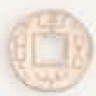
Part 1

Developing Asia and the world



Developing Asia and the world

Developing Asia

Overview

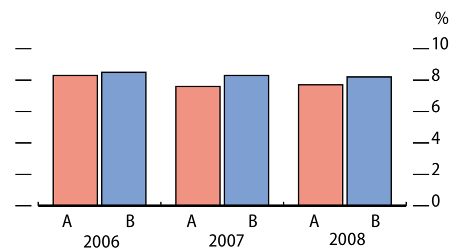
Developing Asia's prodigious growth continued through the first half of 2007, setting the scene for another bumper year. The region is now expected to expand by 8.3%, revised up from 7.6% projected in March's *Asian Development Outlook 2007* (Figure 1.1.1). Growth in 2008 is currently anticipated to 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.

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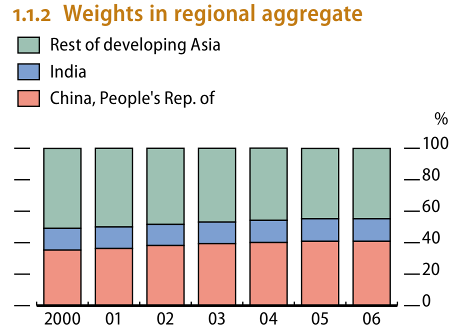
1.1.2 Weights in regional aggregate



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.

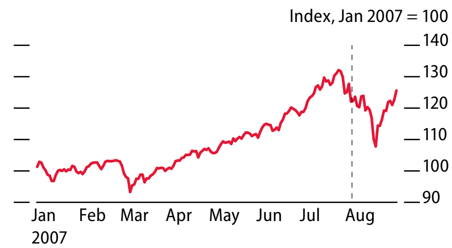
As the informational fog is likely to lift slowly, financial markets could remain jittery and disorderly for some time yet. Only incoming data can provide clues about the possible impact of the credit market squeeze on the outlook for economic growth and inflation. Data released in September on job losses 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).

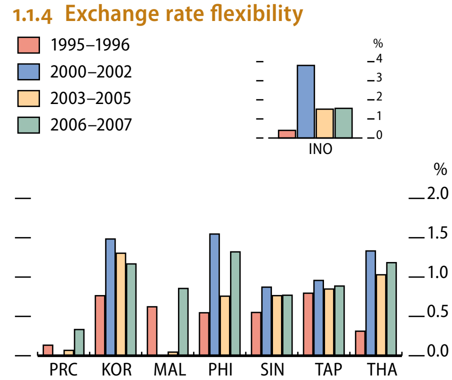
Evidence presented in Part 2, *Export dynamics in East Asia*, suggests that from the perspective of developing durable export platforms, familiar supply-side factors (including the quality of infrastructure and the business investment climate) play a critical role. This analysis also confirms the continuing 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



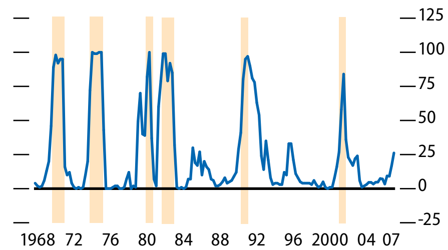
PRC = China, People's Rep. of; INO = Indonesia; KOR = Korea, Rep. of; MAL = Malaysia; PHI = Philippines; SIN = Singapore; TAP = Taipei,China; THA = Thailand.
Note: Data refer to average absolute monthly percentage changes in exchange rate against the US dollar.
Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; www.cbc.gov.tw; all downloaded 10 September 2007.
Click here for figure data

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.

1.1.5 Recession probability index



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.

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

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 Update*s 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 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 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.

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.

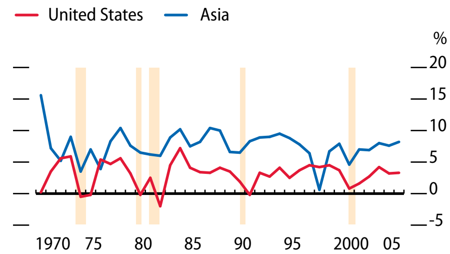
IMF (2007) calculates that for the five US recessions between 1974 and 2001, developing Asia's growth fell by about 0.28 percentage points for each percentage point decline in US growth. But this average masks a wide range. As a broad observation, US recessions that were triggered by wider global shocks (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.

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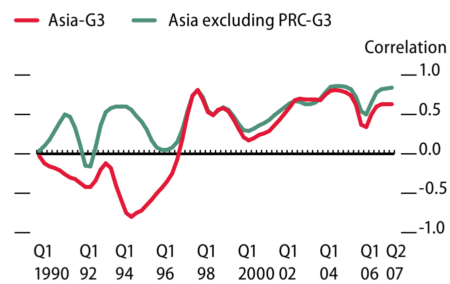
1.1.7 Average interregional business cycle correlations



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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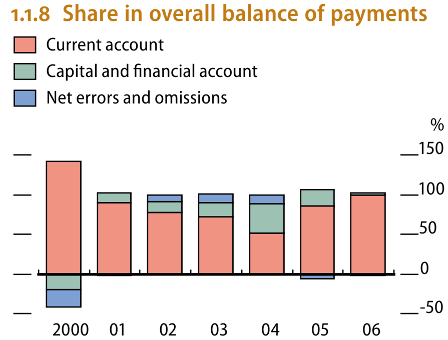
1.1.8 Share in overall balance of payments



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

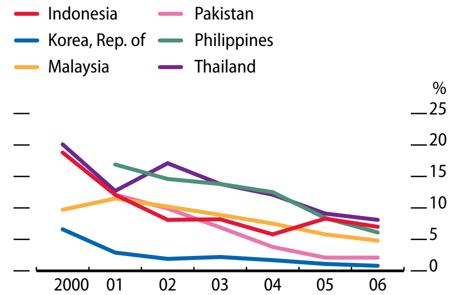
for more data to be brought to bear on the analysis. But the striking differences in apparent spillovers over these phases caution against drawing simple inferences. Looking for regularities in the time series data for the US and developing Asia, IMF (2007) concludes that disturbances to US growth have 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.

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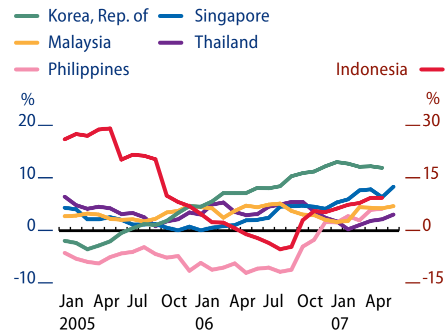
1.1.10 Growth in private sector bank credit



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

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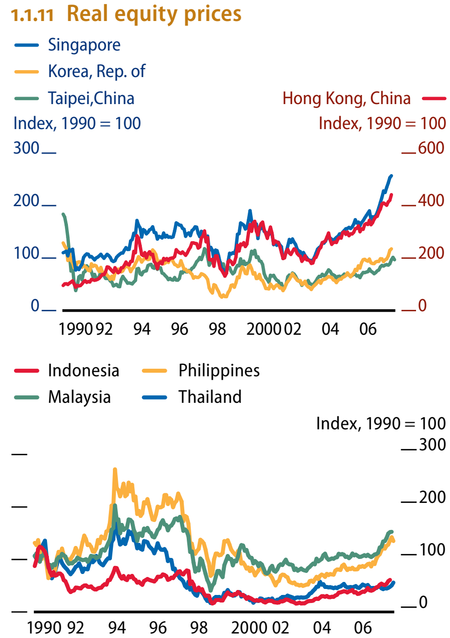
1.1.11 Real equity prices



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

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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.

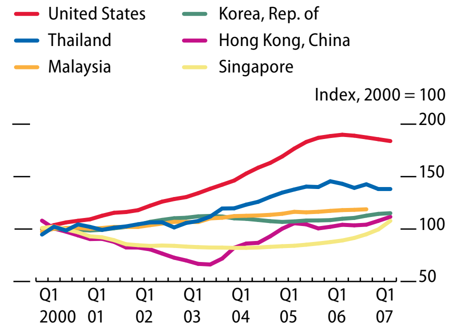
Country-level impacts

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).

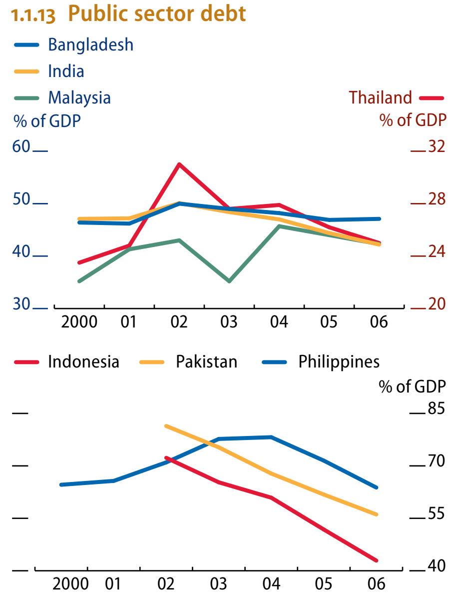
1.1.12 Selected residential property prices



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.

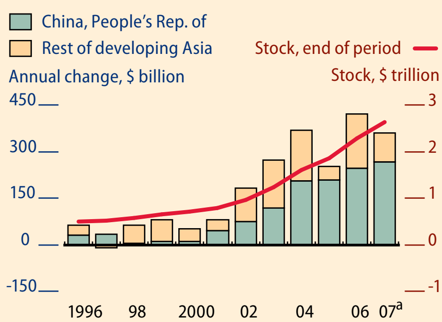
With $1,332.6 billion as of end-June 2007, the PRC holds about 50% of developing Asia's foreign exchange reserves. The next five largest holders (in descending order, Taipei,China; Republic of Korea; India; Singapore; and Hong Kong, China) together hold $1,002.3 billion, or about 38% of the regional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

1 Developing Asia's foreign exchange reserves

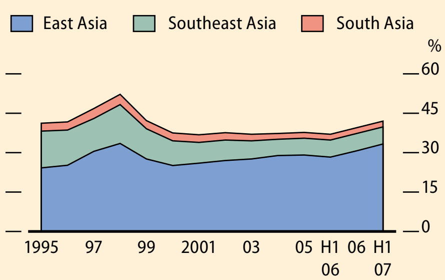


a First half.

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

Developing Asia's foreign exchange reserves ($ billion)

	Stock June 2007	Change in first half of year 2007	Change in first half of year 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

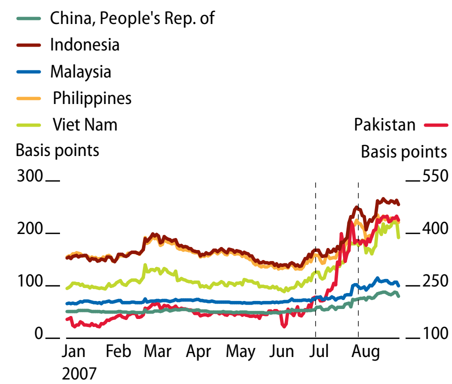
Sources: International Monetary Fund, *International Financial Statistics* online database; www.cbc.gov.tw; Bank of Korea, available: www.bok.or.kr; all downloaded 3 September 2007.

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.

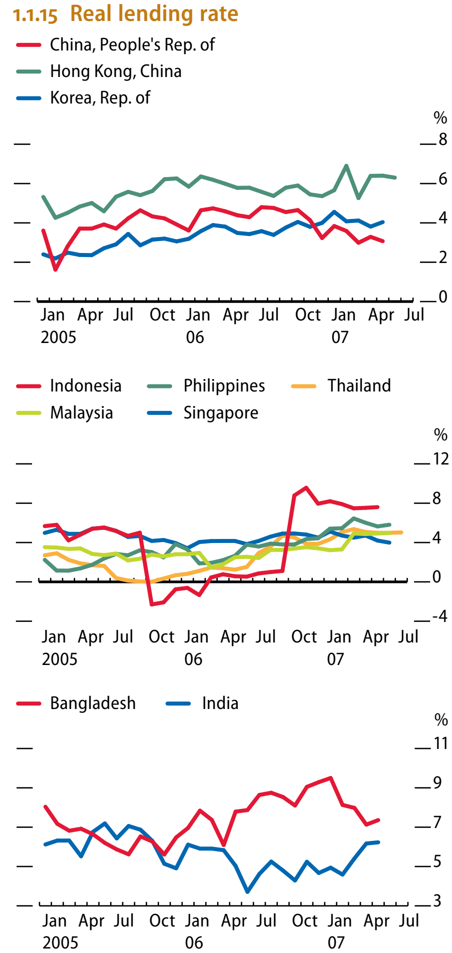
If unfolding evidence suggests that there are threats to growth, the scope for monetary policy adjustments will depend on circumstances. In economies where real interest rates are already very low (Figure 1.1.15), cuts may not have much impact. And in countries where there is overheating, slower growth 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.

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

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.

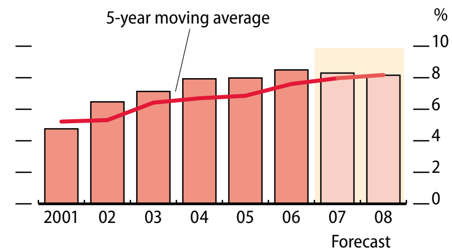
1.1.1 Selected economic indicators, developing Asia, 2006–2008

	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.

1.1.16 GDP growth, developing Asia

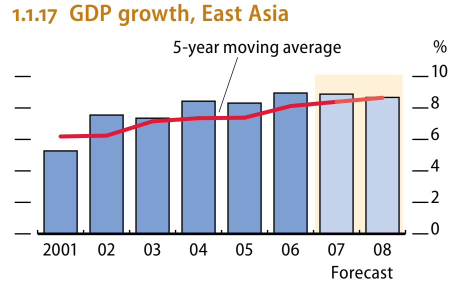


Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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).

1.1.17 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

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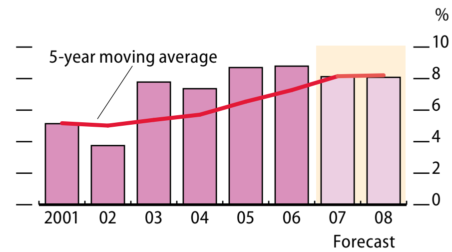
South Asia continues to build on the progress of recent years. Growth of 8.1% is expected in 2007 (Figure 1.1.18). Potential growth rates in Bangladesh, India, and Pakistan, the subregion's largest countries, all appear to have risen and growth is also on a more stable trajectory. India enjoyed its quickest 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*.

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.

1.1.18 GDP growth, South Asia

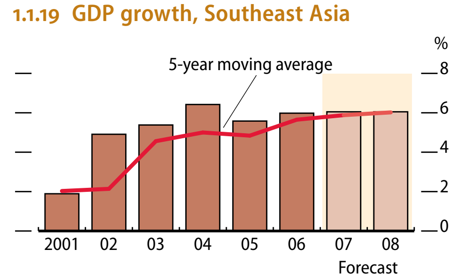


Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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.

1.1.19 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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%.

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* uprates 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.

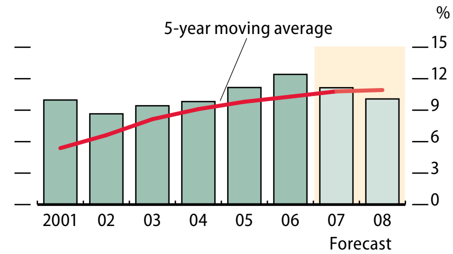
For the Pacific Islands, this *Update* downgrades the projection of growth for 2007 from 4.5% in *ADO 2007* to 3.5% (Figure 1.1.21). In large measure, this is because an expected rebound in Timor-Leste has not been as strong as had been anticipated. The economic fallout in the Fiji Islands from political 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

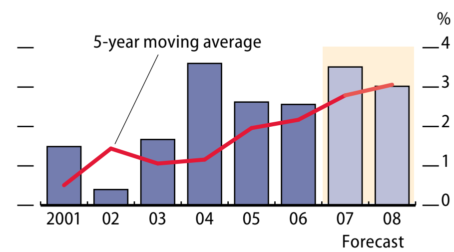
1.1.20 GDP growth, Central Asia



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.

