail prices for the whole population were used by 19% of the economies for gasoline and 25% for diesel. Direct subsidies or tax breaks for targeted industries, such as farming, fishing, and transportation, and for selected uses, such as cooking and electricity, were used by 53% of the economies.

Indirect methods of lowering fuel prices for the whole population, such as regulated pricing, compensatory tax changes, and use of state-owned petroleum companies to absorb losses, were used by 31% of the economies.

Whether directly or indirectly controlled, in over half the economies, regulated prices were raised as world prices rose.

To finance direct and indirect subsidies, governments primarily relied on budgetary provisions, with half the economies that administered fuel prices financing their subsidies through the budget. One third used compensating changes in taxes to soften the impact of fuel price increases. Others (28%) financed subsidies through state-owned enterprises, use of bank loans, issuance of bonds, or cross-subsidies.

The survey data suggest a slowly changing paradigm in fuel price policy in developing Asia. There has been a greater tolerance of the need to pass through rising fuel prices to consumers, even in economies where prices remain administered, suggesting some rebalancing of fiscal priorities. Nevertheless, subsidies and controlled prices persist, and prevail in a majority of economies.

Some governments view price controls and subsidies as an important way of providing support to those on low income, but poor targeting often means that these subsidies are captured by other groups. The opportunity cost of subsidizing fuel remains high.

2 Survey of retail fuel price policy in developing Asia, August 2007

Economy	Fuel price controlled for				Fuel price subsidized for				Change in administered price or subsidy in 2007	Direct subsidies or tax breaks for certain uses or targeted consumers	Subsidy financed through			
	A	B	C	D	A	B	C	D			Gov't. budget	Change in tax	Off budget	Other
Turkmenistan	✓	✓	✓	✓	✓	✓	✓	✓		✓				
Malaysia	✓	✓			✓	✓					✓			
Indonesia	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓			
Kazakhstan	✓	✓	✓	✓		✓			✓	✓		✓		
Myanmar	✓	✓			✓	✓			✓					
Azerbaijan	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓			
Pakistan				✓						✓	✓	✓		
Viet Nam		✓	✓			✓	✓		✓	✓		✓		
Bangladesh	✓	✓	✓						✓	✓				✓
China, People's Rep. of	✓	✓	✓	✓						✓				
Maldives										✓				
Sri Lanka	✓	✓	✓	✓					✓		✓	✓		✓
Afghanistan										✓	✓			
India	✓	✓	✓	✓			✓	✓		✓	✓	✓		✓
Thailand				✓				✓		✓				
Philippines										✓				
Cambodia	✓	✓	✓	✓										
Taipei, China	✓	✓							✓					
Bhutan										✓				
Papua New Guinea	✓	✓	✓						✓					
Lao People's Dem. Rep.	✓	✓												
Nepal	✓	✓	✓	✓	✓	✓	✓	✓					✓	✓
Armenia				✓				✓					✓	
Samoa	✓	✓	✓	✓					✓	✓				
Timor-Leste, Dem. Rep. of										✓	✓	✓		
Fiji Islands	✓	✓	✓	✓					✓	✓		✓		

A = gasoline; B = diesel; C = kerosene; D = LPG/fuel oil/gas.

Note: At the time of the survey, the following economies neither provided fuel subsidies nor controlled fuel prices: Hong Kong, China; Republic of Korea; Kyrgyz Republic; Mongolia; Singapore; and Tajikistan.

Sources: ADB resident missions; national energy agencies; international press reports.

strong comovement of prices for similar assets but also comovement of asset price volatility across markets. IMF (2007) observes that contagion through financial channels, in terms of both prices and volatility, is a particularly potent force for spillovers during asset market retreats. As the US is the global financial center, disturbances there almost inevitably reverberate in other regions.

More traditional transmission channels are also likely to be still in play. For example, a dip in global growth will probably influence the trajectory of primary commodity prices and therefore terms of trade. Exchange rate and interest rate changes may also have wealth effects and influence fiscal positions. But disentangling these and other possible sources of spillovers and making conjectures about their impact if growth in the US lunges downward is far from easy.

The evidence

One approach is to sift for clues from past episodes of US slowdowns. According to the National Bureau of Economic Research (NBER), the US has experienced only seven slowdowns since 1970 (five classified as recessions). Small-sample problems in the historical data are exacerbated by the fact that only a handful of countries in developing Asia actually have quarterly measurements of output that span these events. Annual data for East and Southeast Asia are shown in Figure 1.1.6.

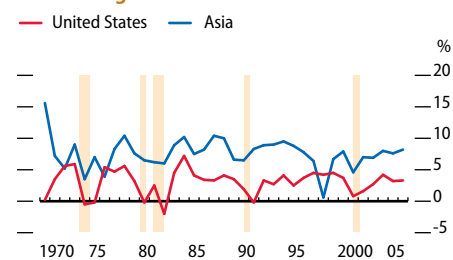
IMF (2007) calculates that for the five US recessions between 1974 and 2001, developing Asia's growth fell by about 0.28 percentage points for each percentage point decline in US growth. But this average masks a wide range. As a broad observation, US recessions that were triggered by wider global shocks (such as the oil price rises of the 1970s) were more closely associated with downturns in other regions. Those recessions incubated domestically (such as the aftermath of the savings and loan crisis of the early 1990s), had more limited spillovers. As the current problems in credit markets bear some superficial resemblance to those that surfaced after that crisis, it might be tempting to conclude that the threat from current ructions is not great. But in the early 1990s, global financial markets were much smaller than now, and not nearly so integrated.

The most recent recession, which started with the “dot-com” meltdown in 2000 and was propagated by a cyclical downturn in the electronics industry, presents a somewhat more arresting picture. During this recession, IMF (2007) estimates that growth in the US declined by 2.9 percentage points with growth in developing Asia falling by 1.1 percentage points. Only the oil price shocks of the early 1970s show more pronounced synchronization of growth decelerations.

Recessions and slowdowns appear to be quite different creatures from the perspective of their potential for spillover effects. NBER identifies two (non-recession) growth slowdowns in the US, in 1986 and 1995. In 1986, developing Asia was rebounding from a homegrown slowdown in growth that occurred in the first half of the 1980s. In the mid-1990s, the region's growth was high and stayed unruffled by slowing in the US. And again, during the course of the current slowdown in the US, growth has accelerated in developing Asia.

Averaging out across different phases of the US business cycle allows

1.1.6 GDP growth and US recessions

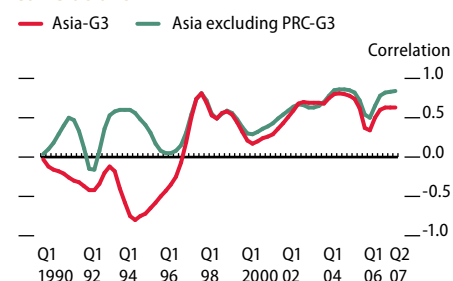


Note: Quarterly periods of US recessions, as defined by the National Bureau of Economic Research (NBER), are identified by the shaded areas. Annual growth rates are centered across the x-axis labels. Asia comprises People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

Sources: World Bank, *World Development Indicators* online database; Directorate-General of Budget, Accounting and Statistics, available: eng.stat.gov.tw; NBER, *Business Cycle Expansions and Contractions*, available: www.nber.org; all downloaded 10 September 2007.