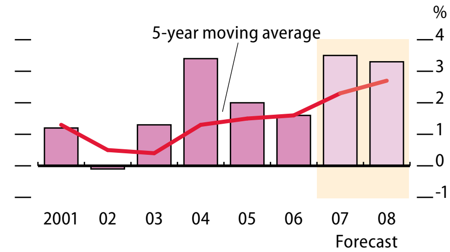
Finally, if a slowing global economy were to cause commodity prices to soften, this would trim prospects in Central Asia, and would have an effect on other economies that have enjoyed the benefits of high prices in past years.

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.

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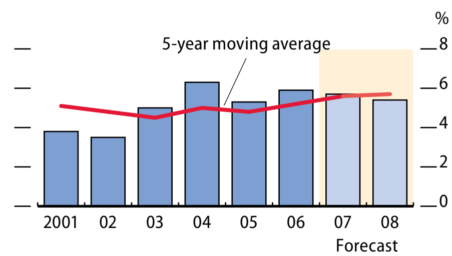
1.1.23 Inflation, South Asia



Sources: Asian Development Outlook database; staff estimates.

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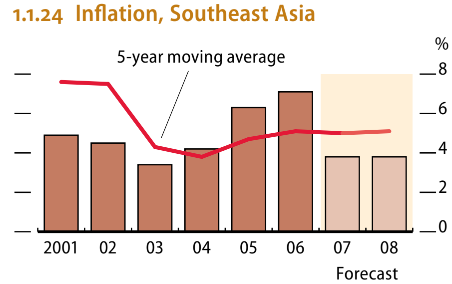
1.1.24 Inflation, Southeast Asia



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.

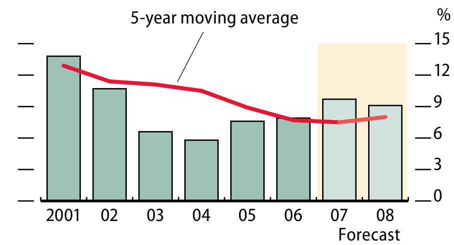
In the Pacific Islands, inflation forecasts are revised up. This is largely due to higher forecast inflation for Papua New Guinea. The local currency, the kina, has depreciated and pass-through of earlier oil price rises continues. Inflation in the Pacific Islands is now expected to average 4.7% in 2007,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

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

1.1.25 Inflation, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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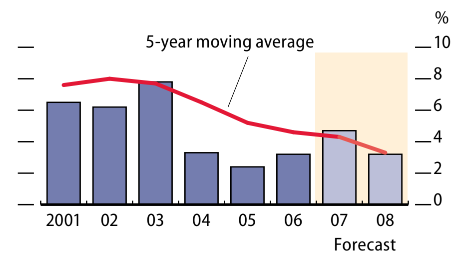
1.1.26 Inflation, The Pacific



Sources: Asian Development Outlook database; staff estimates.

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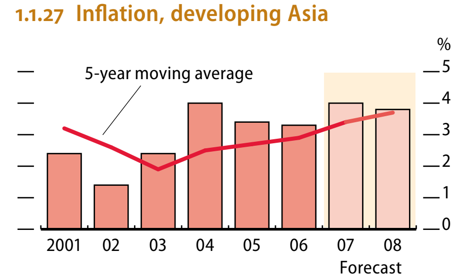
1.1.27 Inflation, developing Asia



Sources: Asian Development Outlook database; staff estimates.

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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.

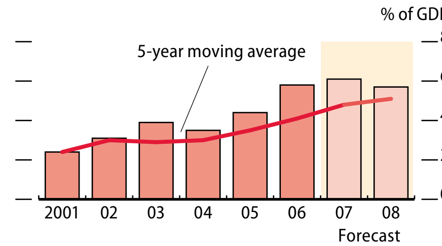
The current account surplus in East Asia for 2007 is now projected at 8.2% of GDP, an increase over the surplus in 2006 (Figure 1.1.30). All economies in East Asia are in surplus. The surplus in the PRC is expected to widen to 10.9% of GDP in 2007 as exports continue to outrun imports. Likewise, Hong 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.

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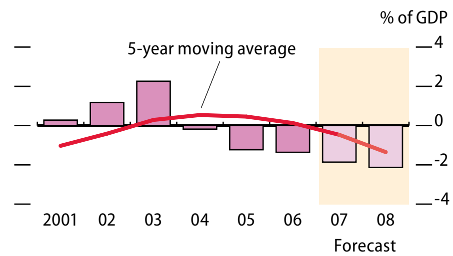
1.1.29 Current account balance, South Asia



Sources: *Asian Development Outlook* database; staff estimates.

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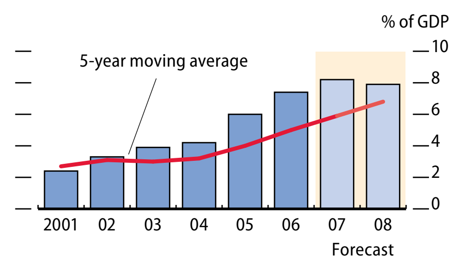
1.1.30 Current account balance, East Asia



Sources: *Asian Development Outlook* database; staff estimates.

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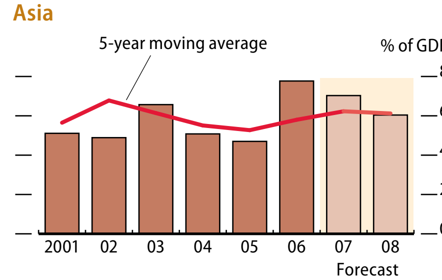
1.1.31 Current account balance, Southeast Asia



Sources: *Asian Development Outlook* database; staff estimates.

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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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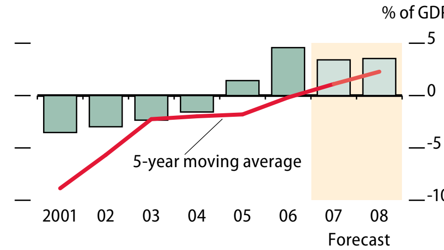
1.1.32 Current account balance, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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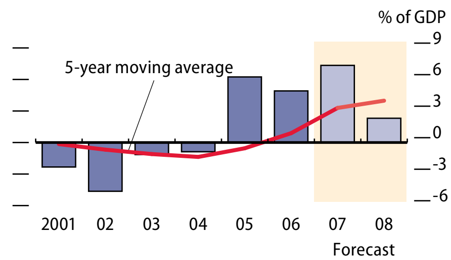
1.1.33 Current account balance, The Pacific



Sources: Asian Development Outlook database; staff estimates.

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World economy

United States

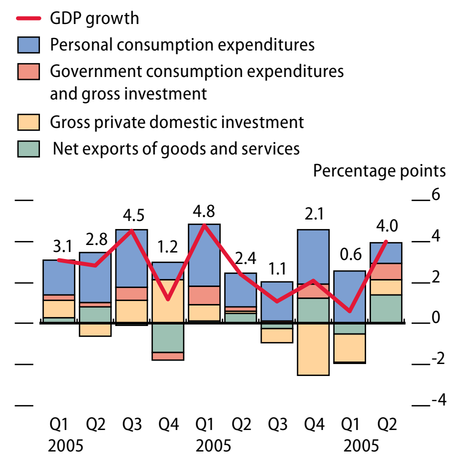
Boosted by strong expansion in business investment, public spending, and net exports, growth in the second quarter of 2007 accelerated to 4.0% (quarter on quarter, seasonally adjusted annualized rate) from a tepid 0.6% in the first (Figure 1.2.1). But the persistent housing slump remains a major risk to economic performance. For the sixth consecutive quarter, private residential investment contracted. On a 12-month moving average basis, housing starts have been declining since April 2006 (Figure 1.2.2), but the inventory of unsold homes is still high. With this overhang, and rising defaults and foreclosures among subprime mortgage-holders continuing to depress the housing market, house prices are likely to drop further (Box 1.2.1).

Facing subprime mortgage anxieties, many US consumers have lost confidence: the August consumer confidence reading dipped to its lowest in a year. Personal consumption expenditures grew by only 1.4% in the second quarter, slowing sharply from 3.7% in the first. Real disposable personal income, too, barely increased in the second quarter, and a pickup in gasoline and food prices depressed spending on nondurable goods. Consumers also face increasing headwinds from falling home prices, rising interest burdens, and slowing employment opportunities. In addition, recent weakness in equity markets associated with the subprime disruptions could add to consumer woes.

On the upside, the strong second quarter rebound reflects underlying strength in corporate spending and resilient business activity. The recovery of corporate profits in the first half of the year set the stage for ongoing improvement of nonresidential investment. Industrial production continued to improve, albeit at a moderate pace, and robust export demand has provided a cushion against slowing consumer spending. Combined with lower inventory levels, additional production should help sustain corporate momentum. This relatively benign business climate is helping hold up the job market: unemployment has stayed low at about 4.5% since the last quarter of 2006, although the July data showed a mild uptick to 4.6%.

Slower growth has helped keep price pressures at bay, with inflation at 2.4% in July. But although core inflation (excluding food and energy prices) remained tame, the headline figure accelerated to an annualized rate of 4.5% for the first 7 months of 2007, compared with an increase of 2.5% for the whole of 2006. Given insipient inflation pressures, the Federal Reserve held overnight rates steady at 5.25% in the wake of August's financial turbulence. It did, though, lower the discount rate on 17 August—the rate charged on direct Federal Reserve loans to banks—providing the necessary liquidity to banks that sought it. Markets now expect that the Federal Reserve will lower interest rates, reflecting the impact of tightening credit market conditions on demand. (Figure 1.2.3).

1.2.1 Contributions to growth (demand), United States



Source: US Bureau of Economic Analysis, available: www.bea.gov, downloaded 31 August 2007.

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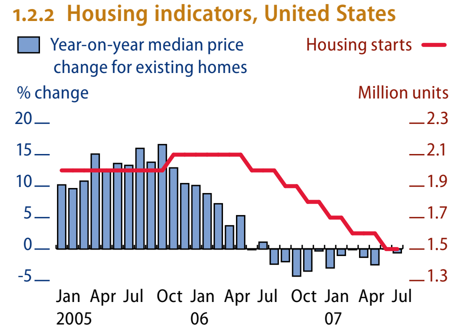
1.2.2 Housing indicators, United States



Sources: CEIC Data Company Ltd.; National Association of Realtors, available: www.realtor.org; US Census Bureau, available: www.census.gov; all downloaded 31 August 2007.

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1.2.1 Credit market disruptions

Distress that had been building in the United States (US) subprime mortgage market since 2006 spilled over into global credit markets in August 2007. Though some normalcy appears to be returning to markets, it is still difficult to tell how disruptive these developments may eventually turn out to be. Credit risks have been repriced, volatility has increased, and investor and consumer confidence has been jolted. If troubles were to deepen in the US housing market and greater credit market problems surfaced, this could aggravate and spread the malaise.

The root of the problem

The genesis of the current subprime mortgage distress can be traced back to the US housing boom. Riding it in 2001–2005, US residential mortgage lending saw rapid growth with an increasing portion made to borrowers with less than perfect credit histories—hence the term "subprime."

Subprime borrowers are charged much higher interest rates than prime borrowers (to compensate for their higher default risks) and their mortgages are often at adjustable (rather than fixed) rates. But booming housing markets, against a backdrop of historically low interest rates and increasing competition among mortgage lenders, induced lenders to relax their loan conditions.

A proliferation of new types of mortgages—also known as "affordability products," which required little or no downpayment and with initial "teaser" interest payments that were set very low—also allowed subprime borrowers to gain easier access to credit. As a result, the subprime mortgage market grew rapidly after 2003—according to some estimates, to as much as one fifth of new mortgages by 2006, from just below one tenth in 2003.

As the Federal Reserve began to raise its policy rates after July 2004 and the US housing market cooled, homeowners—particularly those with adjustable-rate mortgages—faced rising interest payments. Among subprime borrowers especially, monthly loan payments rose sharply as the initial low rates were reset to higher, normal rates. Those with shaky credit histories and little accumulated housing equity also found it increasingly hard to refinance their mortgage on better terms or to pay it off by selling their home.

Consequently, delinquencies on subprime mortgages picked up significantly after mid-2005, to nearly 15% of subprime adjustable-rate mortgages in the first quarter of 2007, compared with about 10% 2 years earlier (according to the US Mortgage Bankers Association). The number of foreclosures also doubled over the same period.

Rising defaults and foreclosures eroded the value of subprime mortgage debts and securities collateralized by them. This hit subprime lenders directly. Some 20 mortgage lenders have reportedly shut down or filed for bankruptcy in the past few months. Many smaller subprime lenders operating on very thin margins have also gone bankrupt, as the lending business has slowed and as the value of mortgage loans in the secondary market has declined. Investors in mortgage-related securities, especially those exposed to subprime loans, have suffered significant losses as well.

Avenues of contagion

Deterioration in the credit quality of subprime mortgages has spread quickly to broad asset classes held by a wide spectrum of investor groups around the globe. The source of contagion has been a boom in credit derivatives, such as collateralized debt obligations (CDOs). CDOs arise from a pool of debts, including subprime mortgage debts. This pool is then partitioned into different "tranches" representing different degrees of risk and sold off to investors with different risk appetites.

Unlike typical mortgage-backed securities, which pool only mortgage debts, CDOs bundle various types of debt into securities structured in such a way that losses from defaults are borne successively, in their entirety, from low-ranking through to high-ranking tranches, thus protecting the latter from the immediate loss. CDO tranches are then awarded credit ratings based on the layers of protection given to each tranche by the subordinate (i.e., lower) tranches as well as on the credit quality of the underlying collateral.

In this process, these structured securities are effectively severed from the credit risk of the original issuer of collateralized debts and rely solely on their own credit ratings. This means that a CDO tranche that includes unrated "junk" assets in its mix of assets used as collateral could still be "AAA-rated." Such a lack of transparency about the exact nature of the underlying collateral and credit quality behind CDOs amplified the August market sell-off amid widespread credit concerns.

Typically, prime mortgages have been pooled, repackaged, and sold to financial intermediaries, which still account for the majority of mortgage-backed securities in the secondary mortgage market. Financial innovation using securitization and credit derivatives, however, has allowed mortgage lenders to sell the riskier portion of mortgage loans to a widespread group of financial institutions. International demand for these securities has been very strong. In an environment awash with liquidity, institutional investors, including pension funds, insurance companies, and highly leveraged hedge funds, bought these securities for their relatively high returns.

1.2.1 Credit market disruptions *(continued)*

Estimated losses from defaulting subprime loans are large in absolute terms, but are limited relative to the size of the market. Although growing rapidly, subprime mortgages account for only about 15% of total outstanding mortgage loans in the US, which is estimated to be about $10 trillion (Agarwal and Ho 2007).

If 30% of these subprime loans default (or twice as high as the current delinquency rate) and banks can recoup only 60% of their loan values (implying a house price fall of nearly half), potential losses could be as high as $180 billion. Yet this would still account for less than 2% of the total US mortgage market and less than 0.5% of US consumer wealth.