[Click here for figure data](#)

1.1.7 Average interregional business cycle correlations

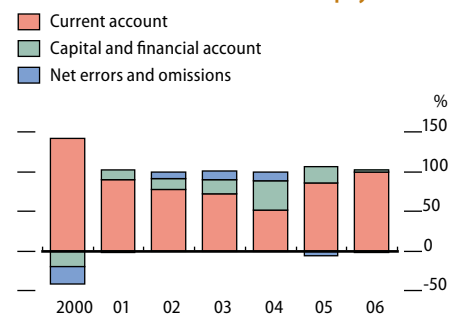


Note: Asia comprises People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. G3 comprises United States, Japan, and euro zone.

Source: Oxford Economics, *Quarterly Model*, August 2007.

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1.1.8 Share in overall balance of payments



Note: Data refer to Bangladesh; People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Singapore; Taipei, China; and Thailand.

Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 10 September 2007.

[Click here for figure data](#)

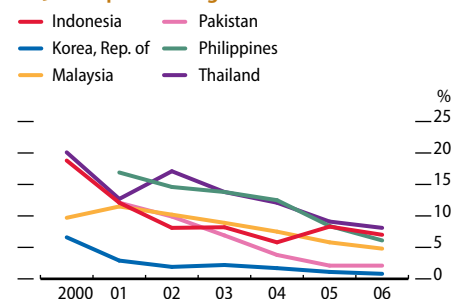
for more data to be brought to bear on the analysis. But the striking differences in apparent spillovers over these phases caution against drawing simple inferences. Looking for regularities in the time series data for the US and developing Asia, IMF (2007) concludes that disturbances to US growth have had significant effects on the newly industrialized economies and the ASEAN-4; but also that impacts have been comparatively short-lived. Dees and Vansteenkiste (2007) conclude that the US and Asian business cycles are largely independent of one another. Given the presence of the PRC in their sample, and its uninterrupted growth over the past 25 years, as well as the violent effects of the Asian crisis on regional growth in the second half of the 1990s, this finding is perhaps not so surprising. But if spillovers really do behave differently between upturns and downturns, and are particularly potent during recessions, it is not clear what can be inferred from averages culled from expansions, contractions, and tranquil periods.

Asian Development Outlook 2007 (in the chapter, *Uncoupling Asia: Myth and reality*), provides another perspective on business-cycle synchronization. It observes that the early 1990s presents strong evidence of detachment of developing Asia from the G3 (US, Japan, and euro zone). But there is also evidence of a pronounced structural break following on the heels of the Asian crisis. Since the crisis, it would seem that there has been much closer synchronization of the Asian and G3 business cycles (Figure 1.1.7). Correlations between PRC and G3 business cycles are weaker. The postcrisis data confirm that the G3 business cycle leads movements in output in developing Asia at intervals of 1 to 3 years. Lying behind these findings might be the strong dependence on export-led growth in the postcrisis period, deepening financial market integration, and indeed, improved policies that have helped promote greater stability. However, intriguing as these findings may be, they do not provide a basis for robust prediction.

Another way of trying to understand how growth in developing Asia might respond to shocks in the US is to apply simulation techniques using models of the global economy. IMF (2007) reports exercises using its global economic model. It finds impacts that are not very different from the numbers calibrated from event studies. In a recent ADB study, Park (2007) uses Oxford Economics' global economic model to examine scenarios in which there is a hypothetical US slowdown, and traces possible impacts on developing Asia. (These scenarios are illustrative and should not be regarded as forecasts.)

Three hypothetical situations are considered in the ADB study. It is assumed, first, that a contraction in US demand leads to a 1 percentage point fall in US output growth and that this downturn endures for 2 years. This lowers output growth in developing Asia by 0.45 percentage points in the first year and by 0.75 percentage points in the second. Second, a 10% depreciation of the US dollar (against all currencies other than the Hong Kong dollar, which is linked to the US dollar) is assumed to occur in tandem with the assumed deceleration in US growth. Now growth in developing Asia slows by close to 2% in each year. In such an event, a depreciation of the US dollar might be needed to stimulate growth in a context of weaker domestic demand in the US. Third, the hypothetical shock to US growth occurs together with an assumed 10%

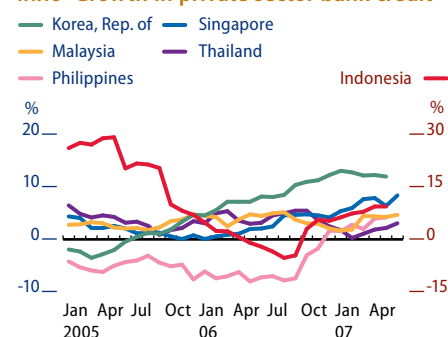
1.1.9 Nonperforming loan ratio



Sources: CEIC Data Company Ltd.; Bank Negara Malaysia, available: www.bnm.gov.my; State Bank of Pakistan, available: www.sbp.org.pk; all downloaded 8 September 2007.

[Click here for figure data](#)

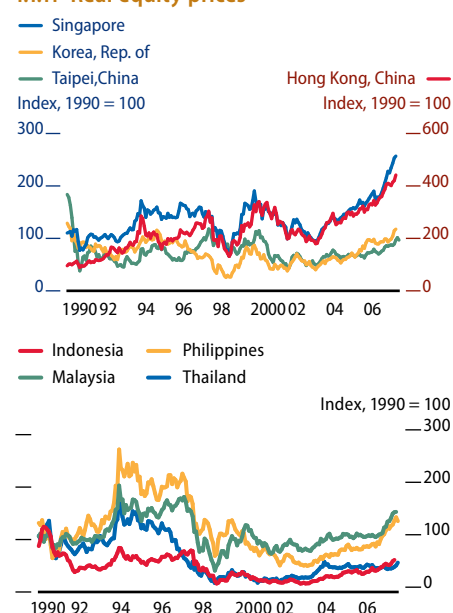
1.1.10 Growth in private sector bank credit



Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 8 September 2007.

[Click here for figure data](#)

1.1.11 Real equity prices



Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 8 September 2007.

[Click here for figure data](#)

decline in investment in the PRC. With deteriorating prospects for growth and trade, there could be cuts in investment spending in the PRC both by domestic and by foreign investors. In the remainder of developing Asia, GDP growth now slows by 0.8 percentage points in year one and by 0.9 percentage points in year two.

Downside risks

Together the evidence from past slowdowns, available statistical findings, and the results of modeling simulation exercises suggests that developing Asia would certainly feel the tremors from a US recession, though these are likely to be modest and short-lived. Even if the worst experiences of the past 35 years were replayed, the attrition of growth is unlikely to be severe.

If a recession of recent median depth and duration occurred in the US—an event that has a low but rising probability—a deceleration of growth in developing Asia by 2 percentage points would be at the upper end of plausible estimates for effects of the spillover, with a central prediction closer to 1 percentage point. Depending on timing, this could possibly prune growth to a range of 6–7% from the baseline prediction of 8.2% in 2008.

To the extent that past events provide a reliable guide, they suggest that the magnitude and speed of impacts will be critically affected by exchange rate adjustments (as illustrated in Park's [2007] simulations), by impacts on primary commodity prices, and by any spillovers from the US to the wider global economy. If evidence of a synchronized and sharp slowdown across the G3 were to appear—again, something considered unlikely—this could make a significant dent on growth in developing Asia.

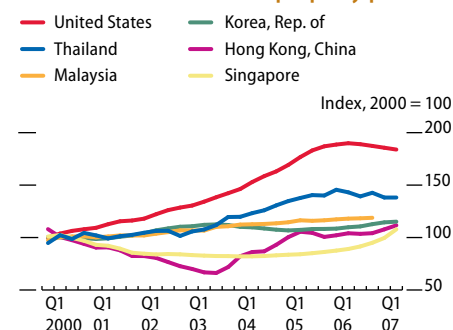
Country-level impacts

At a country level, susceptibility to spillovers from a sharp US downturn would depend on a variety of factors. The buildup of reserves that has occurred across the region certainly provides a strong buffer against external shocks (see Box 1.1.2, *Developing Asia's foreign exchange reserves and the United States merchandise trade deficit*). However, those economies that have built reserves through current account surpluses are in a stronger position than those that have experienced reserve growth through capital inflows. Any capital flight could deplete reserves as investors leave for safer havens. Fortunately, for most economies in developing Asia, current account surpluses have been the primary driver of reserves, though for India (where cover is still ample), and periodically for some other economies, capital inflows have been important (Figure 1.1.8).

Likewise, vulnerabilities have retreated with improved health of domestic financial systems. The quality of banks' assets and their capital strength have been boosted (Figure 1.1.9). The corporate sector too has reduced its exposure to debt (Figure 1.1.10).

Asset valuations generally are in line with fundamentals. It is true that equity prices in developing Asia have enjoyed strong growth since 2004, but this should be seen in the context of quite modest performance over a longer stretch of time (Figure 1.1.11). Property markets are also making a comeback, but valuations have not soared as in some industrial countries, nor have credit risks become elevated in the way that they have in the US (Figure 1.1.12).

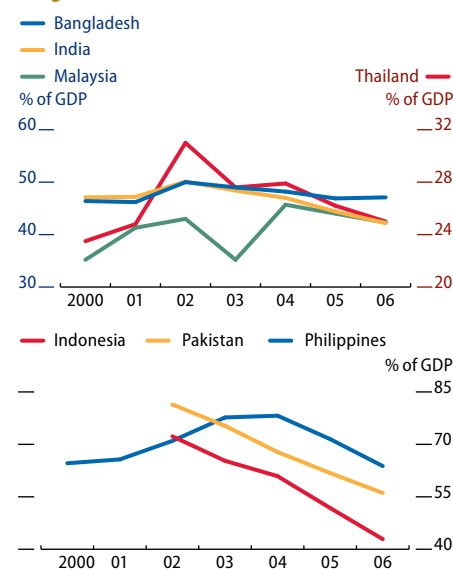
1.1.12 Selected residential property prices



Source: CEIC Data Company Ltd., downloaded 8 September 2007; www.realtor.org/Research.nsf/Pages/MetroPrice, downloaded 15 September 2007.

[Click here for figure data](#)

1.1.13 Public sector debt



Sources: Bangladesh Bank, available www.bangladesh-bank.org; Government of India, Ministry of Finance, available: finmin.nic.in; Bank Indonesia, available: www.bi.go.id/web/en; Government of Indonesia, Debt Management Office, available: dmo.or.id; Singapore Ministry of Trade and Industry, available: app.miti.gov.sg/; Bank of Thailand, available: www.bot.or.th; CEIC Data Company Ltd; International Monetary Fund, *Pakistan: 2006 Article IV Consultation*, Staff Report, available: www.imf.org; all downloaded 10 September 2007.

[Click here for figure data](#)

1.1.2 Developing Asia's foreign exchange reserves and the United States merchandise trade deficit

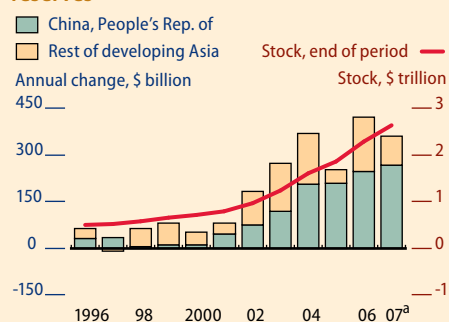
Developing Asia's foreign exchange reserves rose by about \$360 billion in the first half of 2007 to \$2.6 trillion, according to preliminary data (box table). This advance was about two-thirds larger than the \$217 billion increase in the same period of the previous year.

This continues a pattern of large gains made by the region since 2001 (Box figure 1), and developments through June suggest that 2007 will see the largest increase to date. All but one of the economies in the region made reserve gains, with the People's Republic of China (PRC) accounting for about 74% of the rise as its current account surplus strengthened. India accounted for about 10% of the increase, reflecting its larger capital account surplus.

With \$1,332.6 billion as of end-June 2007, the PRC holds about 50% of developing Asia's foreign exchange reserves. The next five largest holders (in descending order, Taipei, China; Republic of Korea; India; Singapore; and Hong Kong, China) together hold \$1,002.3 billion, or about 38% of the regional total.

Box figure 2 indicates that developing Asia's share in the United States (US) merchandise trade deficit (census basis, not seasonally adjusted), which had been essentially stable since 2001, increased at

1 Developing Asia's foreign exchange reserves

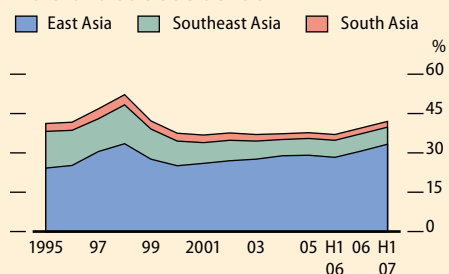


^a First half.

Sources: International Monetary Fund, *International Financial Statistics* online database; www.cbc.gov.tw; Bank of Korea, available: www.bok.or.kr; all downloaded 3 September 2007.

[Click here for figure data](#)

2 Developing Asia's share in the US merchandise trade deficit



Note: Shares of Central Asia and the Pacific are negligible.