Credit quality deterioration could, though, spread beyond subprime mortgages to other mortgages and consumer credit markets. As adjustable-rate mortgages—prime or subprime—become reset over the next couple of years, higher interest payments may put more mortgage-holders under pressure. Delinquency rates on "Alt-A" mortgages, which fall between the prime and subprime categories, are starting to climb. Recent tightening in regulatory standards for mortgage lending, in a context of flat or falling home prices, is also expected to exacerbate problems, at least in the short run. As refinancing conditions turn tougher, existing borrowers are left with little recourse for cash, leading to a greater number of defaults and foreclosures. Higher defaults are also feared in subprime credit card markets as households become strapped for cash.

Direct exposure to the subprime mortgage market might be limited in its total amount, but has been diffused among a wide range of investor groups. More than half total mortgage loans have been securitized and sold to broader investor groups including banks, insurance companies, pension funds, and other institutional investors. The estimated amount of US residential mortgage-related securities reached about $5.8 trillion in January 2007, out of which $850 billion was held by non-US investors (IMF 2007).

Banks and other financial institutions could suffer more losses as credit ratings on mortgage-related securities start to reflect the deterioration in credit quality of the underlying collateral. Losses are likely to be concentrated among the holders of the riskier portion of the securitized interests, such as low-ranking tranches of CDOs.

As credit quality of mortgages worsens, credit ratings for mortgage-related securities drop, which will trigger investors to reappraise these securities at market value (the "mark-to-market" practice). This process normally takes some time, as not all delinquent loans default and lead to foreclosure, a legal procedure that lasts longer than a year. However, highly leveraged investors, such as hedge funds, have already come under pressure. In the midst of heightened uncertainty, investors in and lenders to hedge funds demand more cash and collateral, forcing hedge funds to liquidate their holdings and realize losses.

Reappraisal of credit risks has also affected global stock and bond prices. Stock prices of banking and financial institutions have plummeted. Heightened risk aversion has also led global investors to retreat from risky assets, including those in emerging markets. As investors begin to require higher compensation for assuming risk, high-yield, high-risk corporate bond spreads have widened sharply. With share prices falling and credit conditions tightening, firms will face tougher financing conditions for new investment. Consumer and business confidence are also slipping.

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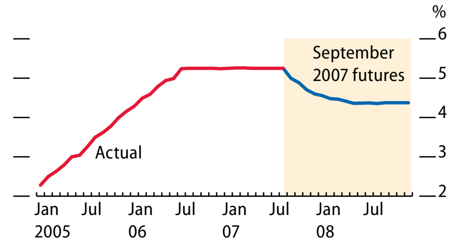
Broadening global expansion and a weakening dollar have boosted exports, while import growth has slowed. The contribution of net exports to growth turned positive in the April–June quarter. With slowing growth of domestic demand, the growth of exports is expected to continue to outpace that of imports. Nevertheless, given base effects, the trade deficit has persisted. In January–June 2007, the seasonally adjusted deficit reached $352.7 billion, down only by $29.5 billion from the same period a year earlier. There was a smaller deficit in goods trade and a larger surplus in services trade.

Government spending expanded robustly in the second quarter, but planned improvements in the fiscal situation seem to be on track. Tax receipts continue to rise, reducing the projected fiscal deficit (excluding the surplus income on the social security trust fund) for 2007 to 3.1%

of GDP from 3.3% in 2006. For 2008, the fiscal deficit is projected to be maintained at 3.1%.

All these influences point to 1.9% growth in GDP in 2007, followed by an investment-led recovery to 2.6% in 2008. But risks are tilted to the downside. The housing market slump is unlikely to quickly reverse and seems to have longer to run. This is likely to affect personal consumption spending. The Federal Reserve's expected interest rate cut (or cuts) may ease some of the housing pain and are likely to provide an additional boost to future investment spending.

1.2.3 Federal Funds rate, United States



Sources: Federal Reserve Board, available: www.federalreserve.gov; FutureSource.com, available: www.futuresource.com; both downloaded 3 September 2007.

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Japan

Economic growth experienced a significant setback in the second quarter, but a moderate expansion for the year as a whole is still expected. Second quarter GDP growth in 2007 turned to a negative 1.2% (quarter on quarter, seasonally adjusted annualized rate), in contrast to the first quarter's strong outturn of 3.0% (Figure 1.2.4). But on a year-on-year basis, this still represented a moderate expansion of 1.7%, although down from 2.6% in the previous quarter.

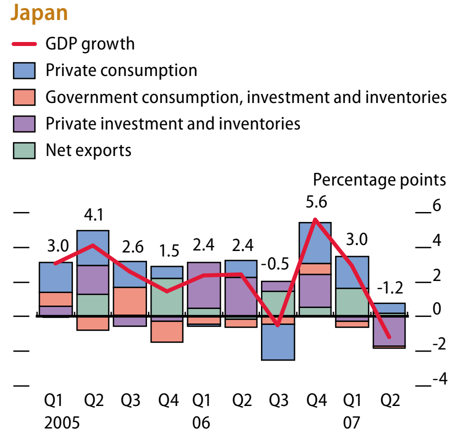
A sharp fall in corporate spending has been the main reason behind the second quarter's setback. Private nonresidential investment, which had been the key driver of the economic recovery over the past few years, fell by 4.8% again after a 0.8% decline in the first quarter. Although business investment tends to be the most volatile component of GDP, increasing economic uncertainties, associated with moderating export growth and the prolonged downcycle of the global high-tech industry, appear to have weighed on investor sentiment.

On the upside, however, corporate profits remain strong. Generally robust export growth so far this year has also tightened capacity constraints both in terms of physical capital and labor. Prospects for a quick turnaround in investment growth remain supported for now on tightened production capacity and strong corporate profits. Adding to this, industrial production is making a modest recovery. Although the combination of a major shutdown in car production and the loss of significant production capacity caused by an earthquake dented industrial production in July, a steady increase in domestic and external demand is expected to support a mild rebound.

There is certainly greater dissonance over Japan's economic strength. The latest data suggest that the economy may be losing growth momentum. Increasing odds of a more severe slowdown in US growth could make a more visible impact on exports. Already, the automobile industry has suffered its second consecutive month of export decline in August. This, together with rising inventory levels and slowing machinery orders, could cut short a tentative recovery in production growth. But support can come from continued tightening in the job market. Corporate hiring is gathering pace, which will ultimately exert a positive influence on wages.

Consumers hold the key to sustained recovery. Private consumption grew by only 1.0% in the second quarter, down from 3.4% in the first. Consumer confidence has also slipped (Figure 1.2.5) as wage growth continues to disappoint, curbing the pace of consumption growth.

1.2.4 Contributions to growth (demand), Japan



Source: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp, downloaded 10 September 2007.

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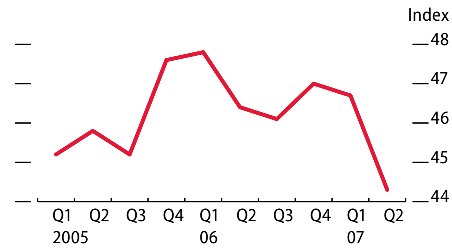
Constant efforts by firms to contain labor costs have been one factor behind the sluggish wage growth. Structural changes in the labor market from the mass retirement of baby boomers and increased participation of part-time workers have also tended to depress average wage levels, at least temporarily. But labor shortages are likely to intensify, largely for demographic reasons, putting upward pressure on wages and so eventually bolstering consumer spending.

Consumer price inflation has slid again so far this year. Although a mild upward trend in producer prices remains in place, this has been largely due to the rise in oil and commodity prices. Core inflation, which excludes fresh food prices, turned negative in February (Figure 1.2.6). With mixed signals about the strength of the economy and a potential return to deflation, the Bank of Japan has kept policy rates at 0.5% since February. The gradual pace of consumption growth, alongside weak inflation, suggests that the central bank will maintain its cautious approach into 2008.

A relatively healthy expansion should continue in Japan, with growth reaching 2.1% in 2007 and 2.2% in 2008. Corporate spending is seen resuming, given healthy export earnings, tight capacity levels, and benign funding conditions. Although consumption growth has been lagging, firming labor market conditions should gradually lift wage income and ultimately support consumer spending.

Still, there are concerns that the July earthquake and the August financial turmoil may further depress consumer and investor sentiment. Recent falls in equity and property prices have already hit consumer confidence. At the height of the global credit concerns, the yen strengthened sharply as a global reappraisal of risks triggered an unwinding of the "carry trade." If weaker US demand spreads globally and the yen (after a recent decline) resumes its rise, exports could be affected, damping business activity and corporate spending.

1.2.5 ESRI consumer confidence, Japan



ESRI = Economic and Social Research Institute of Japan.

Source: CEIC Data Company Ltd., downloaded 3 September 2007.

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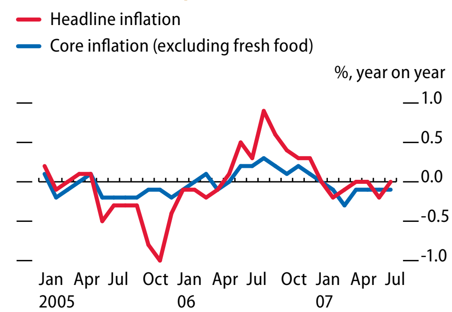
1.2.6 Inflation, Japan



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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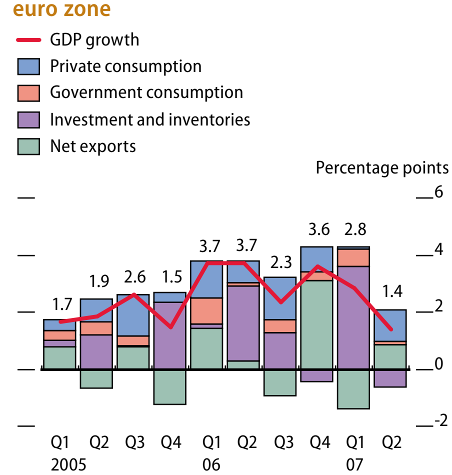
Euro zone

Growth in the euro zone remains strong, though moderating. The second quarter registered 1.4% growth (quarter on quarter, seasonally adjusted annualized rate), down from 2.8% in the first (Figure 1.2.7) due to slippages in growth of the zone's major economies—primarily Germany, France, and Italy. But underlying demand strength paints a relatively bright outlook.

Rising capacity utilization, following a strong expansion in industrial production since 2006, has encouraged corporate spending and hiring. Investment growth advanced to 9.8% in the first quarter of 2007. Although the pace has relaxed, business investment is still solid. Production capacity remains tight, while healthy corporate profits and favorable funding conditions are continuing to support capital spending. Brisk business activity has also exerted a positive influence on consumer spending through developments in the labor market. Average unemployment is dropping fast, to 7.0% in the second quarter, the lowest in a decade (Figure 1.2.8). The firmer labor market is translating into wage income growth, and should eventually provide support to consumer spending.

1.2.7 Contributions to growth (demand), euro zone



Source: Eurostat, available: epp.eurostat.ec.europa.eu, downloaded 5 September 2007.

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After a weak start to the first quarter, private consumption is recovering in the major economies. German consumer demand was hard hit by the 3 percentage point hike in value-added tax (VAT) that came into force in January. VAT now stands at 19%. Private consumption in Germany contracted in the first quarter, but early indicators such as retail sales and consumer confidence indexes point to a subsequent recovery.

Although headline inflation has fallen below the European Central Bank's target rate of 2.0%, largely due to stabilization in global oil prices early this year, inflation pressures are resurfacing (Figure 1.2.9). Less slack in production capacity and the labor market could translate into higher prices and wages. Strong job creation, alongside falling unemployment, is already strengthening workers' bargaining powers. In May, the German metal workers' union won a 4.1% rise, which may signal the beginning of broader wage increases. Robust monetary and credit growth over the past few years also remains a risk to longer-term price stability. At its 6 September meeting, the European Central Bank held its main policy rate at 4.0%. Given the strength of growth, further policy rate increases by the central bank are expected for the remainder of 2007, to keep inflation at bay.

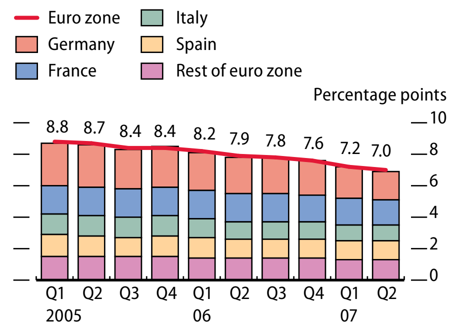
Fiscal sustainability remains a significant concern for the euro zone. Germany has made progress in this area with its January VAT increase, and Italy's efforts are also showing in its declining fiscal deficit figures. But with solid growth since mid-2005, which helped limit the rise in the government deficit-to-GDP ratio to under the 3.0% ceiling of the stability and growth pact, political pressures for greater welfare spending are rising. In France, proposed tax reforms—which include exempting overtime pay from income taxes, capping direct taxes at 50.0% of income, abolishing inheritance taxes, and making interest payments on home mortgages tax deductible—could push the fiscal deficit once more over the pact's ceiling.

The euro zone economy is expected to grow at 2.6% in 2007 and 2.4% in 2008. The outlook for consumption remains bright, with consumer confidence buoyant (Figure 1.2.10), average earnings rising, and the unemployment rate on a downward trend. In addition, proposed tax reforms in France could bolster consumption growth. A more expensive euro is affecting export performance and industrial production to a degree, but support from consumers is expected to sustain the growth momentum into 2008. Business investment should also advance at a healthy pace, given the strength of underlying demand and tightened production capacity. Although growth of industrial production has moderated, due mainly to slowing exports, a modest deceleration could be helpful for relaxing capacity constraints a little, thus easing the pressure exerted by monetary tightening.

World trade and commodity prices

After expansion of 10.2% in 2006, the volume of world trade moderated in the first half of 2007 as US demand slackened. But relatively brisk demand elsewhere continues to support world trade activity, with growth projected to reach 7.5% in 2007 (Table 1.2.1). While better than expected economic performance in the euro zone largely compensated

1.2.8 Contributions to unemployment, euro zone



Note: Data for Italy through first quarter only.

Source: Eurostat, available: epp.eurostat.ec.europa.eu, downloaded 3 September 2007.

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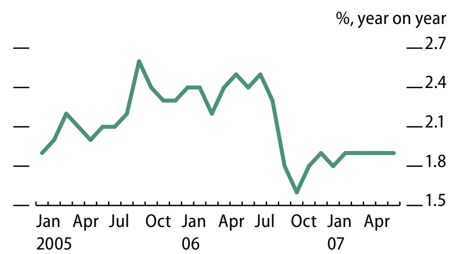
1.2.9 Inflation, euro zone



Source: Eurostat, available: epp.eurostat.ec.europa.eu, downloaded 31 August 2007.

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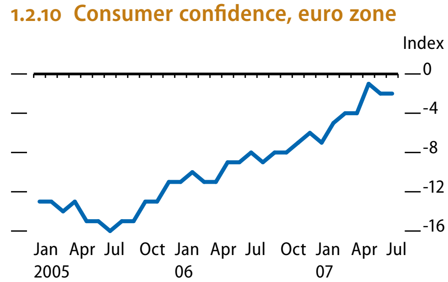
1.2.10 Consumer confidence, euro zone



Source: European Commission, available: ec.europa.eu, downloaded 31 August 2007.

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for softer demand in Japan and the US, economies in developing parts of the world continued to power ahead. The PRC registered another record in the rate of growth of industrial production, as its exports to Europe rose by more than 30% year on year in the first half of 2007. With the PRC playing a leading role as an assembly, processing, and reexporting hub, and with tight backward linkages to the rest of developing Asia, regional partners' exports to the PRC again rose strongly.

A weakening in US high-tech equipment demand, however, took a toll on industrial production across East and Southeast Asia (apart from the PRC). Growth in worldwide sales of semiconductors, a proxy for global high-tech sales, declined to 2.1% in the first 6 months of 2007 compared with 8.7% in the same period of 2006, as shipments to the US contracted by 8.8%. Growth of semiconductor sales in the Asia-Pacific region also fell by more than half to 5.9%, comparing the two periods. Monthly growth of semiconductor sales (in 3-month moving average terms) shows that the downward trend may not yet be over (Figure 1.2.11). The book-to-bill ratio (also in 3-month moving average terms), an indicator of orders vis-à-vis deliveries that precedes global activity by 6–9 months, has also slid for two consecutive months, to 0.84 in July, implying that the slump could stretch further through the rest of the year and into early 2008.

Falling unit prices have accelerated the downswing in the global high-tech industry. Prices of major memory chip units, such as dynamic random access memory (DRAM), have tumbled on fierce global competition and excess inventories (Figure 1.2.12). A rapid expansion in manufacturing capacity over the past few years has contributed to a buildup in inventories. While falling chip prices are weighing down revenue growth, inventory adjustments in the high-tech industry have squeezed production. Reflecting persistent price declines, the Semiconductor Industry Association sharply revised down its 2007 forecast for global semiconductor sales growth to 1.8% in June, from its February projection of 10%.

Global oil prices have risen again, on robust demand and renewed supply interruptions. Benchmark Brent crude, having stabilized at about $60 per barrel in the first quarter of 2007 from last year's peak of nearly $80, hit almost $80 per barrel in early September on the back of supply concerns arising from lower than expected US inventory levels, and severe weather disturbances. Oil demand has been driven in part by strong demand from the PRC and India, and in part by better than expected global economic performance. But the supply side has seen

1.2.1 Baseline assumptions for external conditions, 2005–2008

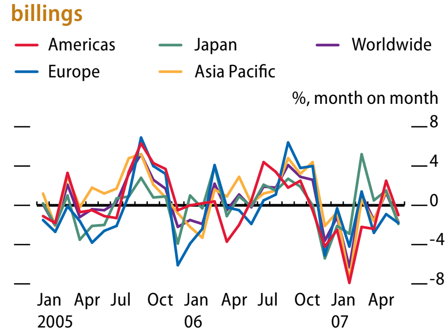
	2005 Actual	2006 Actual	2007 *ADO 2007*	2007 *Update*	2008 *ADO 2007*	2008 *Update*
GDP growth (%)						
Industrial countries [a]	2.3	2.7	2.3	2.2	2.6	2.5
United States	3.1	2.9	2.5	1.9	3.0	2.6
Euro zone	1.5	2.7	2.2	2.6	2.1	2.4
Japan	1.9	2.2	2.0	2.1	2.3	2.2
Memorandum items						
US Federal Funds rate (%, average)	3.2	5.0	5.1	5.2	4.9	4.7
Brent crude oil spot prices ($ per barrel, annual average)	54.4	65.4	57.0	64.0	54.0	65.0
Nonfuel commodity prices (% change) [b]	13.4	24.7	-4.5	12.4	-8.4	-3.0
CPI inflation (OECD, annual average)	2.5	2.6	2.1	1.9	2.0	2.0
World trade volume (% increase)	7.6	10.2	7.5	7.5	8.0	8.0

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

[b] World Bank's non-oil commodity price index.

Sources: US Bureau of Economic Analysis, available: www.bea.gov, downloaded 31 August 2007; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp, downloaded 10 September 2007; Eurostat, available: epp.eurostat.ec.europa.eu, downloaded 5 September 2007; CEIC Data Company Ltd., downloaded 31 August 2007; World Bank, *Commodity Price Data (Pink Sheet)*, available: www.worldbank.org, downloaded 7 September 2007; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, available: www.oecd.org, downloaded 31 August 2007; World Bank, *Prospects for the Global Economy—Forecast Summary*, available: www.worldbank.org, downloaded 31 August 2007; staff estimates.

1.2.11 Growth in global semiconductor billings



Source: Semiconductor Industry Association, available: www.sia-online.org, downloaded 31 August 2007.

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little change: the Organization of the Petroleum Exporting Countries (OPEC) has cut output to meet its lower quotas, set in February this year, while growth from non-OPEC countries has been sluggish due to delays in production from new projects. Tighter market conditions have been further aggravated by supply disruptions in Iraq and Nigeria, and persistent geopolitical uncertainties on oil supply. The Brent crude oil price is projected to stay elevated at over $70 per barrel for the remainder of 2007 and 2008, on the basis of current futures prices (Figure 1.2.13).

Prices of non-oil commodities advanced further (Figure 1.2.14). Metals and minerals prices continued to register double-digit growth rates, rising by 21.3% in the first 8 months of the year. Strong demand from industry and supply disruptions (in some cases) contributed to significant gains in nickel, tin, and lead. Nickel prices soared, rising by 103.9% to end-August, mainly attributed to swelling demand for stainless steel (particularly in the PRC), since about two thirds of global nickel output is used in its manufacture.

Agricultural food prices also surged, led by fats, oilseeds, and grains. Heavy demand from the PRC and India, combined with weather-related supply shortfalls, sent wheat, soybeans and oil, palm oil, and coconut oil prices higher from early this year. Rising (crude) oil prices also reignited demand for biofuels, lifting prices of soybeans and maize. This has resulted in rising costs of feeds, trickling down to higher costs of beef, pork, and poultry, as well as of cooking oil. Higher prices of soybeans and maize have also encouraged farmers to switch to planting them instead of grains, thus pushing grain prices higher.

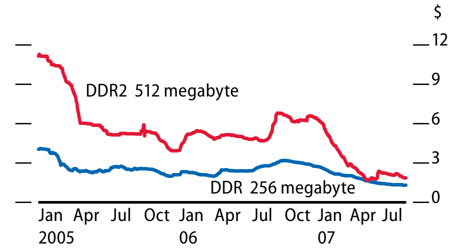
These developments in non-oil commodity markets call for a reassessment of *ADO 2007*'s price projections. Non-oil commodity prices are now seen increasing by 12.4% in 2007. But the prospect of moderating demand from the PRC, together with improving supply conditions, is starting to ease price pressures. Having, it seems, peaked this year, non-oil commodity prices are expected to stabilize gradually over the course of 2008.

Capital flows and financial markets

Developing Asia's financial markets tumbled in August amid concerns over US subprime mortgages and spreading global credit fears. With the notable exception of the PRC, in Asia most equities skidded, credit risk spreads widened, and currencies faltered. Despite this apparently high vulnerability of the region's financial markets to global turbulence, strong growth and generally sound macroeconomic fundamentals are helping the region restore calm to financial markets with relative ease. Asian shares are already bouncing back, limiting the losses from the market sell-off.

The environment for external funding remains broadly positive. On the back of a robust growth outlook, developing Asian markets have attracted heavy private capital inflows. In 2006, net private flows reached an all-time high of $254.5 billion (Figure 1.2.15). Although the pace of equity investment flows has eased (mainly due to a slowdown in offshore issuance of initial public offerings by PRC corporations in response to government efforts to stem investment), net private debt inflows have

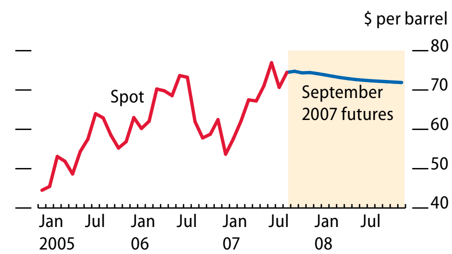
1.2.12 Selected DRAM prices



DRAM = dynamic random access memory; DDR = double data rate.

Source: Bloomberg, downloaded 5 September 2007.

1.2.13 Brent spot and forward prices



Sources: Energy Information Administration, available: www.eia.gov; FutureSource.com, available: www.futuresource.com; both downloaded 10 September 2007.

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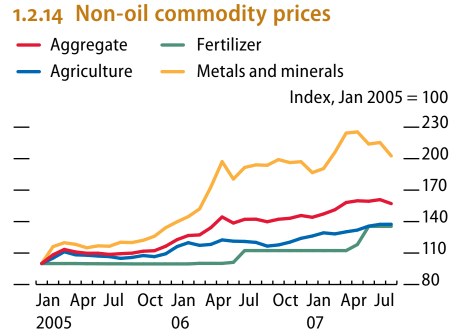
1.2.14 Non-oil commodity prices



Source: World Bank *Commodity Price Data (Pink Sheet)*, various issues, available: www.worldbank.org, downloaded 7 September 2007.

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been climbing. While the repricing of credit risks triggered by the recent financial ferment is likely to slow credit inflows to the region, this may in fact help in mitigating the risk of overheating in some of developing Asia's asset markets.

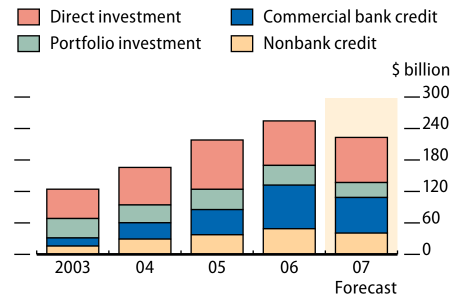
Sovereign credit spreads have widened in the wake of the US subprime turmoil (Figure 1.2.16). Heightened financial volatility and a sharp reversal in risk appetite—together with elevated funding costs—are expected to narrow external funding opportunities for Asian borrowers. But with ample current account surpluses and large foreign reserve holdings, they have less need of external funding. Despite continued low funding costs, the region's strong fiscal position has slowed new issuance of sovereign debt over the past few years.

In fact, many of the larger developing economies in the region have started to invest abroad. The PRC Government has relaxed regulations and granted incentives to targeted industries, encouraging a surge in outward direct investment. India's outward direct investment has also climbed rapidly, to $9.7 billion in 2006 from only $1.8 billion in 2005, as firms have established production, manufacturing, and distribution operations elsewhere.

Robust export growth, along with continued capital inflows, has lifted foreign reserve holdings held by developing Asia's central banks. In the first half of 2007, their reserve accumulation amounted to $360.1 billion, or almost 40% of the worldwide total (see also Box 1.1.2.). Led by the People's Bank of China, all major Asian central banks have reserve holdings that can cover their country's short-term external obligations, even under the most stringent standards for reserve adequacy.

Although the risk of repercussions from the subprime and credit turbulence seriously affecting growth cannot be ruled out, developing Asia's reduced external funding requirements and improved economic fundamentals are expected to buffer impacts. Price adjustments in these markets have been in line with ongoing corrections globally, and have broadly tracked those in both mature and other emerging markets. This resilience reflects robust growth, low inflation, and sound fiscal and external positions.

1.2.15 Net private flows to Asia-Pacific



Note: Asia-Pacific consists of People's Rep. of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand.

Source: The Institute of International Finance, Inc., *Capital Flows to Emerging Market Economies*, various issues, available: www.iif.com, downloaded 31 August 2007.

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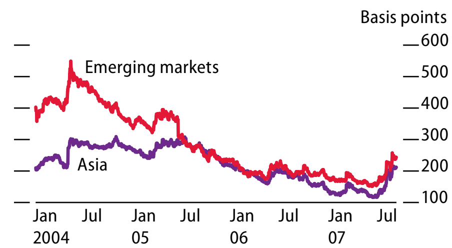
1.2.16 Sovereign credit spreads, emerging markets including Asia



Source: Bloomberg, downloaded 3 September 2007.

Subregional summaries

Central Asia

Subregional performance

The *Update* revises up GDP growth projections made in March's *Asian Development Outlook 2007* (*ADO 2007*) for six of the seven countries in Central Asia (not Tajikistan). This lifts the subregional projection to 11.1% from 10.3%. In the first half of 2007, these countries showed evidence of quickening economic activity.

In Azerbaijan, the pickup was driven by the contribution of net exports on the back of an increase in oil production of almost 65% (year on year) in the first half. Kazakhstan's growth is being pushed higher by strong growth in domestic demand, despite a negative contribution of net exports of goods and nonfactor services. Growth in Turkmenistan has been raised on account of strong gas exports. Uzbekistan also continues to benefit from a favorable external environment, with net exports the main contributor to growth.

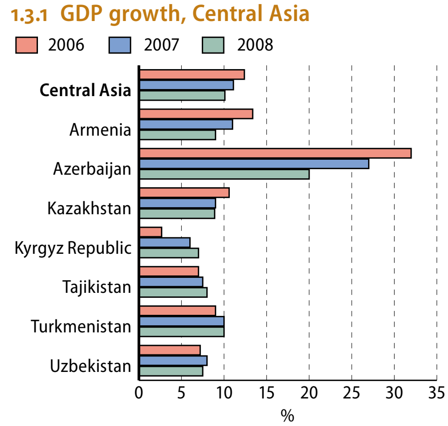
Domestic demand is the main driver of growth for Armenia and the Kyrgyz Republic—the other two countries with raised forecasts—and for Tajikistan. In all three, disposable incomes continue to be boosted by remittance inflows. Armenia and the Kyrgyz Republic are seeing a greater pickup than expected in private investment activity related to FDI inflows. Tajikistan's outlook remains unchanged though, and energy shortages continue to hurt the mainstay of industry, aluminum. The authorities have ramped up public investment spending, but are relying on external sources. The sector pattern of growth across Central Asia shows that construction- and services-driven activity is continuing to accelerate.

Inflation in five countries is on the rise due to rapid monetary expansion resulting from strong foreign exchange inflows and much expanded public spending. The *Update* revises upward the average inflation rate projection for 2007 to 9.7% from 8.6%.

In Azerbaijan, 12-month consumer price index inflation rose to 15.2% in July 2007, driven by a loose fiscal policy, unsterilized interventions in the foreign exchange market, and upward adjustments in administered prices. In Kazakhstan, larger bank borrowing than last year has lifted domestic demand and inflation. Upward adjustments in administered prices were the main factor in raising inflation in Tajikistan. Uzbekistan's officially reported inflation rate for the first half of 2007 was 2.2%, but the findings of a recent International Monetary Fund review mission suggest that although inflation has eased somewhat, 10% is a reasonable estimate. A widening current account surplus (and overall surplus) there continues to exert upward pressure on monetary aggregates.

The subregion's economies (with the exception of Tajikistan) are generally coping with real exchange rate appreciation induced by

1.3.1 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

strong net foreign exchange inflows. In an environment where most of these inflows are expected to be sustained over the medium term, real appreciation pressures are likely to persist. Since influencing the real exchange rate is impossible beyond the short term, central banks should accord primacy to ensuring low inflation, and not resist an orderly appreciation in nominal exchange rates.

The *Update* revises marginally upward the subregion's projected current account surplus for 2007 to 3.5% from 3.2%. Export growth in the main hydrocarbon-exporting countries (Azerbaijan, Kazakhstan, and Turkmenistan) was strong in the first half of 2007. Uzbekistan, too, is realizing large surpluses in both its trade and current accounts. Export growth is picking up across the subregion but is accompanied by accelerating import demand, yielding widening trade deficits.

Subregional prospects

The external environment is expected to be quite favorable in 2008, yet the pace of domestic reforms to energize the private sector will also be an important determinant. While world energy prices are expected to stabilize, they will remain at relatively high levels, supported by global demand. Accordingly, GDP growth forecasts for most hydrocarbon exporters have been revised upward. Nonenergy commodity prices, in particular base metals, are expected to soften only slightly in 2008 while gold prices are expected to remain high. With larger production capacities being installed, exporters of base metals (Armenia and Tajikistan) and gold exporters (Kyrgyz Republic and Uzbekistan), should see improved export performance.

For the subregion as a whole, the *Update* revises upward the GDP growth forecast for 2008 to 10.1% from 9.4%. But surging foreign exchange inflows with potential inflationary consequences will remain a problem, and the inflation forecast for 2008 is revised up to 9.1% from 7.9%. The average current account surplus as a share of GDP has been adjusted upward from 3.3% to 3.6%, mainly due to higher hydrocarbon exports in several countries; capital inflows will also support a high overall balance.