Source: US Census Bureau, available: www.census.gov, downloaded 3 September 2007.

[Click here for figure data](#)

a faster pace in the first half of 2007. The US trade deficit with developing Asia amounted to \$157.4 billion, or 42.1% of the US total (\$373.6 billion), up by 5.2 percentage points from the first half of 2006.

The US trade deficit with the PRC widened by about 15% in January–June 2007 from the prior-year period, to \$117.5 billion, while other developing Asian economies' trade surplus with the US fell by 8.3% to \$39.9 billion.

The PRC has expanded its share of the regional surplus over the years (about 75% in 2007 versus 51% in 2000), reflecting both its emergence as a low-cost producer of manufactured goods, and the growth of intraregional trade (the latter features exports of components and supplies to the PRC for assembly into goods for export, including to the US).

Developing Asia's foreign exchange reserves (\$ billion)

	Stock June 2007	Change in first half of year	
		2007	2006
Central Asia	26.0	3.8	6.4
Armenia	1.2	0.2	0.1
Azerbaijan	2.8	0.3	0.4
Kazakhstan	20.9	3.2	5.8
Kyrgyz Republic	0.9	0.2	0.0
Tajikistan	0.2	0.0	0.0
East Asia	1,986.2	281.2	147.2
China, People's Rep. of	1,332.6	266.3	122.2
Hong Kong, China	136.3	3.1	2.3
Korea, Rep. of	250.2	11.8	15.3
Mongolia	1.0	0.1	0.2
Taipei, China	266.1	-0.1	7.1
South Asia	230.8	40.3	27.5
Bangladesh	5.0	1.2	0.6
Bhutan	0.6	0.0	0.0
India	206.1	35.9	25.0
Maldives	0.2	0.0	0.0
Nepal	1.6	0.0	0.1
Pakistan	14.0	2.7	1.5
Sri Lanka	3.2	0.4	0.1
Southeast Asia	394.5	34.7	35.9
Cambodia	1.3	0.1	0.1
Indonesia	49.2	8.5	5.3
Lao People's Dem. Rep.	0.4	0.1	0.0
Malaysia	90.8	9.1	8.6
Myanmar	1.2	0.0	0.2
Philippines	23.3	3.4	2.3
Singapore	143.6	7.4	11.5
Thailand	71.1	6.0	5.7
Viet Nam	13.4	0.0	2.2
The Pacific	2.2	0.2	0.2
Fiji Islands	0.2	0.0	-0.1
Micronesia, Fed. States of	0.0	0.0	0.0
Papua New Guinea	1.5	0.2	0.2
Samoa	0.1	0.0	0.0
Solomon Islands	0.1	0.0	0.0
Tonga	0.1	0.0	0.0
Vanuatu	0.1	0.0	0.0
Developing Asia	2,639.6	360.1	217.1

Sources: International Monetary Fund, *International Financial Statistics* online database; www.cbc.gov.tw; Bank of Korea, available: www.bok.or.kr; all downloaded 3 September 2007.

Responses

Public sector debt levels remain high in some countries, but have been coming down (Figure 1.1.13). The costs of servicing debt are likely to rise as increased volatility feeds through to the repricing of risks. Indeed this is already happening. During July and August, spreads on Asian sovereigns increased across the board (Figure 1.1.14) though in some cases a reassessment of domestic circumstances also played a part. Rising costs of debt servicing will hurt most where debts are already substantial. Those countries where debt levels are low and deficits are small have greater latitude to use fiscal measures to counteract any weakness coming through other channels. However, long lags in spending could mean that support kicks in just as economies are healing naturally. And if an economic slowdown led to US dollar weakening, this would ease fiscal pressures as the size of US dollar-denominated debts would shrink in local currency terms.

If unfolding evidence suggests that there are threats to growth, the scope for monetary policy adjustments will depend on circumstances. In economies where real interest rates are already very low (Figure 1.1.15), cuts may not have much impact. And in countries where there is overheating, slower growth may help reduce inflation risks. Monetary easing would make most sense where growth may slip below potential and where real interest rates are moderate. Easing would be consistent with inflation (and output) objectives provided that it is appropriately calibrated on the deflationary impulse coming from weakening external demand, and on any induced effects on domestic consumption and investment that could occur through credit and wealth channels.

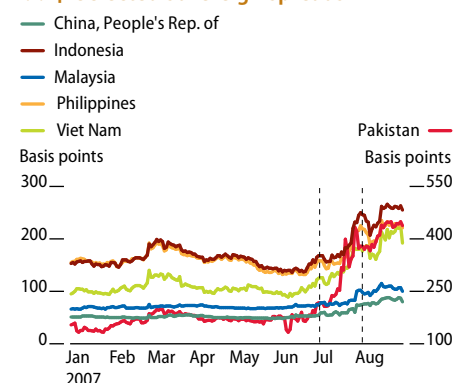
Growth prospects

Growth of 8.3% is now expected in 2007, easing gently to 8.2% in 2008 (Figure 1.1.16 and Table 1.1.1). Momentum in the PRC and India supports fast growth at the regional level. If these two countries are removed from the averages, the other economies are expected to grow by more modest averages of 5.7% in 2007 and 5.6% in 2008.

The baseline forecasts for 2007 anticipate some modest slowing in the global economy, and a mild recovery in the US through 2008. Stabilizing monetary responses seem likely. But the downside risks to growth in 2008 are elevated, and much will depend on whether distress in credit markets deepens and spills over into the wider financial system and real economy (see above).

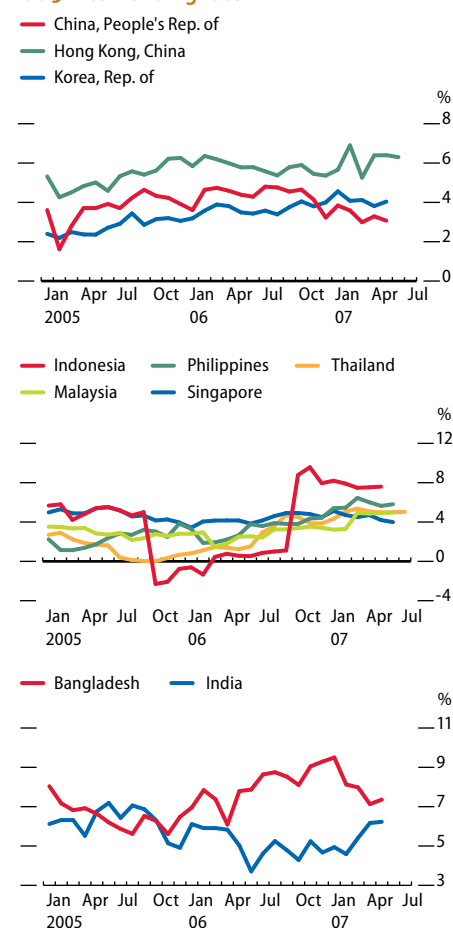
In the first half of 2007, growth in East Asia quickened, lifted by fast expansion in the PRC. Growth in the first half in the PRC was 11.5%, trending up through the second quarter. The now familiar pattern of vigorous investment spending and rapid expansion of exports underpinned growth in the PRC. Efforts by the authorities to rein back investment and export demand growth have, as yet, had limited impact. Investment administered by local governments is again growing at a fast clip, and the withdrawal in midyear of export-supportive measures may have brought forward export deliveries. Private consumption demand, as measured by retail sales, is also growing briskly, bolstered by rapidly expanding incomes in rural as well as urban areas.