Country highlights

Armenia

Projected GDP growth for 2007 has been uprated to 11.0% given the better than expected growth for the first half of 2007 of 11.2%, which largely reflected continued expansion in construction and services. Inflation edged up to 4.5% (year on year) in June 2007, strongly suggesting that the central bank will tighten monetary policy further to achieve its end-of-year inflation target of 4.0%. Fiscal policy remains prudent, with an improving ratio of tax revenue to GDP and moderately higher capital expenditure financed from official external assistance.

Exports are recovering from a slump in 2006 but import demand is even stronger, widening the trade gap. Still, the projected current account deficit for 2007 has now been slightly reduced from *ADO 2007*, reflecting larger inward remittances; FDI inflows are likely to cover this deficit.

Azerbaijan

Azerbaijan's GDP growth for this year has also been revised upward,

from 25% in *ADO 2007* to 27%, as is the forecast for 2008, from 17% to 20%. The economy grew at a torrid 36.2% year on year during the first 5 months of 2007, powered by large increases in oil production and exports (as new projects move toward full production), which spurred growth in construction and services.

Full-year inflation, too, is adjusted upward, from 14% to 18%. Excessive expansion in public spending and the money supply has fanned inflation pressures and, as expected, pushed inflation into double digits in January–June 2007. The central bank has tried to tighten monetary policy and is allowing the manat to appreciate gradually, but this by itself is unlikely to rein in inflation.

Of concern is the projected non-oil fiscal deficit as a share of non-oil GDP since the authorities persist with steep increases in current and capital expenditures (Box 1.3.1). With import growth slowing (as import-dependent hydrocarbon projects near completion), the trade and current accounts are posting large surpluses. FDI inflows, which had boosted investment rates in the last few years, are on the wane. Domestic investment has recently registered an uptick, but a sustained improvement will depend on a significant amelioration in the business climate and in governance reforms.

Kazakhstan

The GDP growth projection for 2007 has been raised from 8.6% to 9.0%; the forecast for 2008 is kept at 8.9%. The pickup in growth in the first half of 2007 stemmed from higher oil production and continued strong domestic demand, driven by private consumption and investment spending. Projected inflation in 2007 is adjusted upward to 8.5% from 8.0% in *ADO 2007*. Consumer price inflation eased slightly (8.1% year on year in June 2007) but inflationary pressures stemming from excessive foreign borrowing by commercial banks for onlending remain a major concern. The central bank has tightened monetary policy, raising the discount rate and reserve requirements for foreign currency borrowing.

Central government spending is expected to be higher than in the original budget, but so too is revenue. The planned increase in the non-oil fiscal deficit as a share of non-oil GDP is moderate and within a "prudent band." Export growth has been buoyant and the trade balance is in surplus, but significant deficits in its services and income balance are widening the current account deficit (fully covered by FDI inflows).

Structurally, the Government has taken several initiatives for improving the competitiveness and productivity of the non-oil sector, but the financial sector remains vulnerable to currency and interest rate risks.

Kyrgyz Republic

Growth for this year is now put at 6.0%, from 4.0% earlier, and the forecast for next year is upgraded from 5.0% to 7.0%. The economy grew strongly in the first half of 2007, by 9.2% relative to the same period last year, with good performance from construction and services and a recovery in industry. Consumer price inflation in January–June 2007 was moderate at 4.8%.

Export growth has strengthened, but imports—mainly energy, consumer durables, and capital goods—have outpaced it. In the financial

1.3.1 Resource windfalls—Oil revenue management in Azerbaijan and Kazakhstan

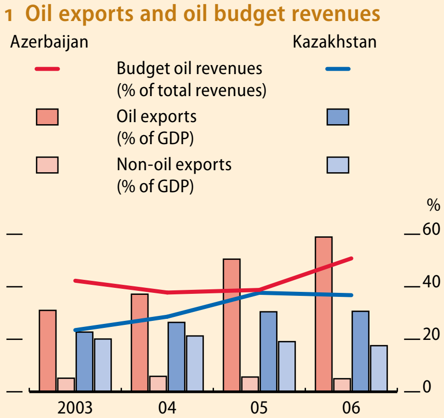
Soaring global commodity prices have produced large windfall revenues for resource-rich economies. Although these revenues have improved external balances, reduced fiscal strain, and accelerated growth, they have also complicated the macroeconomic management of these economies. A major concern in the short run is monetary control. With rigid exchange rate policies limiting nominal appreciation, soaring foreign exchange inflows fuel inflationary pressures. The consequent real appreciation harms the competitiveness of non-oil sectors—a phenomenon known as "Dutch disease"—and thus hampers diversification of the economy. This box explores how two resource-rich economies, namely Azerbaijan and Kazakhstan, have managed their surging oil revenues over the past 4 years.

Following a recovery in 1999, oil prices increased by more than 50% in 2000 to $28 per barrel and stabilized in 2001–2003 at that level. Oil prices have accelerated since 2004, averaging $64 per barrel in 2006. The two countries set up oil funds—the State Oil Fund of Azerbaijan Republic (SOFAR) in 1999 and the National Fund of the Republic of Kazakhstan (NFRK) in 2001. The funds were established with two main aims: to save part of oil revenues for future generations, and to prevent macroeconomic instability arising from the volatility of oil income. The authorities were concerned about political pressure to spend the oil wealth rapidly and inefficiently.

Assets of these funds have been invested in both domestic liquidity assets (deposits and money market instruments) as well as foreign fixed-income and equity instruments, to insulate the domestic economy from potential excess liquidity from oil revenues. The main issue of interest is whether the two funds have achieved their dual objectives.

Due to recent oil price gains, the share of oil in the two countries' exports has increased sharply. Azerbaijan's exports increased to more than 60% of GDP in 2006, up from 36% in 2003, with oil making up more than 90% of total exports (Box figure 1). While Kazakhstan's oil dependency is less pronounced, oil exports still accounted for about 60% of total exports. The increase in oil export revenues between 2003 and 2006 represented 49% of Azerbaijan's and 24% of Kazakhstan's 2006 GDP (Box figure 2). Kazakhstan saved more than 60% of its increased oil export receipts in its oil fund, while Azerbaijan saved 12%.

1 Oil exports and oil budget revenues

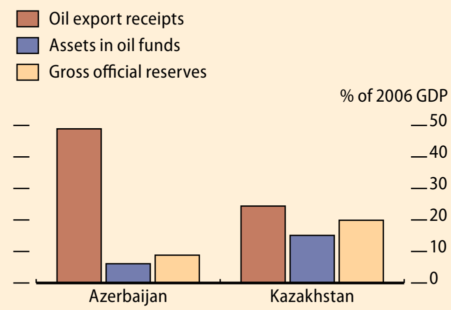


Source: Staff estimates.

Click here for figure data

The two countries also differ in terms of the fiscal arrangements for their oil revenues. Azerbaijan's budget revenues in 2006 soared by 67% relative to the previous year, and half these receipts came from the oil sector (Box figure 1). In Kazakhstan, where fiscal revenues increased by more than 30% in 2006, oil income accounted for 37% of budget revenues.

2 Increase in oil-related indicators 1, 2003–2006

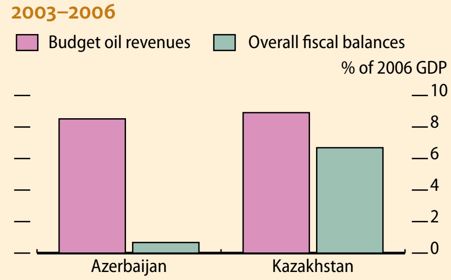


Source: Staff estimates.

Click here for figure data

With ample fiscal resources, Azerbaijan accelerated public spending. It loosened fiscal policy noticeably in 2006, and capital spending more than tripled compared with the previous year. Kazakhstan has consistently kept spending below revenue and ran budget surpluses. Its overall surplus rose to 7.5% of GDP in 2006. On average, Azerbaijan used 8% of the increase in oil revenues accruing to the budget to improve its fiscal balance (measured as the ratio of the increase in the fiscal balance to the increase in fiscal oil revenues between 2003 and 2006), while Kazakhstan used 75% for that purpose (Box figure 3).

3 Increase in oil-related indicators 2, 2003–2006



Source: Staff estimates.

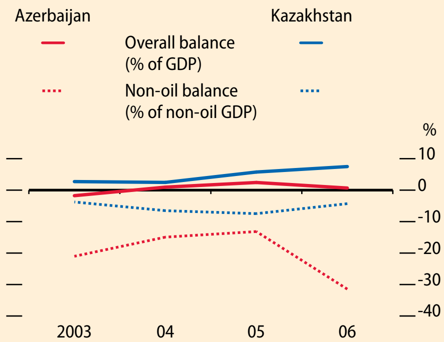
Click here for figure data

For oil-exporting countries, the ratio of non-oil fiscal deficit to non-oil GDP is a good measure of the true fiscal stance. The Azerbaijan Government's ambitious spending program is reflected in a widening non-oil fiscal deficit in 2006. The non-oil deficit of more than 30% of non-oil GDP exceeds most widely accepted thresholds

1.3.1 Resource windfalls—Oil revenue management in Azerbaijan and Kazakhstan *(continued)*

for medium-term fiscal sustainability (Box figure 4). In contrast, Kazakhstan's non-oil fiscal deficit in 2006 dropped to 4.3% of non-oil GDP, with substantial budget surpluses accumulated in NFRK.

4 Fiscal balances



Source: Staff estimates.

Click here for figure data

The two oil funds are differently designed (box table). On paper, Azerbaijan's SOFAR assigns primacy to savings objectives, in the sense that the total amount of outflows cannot exceed inflows in any given year. Yet in practice, a portion of SOFAR funding has been allocated to the state budget to finance public investments. In addition, SOFAR's expenditure policy permits the funding of investment projects outside the state budget, bypassing the public investment program. SOFAR has financed programs assisting internally displaced people, projects for water and irrigation, and has made investments in the Baku-Tbilisi-Ceyhan oil pipeline. These activities have limited SOFAR's saving. Formally, SOFAR attaches low weight to stabilization objectives.

In contrast, Kazakhstan's oil fund emphasizes stabilization but, at the same time, calls for automatic accumulation of oil revenues beyond a predetermined oil price. Although NFRK is allowed to transfer funds to the budget, subject to the president's approval, this rule has never been invoked in the current oil boom. In practice therefore, NFRK has accumulated savings at a brisk rate.

Azerbaijan and Kazakhstan have made significant progress toward transparent management of oil revenues. For example, both countries have already joined the Extractive Industries Transparency Initiative. However, there is still much room for improving oil revenue management, in terms of governance, transparency, integration with the overall fiscal framework, and asset management. Setting up an oil fund by itself does not guarantee either fiscal discipline or commitment to future savings. Only when oil revenues are managed as an integral part of a sound overall fiscal framework, can an oil fund attain its objectives.

The governments in resource-rich Asian countries need to find the right balance between fulfilling development needs (by spending oil revenues), maintaining macroeconomic stability (by stabilizing the impact of oil revenues), and saving part of oil wealth for future generations (by saving oil revenues). Policy makers need to pay close attention to the effects of higher public spending on the real exchange rate and on macroeconomic stability, and should make the best strategic use of windfall revenues for achieving long-term development goals.

Oil funds: Objectives and rules

Fund and date established	Stated objectives	Inflow rules	Outflow rules	Management institutions	Investment abroad	Balance (end-2006)
Azerbaijan State Oil Fund of Azerbaijan Republic (SOFAR), 1999	Greater weight on saving than stabilization	The Government's share in production-sharing agreements with foreign oil companies for post-Soviet oil fields	Withdrawals not to exceed inflows in a given year. Transfers allowed to the budget for public investments. Own investments allowed in projects for refugees, oil pipelines, and water/irrigation.	SOFAR and international asset management companies	60% in liquid assets (cash, money market instruments) 40% in sovereign debt securities	$1.9 billion (17.5% of GDP) *Memo item:* Gross official reserves: $2.5 billion
Kazakhstan National Fund of the Republic of Kazakhstan (NFRK), 2001	Little more emphasis on stabilization than saving	*Stabilization:* Oil revenue above the baseline price. Ad hoc privatization and bonus receipts *Saving:* 10% of baseline budget oil revenues from identified oil companies	Transfers to state and local budgets allowed with president's approval	Central bank and international asset management companies	Stabilization portfolio (25%) in liquid assets Savings portfolio (75%) in sovereign debt securities and shares	$14.1 billion (9.5% of GDP) *Memo item:* Gross official reserves: $19.1 billion

Sources: Economist Intelligence Unit, Azerbaijan and Kazakhstan country reports, various issues; International Monetary Fund reports.

and capital accounts, FDI inflows, particularly from Kazakhstan, have picked up, helping build foreign exchange reserves. Structural reforms have made some progress, particularly in the areas of business regulation, and privatization of energy and banking.

Tajikistan

At 7.3%, economic growth was strong in the first half of 2007, buoyed by higher investment spending and remittance-fueled consumption. Full-year growth is kept unchanged at 7.5%. Energy shortages affected aluminum production. With the pass-through of higher natural gas export prices charged by Uzbekistan and with upward adjustment in electricity tariffs, inflationary pressures are likely to persist for the rest of the year. The *Update* therefore revises upward projected inflation for 2007 from 7.0% to 11.4% (the 12-month rate at end-June 2007 was 9%).

Following debt relief under the Multilateral Debt Relief Initiative, the external debt strategy has taken another turn with the authorities' plan to contract significant amounts of concessional loans to finance infrastructure.

Turkmenistan

Stronger than expected gas exports propelled growth in the first half of 2007, such that GDP growth for 2007 and 2008 is revised upward to 10.0%. At the start of the year, the new Government launched some reforms in education, public health, and social protection, but is keeping the management of hydrocarbon revenues nontransparent and off the budget.

Uzbekistan

The *Update* upgrades projected GDP growth for 2007 from 7.4% to 8.0% and for 2008 from 7.1% to 7.5%. High investment spending and net exports drove first-half 2007 growth of 9.7%. Inflation is expected to be pushed still higher: for 2007 from 9.0% to 10.0% as a sharp increase in net foreign assets has fed monetary expansion. Price pressures are likely to build following large wage and pension hikes of August 2007.

Following negotiations for higher prices in export contracts as well as greater investment, natural gas exports are becoming more important in the export commodity structure. A portion of these receipts is being channeled into the Uzbekistan Fund for Reconstruction and Development.

East Asia

Subregional performance

Growth rates projected for 2007 in all five economies in this subregion have been revised up from those made in *ADO 2007*. Aggregate growth is now put at 8.9%, upgraded from 8.0% in March and close to the vigorous expansion rate of 2006. These figures are dominated by the PRC, where the economy quickened in the first half and the full-year forecast is revised up to 11.2%, the fastest rate in 13 years.

Solid demand for East Asia's manufactured exports helped underpin

economic growth in the first half of 2007. The PRC's exports climbed by nearly 28% in nominal terms from the year-earlier period, about equal to the rapid export growth in 2006, and its imports rose by about 18%. Indeed, strong growth in the PRC's imports has been one reason for robust export gains by other East Asian economies. For example, total exports from the Republic of Korea, the second-biggest economy in the subregion, rose by about 14% in the first half, and exports from Taipei,China increased by nearly 8%. (In both cases export growth moderated from the 2006 pace, partly because of softer global demand for some electronic products.)

Domestic demand generally has strengthened and is adding to growth in the subregion. Both consumption and investment grew rapidly in the PRC in the first half of 2007. Stronger labor markets helped support consumption growth in Hong Kong, China; Korea; and Taipei,China, despite rises in policy interest rates in the latter two economies. In Taipei,China, private consumption is recovering from a weak period in 2006 when credit-card issuers tightened lending after a rise in defaults. Investment in these three economies also picked up in the first half.