1.1.14 Selected sovereign spreads



Source: Bloomberg, downloaded 10 September 2007.

1.1.15 Real lending rate



Source: International Monetary Fund, International Financial Statistics online database; downloaded 8 September 2007.

[Click here for figure data](#)

1.1.1 Selected economic indicators, developing Asia, 2006–2008

	2006	2007		2008	
		ADO 2007	Update	ADO 2007	Update
Gross domestic product (annual % change)					
Developing Asia	8.5	7.6	8.3	7.7	8.2
Central Asia	12.4	10.3	11.1	9.4	10.1
East Asia	9.0	8.0	8.9	8.0	8.7
South Asia	8.8	7.7	8.1	8.0	8.1
Southeast Asia	6.0	5.6	6.1	5.9	6.1
The Pacific	2.6	4.5	3.5	2.8	3.2
Consumer price index (annual % change)					
Developing Asia	3.3	3.0	4.0	3.2	3.8
Central Asia	7.9	8.6	9.7	7.9	9.1
East Asia	1.6	1.9	3.5	2.2	3.3
South Asia ^a	5.9	5.5	5.7	5.3	5.4
Southeast Asia	7.1	4.2	3.8	4.0	3.8
The Pacific	3.2	3.5	4.7	3.3	3.2
Current account balance (% of GDP)					
Developing Asia	5.8	5.0	6.1	5.0	5.7
Central Asia	4.7	3.2	3.5	3.3	3.6
East Asia	7.4	6.8	8.2	6.9	7.9
South Asia	-1.4	-2.2	-1.9	-2.2	-2.1
Southeast Asia	7.8	6.1	7.0	5.6	6.0
The Pacific	4.9	-1.2	7.3	2.0	2.3

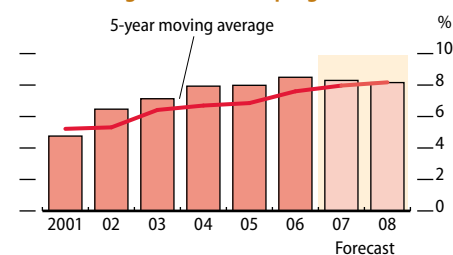
^a India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

Growth in Hong Kong, China continues to benefit from the bristling economic activity in the PRC. In the first half, growth was 6.3% and this *Update*'s prediction is that growth in full-year 2007 will be about 6%. Though this is a little slower than recent outcomes, it is an upward revision on the March forecast of *ADO 2007*. In the Republic of Korea (hereafter Korea), underlying demand pressures have been building, prompting the authorities to unexpectedly raise interest rates in July and August. Reflecting stronger than expected exports and a pickup in consumption, estimated growth for Korea is revised up to 4.6%. In Taipei, China as well, the growth forecast is revised marginally up, mainly on the back of an increase in investment in the first half of 2007. Mongolia is benefiting from strong prices for copper and gold, warranting an upward revision of the growth projection for 2007. It is now expected that Mongolia will grow by 8%, capping 4 straight years of growth in excess of 7%. East Asia is now projected to expand by 8.9% in 2007 (Figure 1.1.17).

South Asia continues to build on the progress of recent years. Growth of 8.1% is expected in 2007 (Figure 1.1.18). Potential growth rates in Bangladesh, India, and Pakistan, the subregion's largest countries, all appear to have risen and growth is also on a more stable trajectory. India enjoyed its quickest expansion in 18 years in FY2006 (ended March 2007) and industry is now spearheading growth. In the first quarter of FY2007 (i.e., April–June 2007), growth showed little let-up despite higher interest rates and a sharp appreciation of the rupee. Still, tighter monetary conditions for the rest of FY2007 will lead to some softening. It is now foreseen that India will grow by 8.5% in 2007, an upward revision to the estimate of 8.0% made in March in *ADO 2007*.

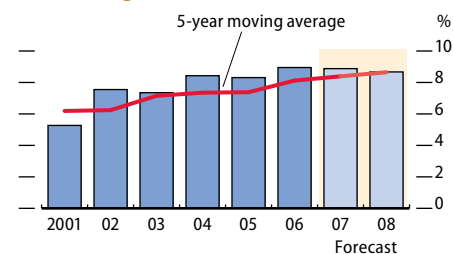
1.1.16 GDP growth, developing Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.17 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

In Bangladesh, political developments continue to dominate, though on the economic front, there has been little change. The textile industry is doing well in the post-quota world and private remittances provide an important source of support for consumption and investment. However, recent measures against corruption and hoarding have added to business sector uncertainty. In Pakistan, growth is put at 6.5% in FY2008 (ending June 2008), but any adverse developments on the political and security front could have a crucial bearing on the economy. Growth of 7.0% in FY2007 (ended June 2007) was largely underpinned by expansion in large-scale manufacturing industry and in services. Remittances from Pakistan's foreign-based workers continue to provide substantial support to domestic demand.

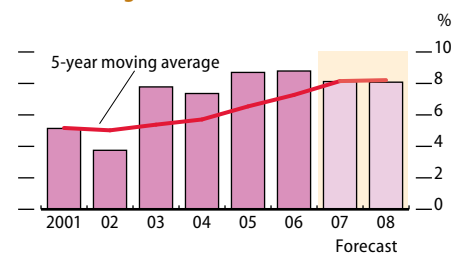
Hopes for improvement in Nepal's economic circumstances and performance have so far not been met. Indeed, this *Update* revises down the estimate for growth in FY2007 (ended 15 July 2007), to 2.5%. In Sri Lanka, real economic growth is expected to hold its course, though the macroeconomic situation continues to give cause for concern. In the Maldives, economic rhythm will return to a more settled pace following the spike in 2006 that reflected tsunami-related reconstruction activities. The completion of a large hydro-project will give a boost to the income growth of Bhutan's small economy. In Afghanistan, growth has been revised up due to a stronger than expected recovery in agriculture.