Most inflation forecasts for the subregion are revised up, particularly for the PRC, where food prices have increased sharply, in part because of a pig disease that has reduced pork supplies. In the PRC, inflation is now forecast at 4.2% for 2007 (1.8% in *ADO 2007*). Revisions to inflation expectations in several other economies also are influenced by rising food prices. Subregional inflation this year is now put at 3.5%, up from 1.9%. Still, inflation remains low (in a range of 1.6–2.5%) for Hong Kong, China; Korea; and Taipei,China.

The *Update* lifts the PRC's projected current account surplus for 2007 to 10.9% from 8.8% in *ADO 2007*, mainly on the basis of a higher than expected trade surplus. Korea's forecast current account surplus is raised to 0.6% from 0.1% in March, reflecting stronger than anticipated exports. External surpluses are projected for Hong Kong, China; Mongolia; and Taipei,China, at the same levels as forecast in March.

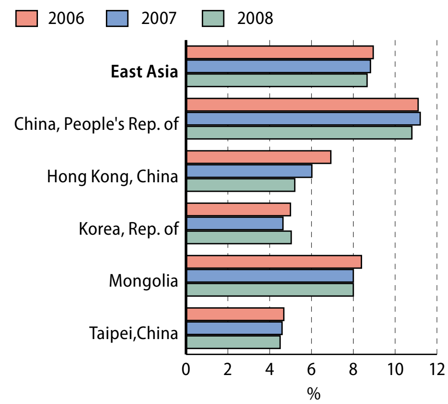
Subregional prospects

The subregional GDP growth forecast for 2008 is uprated to 8.7% from 8.0% in March. For the PRC, the revision is a full 1 percentage point to 10.8%, given the heightened growth momentum of this year. Mongolia's forecast, too, is revised up 1 percentage point, to 8.0%, mainly on expansion of its mining industry and higher government spending. More moderate upward revisions are made for the Hong Kong, China forecast (to 5.4%) and Korea (to 5.0%). The outlook for Taipei,China (growth of 4.5%) is unchanged from March.

Inflation next year is put at 3.3% on a subregional basis, revised up from 2.2% in March. In the PRC, even with slower food price rises, inflation has been revised up to 3.8%. The inflation forecasts for 2008 are also raised for both Hong Kong, China and Mongolia.

All five subregional economies are likely to maintain current account surpluses in 2008. The outlook for the aggregate surplus is raised to 7.9% from 6.9%, due to an upward revision to the forecast for the PRC's current account surplus to 10.5% from 8.9%.

1.3.2 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Country highlights

People's Republic of China

Despite efforts by the authorities to damp investment and exports, GDP growth of 11.5% in the first half of 2007 came in at the fastest rate since 1994. Industry again led the way, expanding by 13.6%, with services up by 10.6% and agriculture by 4.0%. Drivers of investment included strong profitability, buoyant sales, and still-low lending rates. Both fixed asset investment and consumption were strong.

On the external side, merchandise exports grew vigorously, pointing to a projected trade surplus of $300 billion this year. Based on the updated assessment of domestic and external demand, the GDP growth forecast is revised to 11.2%, from 10.0% in *ADO 2007*. The current account surplus is now expected to swell to 10.9% of GDP, revised up from 8.8%. Inflation has turned sharply higher (to 6.5% in August), mainly caused by food price increases, prompting a revision in the 2007 forecast to 4.2% from 1.8% in *ADO 2007*. Housing price increases have quickened in many cities, too.

Continued high trade surpluses and capital inflows took foreign exchange reserves to $1.3 trillion in June and have complicated monetary policy. The central bank has continued to take excess liquidity out of the banking system, but has not completely offset capital inflows. The authorities have allowed the yuan's appreciation against the US dollar to accelerate slightly.

Among recent efforts to curtail liquidity and to tame investment, the Government has raised interest rates, hiked commercial banks' reserve-requirement ratio, and cut some export-supportive measures. But the effectiveness of interest rate rises in cooling demand is hindered by seepages of rising foreign exchange reserves into liquidity and by the fact that the economy is still not fully market-based. Incentives for construction, particularly at the local level, also frustrate efforts to limit investment growth.

This year's momentum is likely to carry into 2008, implying further steps to cool the rapid investment expansion. But top priorities remain the creation of jobs and on lifting income growth in lagging regions, underpinning growth in consumption. Investment will also stay high. The gap between export and import growth will probably close a little as the changes regarding exports take effect. GDP growth for 2008 is revised to 10.8%, up 1 percentage point from the *ADO 2007* forecast. The current account forecast is raised to a surplus of 10.5% of GDP.

The sharp increases in food prices seen in 2007 are assumed to ease next year. This would open the way to carry out planned reforms in the pricing of state-controlled sectors such as water, power, and natural gas, foreshadowing tariff increases. On this basis, the inflation forecast for 2008 is raised from 2.2% to 3.8%, but it may surpass this revised forecast.

The booming stock market presents a risk. A sudden sharp fall could leave banks with rising nonperforming loan ratios, which would likely see them tightening lending, with impacts on the broader economy.

The authorities need to make further progress in rebalancing the economy, i.e., by reducing reliance on exports and investment in favor of private consumption. This could lessen vulnerability to external shocks and ease environmental strains. Policy measures have yet to have much

impact; growth in the trade surplus and investment outpaced retail sales growth in the first half of 2007.

Republic of Korea

Growth in this economy picked up from 4.0% in both the fourth quarter of 2006 and the first quarter of 2007, to 5.0% in the second quarter of this year, lifted by strong exports, improving growth in investment, and a gradual increase in consumer spending. This upward trend is likely to continue through the second half of 2007 and into 2008. The stronger than expected export performance augurs well for further gains in industrial activity and business investment. A steadily strengthening labor market (the seasonally adjusted unemployment rate was 3.2% in August, down from 3.5% a year earlier) is helping support the recovery in consumption. Both business and consumer confidence is rising. Consequently, GDP growth forecasts are revised up slightly, to 4.6% for this year from the *ADO 2007* level of 4.5%, and to 5.0% for 2008 from the previous forecast of 4.8%.

The Bank of Korea raised its overnight call-rate target in both July and August (to 5.0%) to preempt inflation pressures and to prevent a bubble from forming in the property market. Inflation is projected at 2.5% this year (2.4% in *ADO 2007*) and 2.6% in 2008 (unchanged from the March forecast), at the bottom of the central bank's 2.5–3.5% target range. The won/dollar exchange rate has continued to appreciate moderately, helping curb inflation pressures generated by robust domestic demand. Reflecting stronger than expected exports, the current account surplus for 2007 is now projected at 0.6% of GDP (0.1% in *ADO 2007*); the forecast for the 2008 current account surplus is maintained at 0.1%.

Taipei,China

Economic growth was 4.6% in the first half of 2007, slightly stronger than expected. In the second quarter, growth picked up to 5.1%, driven by a 12.5% jump in private fixed investment, particularly by semiconductor companies. Investment is expected to expand further in the second half, but not at the brisk pace seen in the April–June period. Private consumption edged higher during the first half, recovering from weak levels in 2006 after a tightening in consumer credit that followed a bursting of a credit-card bubble. Consumption is expected to strengthen further in the second half, supported by rises in incomes and employment and by firm asset markets.

As a result of the pickup in investment and consumption, domestic demand contributed 40.0% of the GDP expansion in the first 6 months compared with just 7.0% in the year-earlier period. The GDP growth forecast is nudged up to 4.6% for 2007, from 4.3% in March, and the 2008 projection is maintained at 4.5%.

The monetary authorities raised the benchmark discount rate further in the first half, in part because of concern about rises in wholesale inflation even as consumer inflation stays low. For 2007, the consumer price index is projected to rise by an average of 1.6% (accelerating from just 0.6% in 2006), and by 1.5% in 2008, unchanged from *ADO 2007* predictions. The outlook for the current account outcome is still for surpluses of 6–7% of GDP this year and next.

Hong Kong, China

This economy, heavily influenced by trends in the PRC, expanded by a faster than expected 6.3% in the first half of 2007. Growth was broad-based, with external trade gathering strength and domestic demand accelerating. Exports of goods and services rose by about 11.0% in real terms in the second quarter of the year. Services benefited both from buoyant financial market activity, much of it related to capital raising by PRC companies, and from the strength of trade and tourism.

Private consumption spending picked up, supported by rising incomes and a strong labor market (the seasonally adjusted unemployment rate fell to 4.1% in July, a 9-year low). Construction also recovered somewhat, after an extended period of contraction, and investment in equipment was strong. The GDP growth forecast for 2007 is raised to 6.0% from 5.4% in *ADO 2007*, and for 2008 to 5.4% from 5.2%.

Budget initiatives that exerted downward pressure on some prices helped keep inflation to 1.5% in the first 6 months. Prices of food imported from the PRC have been rising, and therefore inflation in the second half will be higher than in the first. For all 2007, the inflation projection is raised marginally to 1.7% from 1.6%, and for next year to 2.5% from 2.3%. The forecast is maintained for a current account surplus of nearly 10.0% this year, rising slightly in 2008.

Mongolia

The least developed economy in the subregion, Mongolia is benefiting from strong global demand for its minerals (mainly copper and gold), good weather last year that is helping agricultural production, and growth in construction, transportation, and telecommunications. Government spending has increased on infrastructure and on social assistance programs, buttressed by rising public revenues from the minerals industry. GDP growth forecasts for both 2007 and 2008 are revised up by 1 percentage point, to 8.0%.

Inflation has been higher than expected owing to rising prices for imports of food from the PRC and petroleum products from the Russian Federation, which increased its petroleum export tariff. Price pressures have also been fueled by high rates of expansion in public spending and in broad money supply. The inflation forecasts are raised to 7.5% from 6.0% in *ADO 2007* for both this year and next. Mongolia is still projected to have current account surpluses equivalent to about 2.0% of GDP in both years.

South Asia

Subregional performance

Economic growth in South Asia, which expanded sharply by about 8.7% in 2005 and 2006, is now projected to moderate slightly to 8.1% in 2007. (*ADO 2007* had forecast a slightly more abrupt deceleration to 7.7%.) This revision reflects primarily a larger than projected expansion in India, which accounts for 80% of South Asia's GDP, of 8.5% instead of 8.0%. Little or no change was made in forecasts for the other large economies—Pakistan and Bangladesh. Sri Lanka also stays unchanged,

with 6.1% growth in 2007, because agricultural growth cannot repeat its strong post-tsunami recovery, and because tourism and related services are suffering from many governments' travel warnings. Nepal has yet to enjoy a "peace dividend" from favorable political developments in 2006; growth is estimated at 2.5% in 2007, slightly lower than had been expected in *ADO 2007*.

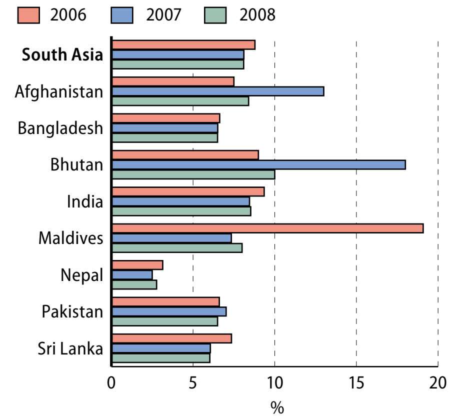
The services sector has been the main driver of growth in South Asia. Its shares of GDP in Bangladesh, India, Pakistan, and Sri Lanka were 49%, 55%, 53%, and 56% respectively in 2006, which is significantly larger than in other countries relative to their respective levels of per capita income and land area. Services in the subregion has been performing well recently, with sector output growing by 10.5% in 2006 led by trade, and transport and communications. The smaller industry sector also expanded rapidly, with sector growth up by 10.1% buoyed by manufacturing. South Asia's agriculture sector grew by 2.7% during the year.

Although inflation has been moderate, it is an issue in some countries—primarily Bangladesh, Pakistan, and Sri Lanka where projections for inflation in 2007 have been nudged up. Despite declining oil prices in the latter part of 2006, upward pressures prevail because weaknesses in subregional agricultural production and higher global prices are pushing up food inflation, while strong domestic demand has made it difficult to rein in nonfood price increases. Most central banks have tightened monetary policy and have managed to reduce demand pressures a little. In the *Update*, subregional inflation is projected at 5.7%, up slightly from the 5.5% forecast in *ADO 2007*.

South Asia's current account deficit is now projected at 1.9% of GDP in 2007, somewhat narrower than the 2.2% deficit foreseen in *ADO 2007*. The trade deficit is widening in most countries as strong domestic demand sucks in imports. However, heavy gains in workers' remittances often help compensate, as do larger services exports in India.

Such remittance inflows have increased substantially in recent years, reaching 14.2% of GDP in Nepal in 2007, 8.6% in Sri Lanka, and 7.7% in Bangladesh in 2006. They have generally boosted consumption rather than investment, and partly explain the consumption-dominated demand structure in South Asia. Capital inflows, especially foreign direct investment, have significantly increased in India and Pakistan because of their growth prospects. In all countries, current account deficits have being readily financed and international reserves have increased.

1.3.3 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

The South Asian subregion is expected to grow by 8.1% in 2008. This outlook is based on the assumptions of ongoing tight monetary policies, normal agricultural production, maintained fiscal discipline, and continued structural reforms. With robust demand for capital goods to solve production capacity bottlenecks and heavy spending to relieve infrastructure constraints, investment is expected to spark growth on the demand side. On the production side, industry is seen adding growth impetus to largely services-driven economies.

Inflation is set to moderate to 5.4% in 2008, assuming that agriculture

has normal rainfall. There are, however, risks. Excess demand pressures may continue, despite efforts at tightening monetary policy. In Bangladesh, India, and Nepal, larger than expected reductions in fuel subsidies would further lift the prices of domestic petroleum products, and hence inflation, by more than forecast. Volatility in international oil prices is, of course, another risk.

South Asia's current account deficit is projected at 2.1%, essentially unchanged from *ADO 2007*. The forecast deficits for Pakistan and Sri Lanka have been widened, but that for India narrowed. Financing current account deficits has not been an issue, though the fallout from the turmoil in global credit markets may crimp some sources of capital inflows and raise the cost of debt financing.

Country highlights

Afghanistan

GDP growth in the licit economy decelerated to 7.5% in FY2006 (21 March 2006–20 March 2007), as drought affected agricultural production more than previously anticipated. Inflation, measured by the consumer price index for Kabul, subsided to 4.8% in March 2007, with declining rents mitigating the impact of higher food and energy prices. The fiscal deficit (including grants) improved to 2.7% of GDP as a result of stronger revenue collection, and execution of development expenditures improved significantly.

For FY2007, GDP growth is now projected to recover to 13%: agriculture is strongly rebounding, and construction and services continue their rapid expansion. Inflation is now put at 5.9%, on rising transportation costs and energy prices. The licit economy still largely depends on reconstruction work funded by foreign aid. Creating a sustainable economic base, phasing out the large illicit economy (opium production rose again substantially in FY2006, despite intensified counter-narcotics efforts), and reinvigorating security remain challenges.

Bangladesh

GDP growth was sustained at 6.5% in FY2007 (July 2006–June 2007). Expansion in industry and services compensated for moderate growth in agriculture. Industrial growth was driven by strong external demand for textiles and clothing, benefiting from the termination of quota arrangements at end-2004. Exports grew significantly in FY2007, due to robust performance in garments, but they were outpaced by even faster-growing imports, widening the trade deficit. Increased workers' remittances offset the trade deficit to maintain a current account surplus.

Despite flooding in August 2007, the growth momentum is expected to continue in FY2008, since conditions for the expansion of industry and services remain favorable. The external sector is also likely to maintain its strength with vigorous growth in exports and workers' remittances. The textile and clothing sector may, however, face tougher competition as the PRC's safeguard quota in the EU and US markets expires at end-2008.

Curbing inflation is an ongoing challenge, but the major risk to the economy lies in political disruption. The caretaker Government's success in maintaining stability and broad public support, until elections are held, is probably the single biggest risk factor for the economy.

Bhutan
This economy is experiencing structural changes both in economic and political dimensions. The phased commissioning of the 1,020 megawatt Tala hydropower project since July 2006 will eventually double electricity export capacity to India. Accordingly, GDP growth is expected to double to 18% in 2007, significantly boosting government revenue. Although Tala should reduce dependence on foreign aid, other economic issues remain. The most pressing is the need to promote private sector activity to create employment, especially for growing numbers of young entrants to the labor force. In the political sphere, Bhutan is scheduled to change from a monarchy to a two-party democratic system in 2008, though this is unlikely to have a major economic impact.

India
Robust growth momentum continues with GDP growth for FY2006 (April 2006–March 2007) estimated at 9.4%, the highest in 18 years. Manufacturing growth has caught up with that in services and has emerged as a driver of accelerated growth, led by increasing investment demand. GDP growth is expected to moderate to 8.5% in FY2007, as rising interest rates damp consumption expenditure, but investment will continue to expand, supported by a robust long-term outlook. Inflation, given by the wholesale price index, fell to 4.4% in July 2007, reflecting the influence of monetary measures on demand pressures.

Despite a widening trade deficit, expansion in the invisibles surplus is expected to limit the current account deficit to 1.6% of GDP in FY2007. Large net capital inflows have resulted in a marked appreciation of the rupee in the first quarter of FY2007, and monetary aggregates also rose steeply. Effective August, the central bank tightened monetary policy by raising banks' cash ratios and adopting tighter external borrowing limits for domestic companies.

Maldives
The economy rebounded sharply in 2006 from the post-tsunami contraction, with GDP growth of 19.1%. GDP is projected to rise by 7.3% in 2007, as the bounceback effect from large restoration activities and the return of tourists fades. While large reconstruction projects are included in the government budget, government consumption also rose due to policies to increase public sector wages and continue power and water subsidies in Malé. Although a delay in planned capital expenditure narrowed the fiscal deficit to 7.3% of GDP in 2006, the wide gap between expenditure and revenue cannot be sustained in the medium term. The 2007 budget will result in a very high fiscal deficit of 27% of GDP if it is implemented as planned.

Nepal
Nepal is yet to enjoy any "peace dividend" from political developments since April 2006 when parliamentary government was restored following a nationwide peaceful movement against the former regime. Revised estimates for GDP have the growth rate for FY2007 (17 July 2006–16 July 2007) decelerating to 2.5% from 2.8% in FY2006, because of renewed political unrest and adverse weather affecting the agriculture sector,

which still accounts for about two fifths of GDP. GDP growth in FY2008 is projected to improve only marginally to 2.8%.

Inflation moderated to 6.4% in FY2007 from 8.0% in the previous year. Although the impact of upward adjustments in petroleum prices and the increased value-added tax rate in FY2005 has subsided, food prices rose sharply as a result of low agricultural production. Imports continued to increase faster than exports in FY2007, but increased workers' remittances helped offset the larger trade deficit, and the current account surplus narrowed to 0.5% of GDP.

Pakistan

Underpinned by strong domestic demand, growth in GDP in FY2007 (July 2006–June 2007) was robust at 7%. It was supported by a recovery in agriculture and continued expansion in manufacturing and services. A slight deceleration to 6.5% is penciled in for FY2008. This is despite an expansionary government budget and policies to raise agricultural productivity and boost industrial investment. Inflation declined only a shade to 7.8% in FY2007. Monetary tightening measures controlled core inflation, but shortages in the supply of some food items, even with the overall strong recovery of agriculture, pushed up food prices.

Fiscal policy was expansionary in FY2007, with public expenditure 19.5% higher than the previous year, but a strong revenue performance kept the fiscal deficit to FY2006's level of 4.3% of GDP. The trade deficit widened: even though the growth in imports decelerated in FY2007, that of exports slowed even more, attributable to the poor performance in textiles and clothing in the wake of increased post-quota competition in global markets as well as a slowdown in several nontextile categories. Burgeoning workers' remittances limited the current account deficit to 5.2% of GDP. Pakistan is receiving large private capital inflows from abroad, including FDI, which have fully covered growing current account deficits and raised foreign exchange reserves.

Sri Lanka

GDP growth accelerated to 7.4% in 2006, despite the intensified conflict between the Government and the Liberation Tigers of Tamil Eelam (LTTE) since August 2006. The stock index lost about 10% in the first half of 2007, partly because business confidence has fallen since LTTE attacks and partly because the interest rates on treasury bills have risen sharply.

Consumer price inflation reached a peak of 18.6% year on year in March 2007 when the central bank was tightening monetary policy. The *Update* now projects inflation to average 14.5% in 2007, partly due to increases in fuel prices to limit subsidies. The fiscal deficit (including foreign-funded projects) is targeted at 9.1% in 2007. No changes are made to *ADO 2007*'s growth forecasts of around 6% in 2007 and 2008.

Southeast Asia

Subregional performance

Aggregate GDP growth in Southeast Asia is now forecast at a brisk 6.1% for 2007, revised up a half percentage point from *ADO 2007*. Four of the

major economies in the subregion—Indonesia, Malaysia, Philippines, and Singapore—are performing better than expected. Only Cambodia's growth projection has been lowered from March, and then by just a touch. If the outturn for the subregion comes in as forecast, this would be above the average of 5.6% over the past 5 years.

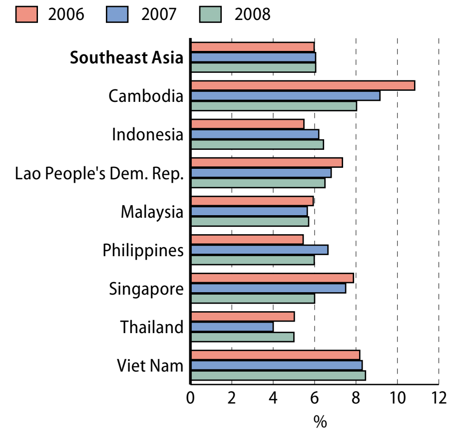
Stronger than expected domestic demand, especially in private consumption, accounts for most of the upward revision. In several economies, the levers of growth shifted from net exports in 2006 to domestic demand this year, but with Thailand an important exception. Exports have generally decelerated in line with lower US growth; softness in global demand for electronic products; and, for the oil-exporting economies of Indonesia, Malaysia, and Viet Nam, a softening in world prices and declines in domestic oil production. However, exports are cushioned by a rise in nonfuel commodity prices and trade with non-US markets, particularly the PRC and India. The extent of export deceleration has thus varied with the economies' relative diversification in terms of markets and products.

The expansion of private consumption this year reflects rising incomes in some countries, including incomes for producers of agricultural commodities; buoyant remittances (especially in the Philippines and Viet Nam); and lower interest rates. Public expenditures on development projects have supported investment growth in Indonesia, Malaysia, and Viet Nam. In the Philippines, public construction investment surged in the first half of the year (although such robust growth might not be sustained) and investment in durable equipment picked up for the first time in 2 years. Both private consumption and investment in Thailand have been damped by political and policy uncertainties.

Projections for the subregion's external current account surplus have been revised up to 7.0% of GDP in 2007 from 6.1% expected in *ADO 2007*. This reflects in part softer growth in imports in Thailand (commensurate with sluggish investment) and in the Philippines (mirroring the import intensity of weaker electronics- and garment-export industries). In Viet Nam, the current account is expected to record a significant deficit this year, as against a small surplus projected in *ADO 2007*. Although exports have benefited from Viet Nam joining WTO in January 2007, capital equipment imports have climbed rapidly on robust investment, and purchases of intermediate goods have stepped up as industrial production expands.

In most countries, current account surpluses and capital inflows exerted upward pressure on domestic currencies in the first half of 2007 but this might not continue through the second half because of uncertainties in international financial markets. Inflation pressures subsided more than expected, partly a result of currency appreciation and of better harvests in some countries. The effects of one-time factors that raised inflation in 2006 (administered fuel price increases in Indonesia and Malaysia and a hike in the value-added tax rate in the Philippines) also subsided. In Viet Nam, by contrast, inflation has increased more than expected, on both strong domestic demand and damage done to the food supply by drought, avian flu, and other livestock diseases. Overall, the subregional inflation forecast is downgraded to 3.8% from 4.2% in *ADO 2007*.

1.3.4 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

The forecast for 2008 subregional growth is uprated to 6.1% from 5.9% in *ADO 2007*. Three economies—Indonesia, Philippines, and Singapore—are projected to grow faster than in *ADO 2007*, based partly on their stronger than expected upward momentum this year. Aggregate growth at this rate would be the same as that expected for 2007. Accommodative monetary and fiscal policies in most countries are likely to support growth. With inflation pressures subsiding, there is scope to maintain low interest rates. Fiscal policies can also remain modestly stimulative, considering the general decline in public debt ratios.

Countries vary in their ability to pursue expansionary macroeconomic policies. Fiscal stimulus in the Philippines will depend on continued progress on tax collection. Viet Nam has less need for expansionary policies since growth is already high and policies are focused more on structural reforms to enhance competitiveness. In Thailand, despite substantial scope for expansionary policies, much of the impetus to growth is likely to come from a hoped-for reduction in political and policy uncertainty after the elections scheduled for end-2007.

Inflation is forecast to remain stable in the subregion in 2008 (at around 3.8%) on the expectation that world commodity prices will decline and domestic currencies will remain strong. With economic growth projected to edge higher in 2008 from this year in the three biggest economies—Indonesia, Malaysia, and Thailand—their current account surpluses are expected to decline somewhat. An upturn in the global electronics cycle would benefit those with a heavy weight in this area, i.e., Malaysia, Philippines, Singapore, and Thailand. This is likely to be offset to some degree by the expected decline in world nonfuel commodity prices. Subregionally, imports are projected to rise in line with stronger domestic demand and the exchange rate of domestic currencies, and in Viet Nam, continued reductions in tariffs.

Country highlights

Indonesia

GDP growth is on a gradual upward trend and is set to exceed 6% this year for the first time since the 1997–98 crisis. The 2007 forecast is revised up to 6.2% because private consumption and investment were stronger than expected in the first half. With the effects of the sharp October 2005 increase in fuel prices receding during 2006, and a consequent fall in inflation, the central bank has cut its policy interest rate significantly.

Domestic demand has taken over as the main driver of GDP growth. Private consumption is picking up on the back of lower interest rates and improved sentiment. A steady acceleration in bank lending and potential benefits from the new Investment Law have also contributed to stronger investment growth. The current account surplus is set to decline as domestic demand strengthens.

These trends are seen continuing in 2008, assuming steady progress in reforms to improve the investment climate. GDP is projected to increase by 6.4%. Inflation will likely remain around 6% on average. The current account surplus is expected to fall to just below 1% of GDP as world commodity prices moderate and domestic demand strengthens further.

Malaysia

The growth outlook has improved for 2007 following a stronger pickup in private consumption, supported by increases in incomes, better prices for agricultural commodities, and stable interest rates. Consequently, GDP is now projected to expand by 5.6% this year, revised up from 5.4%. Resilient domestic demand has offset some of the drag on GDP from weak electronics exports. Public investment has risen with the implementation of development projects under the Ninth Malaysia Plan. Inflation has fallen significantly as the impact of an 18–24% increase in retail fuel prices in March 2006 subsided. The current account surplus is likely to decline to 11.9% this year from a high 16.3% in 2006.

Next year's GDP growth forecast is maintained at 5.7%. The fiscal stimulus to public investment, a boost in civil service incomes, and benign monetary conditions should support domestic demand. Inflation in 2008 is put at 2.5%, the same as this year. Imports are projected to outpace exports, contributing to a further decline in net exports and a slightly smaller current account surplus as a share of GDP than in 2007.

Philippines

The projection for 2007 GDP growth is upgraded sharply to 6.6% from 5.4% in *ADO 2007*. This economy grew much faster than expected in the first half, with gains in net exports, private consumption, and government spending. Remittances from overseas workers continue to support residential real estate investment and private consumption, providing a strong impetus to overall growth. Government spending surged ahead of elections in May.

Investment in durable equipment grew in the first 6 months of this year, for the first time in 2 years. With a tepid rise in imports, net exports contributed significantly to growth. Buoyed by remittances and a narrower trade deficit, the current account surplus is set to rise to 5.4% of GDP in 2007, revised up from 3.2% projected earlier. Inflation pressures have subsided significantly with a stronger currency and receding effects of an increase in the value-added tax rate in early 2006. The 2007 inflation forecast is downgraded to 2.9% from 4.8%.

For 2008, the GDP growth forecast is revised up to 6.0% from 5.7% in *ADO 2007*. Consumption should remain underpinned by remittances. Government spending on infrastructure is projected to support growth in construction, and private investment shows signs of picking up following improvements in the fiscal position and lower inflation. The 2008 inflation forecast is revised down to 3.5% from 5.0%, assuming normal weather patterns, and the current account surplus is now projected to be around 5% of GDP, raised from the *ADO 2007* prediction.

Singapore

This economy grew by 7.6% in the first half of 2007, faster than anticipated in *ADO 2007*. Financial services and tourism performed strongly, driven in part by buoyant economies throughout the subregion. Construction activity surged, supported by a boom in high-end apartment building as well as new office and retail projects and two large resorts. The GDP growth forecast for 2007 is raised to 7.5% from 6.0%

in March. Growth is projected to ease to 6.0% in 2008 (revised up a half percentage point from *ADO 2007*).

Despite buoyant domestic demand, inflation pressures are less than expected. The 2007 inflation forecast is trimmed to 1.2% from 1.6%. Inflation is expected to edge higher from the second half of 2007, in part because of an increase in the goods and services tax from July 2007.

Furthermore, a strong labor market (the unemployment rate was just 2.4% in the second quarter) and rising rents are likely to engender upward pressure on costs for businesses. The inflation forecast for 2008 is revised up slightly to 1.2%. Weaker than expected growth in imports has prompted a revision in the 2007 current account surplus forecast to 28.5% from 27.0% of GDP, although the 2008 projection is maintained at 27.0%.

Thailand

The projections for growth remain the same as in *ADO 2007*. GDP growth is expected to slow to 4.0% this year, the lowest rate in 6 years, as domestic demand has weakened. Political and policy uncertainties have undermined consumer and business sentiment. The external side has performed better than expected, with both agricultural and industrial exports posting broad-based gains, while imports have risen at a modest rate, in part suppressed by weak domestic demand and a decline in oil imports.

The current account surplus is expected to increase to 3% of GDP compared with 1.3% projected in *ADO 2007*. Inflation pressures have moderated substantially, and the 2007 forecast is revised down to 2.0%.

Assuming political and policy uncertainties are reduced in the aftermath of elections scheduled for late 2007, GDP growth is expected to accelerate to 5.0% in 2008, as projected in *ADO 2007*. Consumer and business confidence will likely revive and the new government is expected to continue with the public infrastructure program. Domestic demand should be supported by reductions in interest rates in 2007.

Inflation is anticipated to rise modestly (to 2.5%, unchanged from *ADO 2007*) as domestic demand picks up. Projected firm global growth should prop up exports, in spite of lower commodity prices and the strength of the baht since 2005. The current account surplus is projected to narrow as imports increase faster with stronger domestic demand.