Growth in Indonesia continues to edge up and the outcome in 2007 is now expected to exceed 6%. In the first half, growth of 6.1% added to the evidence of a strengthening economy, with growth accelerating in the second quarter to 6.3%. As inflation has come down, private consumption and investment have led the way, and strength should build in the second half of the year. In the Philippines, first-half growth of 7.3% was the highest in almost 20 years. Growth was propelled by net exports, consumption spending, and by higher levels of government expenditure. On the supply side of the economy, services activity is enjoying vigorous growth but manufacturing growth and investment spending continue to lag. There has been brisk expansion in the mining sector, but from a low base. For 2007, this *Update* revises up its projection to 6.6%, on the assumption that growth in the second half will moderate from the fast pace of the first 6 months.

In Malaysia, domestic demand is supporting growth. Private consumption has grown vigorously and public sector investments in infrastructure projects added to growth in the first half of 2007. The contribution of net exports to growth in Malaysia is ebbing, and is expected to be negative this year. Viet Nam's private sector shows ever-increasing dynamism. Improvements in the business investment climate and World Trade Organization (WTO) entry have added to confidence. On the supply side, growth was almost entirely attributable to industry and services. This *Update's* forecast for growth of 8.3% in 2007 is unchanged from *ADO 2007*.

In Thailand, political uncertainty continues to sap consumer and private investment confidence. Still, in the first half of 2007 better than expected net export performance helped support growth, as did government investment spending. It is expected that Thailand's growth in 2007 will stay unchanged from the original *ADO 2007* projection of 4%.

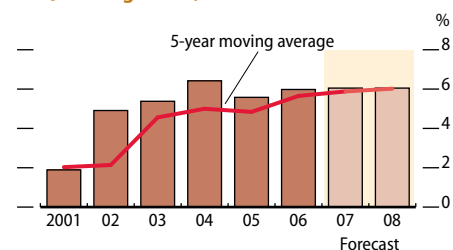
1.1.18 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.19 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

Cambodia sees a marginal downward revision to its growth forecast, but the Lao People's Democratic Republic registers no change. For Southeast Asia as a whole, this *Update* updates the projection of growth from 5.6% to 6.1% for 2007 (Figure 1.1.19).

Growth in Central Asia has again been underpinned by high prices for oil and mineral exports. Higher production and exports are adding directly to growth, but earnings are supporting domestic demand and the expansion of services. This *Update* revises up its projection for GDP growth in 2007 to 11.1% (Figure 1.1.20).

Azerbaijan and Kazakhstan are now set to grow more quickly as a consequence of larger than expected increases in oil production and exports, and stronger domestic demand. In Turkmenistan, growth is supported by larger exports of natural gas. Economic performance in Uzbekistan is improving, with higher investment and exports, and growth has steadily climbed. In the first half, it grew at 9.7% and full-year 2007 growth should be 8.0%, a significant upward revision from the estimate in *ADO 2007*. Growth in both the Kyrgyz Republic and in Tajikistan was strong in the first half of 2007. In the Kyrgyz Republic, the industry sector has bounced back from the disruptions of 2006 and 2005, and investment- and remittance-fuelled consumption has supported strong expansion in Tajikistan.

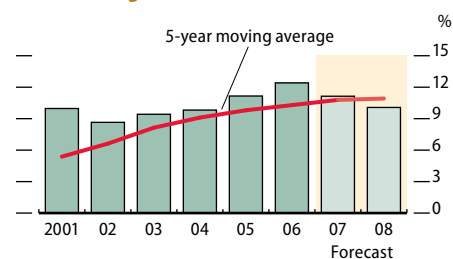
For the Pacific Islands, this *Update* downgrades the projection of growth for 2007 from 4.5% in *ADO 2007* to 3.5% (Figure 1.1.21). In large measure, this is because an expected rebound in Timor-Leste has not been as strong as had been anticipated. The economic fallout in the Fiji Islands from political events has also been more accentuated than was earlier foreseen. However, Papua New Guinea, the largest economy in the Pacific, is expected to do better.

Looking ahead to 2008, this *Update* forecasts regionwide growth of 8.2%, marginally lower than the revised forecast for 2007. Nevertheless, the central forecast of 8.2% is a substantial upward revision of the March forecast of 7.7% in *ADO 2007*. Though growth is revised up for all subregions, most of the increase is due to the upward revision for East Asia, with nearly all of that being attributed to a full 1 percentage point rise in the projection for the PRC. This *Update* now projects growth of 10.8% for the PRC in 2008, up from the 9.8% of *ADO 2007*. The reassessment of prospects for the PRC recognizes that momentum has continued to accelerate through 2007, and that it may be difficult to reverse quickly. Though measures taken to slow the economy have had limited effect so far, they should have greater purchase going forward. Elsewhere in East Asia, growth in Korea is expected to accelerate in 2008 as private consumption strengthens.

In India, growth is expected to hold steady in 2008 at or about its potential level. This projected soft landing assumes that the authorities successfully contain inflation pressures, without crimping either investment or export demand. The outlook for growth in Bangladesh, Pakistan, and Sri Lanka through 2008 is also steady, though these economies face ongoing and significant macroeconomic stabilization challenges.

In Southeast Asia, prospects may brighten for Thailand, provided that new elections deliver a government that has a credible economic program. Malaysia's growth may pick up a little from that seen in 2007, but if the

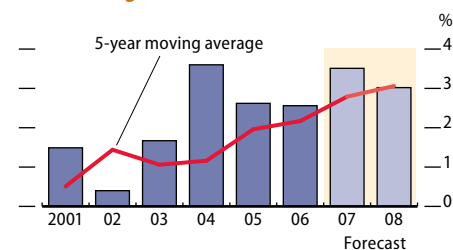
1.1.20 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.21 GDP growth, The Pacific



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

electronics slump continues this will trim its prospects. If Indonesia can continue to make headway on restoring investor and broader economic confidence, its growth could climb further in 2008. For Southeast Asia as a whole, growth of 6.1% is expected for 2008, a slight upward revision from the March forecast of *ADO 2007*.

Prices of oil and minerals are expected to moderate in 2008, shaving growth a little in Central Asia. In 2008, growth of 10.1% is now expected. Growth projections have been revised up for the Pacific Islands. By 2008, the Fiji Islands should be expanding, if only slowly, and Papua New Guinea is expected to grow at 4.5%, boosted by earlier investments in high-grade mining activities.

As explained above, the outlook for 2008 is subject to an unusually large degree of uncertainty, with the possibility that unfavorable external developments could cause growth to slide. For the PRC, the most probable channel of transmission would be through the demand for its exports. Slower export growth would then cascade back down through regional supply chains, hitting other countries in East and Southeast Asia. Despite the limited degree of integration of the PRC's financial markets with the wider international economy, financial market contagion cannot be ruled out. Stresses might then leach into other parts of the economy. In the PRC and in some other countries, fiscal positions would provide room for stabilizing responses.

Domestic rather than external demand has been the main driving force behind India's spurt in growth. Nevertheless, industrial exports have been rising quickly and trade in services has been a mainstay of the current account earnings for some years now. Both would be negatively influenced if the temperature of the global economy were to drop.