Viet Nam

Strong economic momentum has been underpinned by closer integration with global markets that culminated in WTO membership in January this year. The projections for GDP growth in 2007 and 2008 (8.3% and 8.5%, respectively) have not changed from March.

Vigorous growth of industry and services has more than offset the weaker performance of agriculture, affected by drought, avian flu, and other livestock diseases. Demand growth has been broad-based, partly driven by buoyant liquidity and expansionary fiscal policy. Private consumption and investment are expanding robustly.

Inflation pressures remain high though, and the projections for 2007 and 2008 have been revised up (to 7.8% and 6.8%, respectively). Much of the inflation reflects strong overall demand, but the adverse effects of weather and livestock disease on food supply have also contributed.

The projections for the current account have been revised to deficits for both 2007 and 2008 from small surpluses expected in *ADO 2007*. Export growth moderated in the first half of 2007 and imports rose faster than expected.

Other economies

Cambodia continues to consolidate its rapid economic growth based on agriculture, construction, clothing, and tourism. Double-digit GDP growth was recorded from 2004 to 2006, with last year's rate revised up to 10.8%, from the 10.4% estimated in *ADO 2007*. Partly as a result of this higher base, the growth forecast for 2007 is edged down to 9.2% from 9.5%. For 2008, the outlook has become somewhat clouded by increasing competition in clothing export markets from the PRC and Viet Nam. The 2008 GDP forecast is lowered by 1 percentage point to 8.0%. The expected deceleration in economic activity has led to a slight narrowing of forecast current account deficits.

The Lao People's Democratic Republic is benefiting from growth in mining (gold and copper) and hydropower, both attracting significant foreign direct investment, and from infrastructure development. Improvements in the trade and investment climate are planned by the Government as part of its effort to join WTO. GDP growth forecasts are maintained at 6.8% for 2007 and 6.5% for 2008. Inflation has slowed, despite an acceleration in broad money growth, and is expected to average about 5% this year and next.

In Myanmar, GDP growth is expected to continue at a moderate pace and the current account to be supported by natural gas exports. A sharp hike in the price of fuel in August 2007 and higher prices of rice are likely to keep strong pressure on inflation.

The Pacific

Subregional performance

The aggregate growth projection for the 14 Pacific developing member countries in 2007 is revised down to 3.5% from 4.5% in *ADO 2007*, mainly because a rebound in Timor-Leste (the subregion's third biggest economy) has not been as strong as expected, and political instability has led to a deeper than expected contraction in the Fiji Islands (the second largest economy). Tonga's economy, too, is set to contract.

The downgrade in the outlook comes despite a higher growth projection for Papua New Guinea (the largest economy). Although the aggregate forecast is revised down, this year is still expected to exceed subregional growth of 2.6% in 2006 (revised down from 3.1% in *ADO 2007*). The subregional inflation projection for 2007 is raised to 4.7% from 3.5%, primarily in anticipation of the pass-through of exchange-rate depreciation and earlier increases in international oil prices.

Subregional prospects

For 2008, aggregate growth is revised up to 3.2% from 2.8% in *ADO 2007*. This follows an upgrading of economic growth prospects for Papua New Guinea. That would put subregional expansion next year close to

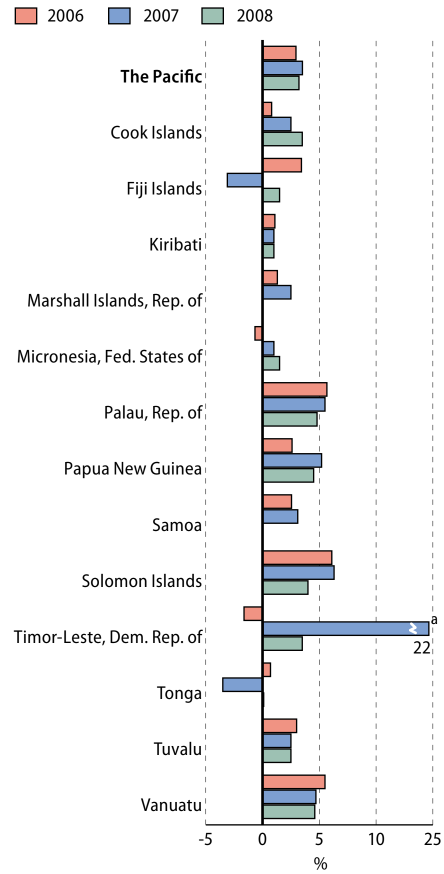
this year's modest level. Fiji Islands and Tonga are expected to resume growth in 2008, albeit at low levels. Timor-Leste, which is recovering from a slump last year, will grow more moderately next year. Subregional inflation is projected to decelerate to 3.2% next year, slightly below the earlier projection.

Recent events have highlighted governance challenges in the subregion. Papua New Guinea and Timor-Leste experienced some violence linked to national elections earlier this year, while episodes of serious civil unrest occurred last year in Solomon Islands, Timor-Leste, and Tonga, and a military coup took place in the Fiji Islands. The macroeconomic management responses undertaken, together with international support provided to most of these countries as well as relatively high export prices, point to the likelihood of these economies growing in 2008. But the underlying weaknesses in governance and the associated constraints to growth remain to be treated.

Growth prospects in the Pacific are also crimped by underinvestment in physical infrastructure and human capital, and insufficient support for private sector-led development. High government wages bills are key causes of the underinvestment, as they compress expenditure on essential goods and services, and on capital works. This constraint has intensified in several economies where public sector wages have been hiked.

A more supportive approach to private investment is required to realize the potential for growth. Continued action to raise the responsiveness of governments to business and community needs, and to enhance accountability, is central to improving public policy and making better use of public resources. Gains in these areas are in turn critical to averting future episodes of civil disorder and political instability.

1.3.5 GDP growth, The Pacific



[a] Non-oil GDP.

Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Country highlights

Fiji Islands

The *ADO 2007* forecast, for a decline of 2.3% in output, is revised to a sharper contraction of 3.1%. This reflects an updated expectation of a fall, rather than slight growth, in sugar production, linked to a progressive reduction in preferential prices paid by the European Union; a sharper than forecast drop of 10% in tourism earnings following the military coup in December 2006; a decline in clothing production as the industry continues to adjust to the loss of trade concessions; and a reduction in crop production caused by flooding early this year.

Building and construction is still forecast to contract by around 20% as a result of reduced public and private investment, exacerbated by the introduction of a credit ceiling on home loans. Business confidence remains low and the retail sales outlook is gloomy. The *ADO 2007* inflation forecast of 3.0% in 2007 is revised up to 4.1%, partly because of the floods (which raised food prices) and the pass-through of earlier increases in oil prices.

Falls in sugar and clothing exports are expected to more than offset rises in exports of fish, forestry products, and mineral water, with the result that exports, according to official estimates, will decline by 2.6%. Merchandise imports are projected to fall by about 2.0% because of the damping effects of the economic contraction and tighter macroeconomic policies. A rise in personal remittances should go some way toward

cushioning a drop in official transfers and tourism receipts, but the current account deficit may exceed 20% of GDP in 2007.

The central bank has taken several measures to protect declining foreign exchange reserves: it set a credit ceiling on commercial bank lending in November 2006; has tightened exchange controls; and has raised its lending rate to commercial banks. Nonresidents' access to domestic financing is restricted. These steps are buttressed by fiscal measures aimed at containing the budget deficit (exclusive of asset sales) to 2.1% of GDP, most notably through a 5% pay cut for public servants. Yet despite macroeconomic tightening, foreign reserves fell to the equivalent of 3.5 months of import cover by the middle of this year, from 3.7 months at end-2006. The external position remains fragile and may compel the monetary authority to contemplate external borrowing.

Next year, economic growth is expected to resume at a rate of about 1.5%. Tourism income is forecast to pick up as visitor numbers rebuild and price discounting by hotels eases. The country's only gold mine, which closed late in 2006, is restarting operations, and increased sugar production is anticipated as industry restructuring moves forward.

Papua New Guinea

This economy is a producer of gold and copper and a net exporter of oil, with mining and oil generating 13% of GDP and 80% of exports. High world prices for these resources have led a turnaround that has now spread more broadly through the economy. GDP growth of 5.2% is projected for 2007, up from *ADO 2007*'s 4.5%. The growth revision reflects a rise in projected growth of nonmining sectors (mainly agriculture and services), from 4.2% in *ADO 2007* to 5.2%. These sectors are buoyed by generally high prices for agricultural exports and improved business and consumer confidence. The weighted average price of agricultural, forestry, and fishing exports rose by an unexpectedly high 23.3% over the first quarter of 2007.

Employment (outside copper, gold, and oil extraction) rose by 4.1% over that quarter, with higher employment recorded in all regions and most sectors. The broad-based nature of the economic strengthening was evident in a 9.8% rise in credit to the private sector in the first 4 months of 2007, led by increased lending to the services sector and to households. However, the improvement in the business climate was set back by a government decision to cancel mobile telephone licenses issued to two foreign firms and instead reserve market rights to a domestic operator.

Papua New Guinea's inflation rate is forecast to average 4.8% in 2007, revised up from 3.0% in *ADO 2007*. Year-on-year inflation accelerated from 1.8% at end-2006 to 4.4% in March 2007. Price pressures are attributable to a depreciation in the kina and the pass-through of previous increases in world oil prices. A rise in import prices, coupled with higher domestic demand, lifted imports and lowered the trade surplus in the first quarter, contributing to the first current account deficit in 2 years. Gross foreign reserves remained high at $1.7 billion as of end-April (9.5 months of nonmining imports). One concern was an increase in government expenditure in the lead-up to national elections in July, against a background of a higher than expected underlying inflation.

Crude oil production is expected to fall in 2008 due to the natural

decline in output from existing fields. This development is forecast to trim overall economic growth to 4.5%. Nonetheless, this projection is an upgrade from *ADO 2007*, reflecting an expectation of higher mining output on the fact that mining companies have invested to raise production and to extract higher-grade ores. Inflation is expected to ease next year as the currency steadies.

Democratic Republic of Timor-Leste

The economy has revived this year, after the economic contraction in 2006 caused by an outbreak of civil unrest. Spending has been stimulated by the presence of international personnel to support national elections and peacekeeping efforts, by high international prices for coffee (the country's main non-oil export), and by increased public outlays. Budget reports for the first half of the fiscal year (ended 30 June 2007) show that recurrent spending was slower than scheduled, but still faster than a year earlier. Capital and development spending increased to almost three times the year-earlier amount. Total bank deposits, and loans and advances, increased by 3.2% and 4.7%, respectively, in the first quarter of 2007 from end-2006 levels.

Parliamentary elections in June resulted in a new coalition Government, but civil unrest broke out again in August. The need to manage tensions and internal policy differences is likely to complicate government efforts to introduce economic and public-sector initiatives needed to ensure sustained growth in the non-oil economy. Government receipts from the offshore oil and gas industry are rising, but this energy production generates little direct employment in Timor-Leste. The Petroleum Fund, established to save the Government's oil and gas revenues and to generate long-term investment income to fund the budget, increased to $1.4 billion, or almost three times non-oil GDP, at end-June, double the level of a year earlier.

Forecast growth in the non-oil economy for 2007 is revised down from *ADO 2007* to a still-high 22%. Inflation, above expectations in the first quarter of this year mainly because of a rise in food prices caused by a shortage of rice, is now forecast at 8.0% for the whole year, revised up from 5.0%. Economic growth in 2008 is projected to slow from this year's rebound, largely on the basis that civil unrest eases, allowing for a decline in the international presence. A pay increase for public servants and government efforts to raise the rate of investment spending are projected to help achieve moderate growth of 3.5%.

Other Pacific economies

Samoa

This economy is expected to achieve the growth forecast of *ADO 2007* (3.1%), with economic activity stimulated by preparations for the 2007 South Pacific Games in August–September 2007, major public sector projects, rising tourist numbers, and high levels of remittances. As of May 2007, bank lending was up by about 25% from a year earlier. Monetary policy was tightened slightly in response to early signs that sustained growth may be overheating the economy—as of May official foreign reserves of $72.9 million, or 3.9 months of imports, were below the central bank's target of 4.0 months of import cover, and underlying

inflation had risen to 5.0%. The full-year inflation forecast has been lifted to 5.0%.

Solomon Islands

The new estimate of 6.3% growth in 2007, revised up from 5.0% in *ADO 2007*, largely reflects an acceleration in the (unsustainable) harvesting and export of logs, as well as faster expansion in palm oil production. The external position is bolstered by strong export growth and inflows of donor grants to finance development projects, including relief and reconstruction projects in response to a tsunami in April that killed 52 people and displaced thousands of others. The tsunami itself is not expected to have a major impact on growth as the affected areas account for only a small share of the economy, and any lost production is expected to be more than offset by increased aid flows.

Foreign reserves in mid-August 2007 were $114.5 million, covering more than 4.5 months of imports of goods and nonfactor services. Inflation is expected to stay at about 8.0%. The *ADO 2007* forecast of an easing in growth in 2008 to 4.0% is maintained. This deceleration reflects a slowdown in logging, linked to the ending of export duty exemptions.

Tonga

The outlook for this economy has deteriorated. It is now forecast to contract by 3.5% in 2007, a revision from *ADO 2007* when flat GDP was foreseen. Factors include a substantial early-2007 fall in remittances, indications that low export prices will reduce plantings of squash (the main agricultural export), and a decline in tourism following riots in the capital in November 2006. These developments add to underlying weakness arising from a downturn in the fishing industry and a near 20% cut in civil service staffing in mid-2006.

On the upside, the currency has steadied, which eased inflation to 3.8% by end-March, about half the rate recorded in mid-2006. The inflation projection for 2007 is revised down to 5.0%, from the *ADO 2007* forecast of 10.0%, reflecting progress in stabilizing both the budget and the balance of payments. An overall budget surplus of 2.0% of GDP is estimated for 2007; reserves were $43.7 million (4.7 months of import cover) at end-March. The economy is expected to recover slowly and be virtually flat in 2008.

Vanuatu

Growth of 4.7% looks set to be achieved in 2007, with tourism-related activities receiving an additional boost from the introduction of new flights to Vanuatu by Air New Zealand and Solomon Airlines. The Government's fiscal position is strained, as expected, by the impact of substantial civil service wage increases, bringing the wages bill up to over half total government expenditure and crowding out capital spending. Inflation is still expected to be around 2.5% this year. In 2008 both GDP growth and inflation will be similar to this year's rates.

Others

In the Cook Islands, growth has picked up from 2006 and is now forecast at 2.5% for this year (revised down from 3.2% in *ADO 2007*). Value-added

tax receipts to May 2007 were 11.4% higher than a year earlier. Visitor arrivals also increased, spurred by a Cook Islands series of the television show "Survivor" and the opening in April of direct flights from Los Angeles to Rarotonga. Pearl exports are expected to improve this year as new pearl farms in Rakahanga come into production. However, the fish catch is down for the second year in a row.

Expected growth this year for the Republic of the Marshall Islands is revised down from 3.5% to 2.5% as a result of cuts in public service staffing. An increase in grant-funded government capital expenditure is helping support economic growth. Additional growth stimulus will come from the reopening, in August 2007, of an upgraded Majuro tuna-loining plant under new management, 3 years after it closed because of financial difficulties. The plant is expected to employ about 650 local workers when it becomes fully operational in December. Inflation is put at 3.1% in 2007, revised upward from 2.4% because of transport cost increases.

In Nauru, the economy is still expected to contract in 2007, but the outlook for next year has improved, since secondary mining of phosphate is scheduled to start then and additional government revenues are expected from offshore fishing rights. Donor-funded construction works are also expected to help the economy recover.

The growth and inflation forecasts for the Federated States of Micronesia made in *ADO 2007* are unchanged. Palau is also expected to achieve the solid growth forecast made for this year. Growth is projected to remain low in Kiribati and Tuvalu.