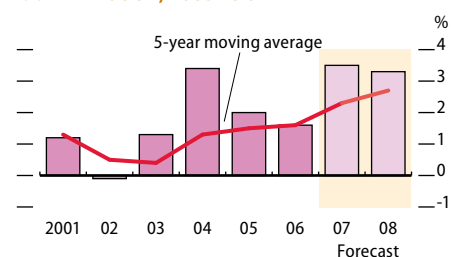
Finally, if a slowing global economy were to cause commodity prices to soften, this would trim prospects in Central Asia, and would have an effect on other economies that have enjoyed the benefits of high prices in past years.

Inflation prospects

Inflation in the PRC, which has for long been tame, picked up in the first half and by August 2007 had risen to 6.5%. Much of the inflation strain is coming from rises in food prices. Though some of these rises reflect temporary factors, food is such a big component of the consumption basket that there is a risk of rising prices spilling over into broader cost pressures. Further interest rate rises look possible as do delays in adjustments to controlled prices of fuels and other commodities.

The PRC's considerable current account surplus and strong capital inflows continue to seep into domestic liquidity, complicating monetary policy. Efforts to contain the growth of liquidity and credit continue, but so far, have had only limited impact. The PRC's equity markets surged again in the first half of 2007, largely impervious to the spasms in global markets. House prices also continued to make steady gains in many cities. Credit demand in the PRC is driven partly by the expectation of further gains in asset markets. Forecast inflation in the PRC is revised up to 4.2% from the March prediction of 1.8% made in *ADO 2007*. In Korea, concerns about rising inflation expectations prompted the authorities to

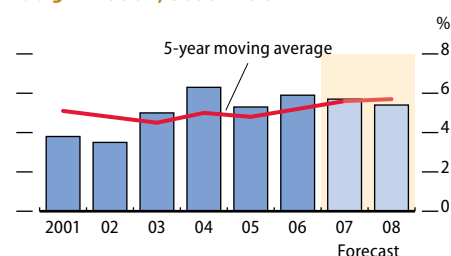
1.1.22 Inflation, East Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

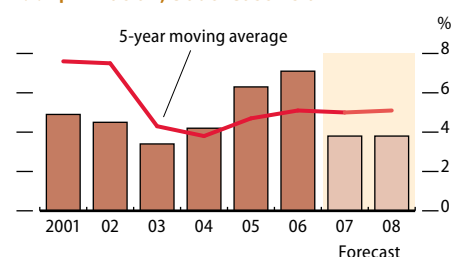
1.1.23 Inflation, South Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.24 Inflation, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

raise interest rates in the last couple of months. For East Asia as whole, the inflation forecast for 2007 is revised up to 3.5% (Figure 1.1.22), from the March forecast of 1.9%.

Monthly wholesale price inflation in India has come off the earlier peaks seen in the first 3 months of 2007, and since June has been within the Reserve Bank of India's target range. A combination of higher policy rates, targeted lending restrictions, appreciation of the rupee, some easing of supply-side pressures on food, and controls on the prices of fuels helped bring down wholesale price inflation to 4.5% at end-July 2007. Elsewhere in South Asia, inflation pressures are not far from the surface. Though central banks are taking tightening measures, inflation rates remain uncomfortably high in Bangladesh, Pakistan, and Sri Lanka. Credit expansion to finance government spending is making the control of inflation more difficult, particularly in Pakistan and Sri Lanka. In Nepal, a poor harvest has added to inflation. These have raised South Asia's inflation forecast for 2007 to 5.7% from 5.5% in *ADO 2007* (Figure 1.1.23).

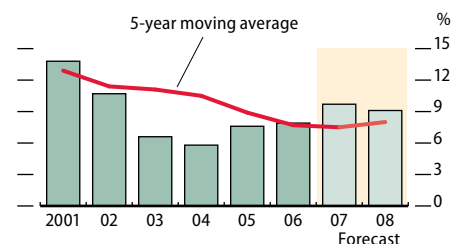
In Southeast Asia, inflation is expected to moderate further in 2007. Aggregate inflation is now seen coming down to 3.8% in 2007 from over 7% in 2006 (Figure 1.1.24). Indonesia accounts for much of this reduction. The authorities there undertook aggressive monetary tightening in late 2005 and 2006 to combat inflation pressures arising from sharp fuel price increases. But the downward revision to the subregional inflation forecast (from 4.2% in *ADO 2007*) is primarily a result of inflation falling more quickly than anticipated in Malaysia, Philippines, Thailand, and Singapore. Inflation is expected to accelerate a little in Viet Nam relative to the 2006 outcome. Buoyant demand in Viet Nam and high levels of liquidity have contributed to high and rising inflation.

Inflation is now expected to accelerate more quickly in Central Asia. The *ADO 2007* forecast of 8.6% for 2007 is revised up to 9.7% (Figure 1.1.25). A major contributor to this pickup is Azerbaijan, where oil revenues are boosting spending. However, a more general pattern of modest upward revisions is discernible. Strong foreign exchange inflows and higher public spending are lifting inflation rates.

In the Pacific Islands, inflation forecasts are revised up. This is largely due to higher forecast inflation for Papua New Guinea. The local currency, the kina, has depreciated and pass-through of earlier oil price rises continues. Inflation in the Pacific Islands is now expected to average 4.7% in 2007, up from the forecast of 3.5% in *ADO 2007* (Figure 1.1.26).

Developing Asia's prospects for inflation (Figure 1.1.27) as well as for output growth in 2008 are complicated by the uncertainty shrouding the global economy. In the baseline, it is expected that inflation will moderate a little over 2007 levels. If growth turns out to be slower than anticipated, inflation could come down more quickly. On a subregional basis, reductions in inflation are expected in East Asia, South Asia, Central Asia, and in the Pacific; but in Southeast Asia, inflation will remain steady.

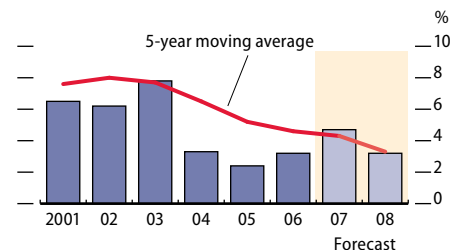
1.1.25 Inflation, Central Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

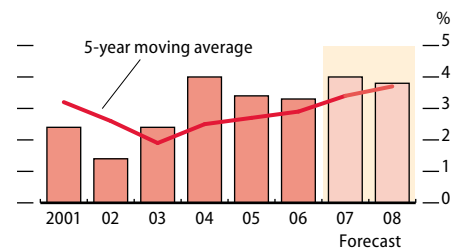
1.1.26 Inflation, The Pacific



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.27 Inflation, developing Asia



Sources: Asian Development Outlook database; staff estimates.

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Balance-of-payments prospects

As a percentage of GDP, developing Asia's current account balance is expected to show little change on 2006's outcome. The revised estimate

of this *Update* is that the current account surplus in 2007 will be 6.1% of regional GDP, compared with 5.8% in 2006 (Figure 1.1.28).

In 2007, only South Asia is expected to have a current account deficit (Figure 1.1.29). India's deficit will probably be larger than in 2006, but has been revised down from the estimate in *ADO 2007's* March forecast. A widening deficit in merchandise goods trade is being partially offset by significant earnings on the services account from software exports, back-office services, and remittance income.

Pakistan's deficit, which is now estimated to expand to 5.2% of GDP, reflects its widening trade gap, as exports from its textiles and clothing sector are pressured by more intense global competition. Though remittance income remains strong, it is insufficient to offset Pakistan's trade deficit. Growing remittances more than finance Bangladesh's trade deficit, and it is now estimated to post a current account surplus of 1.4% of GDP in 2007. In Sri Lanka, the current account deficit is expected to narrow, following the jump in 2006 as rapid growth in imports sparked by tsunami reconstruction efforts have moderated.

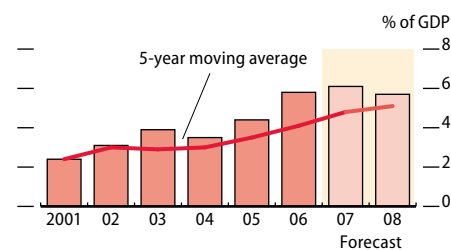
The current account surplus in East Asia for 2007 is now projected at 8.2% of GDP, an increase over the surplus in 2006 (Figure 1.1.30). All economies in East Asia are in surplus. The surplus in the PRC is expected to widen to 10.9% of GDP in 2007 as exports continue to outrun imports. Likewise, Hong Kong, China and Taipei, China are also expected to post large surpluses in 2007. In Hong Kong, China, strong services performance, linked to continued expansion in the PRC, underpins the current account surplus. In Taipei, China, export performance has been strong in the first 6 months, validating the *ADO 2007* projection. For Korea, the narrow current account surplus predicted in *ADO 2007* has been revised up, reflecting stronger exports. A small surplus of 0.6% of GDP is now predicted. Mongolia's expected surplus holds firm at 2% of GDP.

The consolidated current account surplus for Southeast Asia is expected to come off its recent peak. Compared to a surplus of 7.8% of GDP in 2006, the surplus in 2007 is now predicted at 7% (Figure 1.1.31). Surpluses for Indonesia and Malaysia are both expected to shrink, and in the case of Malaysia by more than 4 percentage points of GDP (though from a very high base). Nevertheless, there have been general upward revisions to the forecasts made in *ADO 2007* in March. Thailand's strong export performance is expected to lift its surplus to 3% of GDP in 2007 and Singapore's strong surplus is expected to continue its upward drift. Viet Nam's current account deficit is expected to widen sharply in 2007 as a result of rapid growth in imports of raw materials, and intermediate and capital goods, and a decline in oil exports.

There is little change in the projection of the current account position of Central Asia. This *Update* projects a surplus of 3.5% of GDP (Figure 1.1.32) as against 3.2% in the March estimate of *ADO 2007*. It is expected that a larger projected deficit for Tajikistan, reflecting increased spending on capital imports coupled with sluggish aluminum exports, will be more than counterbalanced by a larger surplus for Turkmenistan driven by strong exports of gas.

For the Pacific, this *Update* incorporates an estimate for Timor-Leste's current account position in 2007. The large surplus reflects a surge in oil and gas revenues as production from existing fields increases. Compared

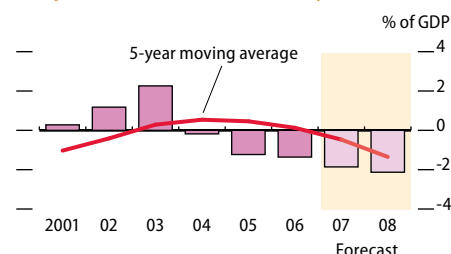
1.1.28 Current account balance, developing Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

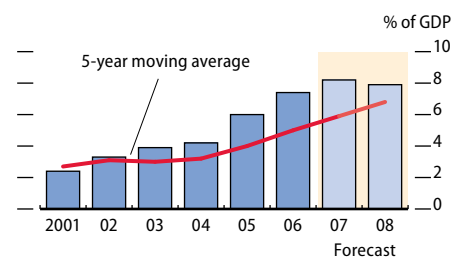
1.1.29 Current account balance, South Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

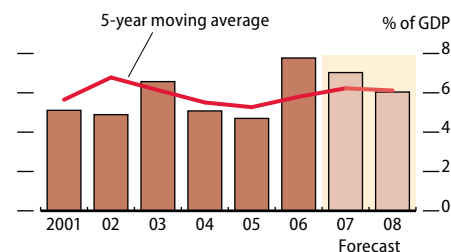
1.1.30 Current account balance, East Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.31 Current account balance, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

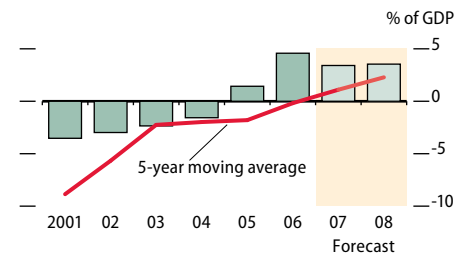
with 2006, the Pacific's current account surplus is estimated to rise to 7.3% of GDP (Figure 1.1.33). Excluding Timor-Leste, the forecast for the Pacific's current account deficit is revised upward to 5.2% of GDP from 1.2% in *ADO 2007*, mainly resulting from a larger projected deficit for the Fiji Islands, where political and security concerns are expected to reduce official transfers and tourism receipts.

The outlook for the current account of the balance of payments in 2008 is for an aggregate surplus of 5.7%. At a subregional level, the surpluses in East Asia and Southeast Asia are projected to decline. Faster economic growth and stronger demand should reduce the surplus in Indonesia and Thailand. Malaysia's surplus may track down if the price of its primary commodity exports soften and the recovery in electronics activity is slow. In East Asia, it is expected that the PRC's surplus will decline slightly to 10.5% of GDP in 2008. Finally, if slower growth in the global economy were to occur in tandem with an appreciation of regional currencies, this would tend to erode the region's current account surplus moving into 2008. Softer prices for oil and minerals would trim export earnings, particularly in Central Asia but also in some other countries.

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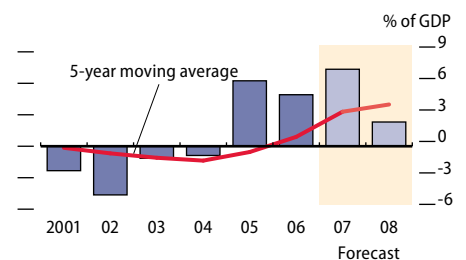
1.1.32 Current account balance, Central Asia



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

1.1.33 Current account balance, The Pacific



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)